



# Canadian Labour Market and Skills Researcher Network

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### Performance Pay and the White-Black Wage Gap

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### **Abstract**

We show that the reported tendency for performance pay to be associated with greater wage inequality at the top of the earnings distribution applies only to white workers. This results in the white-black wage differential among those in performance pay jobs growing over the earnings distribution even as the same differential shrinks over the distribution for those not in performance pay jobs. We show this remains true even when examining suitable counterfactuals that hold observables constant between whites and blacks. We explore reasons behind our finding that performance pay is associated with greater racial earnings gaps at the top of the wage distribution focusing on the interactions between discrimination, unmeasured ability and selection.

**JEL:** J15, J31, J33

**Keywords:** Racial Wage Differentials, Compensation Practices

## Executive Summary

Past evidence on the role of performance pay on earnings differentials is mixed. Some find that performance pay does not influence racial earnings differentials and others argue on the contrary that performance pay based on subjective evaluations such as in a typical merit pay scheme actually increases the latitude for supervisory prejudice. Moreover, even what appears to be formulaic and not subjective may allow ample managerial latitude. One study which uses data from two large firms shows that male managers provide female stockbrokers fewer "complementary inputs" (specifically, the quality of accounts managers distribute to brokers) and that this explains their lower earnings from otherwise formulaic commission schemes.

This paper investigates the relationship between how white and black U.S. workers are paid and the magnitude of the so-called racial wage gap. Our focus is not so much on the much-researched mean wage differential between blacks and whites but instead on how it varies across quantiles of the wage distributions. Fundamentally, our interest is whether or not performance pay plays the same role for blacks and whites. We define performance-pay jobs as employment relationships in which workers receive either a bonus, a commission, or (very rarely) a piece rate at least once over the course of that employment relationship.

We first show that the white-black earnings gap for all workers in the private sector grows toward the top of the wage distribution. In the upper quintile, something is definitely "pulling" the white distribution but not that of the black distribution. We then show that performance pay becomes increasingly common higher in the earnings distribution for whites but less so for blacks. Moreover, performance pay dramatically stretches the distribution of wages for whites but not for blacks. The consequences on the white-black wage differential are striking. Controlling for composition effects, among those not in performance pay jobs, the resulting "unexplained" racial differential shrinks almost monotonically when moving up the earnings distribution reaching essentially zero at the very top of the distribution. Among those in performance pay jobs, the white-black wage differential roughly doubles over the course of the last quintile of the earnings distribution reaching its largest at the very top of the distribution.

Whatever is pulling the white distribution at the top is thus intimately related to performance pay. Reinforcing this pattern, the return to a performance pay job for blacks is smaller than for whites and decreases precipitously in the top quintile of the black wage distribution. For whites, the return to a performance pay job grows dramatically over the full range of the wage distribution. Possibly reflecting these returns, we find that high skill blacks appear far less likely to select performance pay jobs than do high skill whites.

Investigating further the differences in selection patterns across races, we introduce the public sector into the picture. The idea is that performance pay may include an element of arbitrariness or discretion which could affect the return to such jobs for black workers

relative to white workers. This is especially plausible since the vast majority of performance pay at the top of the wage distribution – where the gap is at its highest – consists of bonuses which may be based on subjective evaluations of performance. In contrast, the public sector is characterized by much more rigid pay structures. Essentially, differences in the wage structures of the private and public sectors may contribute to the sharp increase in the white-black wage gap at the top of the private sector distribution. We then show that while skilled whites appear disproportionately in the private sector and its performance pay jobs, skilled blacks appear to remove themselves from the private sector into the more compressed wage structure of the public sector.

Thus, two broad hypotheses exist that might suggest why earnings differentials are larger at the top of the performance pay distribution. On the one hand, there may be unmeasured ability that if appropriately accounted for would cause the differentials to vanish when examining the counterfactuals. We note that including family background caused the racial earnings differential to decline, but did not eliminate its run up at the top of the distribution, which approached 30 percent. On the other hand, it may be that performance pay at the top of the distribution allows greater latitude for prejudice to be translated into earnings differentials. Moreover, the possibility for selection between sectors causes these hypotheses to be related. If more able blacks felt they were not to be rewarded for their ability in performance pay jobs, they may not select those jobs even as more able whites do select them. Our evidence is consistent with this differential pattern of selection.