

Managerial Turnover in a Changing World*

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Abstract

This paper develops a dynamic theory of managerial turnover in a world where the quality of the match between a firm and its top managers changes stochastically over time. Shocks to managerial productivity are anticipated at the time of contracting but privately observed by the managers. We characterize the joint dynamics of retention, compensation and effort decisions under the profit-maximizing contract and compare them to their efficient counterparts. Our key positive result shows that the firm's optimal retention decisions become more permissive with time. What in the eyes of an external observer may thus look like "entrenchment" is, in our theory, the result of a fully-optimal contract in a world where incumbent managers possess privileged information about the firm's prospects under their own control. Our key normative result shows that, compared to what is efficient, the firm's optimal contract either induces excessive retention (i.e., inefficiently low turnover) at all tenure levels, or excessive firing at the early stages of the relationship followed by excessive retention after sufficiently long tenure. These results are obtained by endogenizing the firm's separation payoff accounting for the fact that its performance under each new hire is going to be affected by the same information frictions as in the relationship with the incumbent.

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1 Introduction

The job security and pay of a firm’s top manager typically rests on the firm’s consistently good performance and future prospects. This makes sense given the substantial impact that top managers are believed to have on firms’ fortunes. At the same time, the environment in which most firms operate has become increasingly dynamic, implying that managers who are able to deliver high profits in the present may not be able to do so in the future.¹ Shocks to managerial productivity may originate from the opening of new markets, the arrival of new technologies, industry consolidation, or the introduction of new legislation.

The contracts that successful firms offer to their top employees are thus designed not only to incentivize their effort but also to guarantee the desired level of turnover. This is not an easy task given that managers typically have superior information than the board about the determinants of the firm’s profits, the quality of their match with the firm, and the evolution of their own productivity. Optimal contracts must therefore provide managers with incentives not only to exert effort but also to report promptly to the board variations in the environment that affect the firm’s prospects under their own control and for leaving the firm when these prospects deteriorate (equivalently, when the quality of their match with the firm is not satisfactory anymore).

In this paper, we develop a dynamic theory of managerial contracting which, in addition to the familiar theme of incentivizing effort, accounts explicitly for the following possibilities: (i) managerial ability to generate profits is bound to change (stochastically) over time; (ii) shocks to managerial productivity are anticipated at the time of contracting, but privately observed by the managers; (iii) at each point in time, the board can respond to poor future prospects by replacing an incumbent manager with a new hire; (iv) the firm’s performance under each new hire is going to be affected by the same information frictions as in the relationship with the incumbent.

Accounting for these possibilities not only is realistic, it sheds new light on the joint dynamics (and inefficiency) of effort, retention, and compensation decisions.²

Model Preview. In each period, the firm’s cash flows are the result of (i) the incumbent manager’s productivity (equivalently, the quality of the match between the firm and the manager—hereafter the manager’s “type”), (ii) managerial effort, and (iii) noise. Each manager’s productivity is positively correlated over time and each manager has private information about his current and past productivity, as well as about his effort choices. The board only observes the stream of cash flows generated by each manager.

Upon separating from the incumbent, the firm goes back to the labor market and is randomly matched with a new manager of unknown productivity. Each manager’s initial productivity (i.e., his

¹See, for example, Fine (1998), who argues that technology is increasing the speed at which business environments evolve across a plethora of industries.

²Note that endogenizing the firm’s replacement payoff is essential to the normative results documented in the paper.

productivity at the time of contracting) is the manager’s own private information. Upon joining the firm, each manager’s productivity evolves according to the same stochastic process. This process is meant to capture how the interaction of the environment with the tasks that the manager is asked to perform affects the evolution of the manager’s productivity. The environment is perfectly stationary in the sense that the firm faces the same problem with each manager it hires. As a result, the board offers the same menu of contracts to each manager.^{3,4}

A contract is described by: (i) an effort policy specifying the effort that the firm recommends to the manager as a function of the evolution of his productivity; (ii) a compensation policy specifying the compensation that the firm promises to pay as a function of observed cash flows; and (iii) a turnover policy specifying under which conditions separation will occur.⁵

The positive and normative properties of the joint dynamics of effort, turnover, and performance are identified by characterizing the contract that maximizes the firm’s expected profits (net of managerial compensation) and comparing it to the contract that a benevolent planner would offer to each manager to maximize welfare (defined to be the sum of the firm’s expected cash flows and of all managers’ expected payoffs, hereafter, the “efficient contract”). Both the profit-maximizing and the efficient contracts are obtained by comparing, after each history, the value of continuing the relationship with the incumbent (taking into account the dynamics of future effort and retention decisions) with the expected value from starting a new relationship with a manager of unknown productivity. Importantly, both these values are evaluated from an ex-ante perspective, i.e., at the time each manager is hired. Given the stationarity of the environment, the payoff from hiring a new manager must coincide with the payoff that the firm expected from hiring the incumbent. Both the profit-maximizing and the efficient contracts are thus obtained through a fixed-point dynamic-programming problem that internalizes all relevant trade-offs and whose solution endogenizes the firm’s separation payoff.

³While our analysis focuses on a representative firm, both our positive and normative results apply also to certain competitive labor markets where, after dismissal, managers go back to the market and are randomly matched with other identical firms.

⁴What makes a policy of “selling the firm to the managers” suboptimal is the fact that the managers have private information about their abilities to generate profits for the firm. This private information, since it originates in idiosyncratic characteristics as well as past working experiences, is present from the very first moment a manager is matched with the firm and has persistent (although typically diminishing) effects over time. Because of such private information, if the principal were to sell the firm to the managers, then any type above the lowest would get the full surplus of his higher productivity. To extract some of this surplus, the principal is better off by retaining ownership and introducing distortions in the contract she uses to incentivize the managers’ effort and separation decisions.

⁵In general, a turnover policy based solely on observed cash flows cannot induce the optimal sequence of separation decisions. It may be essential that managers keep communicating with the board, e.g., by explaining the determinants of past performances and/or by describing the firm’s prospects under their control. A key role of the optimal contract in our theory is precisely to induce a prompt exchange of information between the managers and the board, in addition to the more familiar role of incentivizing effort through performance-based compensation.

Key positive results. Our key positive prediction is that the firm’s optimal retention decisions become *more permissive with time*: the productivity level that the firm requires for each manager to be retained declines with the number of periods that the manager has been working for the firm. This result originates from the combination of the following two assumptions: (i) the effect of a manager’s initial productivity on his future productivities declines over time;⁶ and (ii) variations in managerial productivity are anticipated, but privately observed.

The explanation rests on the board’s desire to limit the compensation to the managers who are most productive at the initial contracting stage that is necessary to separate them from the less productive ones. Similar to Laffont and Tirole (1986), such a “rent” originates from the possibility for the most productive managers of generating the same distribution of present and future cash flows as the less productive ones by working less, thus economizing on the disutility of effort. Contrary to Laffont and Tirole’s static analysis, in our dynamic environment firms have two instruments to limit such rents: first, they can induce less productive managers to work less (e.g., by offering them contracts with low-powered incentives where compensation is relatively insensitive to realized cash flows); in addition, they can commit to a replacement policy that is more severe to a manager whose initial productivity is low in terms of the future productivity and performance levels required for retention. Both instruments play the role of discouraging those managers who are most productive at the contracting stage from mimicking the less productive ones and are thus most effective when targeted at those managers whose initial productivity is low.

The key observation is that, when the effect of a manager’s initial productivity on his subsequent productivity declines over time, the effectiveness of such instruments is higher when they are used at the early stages of the relationship than in the distant future. The reason is that, from the perspective of a manager who is initially most productive, his ability to “do better” than a manager who is initially less productive is prominent at the early stages, but expected to decline over time due to the imperfect serial dependence of the productivity process.

The firm’s profit-maximizing retention policy is then obtained by trading off two considerations. On the one hand, the desire to respond promptly and efficiently to variations in the environment that affect the firm’s prospects under the incumbent’s control, of course taking into account the dynamics of future effort and retention decisions. This concern calls for retaining managers whose productivity is expected to remain or turn high irrespective of whether or not their initial productivity was low. On the other hand, the value of offering a contract that reduces the compensation that the firm must pay to the managers who are most productive at the hiring stage. This second concern calls for committing to a retention policy that is most severe to those managers whose initial productivity is low. However, because the value of such commitments declines with the length of the employment

⁶Below, we provide a formal statement of this assumption in terms of a statistical property of the process governing the evolution of managerial productivity.

relationship, the profit-maximizing retention policy becomes gradually more lenient over time.

Our theory thus offers a possible explanation for what in the eyes of an external observer may look like "*entrenchment*". That managers with a longer tenure are retained under the same conditions that would have called for separation at a shorter tenure is, in our theory, the result of a fully optimal contract, as opposed to the result of a lack of commitment or of good governance. In this respect, our explanation is fundamentally different from the alternative view that managers with longer tenure are "entrenched" because they are able to exert more influence over the board, either because of manager-specific investments, as in Shleifer and Vishny (1989), or because of the appointment of less independent directors, as in Hermalin and Weisbach (1998) – see also, Weisbach (1988), Denis, Denis, and Sarin (1997), Hadlock and Lumer (1997), Rose and Shepard (1997), Almazan and Suarez (2003), Bebchuk and Fried (2004), and Fisman, Kuhrana, and Rhodes-Kropf (2005).

Key normative results. Turning to the normative results, we find that, compared to what is efficient, the firm's profit-maximizing contract either induces excessive retention at all tenure levels, or *excessive firing at the early stages of the relationship*, followed by *excessive retention in the long run*. By excessive retention we mean the following. Any manager who is fired after t periods of employment under the profit-maximizing contract is either fired in the same period or earlier under the efficient policy. By excessive firing we mean the exact opposite: any manager fired at the end of period t under the efficient policy is either fired at the end of the same period or earlier under the profit-maximizing contract.

The result that retention decisions become less efficient over time may appear in contrast to findings in the dynamic mechanism design literature that "distortions" in optimal contracts typically decrease over time and vanish in the long-run. (This property has been documented by various authors, going back at least to Besanko's (1985) seminal work; see Battaglini (2005) for a recent contribution, and Pavan, Segal, and Toikka (2011) for a unifying explanation based on the statistical property of declining impulse responses).

The reason why we do not find convergence to efficiency in the long run in the current setting is that the *principal's outside option is endogenous* and affected by the same information and incentive frictions as in the relationship with the incumbent. To understand this result, recall that, from an ex-ante viewpoint (i.e., at the time of hiring), the firm expects to extract more surplus from each incumbent as time goes by. As explained above, the reason is that the effect of each manager's initial private information on his future productivity is expected to decline over time. The fact that the firm can appropriate more surplus as time passes in turn implies that the flow (i.e., per period) payoff that the firm expects from retaining the incumbent increases over time and eventually converges to the flow payoff that a benevolent planner would expect from retaining the same manager. On the other hand, the payoff that the firm expects from going back to the labor market and starting a relationship with a new manager of unknown productivity is necessarily lower than the surplus that

the planner would expect from starting a new relationship. The reason is precisely that the new relationship is expected to be affected by the same informational and incentive problems as the one governing the interaction with the incumbent. This implies that, to reduce the compensation paid to the new hire, the firm expects to introduce distortions in future effort and retention decisions which reduce the surplus of the new relationship relative to the one created under the efficient contract. This in turn implies that, from an ex-ante viewpoint, after tenure grows long enough, replacement becomes less attractive for a firm maximizing profits than for a planner maximizing efficiency. As a result, firms eventually become *excessively* lenient when it comes to their retention decisions.⁷

This last result suggests that policy interventions aimed at inducing firms to sustain a higher turnover, e.g., by offering them temporary tax incentives after a change in management, or through the introduction of a mandatory retirement age for top employees, can, in principle, increase welfare.⁸ Of course, such policies might be expected to encounter opposition on other grounds whose discussion is beyond the scope of this analysis.

Layout. The rest of the paper is organized as follows. In the remainder of this section we briefly review the pertinent literature. Section 2 introduces the model. Section 3 characterizes the efficient contract. Section 4 characterizes the firm’s profit-maximizing contract and uses it to establish the key positive results. Section 5 compares the dynamics of retention decisions under the efficient contract with those under the profit-maximizing contract and establishes the key normative results. All proofs are in the Appendix.

1.1 Related literature

The paper is related to various lines of research in the managerial compensation and turnover literature. A vast body of work documents how the threat of replacement plays an important role in incentivizing effort.⁹ Recent contributions in this area include Tchistyi (2005), Clementi and Hopenhayn (2006), DeMarzo and Sannikov (2006), DeMarzo and Fishman (2007), Biais et al. (2007), and He (2009). The reason why the threat of termination is essential in these papers is that the agent is protected by limited liability. This implies that incentives provided entirely through performance-based compensation need not be strong enough. The threat of termination is also crucial in the “efficiency wages” theory; in particular, see Shapiro and Stiglitz’s (1984) seminal work. However, contrary to the literature cited above, in the efficiency-wages theory, under the optimal contract, no worker shirks and hence replacement does not occur in equilibrium.

⁷Note that this result also applies to a setting in which optimal effort is constant over time.

⁸See Lazear (1979) for alternative explanations for why mandatory retirement can be beneficial.

⁹Despite the vast attention that this property has received in the theoretical literature, the empirical evidence of the effect of turnover on incentives is mixed. See Jenter and Lewellen (2010) for a recent discussion and Gayle, Golan, and Miller (2008) for a recent empirical study of the relationship between promotion, turnover, and compensation in the market for executives.

Related to this line of research is also the work by Spear and Wang (2005), Wang (2008) and Sannikov (2008). These papers show how a risk-averse agent may be optimally induced to cease to exert effort and then retire, once his promised continuation utility becomes either too high or too low, making it too costly for the firm to incentivize further effort.¹⁰

While not all the works cited above focus explicitly on turnover, they do offer implications for the dynamics of retention decisions. For example, Wang (2008) shows how a worker with a shorter tenure faces a higher probability of an involuntary layoff and a lower probability of voluntary retirement than a worker with a longer tenure. In a financial contracting setting, Clementi and Hopenhayn (2006) show how, on average, a borrower's promised continuation utility increases over time and how this requires an increase in the likelihood that the loan is rolled over. Similarly, Fong and Li (2010) find that the turnover rate eventually decreases in the duration of the employment relationship, but, because contracts are relational, they also find that the turnover rate may initially increase.

The above literature does not account for the possibility of changes in managerial productivity (equivalently, in the quality of the match between the manager and the firm). It therefore misses the possibility that turnover is driven by variations in managerial productivity in addition to concerns for incentivizing effort. Such a possibility has long been recognized as important by another body of the literature that dates back at least to Jovanovic (1979).¹¹ This paper considers an environment where productivity (equivalently, the match quality) is constant over time but unknown to both the firm and the worker who jointly learn it over time through the observation of realized output. Because of learning, turnover becomes less likely over time.¹² Our theory differs from Jovanovic (1979) in a few respects. First, and importantly, we allow learning about match quality to be asymmetric between the workers and the firm, with the former possessing superior information than the latter. Second, we explicitly model managerial effort and account for the fact that it must be incentivized. Third, we consider more general processes for the evolution of the match quality. These distinctions lead to important differences in the results. First, while in Jovanovic's model the leniency of turnover decisions originates from the accumulation of information over time, in our model turnover decisions become more lenient over time even when conditioning on the accuracy of available information (formally, even when the kernels, i.e., the transition probabilities, remain

¹⁰Another paper where dismissal helps creating incentives is Sen (1996). In this paper, the manager's private information is the productivity of the firm, which is assumed to be constant over time and independent of the manager who runs it. As in the current paper, commitments to replace the initial manager help reducing informational rents. However, contrary to the current paper, there are no hidden actions and there is a single replacement decision. The analysis in Sen (1996) thus does not permit one to study how the leniency of retention decisions evolves over time.

¹¹Allgood and Farrell (2003) provide empirical support for the importance of variations in managerial productivity and, more generally, in match quality for turnover decisions.

¹²Related is also Holmstrom's (1999) career concerns model. While this paper does not characterize the optimal turnover policy, the evolution of career concerns has been recognized as a possible determinant for turnover; see, for example, Mukherjee (2008).

constant over time). Second, while in Jovanovic's model turnover decisions are always second-best efficient, in our model, turnover decisions are second-best inefficient and the inefficiency of such decisions typically increases over time.¹³

More recent papers where turnover is also driven by variations in match quality include Acharya (1992), Mortensen and Pissarides (1994), Atkeson and Cole (2005), and McAdams (2011). Acharya (1992) studies how the market value of a firm changes after the announcement to replace a CEO and how the probability of replacement is affected by the CEO's degree of risk aversion.¹⁴ Mortensen and Pissarides (1994) show how the optimal turnover policy takes the form of a simple threshold policy, with the threshold being constant over time. Along with the assumption that productivity is drawn independently each time it changes and the fact that the revisions follow a Poisson process, this implies that the probability of terminating a relationship does not vary with tenure. In contrast, in a model of stochastic partnerships, McAdams (2011) finds that relationships become more stable over time due to a survivorship bias. Atkeson and Cole (2005) show how managers who delivered high performance in the past have a higher continuation utility and are then optimally rewarded with job stability. Because a longer tenure implies a higher probability of having delivered a high performance in the past, their model also offers a possible explanation for why retention decisions may become more lenient over time.

An important distinction between our paper and the two bodies of the literature discussed above is that, in our theory, variations in match quality are anticipated but privately observed. As a result, a properly designed contract must not only incentivize effort but also provide managers with incentives for truthfully reporting to the board variations in match quality that call for adjustments in the compensation scheme and possibly for separation decisions. The importance of private information for turnover decisions has been recognized by another body of the literature that includes Levitt and Snyder (1997), Banks and Sundaram (1998), Eisfeldt and Rampini (2008), Yang (2009), Gayle, Golan and Miller (2008), and Inderst and Mueller (2010). Some of these papers show how asymmetric information may lead to a form of entrenchment, i.e., to situations in which the agent remains in place (or the project continues) although the principal would prefer ex-post to replace him (or discontinue the project). What is missing in this literature is an account of the possibility that the managers' private information may change over time and hence an analysis of how the leniency of optimal turnover decisions evolves with the managers' tenure in the firm.¹⁵

¹³Inefficiencies originate in our theory from the combination of asymmetric information at the contracting stage with search frictions. Because neither the firms nor the managers can appropriate the entire surplus, contractual decisions are distorted relative to their second-best counterparts.

¹⁴Acharya (1992) also documents the possible optimality of permanently tenuring a CEO, a possibility that we also accommodate but which we show to never be optimal in our model.

¹⁵An exception is Gayle, Golan and Miller (2008). They use a longitudinal data set to evaluate the importance of moral hazard and job experience in jointly determining promotion, turnover rates, and compensation, and to study how the latter changes across the different layers of an organization. The focus of their analysis is, however, very different

Another important difference between our work and each of the various papers mentioned above is that it offers an analysis of how the inefficiency of turnover decisions evolves over time. To the best of our knowledge, this analysis has no precedents in the literature. As explained above, this is made possible by endogenizing the firm’s separation payoff and recognizing that the relationship with each new hire is going to be affected by the same frictions as the one with each incumbent. Recognizing this possibility is essential to our normative result about the excessive leniency of retention decisions after a long tenure.

From a methodological viewpoint, the paper builds on recent developments in the theory of dynamic mechanism design with persistent shocks to the agents’ private information¹⁶ and in particular on Pavan, Segal and Toikka (2011).¹⁷ Among other things, that paper (i) establishes an envelope theorem for dynamic stochastic problems which is instrumental to the design of optimal dynamic mechanisms and (ii) shows how the dynamics of distortions is driven by the dynamics of the impulse responses of the future types to the initial ones. The current paper applies these insights and, more generally, the methodology of Pavan, Segal and Toikka (2011), to a managerial contracting environment. It also shows how the techniques in Pavan, Segal, and Toikka (2011) must be adapted to accommodate moral hazard in a non-time-separable dynamic mechanism design setting. The core (and distinctive) contribution of the present paper is, however, in the predictions that the theory identifies for the joint dynamics of effort, retention, and compensation.

Related is also Garrett and Pavan (2011b). That work shares with the present paper the same managerial contracting framework. However, it completely abstracts from the possibility of replacement, which is the focus of the present paper. Instead, it investigates how the optimality of seniority-based schemes (that is, schemes that provide managers with longer tenure with more high-powered incentives) is affected by the managers’ degree of risk aversion.¹⁸ In particular, that paper shows that, under risk neutrality and declining impulse responses, optimal effort increases,

from ours.

¹⁶The literature on dynamic mechanism design goes back to the pioneering work of Baron and Besanko (1984) and Besanko (1985). More recent contributions include Courty and Li (2000), Battaglini (2005), Eso and Szentes (2007), Athey and Segal (2007), Board (2008), Gershkov and Moldovanu (2009a,b,c 2010a,b,c), Bergemann and Välimäki (2010), Board and Skrzypacz (2010), Dizdar et al., (2011), Pai and Vohra (2008), Said (2011), and Garrett (2011). For a survey of these papers see Bergemann and Said (2011).

¹⁷The analysis in the current paper, as well as in Pavan, Segal, and Toikka (2011), is in discrete time. Recent contributions in continuous time include Williams (2009), Zhang (2009), and Strulovici (2011). These works show how the solution to a class of dynamic adverse selection problems with persistent private information (but without replacement) can be obtained in a recursive way with the level and derivative of promised utility as state variables. In contrast, both the optimal and the efficient contracts in our paper are obtained through a fixed-point dynamic programming problem whose solution is not recursive, thus permitting us to show how effort, compensation, and retention decisions depend explicitly on the entire history of productivity shocks.

¹⁸While, for simplicity, the current paper does not account for the possibility that the managers are risk averse, we expect all our results to remain true for a low degree of risk aversion.

on average, with time. The same property holds in the present paper, but is not essential for the dynamics of retention decisions. In fact, while we find it instructive to relate these dynamics to the ones for effort, neither our positive nor our normative results hinge on the property that effort, on average, increases with tenure: the same results hold if the firm is constrained to ask the same level of effort from the manager in all periods.¹⁹

Obviously related is also the entire literature on dynamic managerial compensation without replacement. This literature is too vast to be successfully summarized here. We refer the reader to Edmans and Gabaix (2009a) for an overview. See also Edmans and Gabaix (2009b), and Edmans, Gabaix, Sadzik, and Sannikov (2009) for recent contributions where, as in Laffont and Tirole (1986) and in the current paper, the moral hazard problem is solved using techniques from the mechanism design literature. These works consider a setting where (i) there is no turnover, (ii) managers possess no private information at the time of contracting, and (iii) it is optimal to induce a constant level of effort over time. Relaxing (i) and (ii) is essential to our results. As explained above, endogenizing effort is also important for our predictions about the joint dynamics of effort, retention, and compensation, but is not essential to the key properties identified in this paper.

2 Model

Players. A principal (the board of directors, acting on behalf of the shareholders of the firm) is in charge of designing a new employment contract to govern the firm's interaction with its managers.²⁰ The firm is expected to operate for infinitely many periods and each manager is expected to live as long as the firm. There are infinitely many managers. All managers are ex-ante identical, meaning that they have the same preferences and a productivity (to be interpreted as the ability to generate cash flows for the firm) that is expected to evolve over time according to the same Markov process described below.

Stochastic process. The process governing the evolution of managerial productivity has two components, the distribution from which each manager's initial productivity is drawn, and the family

¹⁹For example, dynamics of retention decisions qualitatively similar to the ones in this paper arise in an environment where effort can take only negative values, say $e \in [-K, 0]$, and where $e = 0$ is interpreted as "no stealing" and is optimally sustained at all periods, as in DeMarzo and Fishman (2007).

²⁰As anticipated above, the focus of the analysis is on the contracts offered by a representative firm for given contracts offered by all other competing firms (equivalently, for given managers' outside options). However, the profit-maximizing and efficient contracts characterized below are also equilibrium and welfare-maximizing contracts in a setting where unemployed managers are randomly matched with many (ex-ante identical) firms. Indeed, as it will become clear, as long as the number of potential managers is large compared to the number of competing firms, so that the matching probabilities remain independent of the contracts selected, then the managers' outside options (i.e., their payoff after separation occurs) have an effect on the level of compensation but not on the profit-maximizing and efficient effort and retention policies.

of conditional distributions describing how productivity evolves upon joining the firm.

Each manager’s productivity during the first period of employment coincides with his productivity prior to joining the firm. This productivity is drawn from the absolutely continuous distribution F_1 with bounded support $\Theta = [\underline{\theta}, \bar{\theta}] \subset \mathbb{R}$. This distribution F_1 is meant to capture the distribution of managerial talent in the population and is assumed to be time invariant and exogenous to the firm’s decisions.

Next, for any $t > 1$, let θ_t denote a manager’s productivity during the t^{th} period of employment, with $t \in \mathbb{N}$. Irrespective of the date of hiring, θ_t is drawn from the cumulative distribution function $F(\cdot|\theta_{t-1})$ with support Θ .²¹

Given F_1 and the family $F \equiv \langle F(\cdot|\theta) \rangle_{\theta \in \Theta}$ of conditional distributions, we then define the *impulse responses* of future productivity to earlier productivity as follows (the definition here parallels that in Pavan, Segal and Toikka, 2011). Let \mathcal{E} be a measurable space, G a probability distribution over \mathcal{E} , and $z : \Theta \times \mathcal{E} \rightarrow \Theta$ a measurable function. We say that $\langle \mathcal{E}, G, z \rangle$ is an “independent–shock representation” of the kernels F if, for any $\theta \in \Theta$, when $\tilde{\varepsilon}$ is a random variable distributed according to G , then $z(\theta, \tilde{\varepsilon})$ is a random variable distributed according to $F(\cdot|\theta)$. Note that all kernels admit at least one such representation.

Hereafter, we assume that the kernels F admit a representation in which the function z is differentiable and strictly increasing in each argument. Note that the monotonicity of z in θ is a “*first-order stochastic dominance assumption*”. It imposes that, for any θ , if $\theta', \theta'' \in \Theta$ with $\theta'' > \theta'$, then $F(\theta|\theta'') \leq F(\theta|\theta')$.

The assumption that z is also strictly increasing in ε is not needed for our results. However, it facilitates the exposition by guaranteeing that, for any history $\theta^t \equiv (\theta_1, \dots, \theta_t) \in \Theta^t$,²² and for any $s \leq t$, there exists a unique sequence of shocks $\varepsilon_{>s}^t \equiv (\varepsilon_{s+1}, \dots, \varepsilon_t)$ that leads to θ^t starting from θ^s . In other words, starting from θ^s , one can think of the continuation history $\theta_{>s}^t = (\theta_{s+1}, \dots, \theta_t)$ as being generated by the shocks $\varepsilon_{>s}^t$ as follows: $\theta_{s+1} = Z_1(\theta_s, \varepsilon_{s+1}) \equiv z(\theta_s, \varepsilon_{s+1})$; $\theta_{s+2} = Z_2(\theta_s, \varepsilon_{s+1}, \varepsilon_{s+2}) = z(Z_1(\theta_s, \varepsilon_{s+1}), \varepsilon_{s+2})$ and so forth.

²¹The process is thus *time autonomous*: the kernels are independent of the length of the employment relationship so that $F_t(\cdot|\cdot) = F(\cdot|\cdot)$ all $t > 1$. Each kernel has support on the same interval Θ that defines the support of the period-1 distribution F_1 . Both of these assumptions simplify the exposition but are not essential for the results. They also permit us to highlight dynamics of the optimal policy that arise *irrespective of the process being time autonomous* and which are due to the evolution of the managers’ private information. See the working paper version of the manuscript, Garrett and Pavan (2011a), for how to accomodate non time-autonomous processes with shifting supports. On the other hand, allowing for more than two periods is essential to our results about the dynamics of retention decisions. Allowing for more than two productivity levels is also essential. In fact, one can easily verify that with two productivity levels, the optimal retention policy takes one of the following three forms: (i) either the manager is never replaced, irrespective of the evolution of his productivity; or (ii) he is retained if and only if his initial productivity was high; or (iii) he is fired as soon as his productivity turns low. In each case, the retention policy (i.e., whether the manager is retained as a function of his period- t productivity) is independent of the length of the employment relationship.

²²Throughout the entire manuscript, we will use superscripts to denote sequences of variables.

For any t and s , $t > s$, and any $\theta_{\geq s}^t = (\theta_s, \dots, \theta_t)$, we denote by $\varepsilon^{t-s}(\theta_{\geq s}^t)$ the unique sequence of shocks that, starting from θ_s , leads to the continuation history $\theta_{\geq s}^t$. We then assume that each function Z_τ , $\tau \in \mathbb{N}$, with domain $\Theta \times \mathcal{E}^\tau$, is differentiable in θ with derivative bounded uniformly by a constant $k > 0$. We then define the impulse response of θ_t to θ_s by

$$J_s^t(\theta_{\geq s}^t) \equiv \frac{\partial Z_{t-s}(\theta_s, \varepsilon^{t-s}(\theta_{\geq s}^t))}{\partial \theta_s}.$$

Note that these impulse response functions are the nonlinear analogs of the familiar constant linear impulse responses for autoregressive processes. For example, when productivity evolves according to an AR(1) process, so that $\theta_t = z(\theta_{t-1}, \varepsilon_t) = \gamma\theta_{t-1} + \varepsilon_t$, the impulse response of θ_t to θ_s is simply given by the scalar $J_s^t = \gamma^{t-s}$. More generally, the impulse response $J_s^t(\theta_{\geq s}^t)$ of θ_t to θ_s captures the total effect of an infinitesimal variation of θ_s on θ_t , holding constant all the shocks that lead to the intermediate types $(\theta_{s+1}, \dots, \theta_t)$. By the law of iterated expectations, this also means that

$$\frac{\partial \mathbb{E}_{\tilde{\theta}_t | \theta_s}[\tilde{\theta}_t]}{\partial \theta_s} = \mathbb{E}_{\tilde{\theta}_t | \theta_s} \left[J_s^t(\tilde{\theta}_{\geq s}^t) \right].$$

As shown below, these functions play a key role in determining the dynamics of profit-maximizing effort and turnover policies.

Throughout, we will maintain the assumption that types evolve *independently across managers*.

Effort, cash flows, and payoffs. After learning his period- t productivity θ_t , the manager currently employed by the firm must choose an effort level $e_t \in E = \mathbb{R}$. The firm's per-period cash flows, gross of the manager's compensation, are given by

$$\pi_t = \theta_t + e_t + \nu_t, \tag{1}$$

where ν_t is transitory noise. The shocks ν_t are i.i.d. over time, independent across managers, and drawn from the distribution Φ , with expectation $\mathbb{E}[\tilde{\nu}_t] = 0$. The sequences of productivities θ^t and effort choices $e^t \equiv (e_1, \dots, e_t) \in E^t$ are the manager's private information. In contrast, the history of cash flows $\pi^t \equiv (\pi_1, \dots, \pi_t) \in \mathbb{R}^t$ generated by each manager is verifiable and can be used as a basis for compensation.

By choosing effort e_t in period t , the manager suffers a disutility $\psi(e_t)$. As in Laffont and Tirole (1986), there exists a scalar $\bar{e} > 0$ such that ψ is thrice continuously differentiable over $(0, \bar{e})$ with $\psi'(e), \psi''(e) > 0$ and $\psi'''(e) \geq 0$ for all $e \in (0, \bar{e})$, with $\psi'(\bar{e}) > 1$. In addition, we assume that ψ can be extended from $(0, \bar{e})$ to \mathbb{R} so that $\psi(0) = 0$, ψ is non-negative, differentiable, and Lipschitz continuous over the entire real line, and $\psi'(e) > 1$ for all $e > \bar{e}$. These last properties guarantee that both the efficient and the profit-maximizing effort levels are interior and that the agent's payoff is equi-Lipschitz continuous in effort, which in turn permits us to conveniently express the value function through a differentiable envelope formula (more below). Note that these conditions are

satisfied, for example, when $\bar{e} > 1$, $\psi(e) = (1/2)e^2$ for all $e \in (0, \bar{e})$, and $\psi(e) = \bar{e}e - \bar{e}^2/2$ for all $e > \bar{e}$.²³

Denoting by c_t the compensation that the manager receives in period t (equivalently, his period- t consumption), the manager's preferences over (lotteries over) streams of consumption levels $c \equiv (c_1, c_2, \dots)$ and streams of effort choices $e \equiv (e_1, e_2, \dots)$ are described by an expected utility function with (Bernoulli) utility given by

$$U^A(c, e) = \sum_{t=1}^{\infty} \delta^{t-1} [c_t - \psi(e_t)], \quad (2)$$

where $\delta < 1$ is the (common) discount factor.

The principal's objective is to maximize the discounted sum of the firm's expected profits, defined to be cash flows net of managerial compensation. Formally, let π_{it} and c_{it} denote, respectively, the cash flow generated and the compensation received by the i^{th} manager employed by the firm in his t^{th} period of employment. Then, let T_i denote the number of periods for which manager i works for the firm. The contribution of manager i to the firm's payoff, evaluated at the time manager i is hired, is given by

$$X_i(\pi_i^{T_i}, c_i^{T_i}) = \sum_{t=1}^{T_i} \delta^{t-1} [\pi_{it} - c_{it}].$$

Next, denote by $I \in \mathbb{N} \cup \{+\infty\}$ the total number of managers hired by the firm over its infinite life. The firm's payoff, given the cash flows and payments $(\pi_i^{T_i}, c_i^{T_i})_{i=1}^I$, is then given by

$$U^P = \sum_{i=1}^I \delta^{\sum_{j=1}^{i-1} T_j} X_i(\pi_i^{T_i}, c_i^{T_i}). \quad (3)$$

Given the stationarity of the environment, with an abuse of notation, throughout the entire analysis, we will omit all indices i referring to the identities of the managers.

Timing and labor market. The firm's interaction with the labor market unfolds as follows. Each manager learns his initial productivity θ_1 prior to being matched with the firm. After being matched, the manager is offered a menu of contracts described in detail below. While the firm can perfectly commit to the contracts it offers, each manager is free to leave the firm at each point in time. After leaving the firm, the manager receives a continuation payoff equal to $U^o \geq 0$.²⁴

²³There are two reasons why we allow effort to take values over the entire real line. First, this permits us to dispense with corner solutions in the optimal effort policy. Second, it ensures that the agent can always choose to generate the level of cash flows consistent with his reported level of productivity. This assumption thus allows us to dispense with uninteresting technical difficulties and facilitates the construction of the optimal contract.

²⁴That the outside option is invariant to the manager's productivity is a simplification. All our results extend qualitatively to a setting where the outside option is type dependent as long as the derivative of the outside option $U^o(\theta_t)$ with respect to current productivity is sufficiently small that the single-crossing conditions of Section 4 are preserved. This is the case, for example, when (i) the discount factor is not very high, and/or (ii) it takes a long time

We assume that (i) it is never optimal for the firm to operate without a manager being in control, (ii) that it is too costly to sample another manager before separating from the incumbent, and (iii) that all replacement decisions must be planned at least one period in advance. These assumptions capture (in a reduced form) various frictions in the recruiting process that prevent firms from sampling until they find a manager of the highest possible productivity, which is unrealistic and would make the analysis uninteresting.²⁵

After signing one of the contracts, the manager privately chooses effort e_1 . Nature then draws ν_1 from the distribution Φ and the firm's (gross) cash flows π_1 are determined according to (1). After observing the cash flows π_1 , the firm pays the manager a compensation c_1 which may depend on the specific contract selected by the manager and on the verifiable cash flow π_1 . Based on the specific contract selected at the time of contracting and on the observed cash flow, the manager is then either retained or dismissed at the end of the period.²⁶ If the manager is retained, his second-period productivity is then drawn from the distribution $F(\cdot|\theta_1)$. After privately learning θ_2 , at the beginning of the second period of employment, the manager then decides whether or not to leave the firm. If he leaves, he obtains the continuation payoff U^o . If he stays, he is then offered the possibility of modifying the terms of the contract that pertain to future compensation and retention decisions within limits specified by the contract signed in the first period (as it will become clear in a moment, these adjustments are formally equivalent to reporting the new productivity θ_2). After these adjustments are made, the manager privately chooses effort e_2 , cash flows π_2 are realized, and the manager is then paid a compensation c_2 as specified by the original contract along with the adjustments made at the beginning of the second period (clearly, the compensation c_2 may also depend on the entire history of observed cash flows $\pi^2 = (\pi_1, \pi_2)$). Given the contract initially signed, the adjustments made in period two, and the observed cash flows π^2 , the manager is then

for a manager to find a new job. Also note that, from the perspective of the firm under examination, this outside option is exogenous. However, in a richer setting with multiple identical firms and exogenous matching probabilities, U^o will coincide with the equilibrium continuation payoff that each manager expects from going back to the labor market and being randomly matched (possibly after an unemployment phase) with another firm. In such an environment, each manager's outside option is both time- and type-invariant (and equal to zero) if there are infinitely more managers than firms.

²⁵The assumption of random matching is also quite standard in the labor/matching literature (see, e.g., Jovanovic, 1979). In our setting, it implies that there is no direct competition among managers for employment contracts. This distinguishes our environment from an auction-like setting where, in each period, the principal consults simultaneously with multiple managers and then chooses which one to hire/retain.

²⁶That retention decisions are specified explicitly in the contract simplifies the exposition but is not essential. For example, by committing to pay a sufficiently low compensation after all histories that are supposed to lead to separation, the firm can always implement the desired retention policy by delegating to the managers the choice of whether or not to stay in the relationship. It will become clear from the analysis below that, while both the optimal and the efficient retention policies are unique, there are many ways these policies can be implemented (see, e.g., Yermack, 2006 for a description of the most popular termination clauses and "golden handshakes" practices).

either retained into the next period or dismissed at the end of the period.

The entire sequence of events described above repeats itself over time until the firm separates from the manager or the latter unilaterally decides to leave the firm. After separation occurs, at the beginning of the subsequent period, the firm goes back to the labor market and is randomly matched with a new manager whose initial productivity θ_1 is drawn from the same stationary distribution F_1 from which the incumbent's initial productivity was drawn. The relationship between any newly sampled manager and the firm then unfolds in the same way as described above for the incumbent.

2.1 The employment relationship as a dynamic mechanism

Because all managers are ex-ante identical, time is infinite, and types evolve independently across managers, the firm offers the same menu of contracts to each manager it is matched with. Under any such contract, the compensation that the firm pays to the manager (as well as the retention decisions) may depend on the cash flows produced by the manager as well as on messages sent by the manager over time (as explained above, the role of these messages is to permit the firm to respond to variations in productivity). However, both compensation and retention decisions are independent of both the calendar time at which the manager was hired and of the history of messages sent and cash flows generated by other managers. Hereafter, we will thus maintain the notation that t denotes the number of periods that a representative manager has been working for the firm and not the calendar time.

Furthermore, because the firm can commit, one can conveniently describe the firm's contract as a direct revelation mechanism. This specifies, for each period t , a recommended effort choice, the contingent compensation, and a retention decision.

In principle, both the level of effort recommended and the retention decision may depend on the history of reported productivities and on the history of cash flow realizations. However, one can verify that, under both the efficient and the profit-maximizing contracts, the optimal effort and retention decisions depend only on reported productivities θ^t . This is because cash flows are a noisy transformation of effort and productivity, and because effort can always be incentivized with money (recall that there are no cash constraints that require using separation decisions as a threat to punish unsatisfactory performance).²⁷ On the other hand, because the effort decisions are “hidden actions”

²⁷A formal proof for this result can be found in the Online Supplementary Material. The intuition for this result can be explained heuristically as follows. Consider a setting without transitory noise, i.e., where v_t is identically equal to zero, all t . Then observe that both the maximal welfare and the firm's maximal intertemporal expected profits in this setting are necessarily weakly higher than in the setting with transitory noise considered in the paper. (This follows from two observations. First, cash flows are a more precise measurement of effort if there is no transitory noise. Second, any benefit from making effort and/or retention decisions stochastic by conditioning them on transitory noise can be replicated by conditioning on arbitrary lotteries.) The result then follows from observing that (i) the effort and retention policies that maximize, respectively, welfare and the firm's intertemporal expected profits in the environment

(i.e., because of moral hazard) it is essential that the total compensation be allowed to depend both on the reported productivities θ^t as well as on past and current cash flows π^t .

Hereafter, we will thus model the employment relationship induced by the profit-maximizing and the efficient contracts as a direct revelation mechanism $\Omega \equiv \langle \xi, x, \kappa \rangle$. This consists of a sequences of functions $\xi \equiv (\xi_t : \Theta^t \rightarrow E)_{t=1}^\infty$, $x \equiv (x_t : \Theta^t \times \Pi^t \rightarrow \mathbb{R})_{t=1}^\infty$ and $\kappa \equiv (\kappa_t : \Theta^t \rightarrow \{0, 1\})_{t=1}^\infty$ such that:

- $\xi_t(\theta^t)$ is the recommended period- t effort;
- $x_t(\theta^t, \pi^t)$ is the compensation paid at the end of period t ;
- $\kappa_t(\theta^t)$ is the retention decision for period t , with $\kappa_t(\theta^t) = 1$ if the manager is to be retained, which means he is granted the possibility of working for the firm also in period $t + 1$, regardless of his period- $(t + 1)$ productivity θ_{t+1} ,²⁸ and $\kappa_t(\theta^t) = 0$ if (i) either he is dismissed at the end of period t , or (ii) he was dismissed in previous periods; i.e., $\kappa_t(\theta^t) = 0$ implies $\kappa_s(\theta^s) = 0$ for all $s > t$, all θ^s .²⁹ Given any sequence θ^∞ , we then denote by $\tau(\theta^\infty) \equiv \min \{t : \kappa_t(\theta^t) = 0\}$ the corresponding *length* of the employment relationship.

In each period t , given the previous reports $\hat{\theta}^{t-1}$ and cash flow realizations π^{t-1} , the employment relationship unfolds as follows:

- After learning his period- t productivity $\theta_t \in \Theta_t$, and upon deciding to stay in the relationship, the manager sends a report $\hat{\theta}_t \in \Theta_t$;
- The mechanism then prescribes effort $\xi_t(\hat{\theta}^{t-1}, \hat{\theta}_t)$ and specifies a reward scheme $x_t(\hat{\theta}^{t-1}, \hat{\theta}_t, \pi^{t-1}, \cdot) : \Pi_t \rightarrow \mathbb{R}$ along with a retention decision $\kappa_t(\hat{\theta}^{t-1}, \hat{\theta}_t)$;
- The manager then chooses effort e_t ;
- After observing the realized cash flows $\pi_t = e_t + \theta_t + \nu_t$, the manager is paid $x_t(\hat{\theta}^{t-1}, \hat{\theta}_t, \pi^{t-1}, \pi_t)$ and is then either retained or replaced according to the decision $\kappa_t(\hat{\theta}^{t-1}, \hat{\theta}_t)$.

By the revelation principle, we restrict attention to direct mechanisms for which (i) a *truthful* and *obedient* strategy is optimal for the manager, and (ii) after any truthful and obedient history, the

without transitory noise are independent of realized cash flows and coincide, respectively, with the ones in Propositions 1 and 3 below for the environment with noise, and (ii) under these policies, both welfare and the firm's expected profits in the presence of noise are the same as in its absence.

²⁸Recall that separation decisions must be planned one period in advance, and that it is too costly to go back to the labor market and consult another manager before separating from the incumbent. Along with the assumption that it is never desirable to operate the firm without a manager, these assumptions imply that a manager who is retained at the end of period t will never be dismissed at the beginning of period $t + 1$, irrespective of his period- $t + 1$ productivity.

²⁹For expositional convenience, we allow the policies ξ_t , x_t , and κ_t to be defined over all possible histories, including those histories that lead to separation at some $s < t$. This, of course, is inconsequential for the analysis.

manager finds it optimal to stay in the relationship whenever offered the possibility of doing so (i.e., the manager never finds it optimal to leave the firm when he has the option to stay). In the language of mechanism design, the first property means that the mechanism is "*incentive compatible*" while the second property means that it is "*periodically individually rational*".

Remark: While we are not imposing limited liability (or cash) constraints on the principal's problem, the effort and retention policies that we characterize below turn out to be implementable with non-negative payments for reasonable parameter specifications (see Corollary 1 below).

3 The efficient contract

We begin by describing the effort and turnover policies, ξ^E and κ^E , that maximize ex-ante welfare, defined to be the sum of a representative manager's expected payoff and of the firm's expected profits (the "efficient" policies). Although we are clearly interested in characterizing these policies for the same environment as described above, it turns out that these policies coincide with the ones that maximize ex-ante welfare in an environment with symmetric information, in which the managers' productivities and effort choices are observable and verifiable. In turn, because all players' payoffs are linear in payments, these policies also coincide with the equilibrium ones that each firm would choose under symmetric information to maximize expected profits. For simplicity, in this section, we thus assume information is symmetric and then show in Section 5 — Proposition 7 — that the efficient policies under symmetric information remain implementable also under asymmetric information.

The efficient effort policy is very simple: Because all players are risk neutral and because each manager's productivity has no effect on the marginal cost or the marginal benefit of effort, the efficient effort level e^E is independent of the history of realized productivities and implicitly defined by the first-order condition $\psi'(e^E) = 1$.

The efficient turnover policy, on the other hand, is the solution to a dynamic programming problem. Because the firm does not know the future productivity of its current manager, nor the productivities of its future hires, this problem involves a trade-off in each period between experimenting with a new manager and continuing experimenting with the incumbent. Denote by \mathcal{B}^E the set of all bounded functions from Θ to \mathbb{R} . The solution to the aforementioned trade-off can be represented as a value function $W^E \in \mathcal{B}^E$ that, for any $\theta \in \Theta$, and irrespective of t , gives the firm's expected continuation payoff when the incumbent manager's productivity is θ .³⁰ Clearly, the value $W^E(\theta)$ takes into account the possibility of replacing the manager in the future. As we show in the Appendix, the function W^E is the unique fixed point to the mapping $T_E : \mathcal{B}^E \rightarrow \mathcal{B}^E$ defined, for all

³⁰Note that if the process were not autonomous, the efficient retention decision would obviously depend also on the length t of the employment relationship. See the working paper version of the manuscript Garrett and Pavan (2011a) for how the result in the next proposition must be adapted to accommodate non-autonomous processes.

$W \in \mathcal{B}^E$, all $\theta \in \Theta$, by³¹

$$T_E W(\theta) = \theta + e^E - \psi(e^E) - (1 - \delta) U^o + \delta \max\{\mathbb{E}_{\tilde{\theta}|\theta}[W(\tilde{\theta})]; \mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]\}.$$

The efficient contract can then be described as follows.

Proposition 1 *The efficient effort and turnover policies satisfy the following properties.³² (i) For all t , all $\theta^t \in \Theta^t$, $\xi_t^E(\theta^t) = e^E$, with e^E implicitly defined by $\psi'(e^E) = 1$. (ii) Conditional on being employed in period t , the manager is retained at the end of period t if and only if $\theta_t \geq \theta^E$, where*

$$\theta^E = \inf\{\theta \in \Theta : \mathbb{E}_{\tilde{\theta}|\theta}[W^E(\tilde{\theta})] \geq \mathbb{E}_{\tilde{\theta}_1}[W^E(\tilde{\theta}_1)]\}.$$

The proof uses the Contraction Mapping Theorem to establish existence and uniqueness of a function W^E that is a fixed point to the mapping $T_E : \mathcal{B}^E \rightarrow \mathcal{B}^E$ defined above. It then shows that this function is indeed the value function for the problem described above. Finally, it establishes that the function W^E is nondecreasing. These properties, together with the assumptions that the process is Markov, autonomous, and satisfies the property of first-order stochastic dominance in types, imply that turnover decisions must be taken according to the cut-off rule given in the proposition.

4 The profit-maximizing contract

We now turn to the contract that maximizes the firm's expected profits in a setting where neither the managers' productivities nor their effort choices are observable. As anticipated above, what prevents the firm from appropriating the entire surplus (equivalently, from "selling out" the project to the managers) is the fact that, both at the initial contracting stage, as well as at any subsequent period, each manager is privately informed about his productivity. To extract some of the surplus from the most productive types, the firm must then introduce distortions in effort and retention decisions, which require retaining ownership of the project.

We start by showing that, in *any* incentive-compatible mechanism $\Omega \equiv \langle \xi, x, \kappa \rangle$, each type's intertemporal expected payoff under a truthful and obedient strategy $V^\Omega(\theta_1)$ must satisfy

$$V^\Omega(\theta_1) = V^\Omega(\underline{\theta}) + \int_{\underline{\theta}}^{\theta_1} \mathbb{E}_{\tilde{\theta}_{>1}^\infty|s} \left[\sum_{t=1}^{\tau(s, \tilde{\theta}_{>1}^\infty)} \delta^{t-1} J_1^t(s, \tilde{\theta}_{>1}^t) \psi'(\xi_t(s, \tilde{\theta}_{>1}^t)) \right] ds. \quad (4)$$

The derivation of this formula follows from arguments similar to those in Pavan, Segal, and Toikka (2011), adapted to the environment under examination here.

To establish (4), consider the following fictitious environment where the agent can misrepresent his type but is then "forced" to choose effort so as to hide his lies by inducing the same distribution

³¹The expectations $\mathbb{E}_{\tilde{\theta}|\theta}[W(\tilde{\theta})]$ and $\mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]$ are, respectively, under the measures $F(\cdot|\theta)$ and $F_1(\cdot)$ — recall that, under the simplifying assumption that the process is autonomous, for any $t > 1$, any $\theta \in \Theta$, $F_t(\cdot|\theta) = F(\cdot|\theta)$.

³²The efficient policies are "essentially unique", i.e., unique up to a zero-measure set of histories.

of cash flows as if his reported type coincided with the true one. This is to say that, at any period t , given the history of reports $\hat{\theta}^t$ and the true current productivity θ_t , the agent must choose effort

$$e_t^\#(\theta_t; \hat{\theta}^t) = \hat{\theta}_t + \xi_t(\hat{\theta}^t) - \theta_t. \quad (5)$$

so that the distribution of the period- t cash flows is the same as when the agent's true period- t productivity is $\hat{\theta}_t$ and the agent follows the principal's recommended effort choice $\xi_t(\hat{\theta}^t)$.

Clearly, if the mechanism Ω is incentive compatible and periodically individually rational in the original environment where the agent is free to choose his effort after misreporting his type, it must also be in this fictitious one, where he is forced to choose effort according to (5). This allows us to focus on a necessary condition for the optimality of truthful reporting by the agent in the fictitious environment which remains necessary for such behavior in the original one.

Fix an arbitrary sequence of reports $\hat{\theta}^\infty$ and an arbitrary sequence of true productivities θ^∞ . Let $C(\hat{\theta}^\infty)$ denote the present value of the stream of payments that the agent expects to receive from the principal when the sequence of reported productivities is $\hat{\theta}^\infty$ and, in each period, he chooses effort according to (5).³³ For any $(\theta^\infty, \hat{\theta}^\infty)$, the agent's expected payoff in this fictitious environment is given by

$$\begin{aligned} \mathcal{U}(\theta^\infty, \hat{\theta}^\infty) &\equiv C(\hat{\theta}^\infty) - \sum_{t=1}^{\infty} \delta^{t-1} \kappa_{t-1}(\hat{\theta}^{t-1}) \psi(\hat{\theta}_t + \xi_t(\hat{\theta}^t) - \theta_t) \\ &\quad + \sum_{t=1}^{\infty} \delta^{t-1} (1 - \kappa_{t-1}(\hat{\theta}^{t-1})) (1 - \delta) U^o. \end{aligned}$$

The assumption that ψ is differentiable and Lipschitz continuous implies that \mathcal{U} is totally differentiable in θ^t , any t , and equi-Lipschitz continuous in θ^∞ in the norm

$$\|\theta^\infty\| \equiv \sum_{t=1}^{\infty} \delta^t |\theta_t|.$$

Together with the fact that $\|\theta^\infty\|$ is finite (which is implied by the assumption that Θ is bounded) and that the impulse responses $J_s^t(\theta^t)$ are uniformly bounded, this means that the dynamic envelope theorem of Pavan, Segal and Toikka (2011) (Proposition 4) applies to this environment. Hence, a necessary condition for truthful reporting to be optimal for the agent in this fictitious environment (and by implication also in the original one) is that the value function $V^\Omega(\theta_1)$ associated to the problem that involves choosing the reports and then selecting effort according to (5) is Lipschitz continuous and, at each point of differentiability, satisfies

$$\frac{dV^\Omega(\theta_1)}{d\theta_1} = \mathbb{E}_{\tilde{\theta}_{>1}^\infty | \theta_1} \left[\sum_{t=1}^{\infty} \delta^{t-1} J_1^t(\theta_1, \tilde{\theta}_{>1}^t) \frac{\partial \mathcal{U}(\tilde{\theta}^\infty; \tilde{\theta}^\infty)}{\partial \theta_t} \right],$$

³³Note that, by construction, C does not depend on the true productivities θ^∞ . Also note that the expectation here is over the transitory noise v^∞ .

where $\partial\mathcal{U}(\theta^\infty; \theta^\infty)/\partial\theta_t$ denotes the partial derivative of $\mathcal{U}(\theta^\infty, \theta^\infty)$ with respect to the true (rather than the reported) type θ_t . The result then follows from the fact that

$$\frac{\partial\mathcal{U}(\theta^\infty; \theta^\infty)}{\partial\theta_t} = \kappa_{t-1}(\theta^{t-1})\psi'(\xi_t(\theta^t))$$

and the definition of the stopping time $\tau(\theta^\infty) \equiv \min\{t : \kappa_t(\theta^t) = 0\}$.

The formula in (4) confirms the intuition that the expected surplus that the principal must leave to each period-1 type is determined by the dynamics of *effort* and *retention* decisions under the contracts offered to the less productive types. As anticipated in the Introduction, this is because those managers who are most productive at the contracting stage expect to be able to obtain a "rent" when mimicking the less productive types. This rent originates from the possibility of generating the same cash flows as the less productive types by working less, thus economizing on the disutility of effort. The amount of effort they expect to save must, however, take into account the fact that their own productivity, as well as that of the types they are mimicking, will change over time. This is done by weighting the amount of effort saved in all subsequent periods by the impulse response functions J_1^t , which, as explained above, control for how the effect of the initial productivity on future productivity evolves over time.

Let $\eta(\theta_1) \equiv \frac{1-F_1(\theta_1)}{f_1(\theta_1)}$ denote the inverse hazard rate of the first-period distribution. Then (4) gives the following useful result (the proof follows from the arguments above).

Proposition 2 *In any incentive-compatible and periodically individually rational mechanism $\Omega \equiv (\xi, x, \kappa)$, the firm's expected profit from each manager it hires is given by*

$$\mathbb{E}_{\tilde{\theta}^\infty, \tilde{v}^\infty} \left[\sum_{t=1}^{\tau(\tilde{\theta}^\infty)} \delta^{t-1} \left\{ \begin{array}{l} \tilde{\theta}_t + \xi_t(\tilde{\theta}^t) + \tilde{v}_t - \psi(\xi_t(\tilde{\theta}^t)) \\ -\eta(\tilde{\theta}_1)J_1^t(\tilde{\theta}^t)\psi'(\xi_t(\tilde{\theta}^t)) - (1-\delta)U^o \end{array} \right\} \right] + U^o - V^\Omega(\underline{\theta}), \quad (6)$$

where $V^\Omega(\underline{\theta}) \geq U^o$ denotes the expected payoff of the lowest period-1 type.

The formula in (6) is the dynamic analog of the familiar *virtual surplus* formula for static adverse selection settings. It expresses the firm's expected profits as the discounted expected total surplus generated by the relationship, net of terms that control for the surplus that the firm must leave to the manager to induce him to participate in the mechanism and to truthfully reveal his private information.

Equipped with the aforementioned representation, we now consider a "*relaxed program*" that involves choosing the policies $(\xi_t(\cdot), \kappa_t(\cdot))_{t=1}^\infty$ so as to maximize the sum of the profits the firm expects from each manager it hires, taking the contribution of each manager to be (6) (note that this incorporates only the local incentive constraints) and subject to the participation constraints of the lowest period-1 types $V^\Omega(\underline{\theta}) \geq U^o$.

Below, we first characterize the policies $(\xi_t^*(\cdot), \kappa_t^*(\cdot))_{t=1}^\infty$ that solve the relaxed program. We then provide sufficient conditions for the existence of a compensation scheme x^* such that the mechanism $\Omega \equiv \langle \xi^*, x^*, \kappa^* \rangle$ is incentive compatible and periodically individually rational (and hence profit maximizing for the firm).

Let $A = \cup_{t=1}^\infty \Theta^t$ and denote by \mathcal{B} the set of bounded functions from A to \mathbb{R} . For any effort policy ξ , let W_ξ^* denote the unique fixed point to the mapping $T(\xi) : \mathcal{B} \rightarrow \mathcal{B}$ defined, for all $W \in \mathcal{B}$, all t , all θ^t , by

$$\begin{aligned} T(\xi) W(\theta^t) &\equiv \xi_t(\theta^t) + \theta_t - \psi(\xi_t(\theta^t)) - \eta(\theta_1) J_1^t(\theta^t) \psi'(\xi_t(\theta^t)) \\ &\quad - (1 - \delta) U^o + \delta \max\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W(\tilde{\theta}^{t+1})], \mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]\}. \end{aligned} \quad (7)$$

Proposition 3 *Let ξ^* be the effort policy implicitly defined, for all t , all $\theta^t \in \Theta^t$, by³⁴*

$$\psi'(\xi_t^*(\theta^t)) = 1 - \eta(\theta_1) J_1^t(\theta^t) \psi''(\xi_t^*(\theta^t)) \quad (8)$$

and (suppressing the dependence on ξ^* to ease the exposition) let W^* be the unique fixed point to the mapping $T(\xi^*)$ defined by (7). Let κ^* denote the retention policy such that, for any t and any $\theta^t \in \Theta^t$, conditional on the manager being employed in period t , he is retained at the end of period t if and only if $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] \geq \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. The pair of policies (ξ^*, κ^*) solves the firm's relaxed program.

The effort and turnover policies that solve the relaxed program are thus the “virtual analogs” of the policies ξ^E and κ^E that maximize efficiency, as given in Proposition 1. Note that, in each period t , and for each history $\theta^t \in \Theta^t$, the optimal effort $\xi_t^*(\theta^t)$ is chosen so as to trade off the effect of a marginal variation in effort on total surplus $e_t + \theta_t - \psi(e_t) - (1 - \delta) U^o$ with its effect on the managers' informational rents, as computed from period one's perspective (i.e., at the time the managers are hired). The fact that both the firm's and the managers' preferences are additively separable over time implies that this trade-off is unaffected by the possibility that the firm replaces the managers. Furthermore, because the rent $V^\Omega(\theta_1)$ that each type θ_1 expects at the time he is hired is increasing in the effort $\xi_t(\theta_1', \theta_{>1}^t)$ that the firm asks each less productive type $\theta_1' < \theta_1$ to exert in each period $t \geq 1$, as implied by (4), the effort policy that maximizes the firm's profits is systematically downward distorted with respect to its efficient counterpart ξ^E . Such a downward distortion should be expected, for it essentially comes from the same considerations as in familiar static models like Laffont and Tirole (1986).

More interestingly, note that, fixing the initial type θ_1 , the dynamics of effort in subsequent periods is entirely driven by the dynamics of the impulse response functions J_1^t . These functions,

³⁴For simplicity, we assume throughout that the profit-maximizing policy specifies positive effort choices in each period t and for each history $\theta^t \in \Theta^t$. This amounts to assuming that, for all t all $\theta^t \in \Theta^t$, $\psi''(0) < 1/[\eta(\theta_1) J_1^t(\theta^t)]$. When this condition does not hold, optimal effort is simply given by $\xi_t^*(\theta^t) = 0$.

by describing the effect of period-one productivity on subsequent productivity, capture how the persistence of the managers' initial private information evolves over time. Because such persistence is what makes more productive (period-one) types expect larger surplus in subsequent periods than initially less productive types, the dynamics of the impulse responses J_1^t are what determine the dynamics of effort decisions ξ_t^* , as pointed out in Garrett and Pavan (2011b).

Next, consider the turnover policy, which is the focus of this paper. The characterization of the profit-maximizing policy κ^* parallels the one for the efficient policy κ^E in Proposition 1. The proof in the Appendix first establishes that the (unique) fixed point W^* to the mapping $T(\xi^*)$ given by (7) coincides with the value function associated with the problem that involves choosing the turnover policy so as to maximize the firm's virtual surplus (given for each manager by (6)) taking as given the profit-maximizing effort policy ξ^* . It then uses W^* to derive the optimal retention policy.

For any t , any $\theta^t \in \Theta^t$, $W^*(\theta^t)$ gives the firm's expected continuation profits from continuing the relationship with an incumbent manager who has worked already for $t - 1$ periods and who will continue working for at least one more period (period t). As with the efficient policy, this value is computed taking into account future retention and effort decisions. However, contrary to the case of efficiency, the value $W^*(\theta^t)$ in general depends on the entire history of productivities θ^t , as opposed to only the current productivity θ_t . The reason is twofold. First, as shown above, the profit-maximizing effort policy typically depends on the entire history θ^t . Second, even if effort were exogenously fixed at a constant level, the "virtual value" of continuing the relationship after t periods would typically depend on the entire history θ^t . The reason is that this value is computed from an ex-ante perspective, and takes into account the managers' informational rents, as expected at the time of hiring. As shown above, these rents are determined by the dynamics of the impulse response functions J_1^t which capture the effects of the managers' initial private information on their productivity in the subsequent periods. Because these impulse responses typically depend on the entire history of productivity realizations θ^t , so does the profit-maximizing turnover policy κ^* .³⁵

The profit-maximizing turnover policy can then be determined straightforwardly from the value function W^* : each incumbent manager is replaced whenever the expected value $\mathbb{E}_{\tilde{\theta}_1} [W^*(\tilde{\theta}_1)]$ of starting a relationship with a new manager of unknown productivity exceeds the expected value $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t} [W^*(\tilde{\theta}^{t+1})]$ of continuing the relationship with the incumbent. Once again, these values are calculated from the perspective of the time at which the incumbent is hired and take into account the optimality of future effort and retention decisions.

Having characterized the policies that solve the relaxed program, we now turn to sufficient conditions that guarantee that such policies are indeed implemented under any optimal contract for the firm—in other words, solve the firm's full program (recall that (6) only incorporates local IC

³⁵A notable exception is when θ_t evolves according to an autoregressive processes, i.e., $\theta_t = \gamma\theta_{t-1} + \varepsilon_t$. In this case, the impulse responses $J_1^t = \gamma^t$ are scalars and the expected value from continuing a relationship after t periods depends only on the current productivity θ_t , the initial productivity θ_1 , and the length t of the employment relationship.

conditions, as implied by the envelope formula (4)).

We establish the result by showing existence of a compensation scheme x^* that implements the policies (ξ^*, κ^*) at minimal cost for the firm. In particular, given the mechanism $\Omega^* = (\xi^*, x^*, \kappa^*)$, the following properties hold true: (i) after any history $h_t = (\theta^t, \hat{\theta}^{t-1}, e^{t-1}, \pi^{t-1})$ such that $\kappa_{t-1}^*(\hat{\theta}^{t-1}) = 1$, each manager prefers to follow a truthful and obedient strategy in the entire continuation game that starts in period t with history h_t than following any other strategy; (ii) the lowest period-1 type's expected payoff $V^\Omega(\underline{\theta})$ from following a truthful and obedient strategy in the entire game is exactly equal to his outside option U^o ; and (iii) after any history $h_t = (\theta^t, \hat{\theta}^{t-1}, e^{t-1}, \pi^{t-1})$ such that $\kappa_{t-1}^*(\hat{\theta}^{t-1}) = 1$, each manager's continuation payoff under a truthful and obedient strategy remains at least as high as his outside option U^o . That the mechanism Ω^* is optimal for the firm then follows from the fact that the mechanism is incentive compatible and periodically individually rational, along with the results in Propositions 2 and 3.

Proposition 4 *Suppose that the policies (ξ^*, κ^*) defined in Proposition 3 satisfy the following **single-crossing conditions** for all $t \geq 1$, all $\theta_t, \hat{\theta}_t \in \Theta_t$, all $\hat{\theta}^{t-1} \in \Theta^{t-1}$ such that $\kappa_{t-1}(\hat{\theta}^{t-1}) = 1$:*

$$\mathbb{E}_{\hat{\theta}_{>t}^\infty | \theta_t} \left[\begin{array}{l} \sum_{k=t}^{\tau(\hat{\theta}^{t-1}, \theta_t, \tilde{\theta}_{>t}^\infty)} \delta^{k-t} J_t^k(\theta_t, \tilde{\theta}_{>t}^k) \psi' \left(\xi_k^*(\hat{\theta}^{t-1}, \theta_t, \tilde{\theta}_{>t}^k) \right) \\ - \sum_{k=t}^{\tau(\hat{\theta}^{t-1}, \hat{\theta}_t, \tilde{\theta}_{>t}^\infty)} \delta^{k-t} J_t^k(\theta_t, \tilde{\theta}_{>t}^k) \psi' \left(\xi_k^*(\hat{\theta}^{t-1}, \hat{\theta}_t, \tilde{\theta}_{>t}^k) \right) \end{array} \right] [\theta_t - \hat{\theta}_t] \geq 0. \quad (9)$$

Then there exists a **linear reward scheme** of the form

$$x_t^*(\theta^t, \pi^t) = S_t(\theta^t) + \alpha_t(\theta^t) \pi_t \text{ all } t, \text{ all } \theta^t \in \Theta^t, \quad (10)$$

where $S_t(\theta^t)$ and $\alpha_t(\theta^t)$ are scalars that depend on the history of reported productivities, such that, irrespective of the distribution Φ of the (zero-mean) transitory noise, the mechanism $\Omega = (\xi^*, x^*, \kappa^*)$ is incentive compatible and periodically individually rational and maximizes the firm's profits. Furthermore, any contract that is incentive compatible and periodically individually rational and maximizes the firm's profits implements the policies (ξ^*, κ^*) with probability one (i.e., except over a zero-measure set of histories).

The single-crossing conditions in the proposition say that higher reports about current productivity lead, on average, to higher chances of retention and to higher effort choices both in the present as well as in subsequent periods, where the average is over future histories, weighted by the impulse responses. These conditions are trivially satisfied when the effort and retention policies are *strongly monotone*, i.e., when each $\xi_t^*(\cdot)$ and $\kappa_t^*(\cdot)$ is nondecreasing in θ^t . More generally, the conditions in the propositions only require that the expected sum of marginal disutilities of effort, conditional on retention and weighted by the impulse responses, changes sign only once when the manager changes his report about current productivity.

Turning to the components of the linear scheme, the coefficients α_t are chosen so as to provide the manager with the right incentives to choose effort obediently. Because neither future cash flows nor future retention decisions depend on current cash flows (and, as a result, on current effort), it is easy to see that, when the sensitivity of the manager's compensation to the current cash flows is given by $\alpha_t = \psi'(\xi_t^*(\theta^t))$, by choosing effort $e_t = \xi_t(\theta^t)$, the manager equates the marginal disutility of effort to its marginal benefit and hence maximizes his continuation payoff. This is irrespective of whether or not the manager has reported his productivity truthfully. Under the proposed scheme, the moral-hazard part of the problem is thus controlled entirely through the variable components α_t .

Given α_t , the fixed components S_t are then chosen to control for the adverse-selection part of the problem, i.e., to induce the managers to reveal their productivity. As we show in the Appendix, when the policies ξ and κ satisfy the single-crossing conditions in the proposition, then considering the two components α and S together, the following property holds: In the continuation game that starts with *any* arbitrary history $h_t = (\theta^t, \hat{\theta}^{t-1}, e^{t-1}, \pi^{t-1})$, irrespective of whether or not the manager has been truthful in the past, he finds one-stage deviations from the truthful and obedient strategy unprofitable. Together with a certain property of continuity-at-infinity discussed in the Appendix, this result in turn implies that no other deviations are profitable either.³⁶

In a moment, we turn to primitive conditions that guarantee that the policies (ξ^*, κ^*) of Proposition 3 satisfy the single crossing conditions of Proposition 4. Before doing so, we notice that, under reasonable conditions, the linear schemes of Proposition 4 entail a nonnegative payment to the manager in every period and for any history. We conclude that neither our positive nor our normative results below depend critically on our simplifying assumption of disregarding limited liability (or cash) constraints.

Corollary 1 *When (i) the lower bound \underline{v} on the transitory noise shocks ν is not too small (i.e., not too large in absolute value), (ii) the level of the outside option U^o is not too small, and (iii) the discount factor δ is not too high, the linear schemes of Proposition 4 can be chosen so as to entail a nonnegative payment to the manager in every period and for any history. Under these additional assumptions, the corresponding mechanism $\Omega = (\xi^*, x^*, \kappa^*)$ remains optimal also in settings where the managers are protected by limited liability.*

We now turn to primitive conditions that guarantee that the policies (ξ^*, κ^*) that solve the relaxed program satisfy the conditions of Proposition 4 and hence are sustained under any optimal mechanism.

³⁶A similar sufficiency result is established in Garrett and Pavan (2011b) for the special case where retention decisions are exogenously fixed at $\kappa_t^*(\theta^t) = 1$ for all t , all θ^t (i.e., where the manager is never replaced). In that case, the single-crossing conditions of Proposition 4 depend on the effort policy only. As explained above, the primary contribution here is not in extending these conditions to allow for managerial turnover but rather in using the above result to identify important properties of the *optimal* retention policy, which is what we do in the rest of this section.

Proposition 5 *A sufficient condition for the policies (ξ^*, κ^*) of Proposition 3 to satisfy the single-crossing conditions of Proposition 4 (and hence to be part of an optimal mechanism) is that, for each t , the function $\eta(\cdot)J_1^t(\cdot)$ is nonincreasing on Θ^t . When this is the case, the optimal retention policy takes the form of a **cut-off rule**: There exists a sequence of nonincreasing threshold functions $(\theta_t^*(\cdot))_{t=1}^\infty$, $\theta_t^* : \Theta^{t-1} \rightarrow \mathbb{R}$, all $t \geq 1$,³⁷ such that, conditional on being employed in period t , the manager is retained at the end of period t if and only if $\theta_t \geq \theta_t^*(\theta^{t-1})$.*

Note that the monotonicity condition in the proposition is the dynamic analog of the *regularity condition* for static mechanism design (see Myerson, 1981); it combines the familiar condition of monotone hazard rate of the first-period distribution F_1 with the assumption of nonincreasing impulse responses J_1^t . Under this condition, the flow virtual surplus

$$VS_t(\theta^t) \equiv \xi_t^*(\theta^t) + \theta_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1)J_1^t(\theta^t)\psi'(\xi_t^*(\theta^t)) - (1 - \delta)U^o \quad (11)$$

that the firm expects from each incumbent during the t -th period of employment is nondecreasing in the history of productivities θ^t . Together with the condition of “first-order stochastic dominance in types” (which implies that impulse responses are non-negative), this property in turn implies that the value $W^*(\theta^t)$ of continuing the relationship after t periods is nondecreasing. In this case, the turnover policy κ^* that maximizes the firm’s virtual surplus is also nondecreasing and takes the form of a simple cut-off rule, with cut-off functions $(\theta_t^*(\cdot))_{t=1}^\infty$ satisfying the properties in the proposition.

We are now ready to establish our key positive result. We start with the following definition.

Definition 1 *The kernels F satisfy the property of “**declining impulse responses**” if, for any $s > t \geq 1$, any $(\theta^t, \theta_{>t}^s)$, $\theta_s \geq \theta_t$ implies that $J_1^s(\theta^t, \theta_{>t}^s) \leq J_1^t(\theta^t)$.*

As anticipated in the Introduction, this property captures the idea that the effect of a manager’s initial productivity on his future productivity declines with the length of the employment relationship, a property that seems reasonable for many cases of interest. This property is satisfied, for example, by an autonomous AR(1) process $\theta_t = \gamma\theta_{t-1} + \varepsilon_t$ with coefficient γ of linear dependence smaller than one.

We then have the following result.

Proposition 6 *Suppose that, in addition to the properties of Proposition 5, the kernels F satisfy the property of declining impulse responses. Take an arbitrary period $t \geq 1$ and let $\theta^t \in \Theta^t$ be such that $\kappa_{t-1}^*(\theta^{t-1}) = 1$. Suppose that $\theta_s \leq \theta_t$ for some $s < t$. Then $\kappa_t^*(\theta^t) = 1$.*

The proposition says that the productivity level that the firm requires for retention declines with the length of the employment relationship. That is, the manager is retained in any period t

³⁷Because θ_0 is given, in period one, the cut-off function $\theta_1^* : R^0 \rightarrow \mathbb{R}$ reduces to a constant cut-off $\theta_1^* \in \mathbb{R}$.

whenever his period- t productivity is no lower than in *any* of the previous periods. In other words, when separation occurs, it must necessarily be the case that the manager's productivity is at its historical lowest.

The reason why the retention policy becomes gradually more permissive over time is the one anticipated in the Introduction. Suppose that the effect of the initial productivity on future productivity declines over time (satisfies declining impulse responses) and consider a manager whose initial type is θ_1 . A commitment to replace this manager in the distant future is less effective in reducing the informational rent that the firm must leave to each more productive type $\theta'_1 > \theta_1$ than a commitment to replace him in the near future (for given productivity at the time of dismissal). Formally, for any given productivity $\theta \in \Theta$, the net flow payoff that the firm expects (ex-ante) from retaining the incumbent in period t , as captured by (11), increases with the length of the employment relationship, implying that the value function W^* increases as well.

Remark 1 *Note that, while the result in Proposition 6 is reinforced by the fact that, under the optimal contract, effort increases over time, it is not driven by this property. The same result would hold if the level of effort that the firm asks of the manager were exogenously fixed at some constant level \hat{e} .*

The result that the optimal turnover policy becomes more permissive over time, together with the result that the productivity level $\theta_t^*(\theta^{t-1})$ required for retention decreases with the productivity experienced in past periods, may help explain the practice of rewarding managers that are highly productive at the early stages (and hence, on average, generate higher profits) by offering them job stability once their tenure in the firm becomes long enough. Thus what in the eyes of an external observer may look like "entrenchment" can actually be the result of a profit-maximizing contract in a world where managerial productivity is expected to change over time and to be the managers' private information. Importantly, note that this property holds independently of the level of the managers' outside option U^o . We thus expect such a property to hold irrespective of whether one looks at a given firm or at the entire market equilibrium.

It is, however, important to recognize that, while the property that retention decisions become more permissive over time holds when conditioning on productivity (equivalently, on match quality), it need not hold when averaging across the entire pool of productivities of retained managers. Indeed, while the probability of retention for a given productivity level necessarily increases with tenure, the unconditional probability of retention need not be monotonic in the length of the employment relationship because of composition effects that can push in the opposite direction. It is thus essential for the econometrician testing for our positive prediction to collect data that either directly, or indirectly, permit him to condition on managerial productivity.

5 On the (in)efficiency of profit-maximizing retention decisions

We now turn to the normative implications of the result that profit-maximizing retention policies become more permissive with time. We start by establishing that the first-best effort and turnover policies of Proposition 1 remain implementable also when productivity and effort choices are the managers' private information.

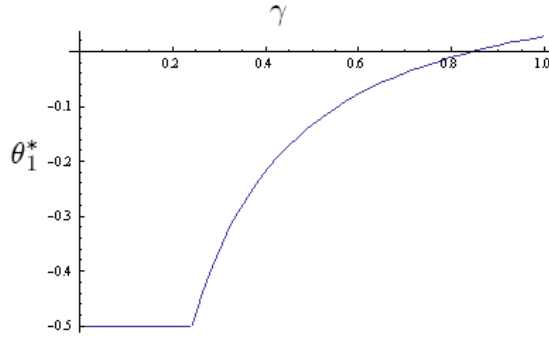
Proposition 7 *Assume that both productivity and effort choices are the managers' private information. There exists a linear compensation scheme of the type described in Proposition 4 that implements the first-best effort and turnover policies of Proposition 1.*

We can now compare the firms' profit-maximizing policies with their efficient counterparts. As shown in the previous section, when impulse responses decline over time and eventually vanish in the long run, effort under the firm's optimal contract gradually converges to its efficient level as the length of the employment relationship grows sufficiently large. One might expect a similar convergence result to apply also to retention decisions. This conjecture, however, fails to take into account that firms' separation payoffs are endogenous and affected by the same frictions as in the relationship with each incumbent. Taking this endogeneity into account is indeed what leads to the fixed-point result in Proposition 3. Having endogenized the firms' separation payoff in turn permits us to establish our key normative result that, once the length of the employment relationship has grown sufficiently large, profit-maximizing retention decisions eventually become excessively permissive as compared to what efficiency requires. We formalize this result in Proposition 8 below. Before doing that, as a preliminary step towards understanding the result, we consider a simplified example.³⁸

Example 1 *Consider a firm operating for only two periods and assume that this is commonly known. In addition, suppose that both θ_1 and ε_2 are uniformly distributed over $[-.5, +.5]$ and that $\theta_2 = \gamma\theta_1 + \varepsilon_2$. Finally, suppose that $\psi(e) = e^2/2$ for all $e \in [0, 1]$, and that $U^o = 0$. In this example, the profit-maximizing contract induces too much (respectively, too little) turnover if $\gamma > 0.845$ (respectively, if $\gamma < 0.845$), where $J_1^2 = \gamma$ is the impulse response of θ_2 to θ_1 .*

The relation between the profit-maximizing thresholds θ_1^* and the impulse response γ of θ_2 to θ_1 is depicted in Figure 1 below (the efficient threshold is $\theta^E = 0$).

³⁸The reader may notice that this example fails to satisfy the assumption that each kernel has the same support. However, recall that such assumption was made only to simplify the exposition. All our results extend to processes with shifting supports, as well as to non-autonomous processes (see the working-paper version of the manuscript, Garrett and Pavan, 2011a).



The example indicates that whether the profit-maximizing threshold for retention is higher or lower than its efficient counterpart depends crucially on the magnitude of the impulse response of θ_2 to θ_1 . When γ is small, the effect of θ_1 on θ_2 is small, in which case the firm can appropriate a large fraction of the surplus generated by the incumbent in the second period. As a result, the firm optimally commits in period one to retain the incumbent for a large set of his period-one productivities. In particular, when γ is very small (i.e., when θ_1 and θ_2 are close to be independent) the firm optimally commits to retain the incumbent irrespective of his period-one productivity. Such a low turnover is clearly inefficient, for efficiency requires that the incumbent be retained only when his expected period-2 productivity is higher than that of a newly hired manager, which is the case only when $\theta_1 \geq \theta^E = 0$.

On the other hand, when γ is close to 1, the threshold productivity for retention under the profit-maximizing policy is higher than the efficient one. To see why, suppose that productivity is fully persistent, i.e. that $\gamma = 1$. Then, as is readily checked, $VS_1(\theta_1) = \mathbb{E}_{\tilde{\theta}_2|\theta_1} [VS_2(\theta_1, \tilde{\theta}_2)]$, where the virtual surplus functions VS_1 and VS_2 are given by (11). In this example, VS_1 is strictly convex. Noting that $\theta^E = \mathbb{E}[\tilde{\theta}_1]$, we then have that $\mathbb{E}[VS_1(\tilde{\theta}_1)] > VS_1(\theta^E) = \mathbb{E}_{\tilde{\theta}_2|\theta^E} [VS_2(\theta^E, \tilde{\theta}_2)]$, i.e., the expected value of replacing the incumbent is greater than the value from keeping him when his first-period productivity equals the efficient threshold. The same result holds for γ close to 1. When productivity is highly persistent, the firm's optimal contract may thus induce excessive firing (equivalently, too high a level of turnover) as compared to what is efficient.

As shown below, the above comparative statics have a natural analog in a dynamic setting by replacing the degree of serial correlation γ in the example with the length of the employment relationship. We start with the following definition.

Definition 2 *The kernels F satisfy the property of “vanishing impulse responses” if, for any $\epsilon > 0$, there exists t_ϵ such that, for all $t > t_\epsilon$, $\eta(\theta_1)J_1^t(\theta^t) < \epsilon$ for all $\theta^t \in \Theta^t$.*

This condition simply says that the effect of the managers' initial productivity on their subsequent productivity eventually vanishes after sufficiently long tenure, and that this occurs uniformly over all histories.

Next, we introduce an additional technical condition that plays no substantial role but permits us to state our key normative result in the cleanest possible manner.

Condition LC [Lipschitz Continuity]: *There exists a constant $\beta \in \mathbb{R}_{++}$ such that, for each $t \geq 2$, each $\theta_1 \in \Theta$, the function $\eta(\theta_1)J_1^t((\theta_1, \cdot))$ is Lipschitz continuous over Θ^{t-1} with Lipschitz constant β ; and (b) there exists a constant $\rho \in \mathbb{R}_{++}$ such that, for $\theta \in \Theta$, the function $f(\theta|\cdot)$ is Lipschitz continuous over Θ with constant ρ .*

We then have the following result (the result in this proposition, as well as the result in Corollary 2 below, refer to the interesting case where $\theta^E \in \text{int}\{\Theta\}$).

Proposition 8 (i) *Suppose that, in addition to the properties of Proposition 5, the kernels F satisfy the property of vanishing impulse responses. There exists $\bar{t} \in \mathbb{N}$ such that, for any $t > \bar{t}$ and any $\theta^t \in \Theta^t$ for which $\theta_t \geq \theta^E$, $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] > \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. (ii) *Suppose, in addition, that F satisfies the properties of Condition LC. Then there exists $\bar{t} \in \mathbb{N}$ such that, for any $t > \bar{t}$, any $\theta^{t-1} \in \Theta^{t-1}$ for which $\kappa_{t-1}^*(\theta^{t-1}) = 1$, $\theta_t^*(\theta^{t-1}) < \theta^E$.**

Part (i) of Proposition 8 establishes existence of a critical length \bar{t} for the employment relationship after which retention is excessive under the profit-maximizing contract. For any $t > \bar{t}$, any $\theta^t \in \Theta^t$, if the manager is retained at the end of period t under the efficient contract, he is also retained under the profit-maximizing contract. Condition LC implies continuity in θ_t of the expected continuation payoffs $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})]$ and $\mathbb{E}_{\tilde{\theta}_{t+1}|\theta^t}[W^E(\tilde{\theta}_{t+1})]$ for any period $t \geq 2$ and history of productivities $\theta^{t-1} \in \Theta^{t-1}$. This in turn establishes that the profit-maximizing retention thresholds will eventually become *strictly* smaller than their efficient counterparts (as stated by Part (ii)).

The proof for Proposition 8 can be understood heuristically by considering the “fictitious problem” that involves maximizing the firm’s expected profits in a setting where the firm can observe its incumbent manager’s types and effort choices, but not those of its future hires. In this environment, the firm optimally asks the incumbent to follow the efficient effort policy in each period, it extracts all surplus from the incumbent (i.e., the incumbent receives a payoff equal to his outside option), and offers the contract identified in Proposition 3 to each new hire.

Now, consider the actual problem. After a sufficiently long tenure, the cutoffs for retaining the incumbent in this problem must converge to those in the fictitious problem. The reason is that, after a sufficiently long tenure, distorting effort and retention decisions has almost no effect on the ex-ante surplus that the firm must leave to the incumbent. Together with the fact that the firm’s “outside option” (i.e., its expected payoff from hiring a new manager) is the same in the two problems, this implies that the firm’s decision on whether or not to retain the incumbent must eventually coincide in the two problems.

Next, note that the firm’s outside option in the fictitious problem is strictly lower than the firm’s outside option in a setting where the firm can observe *all* managers’ types and effort choices.

The reason is that, with asymmetric information, it is impossible for the firm to implement the efficient policies while extracting all surplus from the managers, whilst this is possible with symmetric information. It follows that, after a sufficiently long tenure, the value that the firm assigns to retaining the incumbent relative to hiring a new manager is necessarily higher in the fictitious problem (and therefore in the actual one) than in a setting with symmetric information: the profit that the firm obtains under the incumbent's control is the same, while the payoff from hiring a new manager is lower. Furthermore, because the value that the firm assigns to retaining the incumbent (relative to hiring a new manager) in a setting with symmetric information coincides with the one assigned by the planner when maximizing welfare,³⁹ we have that the firm's retention policy necessarily becomes more permissive than the efficient one after sufficiently long tenure.

The findings of Propositions 6 and 8 can be combined together to establish the following corollary, which contains our key normative result. (The result refers to the interesting case in which the profit-maximizing policy retains each manager after the first period with positive probability, that is, $\theta_1^* < \bar{\theta}$).

Corollary 2 *Suppose that, in addition to the properties of Proposition 5, the kernels F satisfy both the properties of declining and vanishing impulse responses. Then, relative to what is efficient, the profit-maximizing contract either induces excessive retention (i.e., too little turnover) throughout the entire relationship, or excessive firing at the early stages followed by excessive retention in the long run. Formally, there exist dates $\underline{t}, \bar{t} \in \mathbb{N}$, with $1 \leq \underline{t} \leq \bar{t}$, such that (a) for any $t < \underline{t}$, and almost any $\theta^t \in \Theta^t$, if $\kappa_{t-1}^E(\theta^{t-1}) = 1$ and $\kappa_t^E(\theta^t) = 0$, then $\kappa_t^*(\theta^t) = 0$, and that (b) for any $t > \bar{t}$, and almost any $\theta^t \in \Theta^t$, if $\kappa_{t-1}^*(\theta^{t-1}) = 1$ and $\kappa_t^*(\theta^t) = 0$, then $\kappa_t^E(\theta^t) = 0$.*

Hence, any manager who is fired at the end of period $t < \underline{t}$ under the efficient policy is either fired at the end of the same period or earlier under the profit-maximizing contract, whereas any manager fired at the end of period $t > \bar{t}$ under the profit-maximizing contract is either fired at the end of the same period or earlier under the efficient policy.

6 Conclusions

We developed a tractable, yet rich, model of dynamic managerial contracting that explicitly accounts for the following possibilities: (i) turnover is driven by variations in the managers' ability to generate profits for the firm (equivalently, in the match quality); (ii) variations in managerial productivity are anticipated at the time of contracting but privately observed by the managers; (iii) at each point in time, the firm can go back to the labor market and replace an incumbent manager with a new hire;

³⁹Recall that welfare under the efficient contract with asymmetric information coincides with the sum of the firm's expected profits and of all the managers' outside options under the contract that the firm would offer if information about all managers' effort and productivities were symmetric.

(iv) the firm's prospects under the new hire are affected by the same information frictions as in the relationship with each incumbent.

Allowing for the aforementioned possibilities permitted us to identify important properties of the employment relationship. On the positive side, we showed that profit-maximizing contracts require job instability early in the relationship followed by job security later on. These dynamics balance the firm's concern for responding promptly to variations in the environment that call for a change in management with its concern for limiting the level of managerial compensation that is necessary to induce a truthful exchange of information between the management and the board. What in the eyes of an external observer may thus look like "entrenchment" driven by poor governance or lack of commitment, can actually be the result of a fully optimal contract in a world where the board's objectives are perfectly aligned with those of the shareholders. This result, however, does not mean that firms' retention decisions are efficient. We showed that the contracts that firms offer to their top managers either induce excessive retention (i.e., insufficiently low turnover) at all tenure levels, or excessive firing at the early stages followed by excessive retention after long tenure.

Throughout the analysis, we maintained the assumption that the process that matches managers to firms is exogenous. Endogenizing the matching process is an important, yet challenging, direction for future research which is likely to shed further light on the joint dynamics of compensation, performance, and retention decisions.

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Appendix

Proof of Proposition 1. That the efficient effort policy is given by $\xi_t^E(\theta^t) = e^E$ for all t , all θ^t , follows directly from inspection of the firm’s payoff (3), the managers’ payoff (2), and the definition of cash flows (1).

Consider the retention policy. Because all managers are ex-ante identical, and because the process governing the evolution of the managers’ productivities is Markov and autonomous, it is immediate that, in each period, the decision of whether or not to retain a manager must depend only on the manager’s current productivity θ . We will denote by $W^E : \Theta \rightarrow \mathbb{R}$ the value function associated with the problem that involves choosing the efficient Markovian retention policy, given the constant effort policy described above. For any $\theta \in \Theta$, $W^E(\theta)$ specifies the maximal continuation expected

welfare that can be achieved when the incumbent manager's productivity is θ . It is immediate that W^E is the value function of the problem described above only if it is a fixed point to the mapping T_E defined in the main text.

Now let $\mathcal{N}^E \subset \mathcal{B}^E$ denote the space of bounded functions from Θ to \mathbb{R} that are nondecreasing. Below, we first establish existence and uniqueness of a function $\hat{W}^E \in \mathcal{N}^E$ such that $T_E \hat{W}^E = \hat{W}^E$. Next, we verify that $W^E = \hat{W}^E$.

Note that the set \mathcal{N}^E , together with the uniform metric, is a complete metric space. Because the process satisfies the assumption of first-order-stochastic dominance in types, \mathcal{N}^E is closed under T_E . Moreover, "Blackwell's sufficient conditions" (namely, "monotonicity" and "discounting", where the latter is guaranteed by the assumption that $\delta < 1$) imply that T_E is a contraction. Therefore, by the Contraction Mapping Theorem (see, e.g., Theorem 3.2 of Stokey and Lucas, 1989), for any $W \in \mathcal{N}^E$, $\hat{W}^E = \lim_{n \rightarrow \infty} T_E^n W$ exists, is unique, and belongs to \mathcal{N}^E .

Now, we claim that the following retention policy is efficient: for any t , any $\theta^t \in \Theta^t$, $\kappa_{t-1}(\theta^{t-1}) = 1$ implies $\kappa_t(\theta^t) = 1$ if $\mathbb{E}_{\tilde{\theta}|\theta^t} [\hat{W}^E(\tilde{\theta})] \geq \mathbb{E}_{\tilde{\theta}_1} [\hat{W}^E(\tilde{\theta}_1)]$ and $\kappa_t(\theta^t) = 0$ otherwise. Note that, because the process satisfies the assumption of first-order-stochastic dominance in types, and because \hat{W} is nondecreasing, this retention policy is a cut-off policy. This property, together with the fact that the "flow payoffs" $\theta + e^E - \psi(e^E) - (1 - \delta)U^o$ and \hat{W}^E are uniformly bounded on Θ , then permit one to verify, via standard verification arguments, that the constructed policy is indeed efficient and that $W^E = \hat{W}^E$.⁴⁰ ■

Proof of Proposition 3. First, consider the effort policy. It is easy to see that the policy ξ^* that solves the relaxed program is independent of the retention policy κ and is such that $\xi_t^*(\theta^t)$ is given by (8) for all t , all $\theta^t \in \Theta^t$. Next, consider the retention policy. We first prove existence of a unique fixed point $W^* \in \mathcal{B}$ to the mapping $T(\xi^*)$. To this end, endow \mathcal{B} with the uniform metric. That \mathcal{B} is closed under $T(\xi^*)$ is ensured by the restrictions on ψ and by the definition of ξ^* , which together imply that each function $VS_t : \Theta^t \rightarrow \mathbb{R}$ defined by

$$VS_t(\theta^t) \equiv \xi_t^*(\theta^t) + \theta_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1)J_1^t(\theta^t)\psi'(\xi_t^*(\theta^t)) - (1 - \delta)U^o$$

is uniformly bounded over A . Blackwell's theorem implies that $T(\xi^*)$ is a contraction mapping and the Contraction Mapping Theorem (see Stokey and Lucas, 1989) then implies the result. Standard arguments then permit one to verify that $W^*(\theta^t)$ is indeed the value function associated with the problem that involves choosing a retention policy from period t onwards that, given the history of productivities $\theta^t \in \Theta^t$ and given the profit-maximizing effort policy ξ^* , maximizes the firm's total expected discounted profits.⁴¹ Having established this result, it is then easy to see that any retention

⁴⁰This verification is standard in dynamic programming and hence omitted for brevity.

⁴¹The reason why the term $-(1 - \delta)U^o$ disappears from the mapping $T(\xi^*)$ is that this term is constant across t and across all managers.

policy κ^* that, given the effort policy ξ^* , maximizes the firm's total profits must satisfy the conditions in the proposition. ■

Proof of Proposition 4. Consider the linear reward scheme $x = (x_t : \Theta^t \times \mathbb{R} \rightarrow \mathbb{R})_{t=1}^\infty$ where $x_t(\theta^t, \pi_t) = S_t(\theta^t) + \alpha_t(\theta^t)\pi_t$ for all t , with

$$\alpha_t(\theta^t) \equiv \psi'(\xi_t^*(\theta^t)) \quad (12)$$

and

$$\begin{aligned} S_t(\theta^t) &= \psi(\xi_t^*(\theta^t)) - \alpha_t(\theta^t) (\xi_t^*(\theta^t) + \theta_t) + (1 - \delta) U^o \\ &+ \int_{\underline{\theta}}^{\theta_t} \mathbb{E}_{\tilde{\theta}_{>t}^\infty | s} \left[\sum_{k=t}^{\tau(\theta^{t-1}, s, \tilde{\theta}_{>t}^\infty)} \delta^{k-t} J_t^k(s, \tilde{\theta}_{>t}^k) \psi'(\xi_k^*(\theta^{t-1}, s, \tilde{\theta}_{>t}^k)) \right] ds \\ &- \delta \kappa_t^*(\theta^t) \mathbb{E}_{\tilde{\theta}_{t+1} | \theta_t} [u_{t+1}(\tilde{\theta}_{t+1}; \theta^t)] \end{aligned} \quad (13)$$

where

$$u_{t+1}(\theta_{t+1}; \theta^t) \equiv \int_{\underline{\theta}}^{\theta_{t+1}} \mathbb{E}_{\tilde{\theta}_{>t+1}^\infty | s} \left[\sum_{k=t+1}^{\tau(\theta^t, s, \tilde{\theta}_{>t+1}^\infty)} \delta^{k-(t+1)} J_{t+1}^k(s, \tilde{\theta}_{>t+1}^k) \psi'(\xi_k^*(\theta^t, s, \tilde{\theta}_{>t+1}^k)) \right] ds \quad (14)$$

denotes the manager's period-(t+1) continuation payoff (over and above his outside option) under the truthful and obedient strategy.

Note that, because retention does not depend on cash flows, it does not affect the manager's incentives for effort. From the law of iterated expectations, it then follows that, for any given history of reports $\hat{\theta}^{t-1}$ such that the manager is still employed in period $t \geq 1$ (i.e., $\kappa_{t-1}^*(\hat{\theta}^{t-1}) = 1$) and for any period- t productivity θ_t , the manager's continuation payoff at the beginning of period t when the manager plans to follow a truthful and obedient strategy from period t onwards is given by $U^o + u_t(\theta_t; \hat{\theta}^{t-1})$ where⁴²

$$u_t(\theta_t; \hat{\theta}^{t-1}) \equiv \int_{\underline{\theta}}^{\theta_t} \mathbb{E}_{\tilde{\theta}_{>t}^\infty | s} \left[\sum_{k=t}^{\tau(\hat{\theta}^{t-1}, s, \tilde{\theta}_{>t}^\infty)} \delta^{k-t} J_t^k(s, \tilde{\theta}_{>t}^k) \psi'(\xi_k(\hat{\theta}^{t-1}, s, \tilde{\theta}_{>t}^k)) \right] ds.$$

Because $u_t(\theta_t; \hat{\theta}^{t-1}) \geq 0$, the above scheme guarantees that, after any truthful and obedient history, the manager finds it optimal to stay in the relationship whenever the firm's retention policy permits him to do so.

Now, take an arbitrary history of past reports $\hat{\theta}^{t-1}$. Suppose that, in period t , the manager's true type is θ_t and that he reports $\hat{\theta}_t$, then optimally chooses effort $\xi_t(\hat{\theta}^{t-1}, \hat{\theta}_t)$ in period t , and then,

⁴²Note that, under the proposed scheme, a manager's continuation payoff depends on past announcements $\hat{\theta}^{t-1}$, but not on past productivities θ^{t-1} , effort choices e^{t-1} , or cash flows π^{t-1} .

starting from period $t+1$ onwards, he follows a truthful and obedient strategy. One can easily verify that, under the proposed linear scheme, the manager's continuation payoff is then given by

$$\begin{aligned} \hat{u}_t(\theta_t, \hat{\theta}_t; \hat{\theta}^{t-1}) &= u_t(\hat{\theta}_t; \hat{\theta}^{t-1}) + \psi'(\xi_t^*(\hat{\theta}^{t-1}, \hat{\theta}_t))[\theta_t - \hat{\theta}_t] \\ &\quad + \delta \kappa_t^*(\hat{\theta}_t; \hat{\theta}^{t-1}) \left\{ \mathbb{E}_{\tilde{\theta}_{t+1}|\theta_t} [u_{t+1}(\tilde{\theta}_{t+1}; \hat{\theta}^{t-1}, \hat{\theta}_t)] - \mathbb{E}_{\tilde{\theta}_{t+1}|\hat{\theta}_t} [u_{t+1}(\tilde{\theta}_{t+1}; \hat{\theta}^{t-1}, \hat{\theta}_t)] \right\}. \end{aligned}$$

The single-crossing conditions in the proposition then imply that, for all t , all $\hat{\theta}^{t-1} \in \Theta^{t-1}$, all $\theta_t, \hat{\theta}_t \in \Theta_t$,

$$\left[\frac{du_t(\theta_t; \hat{\theta}^{t-1})}{d\theta_t} - \frac{\partial \hat{u}_t(\theta_t, \hat{\theta}_t; \hat{\theta}^{t-1})}{\partial \theta_t} \right] [\theta_t - \hat{\theta}_t] \geq 0.$$

One can easily verify that this condition in turn implies that following a truthful and obedient strategy from period t onwards gives type θ_t a higher continuation payoff than lying in period t by reporting $\hat{\theta}_t$, then optimally choosing effort $\xi_t^*(\hat{\theta}^{t-1}, \hat{\theta}_t)$ in period t , and then going back to a truthful and obedient strategy from period $t+1$ onwards.

Now, to establish the result in the proposition, it suffices to compare the manager's continuation payoff at any period t , given any possible type θ_t and any possible history of past reports $\hat{\theta}^{t-1} \in \Theta^{t-1}$ under a truthful and obedient strategy from period t onwards, with the manager's expected payoff under any continuation strategy that satisfies the following property. In each period $s \geq t$, and after any possible history of reports $\hat{\theta}^s \in \Theta^s$, the effort specified by the strategy for period s coincides with the one prescribed by the recommendation policy ξ_s ; that is, after any sequence of reports $\hat{\theta}^s$, effort is given by $\xi_s(\hat{\theta}^s)$, where $\xi_s(\hat{\theta}^s)$ is implicitly defined by

$$\psi'(\xi_s(\hat{\theta}^s)) = \alpha_s(\hat{\theta}^s). \quad (15)$$

Restricting attention to continuation strategies in which, at any period $s \geq t$, the manager follows the recommended effort policy $\xi_s(\hat{\theta}^s)$ is justified by: (i) the fact that the compensation paid in each period $s \geq t$ is independent of past cash flows π^{s-1} ; (ii) under the proposed scheme, the manager's period- s compensation, net of his disutility of effort, is maximized at $e_s = \xi_s(\hat{\theta}^s)$; (iii) cash flows have no effect on retention. Together, these properties imply that, given any continuation strategy that prescribes effort choices different from those implied by (15), there exists another continuation strategy whose effort choices comply with (15) for all $s \geq t$, all $\hat{\theta}^s$, which gives the manager a (weakly) higher expected continuation payoff.

Next, it is easy to see that, under any continuation strategy that satisfies the aforementioned effort property, the manager's expected payoff in each period $s \geq t$ is bounded uniformly over Θ^s . In turn, this implies that a continuity-at-infinity condition similar to that in Fudenberg and Levine (1983) holds in this environment. Precisely, for any $\epsilon > 0$, there exists t large enough such that, for all $\theta_t \in \Theta_t$, and all $\hat{\theta}^{t-1}, \check{\theta}^{t-1} \in \Theta^{t-1}$, $\delta^t \left| \hat{u}_t(\theta_t; \hat{\theta}^{t-1}) - \check{u}_t(\theta_t; \check{\theta}^{t-1}) \right| < \epsilon$, where \hat{u}_t and \check{u}_t are continuation payoffs under arbitrary continuation strategies satisfying the above effort restriction,

given arbitrary histories of reports $\hat{\theta}^{t-1}$ and $\check{\theta}^{t-1}$. This continuity-at-infinity property, together with the aforementioned property about one-stage deviations from a truthful and obedient strategy, imply that, after any history, the manager's continuation payoff under a truthful and obedient strategy from that period onwards is weakly higher than the expected payoff under *any* other continuation strategy. We thus conclude that, whenever the pair of policies (ξ^*, κ^*) satisfies all the single-crossing conditions in the proposition, it can be implemented by the proposed linear reward scheme. That is, the mechanism $\Omega^* = (\xi^*, \kappa^*, s^*)$ is incentive compatible and periodically individually rational.

That the mechanism Ω^* is optimal follows from Proposition 2 by observing that, under Ω^* , type $\underline{\theta}$ obtains an expected payoff equal to his outside option, i.e., $V^{\Omega^*}(\underline{\theta}) = U^o$. The last claim in the proposition that the policies (ξ^*, κ^*) are implemented under any mechanism that is optimal for the firm then follows from the fact that such policies are the "essentially" unique policies that maximizes (6), where essentially means up to a zero measure set of histories.⁴³ ■

Proof of Corollary 1. The result follows from inspecting the terms S_t and α_t of the linear scheme defined in the proof of Proposition 4. ■

Proof of Proposition 5. Assume that each function $h_t(\cdot) \equiv -\eta(\cdot)J_1^t(\cdot)$ is nondecreasing. Because the function $g(e, h, \theta) \equiv e + \theta - \psi(e) + h\psi'(e) - (1 - \delta)U^o$ has the strict increasing differences property with respect to e and h , each function $\xi_t^*(\cdot)$ is nondecreasing. This property follows from standard monotone comparative statics results by noting that, for each t , each θ^t , $\xi_t^*(\theta^t) = \arg \max_{e \in E} g(e, h_t(\theta^t), \theta_t)$.

Next, we show that, for all t , the function $W^*(\theta^t)$ is nondecreasing. To this aim, let $\mathcal{N} \subset \mathcal{B}$ denote the set of all bounded functions from $A \equiv \cup_{t=1}^{\infty} \Theta^t$ to \mathbb{R} that, for each t , are nondecreasing in θ^t . Note that, since $-\eta(\cdot)J_1^t(\cdot)$ is nondecreasing, so is the function $V S_t(\cdot)$ — this is an immediate implication of the envelope theorem. This property, together with the fact that the process describing the evolution of the managers' productivities satisfies the assumption of "first-order stochastic dominance in types" implies that \mathcal{N} is closed under the operator $T(\xi^*)$. It follows that $\lim_{n \rightarrow \infty} T(\xi^*)^n W$ is in \mathcal{N} . The fact that $T(\xi^*) : \mathcal{B} \rightarrow \mathcal{B}$ admits a unique fixed point then implies that $\lim_{n \rightarrow \infty} T(\xi^*)^n W = W^*$.

The last result, together with "first-order stochastic dominance in types" implies that, for each t , each $\theta^{t-1} \in \Theta^{t-1}$, $\mathbb{E}_{\check{\theta}^{t+1} | (\theta^{t-1}, \cdot)} \left[W^*(\check{\theta}^{t+1}) \right]$ is nondecreasing in θ_t . Given the monotonicity of each function $\mathbb{E}_{\hat{\theta}^{t+1} | (\theta^{t-1}, \cdot)} \left[W^*(\hat{\theta}^{t+1}) \right]$, it is then immediate that the retention policy κ^* that maximizes the firm's profits must be a cut-off rule with cut-off functions $(\theta_t^*(\cdot))_{t=1}^{\infty}$ satisfying the conditions in the proposition. A sequence of cut-off functions $(\theta_t^*(\cdot))_{t=1}^{\infty}$ satisfying these conditions is, for example,

⁴³Formally, any two pair of policies (ξ^*, κ^*) and (ξ', κ') that maximize (6) must implement the same decisions with F-probability one.

the following: for any t , any $\theta^{t-1} \in \Theta^{t-1}$,

$$\theta_t^*(\theta^{t-1}) = \begin{cases} \underline{\theta} & \text{if } \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] > \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)] \text{ for all } \theta_t \in \Theta \\ \bar{\theta} & \text{if } \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] < \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)] \text{ for all } \theta_t \in \Theta \\ \min \left\{ \theta_t \in \Theta : \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] \geq \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)] \right\} & \\ \text{if } \left\{ \theta_t \in \Theta : \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] = \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)] \right\} \neq \emptyset & \end{cases}$$

The property that each $\xi_t^*(\cdot)$ and $\kappa_t^*(\cdot)$ are nondecreasing implies that the policy ξ^* and κ^* satisfy all the single-crossing conditions of Proposition 4. ■

Proof of Proposition 6. We prove the proposition by showing that, for any arbitrary pair of periods s, t , with $s < t$, and an arbitrary history of productivities $\theta^t = (\theta^s, \theta_{>s}^t) \in \Theta^t$, $\theta_s \leq \theta_t$ implies that $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] \geq \mathbb{E}_{\tilde{\theta}^{s+1}|\theta^s}[W^*(\tilde{\theta}^{s+1})]$.

Let $\hat{\mathcal{N}}$ denote the subclass of all functions $W \in \mathcal{B}$ satisfying the following properties: (a) for each s , $W(\theta^s)$ is non-decreasing over Θ^s ; and (b) for any $t > s$, any $\theta^s \in \Theta^s$ and any $\theta_{>t}^t$ such that $\theta^t = (\theta^s, \theta_{>s}^t) \in \Theta^t$, if $\theta_s \leq \theta_t$, then $W(\theta^s) \leq W(\theta^t)$.

We established already in the proof of Proposition 5 that the operator $T(\xi^*)$ preserves property (a). The property of declining impulse responses, together with the property of first-order stochastic dominance in types, implies that $T(\xi^*)$ also preserves (b). The unique fixed point W^* to the mapping $T(\xi^*) : \mathcal{B} \rightarrow \mathcal{B}$ thus satisfies properties (a) and (b) above. First-order stochastic dominance in types then implies that $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] \geq \mathbb{E}_{\tilde{\theta}^{s+1}|\theta^s}[W^*(\tilde{\theta}^{s+1})]$. ■

Proof of Proposition 7. The result follows from the same arguments as in the proof of Proposition 4, by observing that the first-best policies are nondecreasing. ■

Proof of Example 1. Note that $\eta(\theta_1) = \frac{1}{2} - \theta_1$. Thus, $\xi_1^*(\theta_1) = \frac{1}{2} + \theta_1$ and the payoff from hiring a new manager in period 2 is $\mathbb{E} \left[\xi_1^*(\tilde{\theta}_1) + \tilde{\theta}_1 - \psi(\xi_1^*(\tilde{\theta}_1)) - \eta(\tilde{\theta}_1)\psi'(\xi_1^*(\tilde{\theta}_1)) \right] = 1/6$. The manager is thus retained if and only if $\mathbb{E}_{\tilde{\theta}_2|\theta_1} \left[\xi_2^*(\theta_1) + \tilde{\theta}_2 - \psi(\xi_2^*(\theta_1)) - \eta(\theta_1)\gamma\psi'(\xi_2^*(\theta_1)) \right] \geq 1/6$, where $\xi_2^*(\theta_1) = 1 - \frac{\gamma}{2} + \gamma\theta_1$ and $\mathbb{E}_{\tilde{\theta}_2|\theta_1} [\tilde{\theta}_2] = \gamma\theta_1$. The inequality holds for all $\theta_1 \in [-\frac{1}{2}, +\frac{1}{2}]$ if $\gamma \leq 0.242$. Otherwise it holds if and only if $\theta_1 \geq \theta_1^*$ for some $\theta_1^* \in (-\frac{1}{2}, +\frac{1}{2})$ such that $\theta_1^* < 0$ if $\gamma \in (0.242, 0.845)$ and $\theta_1^* > 0$ if $\gamma > 0.845$. ■

Proof of Proposition 8. The proof follows from five lemmas. Lemmas A1-A3 establish Part (i) of the proposition. Lemmas A4 and A5, together with Part (i), establish Part (ii).

Part (i). We start with the following lemma which does not require any specific assumption on the stochastic process and provides a useful property for a class of stopping problems with an exogenous separation payoff.

Lemma A1. For any $c \in \mathbb{R}$, there exists a unique function $W^{E,c} \in \mathcal{B}^E$ that is a fixed point to the mapping $T_{E,c} : \mathcal{B}^E \rightarrow \mathcal{B}^E$ defined, for all $W \in \mathcal{B}^E$, all $\theta \in \Theta$, by

$$T_{E,c}W(\theta) = \theta + e^E - \psi(e^E) - (1 - \delta)U^o + \delta \max \left\{ \mathbb{E}_{\tilde{\theta}|\theta} [W(\tilde{\theta})]; c \right\}.$$

Fix $c', c'' \in \mathbb{R}$ with $c'' > c'$. There exists $\iota > 0$ such that, for all t , all $\theta \in \Theta$,

$$\mathbb{E}_{\tilde{\theta}|\theta}[W^{E,c''}(\tilde{\theta})] \geq c'' \implies \mathbb{E}_{\tilde{\theta}|\theta}[W^{E,c'}(\tilde{\theta})] > c' + \iota.$$

Proof of Lemma A1. Take any $c \in \mathbb{R}$. Because \mathcal{B}^E , together with the uniform metric, is a complete metric space, and because $T_{E,c}$ is a contraction, $T_{E,c}$ has a unique fixed point $W^{E,c} \in \mathcal{B}^E$. Now take a pair (c'', c') , with $c'' > c'$, and let $\mathcal{C}(c'', c') \subset \mathcal{B}^E$ be the space of bounded functions from Θ to \mathbb{R} such that, for all $\theta \in \Theta$, $W(\theta) \geq W^{E,c''}(\theta) - \delta(c'' - c')$. First note that $\mathcal{C}(c'', c')$ is closed under $T_{E,c'}$. To see this, take any $W \in \mathcal{C}(c'', c')$. Then, for any $\theta \in \Theta$,

$$\begin{aligned} T_{E,c'}W(\theta) - W^{E,c''}(\theta) &= T_{E,c'}W(\theta) - T_{E,c'}W^{E,c''}(\theta) \\ &= \delta \left(\begin{array}{c} \max\{\mathbb{E}_{\tilde{\theta}|\theta}[W(\tilde{\theta})]; c'\} \\ - \max\{\mathbb{E}_{\tilde{\theta}|\theta}[W^{E,c''}(\tilde{\theta})]; c''\} \end{array} \right) \\ &\geq -\delta(c'' - c'). \end{aligned}$$

Also, once endowed with the uniform metric, $\mathcal{C}(c'', c')$ is a complete metric space. Hence, from the same arguments as in the proofs of the previous propositions, the unique fixed point $W^{E,c'} \in \mathcal{B}^E$ to the operator $T_{E,c'}$ must be an element of $\mathcal{C}(c'', c')$. That is, for all $\theta \in \Theta$, $W^{E,c'}(\theta) - W^{E,c''}(\theta) \geq -\delta(c'' - c')$.

Finally, for any t , any $\theta \in \Theta$, if $\mathbb{E}_{\tilde{\theta}|\theta}[W^{E,c''}(\tilde{\theta})] \geq c''$, then

$$\mathbb{E}_{\tilde{\theta}|\theta}[W^{E,c'}(\tilde{\theta})] \geq \mathbb{E}_{\tilde{\theta}|\theta}[W^{E,c''}(\tilde{\theta})] - \delta(c'' - c') \geq c'' - \delta(c'' - c') > c' + \iota$$

for some $\iota > 0$. ■

The next lemma establishes a strict ranking between the separation payoffs under the efficient and the profit-maximizing contracts.

Lemma A2. $\mathbb{E}_{\tilde{\theta}_1} [W^E(\tilde{\theta}_1)] > \mathbb{E}_{\tilde{\theta}_1} [W^*(\tilde{\theta}_1)]$.

Proof of Lemma A2. Let $\mathcal{D}(W^E) \subset \mathcal{B}$ be the space of bounded functions W from $A \equiv \cup_{t=1}^{\infty} \Theta^t$ to \mathbb{R} such that $W(\theta^t) \leq W^E(\theta_t)$ for all t , all $\theta^t \in \Theta^t$. The set $\mathcal{D}(W^E)$ is closed under the operator $T(\xi^*)$, as defined in Proposition 3. To see this, let $W \in \mathcal{D}(W^E)$. Then, for all t , all $\theta^t \in \Theta^t$,

$$\begin{aligned} T(\xi^*)W(\theta^t) &= \xi_t^*(\theta^t) + \theta_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1)J_1^t(\theta^t)\psi'(\xi_t^*(\theta^t)) \\ &\quad - (1 - \delta)U^o + \delta \max\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W(\tilde{\theta}^t)], \mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]\} \\ &\leq e^E + \theta_t - \psi(e^E) - (1 - \delta)U^o \\ &\quad + \delta \max\{\mathbb{E}_{\tilde{\theta}|\theta_t}[W^E(\tilde{\theta})], \mathbb{E}_{\tilde{\theta}_1}[W^E(\tilde{\theta}_1)]\} \\ &= T_E W^E(\theta_t) = W^E(\theta_t). \end{aligned}$$

Since $\mathcal{D}(W^E)$, together with the uniform metric, is a complete metric space, and since $T(\xi^*)$ is a contraction, given any $W \in \mathcal{D}(W^E)$, $\lim_{n \rightarrow \infty} T(\xi^*)^n W$ exists and belongs to $\mathcal{D}(W^E)$. Since W^* is the unique fixed point to the mapping $T(\xi^*) : \mathcal{B} \rightarrow \mathcal{B}$, it must be that $W^* = \lim_{n \rightarrow \infty} T(\xi^*)^n W$.

Hence, $W^* \in \mathcal{D}(W^E)$. That is, for any t , any $\theta^t \in \Theta^t$, $W^*(\theta^t) \leq W^E(\theta^t)$. The result then follows by noting that, for any $\theta_1 \in \Theta \setminus \{\bar{\theta}\}$,

$$\begin{aligned}
W^*(\theta_1) &= T(\xi^*)W^*(\theta_1) \\
&= \xi_1^*(\theta_1) + \theta_1 - \psi(\xi_1^*(\theta_1)) - \eta(\theta_1)\psi'(\xi_1^*(\theta_1)) \\
&\quad - (1 - \delta)U^o + \delta \max\{\mathbb{E}_{\tilde{\theta}_2|\theta_1}[W^*(\tilde{\theta}^2)], \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]\} \\
&< \theta_1 + e^E - \psi(e^E) - (1 - \delta)U^o \\
&\quad + \delta \max\{\mathbb{E}_{\tilde{\theta}_2|\theta_1}[W^E(\tilde{\theta}_2)], \mathbb{E}_{\tilde{\theta}_1}[W^E(\tilde{\theta}_1)]\} \\
&= W^E(\theta_1),
\end{aligned}$$

where the inequality is strict because $\eta(\theta_1) > 0$ on $\Theta \setminus \{\bar{\theta}\}$. ■

The next lemma combines the results in the previous two lemmas to establish Part (i) in the proposition.

Lemma A3. *There exists $\bar{t} \geq 1$ such that, for any $t > \bar{t}$, any $\theta^t \in \Theta^t$,*

$$\mathbb{E}_{\tilde{\theta}_{t+1}|\theta^t}[W^E(\tilde{\theta}_{t+1})] \geq \mathbb{E}_{\tilde{\theta}_1}[W^E(\tilde{\theta}_1)] \implies \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] > \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)].$$

Proof of Lemma A3. Recall that $W^{E,c'}$, as defined in Lemma A1, is the value function for the stopping problem with efficient flow payoffs $\theta_t + e^E - \psi(e^E) - (1 - \delta)U^o$ and exogenous separation payoff c' . Now let $c' = \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. Below, we will compare the function $W^{E,c'}$ with the value function W^* associated with the profit-maximizing stopping problem. Recall that the latter is a stopping problem with flow payoffs, for each t , and each θ^t , given by

$$VS_t(\theta^t) \equiv \xi_t^*(\theta^t) + \theta_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1)J_1^t(\theta^t)\psi'(\xi_t^*(\theta^t)) - (1 - \delta)U^o$$

and separation payoff $c' = \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. By the property of “vanishing impulse responses”, for any $\omega > 0$, there exists \bar{t} such that, for any $t > \bar{t}$, any $\theta^t \in \Theta^t$, $VS_t(\theta^t) > \theta_t + e^E - \psi(e^E) - (1 - \delta)U^o - \omega$. That is, for $t > \bar{t}$, the flow payoff in the stopping problem that leads to the firm’s optimal contract is never less by more than ω than the corresponding flow payoff in the stopping problem with efficient flow payoffs and exogenous separation payoff $c' = \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. In terms of value functions, this implies that, for all $t > \bar{t}$, all $\theta^t \in \Theta^t$,

$$W^*(\theta^t) \geq W^{E,c'}(\theta^t) - \frac{\omega}{1 - \delta}. \quad (16)$$

To see this, consider the set $\mathcal{W} \subset \mathcal{B}$ of all bounded functions W from $A \equiv \cup_{t=1}^{\infty} \Theta^t$ to \mathbb{R} such that, for all $t > \bar{t}$, all $\theta^t \in \Theta^t$, $W(\theta^t) \geq W^{E,c'}(\theta^t) - \frac{\omega}{1 - \delta}$ and consider the operator $T_{c'} : \mathcal{B} \rightarrow \mathcal{B}$ defined, for

all $t > \bar{t}$, all $\theta^t \in \Theta^t$, by

$$T_{c'}W(\theta^t) = VS_t(\theta^t) + \delta \max\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W(\tilde{\theta}^{t+1})], c'\}.$$

The set \mathcal{W} is closed under $T_{c'}$. Indeed, if $W \in \mathcal{W}$, then, for any $t > \bar{t}$, any $\theta^t \in \Theta^t$,

$$\begin{aligned} T_{c'}W(\theta^t) - W^{E,c'}(\theta^t) &= VS_t(\theta^t) + \delta \max\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W(\tilde{\theta}^{t+1})], c'\} \\ &\quad - \left(\begin{array}{l} \theta_t + e^E - \psi(e^E) - (1-\delta)U^o \\ + \delta \max\{\mathbb{E}_{\tilde{\theta}_{t+1}|\theta_t}[W^{E,c'}(\tilde{\theta}_{t+1})], c'\} \end{array} \right) \\ &\geq -\omega - \frac{\delta\omega}{1-\delta} = -\frac{\omega}{1-\delta}. \end{aligned}$$

Since \mathcal{W} , together with the uniform metric, is a complete metric space, and since $T_{c'}$ is a contraction, given any $W \in \mathcal{W}$, $\lim_{n \rightarrow \infty} T_{c'}^n W$ exists and belongs to \mathcal{W} . Furthermore, because $c' = \mathbb{E}_{\tilde{\theta}_1} [W^*(\tilde{\theta}_1)]$, it must be that $W^* = \lim_{n \rightarrow \infty} T_{c'}^n W$. Hence, $W^* \in \mathcal{W}$, which proves (16).

Now, let $c'' = \mathbb{E}_{\tilde{\theta}_1} [W^E(\tilde{\theta}_1)]$. By Lemma A2, $c'' > c'$. Now observe that $W^E = W^{E,c''}$. It follows that, for all $t > \bar{t}$ and all $\theta^t \in \Theta^t$, if $\mathbb{E}_{\tilde{\theta}_{t+1}|\theta^t} [W^E(\tilde{\theta}_{t+1})] \geq \mathbb{E}_{\tilde{\theta}_1} [W^E(\tilde{\theta}_1)]$, then

$$\begin{aligned} \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] &\geq \mathbb{E}_{\tilde{\theta}_{t+1}|\theta^t}[W^{E,c'}(\tilde{\theta}_{t+1})] - \frac{\omega}{1-\delta} \\ &> \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)] + \iota - \frac{\omega}{1-\delta}. \end{aligned}$$

The first inequality follows from (16), while the second inequality follows from Lemma A1 using $c' = \mathbb{E}_{\tilde{\theta}_1} [W^*(\tilde{\theta}_1)]$ and choosing ι as in that lemma. The result then follows by choosing ω sufficiently small that $\iota - \frac{\omega}{1-\delta} > 0$. ■

Part (ii). The proof follows from two lemmas. Lemma A4 establishes Lipschitz continuity in θ_t of the expected value of continuing the relationship in period $t+1$, respectively under the firm's profit-maximizing contract and the efficient contract. This result is then used in Lemma A5 to prove Part (ii) of the proposition.

Lemma A4. *Suppose that F satisfies the properties of Condition LC. Then, for each $t \geq 2$ and each $\theta^{t-1} \in \Theta^{t-1}$, $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^{t-1}, \cdot} [W^*(\tilde{\theta}^{t+1})]$ is Lipschitz continuous over Θ . Moreover, $\mathbb{E}_{\tilde{\theta}_1} [W^E(\tilde{\theta})]$ is Lipschitz continuous over Θ .*

Proof of Lemma A4. We show that, for any $t \geq 2$ any $\theta^{t-1} \in \Theta^{t-1}$, $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^{t-1}, \cdot} [W^*(\tilde{\theta}^{t+1})]$ is Lipschitz continuous over Θ . The proof that $\mathbb{E}_{\tilde{\theta}_1} [W^E(\tilde{\theta})]$ is Lipschitz continuous over Θ is similar and omitted. Let

$$M \equiv \frac{e^E + K - \psi(e^E) - (1-\delta)U^o}{1-\delta} \quad \text{and} \quad m \equiv \frac{1 + \beta L + 2\delta\rho MK}{1-\delta}$$

where $K = \max\{|\underline{\theta}|, \bar{\theta}\}$ and $L > 0$ is a uniform bound on ψ' .

We will show that, for any $\theta_1 \in \Theta$, any $t \geq 2$, the function $W^*(\theta_1, \cdot)$ is Lipschitz continuous over $\Theta_{>1}^t = \Theta^{t-1}$ with constant m . For this purpose, let $\mathcal{L}(M, m) \subset \mathcal{B}$ denote the space of functions

$W : A \rightarrow \mathbb{R}$ that satisfy the following properties: (i) for any t , any $\theta^t \in \Theta^t$, $|W(\theta^t)| \leq M$; (ii) for any $\theta_1 \in \Theta$, any $t \geq 2$, $W(\theta_1, \cdot)$ is Lipschitz continuous over $\Theta_{>1}^t$ with constant m ; (iii) for any $\theta_1 \in \Theta$, any $t \geq 2$, $W(\theta_1, \cdot)$ is nondecreasing over $\Theta_{>1}^t$.

We first show that $\mathcal{L}(M, m)$ is closed under the operator $T(\xi^*)$ defined in Proposition 3. To see this, take an arbitrary $W \in \mathcal{L}(M, m)$. First note that, for any t , any $\theta^t \in \Theta^t$,

$$\begin{aligned} T(\xi^*)W(\theta^t) &= VS_t(\theta^t) + \delta \max\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W(\tilde{\theta}^{t+1})], \mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]\} \\ &\leq e^E + K - \psi(e^E) - (1 - \delta)U^o + \delta M = M. \end{aligned}$$

Next note that, for any t , any $\theta^t \in \Theta^t$, $T(\xi^*)W(\theta^t) \geq -K - \delta M > -M$. The function $T(\xi^*)W$ thus satisfies property (i). To see that the function $T(\xi^*)W$ satisfies property (ii), let $t \geq 2$ and consider an arbitrary period τ , $2 \leq \tau \leq t$. Then take two arbitrary sequences $(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t), (\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t) \in \Theta^t$. Suppose, without loss of generality, that $\theta'_\tau > \theta''_\tau$. Then,

$$\begin{aligned} &T(\xi^*)W(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t) - T(\xi^*)W(\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t) \tag{17} \\ &= [\xi_t^*(\theta^t) + \theta_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1)J_1^t(\theta^t)\psi'(\xi_t^*(\theta^t)) - (1 - \delta)U^o]_{\theta^t=(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t)} \\ &\quad - [\xi_t^*(\theta^t) + \theta_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1)J_1^t(\theta^t)\psi'(\xi_t^*(\theta^t)) - (1 - \delta)U^o]_{\theta^t=(\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t)} \\ &\quad + \delta \left(\begin{aligned} &\max\left\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t}[W(\tilde{\theta}^{t+1})], \mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]\right\} \\ & - \max\left\{\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t}[W(\tilde{\theta}^{t+1})], \mathbb{E}_{\tilde{\theta}_1}[W(\tilde{\theta}_1)]\right\} \end{aligned} \right) \end{aligned}$$

The first two terms on the right-hand side of (17) are no greater than $(1 + \beta L)(\theta'_\tau - \theta''_\tau)$. This can be derived as follows. For any $2 \leq \tau \leq t$, any $\theta^t \in \Theta^t$, any $e \in E$, define $g_t(\theta^t, e) = e + \theta_t - \psi(e) - \eta(\theta_1)J_1^t(\theta^t)\psi'(e) - (1 - \delta)U^o$. For any $\theta^t = (\theta^{\tau-1}, \theta_\tau, \theta_{>\tau}^t) \in \Theta^t$, g_t is Lipschitz continuous in θ_τ and $\frac{\partial}{\partial \theta_\tau} g_t(\theta^{\tau-1}, \theta_\tau, \theta_{>\tau}^t, e) \leq 1 + \beta L$ for all $e \in E$ and almost all $\theta_\tau \in \Theta$. The same sequence of inequalities as in Theorem 2 of Milgrom and Segal (2002) then implies the result. The final term on the right-hand side in (17) is no greater than $\delta(2\rho MK + m)(\theta'_\tau - \theta''_\tau)$. This follows because

$$\begin{aligned} &\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t}[W(\tilde{\theta}^{t+1})] - \mathbb{E}_{\tilde{\theta}^{t+1}|\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t}[W(\tilde{\theta}^{t+1})] \tag{18} \\ &= \mathbb{E}_{\tilde{\theta}_{t+1}|\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t}[W(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t, \tilde{\theta}_{t+1})] \\ &\quad - \mathbb{E}_{\tilde{\theta}_{t+1}|\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t}[W(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t, \tilde{\theta}_{t+1})] \\ &\quad + \mathbb{E}_{\tilde{\theta}_{t+1}|\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t}[W(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t, \tilde{\theta}_{t+1}) - W(\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t, \tilde{\theta}_{t+1})] \\ &= \int_{\Theta} W(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t, \theta_{t+1}) [f(\theta_{t+1}|\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t) - f(\theta_{t+1}|\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t)] d\theta_{t+1} \\ &\quad + \mathbb{E}_{\tilde{\theta}_{t+1}|\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t}[W(\theta^{\tau-1}, \theta'_\tau, \theta_{>\tau}^t, \tilde{\theta}_{t+1}) - W(\theta^{\tau-1}, \theta''_\tau, \theta_{>\tau}^t, \tilde{\theta}_{t+1})] \\ &\leq (2\rho MK + m)(\theta'_\tau - \theta''_\tau), \end{aligned}$$

where the inequality follows from the fact that, for any $\theta_{t+1} \in \Theta_{t+1}$, any $(\theta^{\tau-1}, \theta_{>\tau}^t)$, the function $f_{t+1}(\theta_{t+1}|\theta^{\tau-1}, \cdot, \theta_{>\tau}^t)$ is Lipschitz continuous with constant ρ together with the fact that $|\theta_t| \leq K$

all t . We conclude that

$$\begin{aligned} T(\xi^*)W(\theta^{\tau-1}, \theta'_\tau, \theta^t_{>\tau}) - T(\xi^*)W(\theta^{\tau-1}, \theta''_\tau, \theta^t_{>\tau}) &\leq (1 + \beta L + 2\delta\rho MK + \delta m) (\theta'_\tau - \theta''_\tau) \\ &= m (\theta'_\tau - \theta''_\tau). \end{aligned}$$

Since $(\theta^{\tau-1}, \theta'_\tau, \theta^t_{>\tau})$ and $(\theta^{\tau-1}, \theta''_\tau, \theta^t_{>\tau})$ were arbitrary, it follows that for any $\theta_1 \in \Theta$, and any t , the function $T(\xi^*)W(\theta_1, \cdot)$ is Lipschitz continuous over $\Theta^t_{>1}$ with constant m , i.e. $T(\xi^*)W$ indeed satisfies property (ii) above. Lastly that $T(\xi^*)W$ satisfies property (iii) follows from the fact that the mapping $T(\xi^*)$ preserves the monotonicity of W . We thus conclude that $T(\xi^*)W \in \mathcal{L}(M, m)$ which verifies that $\mathcal{L}(M, m)$ is closed under the $T(\xi^*)$ operator. The fact that $\mathcal{L}(M, m) \subset \mathcal{B}$, endowed with the uniform metric, is a complete metric space, together with the fact that $T(\xi^*)$ is a contraction, then implies that $W^* \in \mathcal{L}(M, m)$. Using the same argument as in (18), we then have that $\mathbb{E}_{\tilde{\theta}^{t+1} | (\theta^{t-1}, \cdot)}[W^*(\tilde{\theta}^{t+1})]$ is Lipschitz continuous over Θ with constant $(2\rho MK + m)$. ■

The next lemma uses the result in the previous lemma to establish Part (ii) in the proposition.

Lemma A5. *Suppose that the conditions in Lemma A4 hold. Then the result in Part (ii) in the proposition holds.*

Proof of Lemma A5. Let \bar{t} be as defined in Lemma A3. Take an arbitrary $t > \bar{t}$ and note that $\theta^E \in \text{int}\{\Theta\}$. The continuity of $\mathbb{E}_{\tilde{\theta}}[W^E(\tilde{\theta})]$ established in the previous lemma, implies $\mathbb{E}_{\tilde{\theta}|\theta^E}[W^E(\tilde{\theta})] = \mathbb{E}_{\tilde{\theta}_1}[W^E(\tilde{\theta}_1)]$. Since $t > \bar{t}$, by Lemma A3, it follows that $\mathbb{E}_{\tilde{\theta}^{t+1} | (\theta^{t-1}, \theta^E)}[W^*(\tilde{\theta}^{t+1})] > \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. By Lemma A4, $\mathbb{E}_{\tilde{\theta}^{t+1} | (\theta^{t-1}, \cdot)}[W^*(\tilde{\theta}^{t+1})]$ is continuous. Since $\theta^E \in \text{int}\{\Theta\}$, there exists $\epsilon > 0$ such that, for all $(\theta^{t-1}, \theta_t) \in \Theta^t$ with $\theta_t \in (\theta^E - \epsilon, \theta^E)$, $\mathbb{E}_{\tilde{\theta}^{t+1} | (\theta^{t-1}, \theta_t)}[W^*(\tilde{\theta}^{t+1})] > \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. It follows that $\theta_t^* (\theta^{t-1}) < \theta^E$. ■ □

Proof of Corollary 2. Firstly, consider the case where, for all $\theta_1 > \theta^E$, $\mathbb{E}_{\tilde{\theta}_2|\theta_1}[W^*(\tilde{\theta}^2)] > \mathbb{E}[W^*(\tilde{\theta}_1)]$. Proposition 6, together with the monotonicity property of W^* established in Proposition 5, then implies that, for any $t \geq 1$, any $\theta^t \in \Theta^t$ such that $\theta_1, \theta_t > \theta^E$, $\mathbb{E}_{\tilde{\theta}^{t+1}|\theta^t}[W^*(\tilde{\theta}^{t+1})] > \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$. This means that, for any t any $\theta^t \in \Theta^t$ such that $\kappa_{t-1}^*(\theta^{t-1}) = 1$ and $\kappa_t^*(\theta^t) = 0$, necessarily $\kappa_t^E(\theta^t) = 0$ (except for the possibility that θ^t is such that $\theta_s = \theta^E$ for some $s \leq t$, which, however, has zero measure). That is, any manager who is fired in period t under the firm's profit-maximizing contract, is either fired in the same period or earlier under the efficient contract. The result in the proposition then holds for $\underline{t} = \bar{t} = 1$.

Next, assume that there exists a $\theta_1 > \theta^E$ such that $\mathbb{E}_{\tilde{\theta}_2|\theta_1}[W^*(\tilde{\theta}^2)] < \mathbb{E}_{\tilde{\theta}_1}[W^*(\tilde{\theta}_1)]$, which implies that $\theta_1^* > \theta^E$. By assumption, the manager is retained with positive probability after the first period, i.e. $\theta_1^* \in (\theta^E, \bar{\theta})$. The result then holds by letting $\underline{t} = 2$. In this case, the existence of a $\bar{t} \geq \underline{t}$ satisfying the property in the Corollary follows directly from 8. ■

7 Supplementary Material: not for publication

In these notes, we formally prove that the effort and retention policies that maximize the firm's profits are independent of realized cash flows.

The proof is in two steps. The first step establishes that, in any mechanism that is incentive compatible and periodically individually rational for the agents, the firm's expected profits from each manager it hires are given by a formula analogous to that in Proposition 2 in the main text. The second step then shows that the effort and retention policies of Proposition 3 continue to solve the relaxed program also in this more general environment where effort and retention decisions are allowed to depend also on observed cash flows.

Step 1. Suppose that the firm were to offer a mechanism $\Omega \equiv \langle \xi, x, \kappa \rangle$ where the effort and retention policies $\xi_t(\theta^t, \pi^{t-1})$ and $\kappa_t(\theta^t, \pi^t)$ possibly depend on realized cash flows — note that while the recommended effort choice for each period t naturally depends only on past cash flows, the retention decision may depend also on the cash flow π_t observed at the end of the period.

Following arguments identical to those in the main text, one can then verify that, in *any* mechanism $\Omega \equiv \langle \xi, x, \kappa \rangle$ that is incentive-compatible and periodically individually rational, each manager's intertemporal expected payoff under a truthful and obedient strategy must satisfy

$$V^\Omega(\theta_1) = V^\Omega(\underline{\theta}) + \int_{\underline{\theta}}^{\theta_1} \mathbb{E}_{\tilde{\theta}_{>1}^\infty, v^\infty | s} \left[\sum_{t=1}^{\tau(s, \tilde{\theta}_{>1}^\infty, v^\infty)} \delta^{t-1} J_1^t(s, \tilde{\theta}_{>1}^t) \psi'(\xi_t(s, \tilde{\theta}_{>1}^t, \pi^{t-1}(s, \tilde{\theta}_{>1}^{t-1}, v^{t-1}))) \right] dx \quad (19)$$

where $\pi^{t-1}(\theta^{t-1}, v^{t-1})$ denotes the history of cash flows under a truthful and obedient strategy when the history of productivity realizations is θ^{t-1} and the history of transitory noise shocks is v^{t-1} .

To see this, consider a fictitious environment identical to the one defined in the main text. In this environment, after any history $h_t = (\theta^t, \hat{\theta}^{t-1}, e^{t-1}, \pi^{t-1})$, the agent can misrepresent his productivity to be $\hat{\theta}_t$ but then has to choose effort equal to

$$e_t^\#(\theta_t; \hat{\theta}_t, \pi^{t-1}) = \hat{\theta}_t + \xi_t(\hat{\theta}_t, \pi^{t-1}) - \theta_t \quad (20)$$

so that the distribution of period- t cash flows π_t is the same as when the agent's true period- t productivity is $\hat{\theta}_t$ and he follows the principal's recommended effort choice $\xi_t(\hat{\theta}_t, \pi^{t-1})$.

Now fix an arbitrary sequence of reports $\hat{\theta}^\infty$ and an arbitrary sequence of true productivities θ^∞ and let $C(\hat{\theta}^\infty)$ denote the net present value of the stream of payments that the agent expects to receive from the principal when the sequence of reported productivities is $\hat{\theta}^\infty$ and in each period he chooses effort according to (20). Note that, by construction, C does not depend on the true productivities θ^∞ . Also note that the expectation here is over the transitory noise v^∞ . For any

$(\theta^\infty, \hat{\theta}^\infty)$, the agent's expected payoff in this fictitious environment is then given by

$$\mathcal{U}(\theta^\infty, \hat{\theta}^\infty) \equiv C(\hat{\theta}^\infty) + \mathbb{E}_{v^\infty} \left[- \sum_{t=1}^{\infty} \delta^{t-1} \kappa_{t-1}(\hat{\theta}^{t-1}, \pi^{t-1}(\hat{\theta}^{t-1}, \tilde{v}^{t-1})) \psi(\hat{\theta}_t + \xi_t(\hat{\theta}^t, \pi^{t-1}(\hat{\theta}^{t-1}, \tilde{v}^{t-1}))) - \theta_t \right] \\ + \sum_{t=1}^{\infty} \delta^{t-1} \left(1 - \kappa_{t-1}(\hat{\theta}^{t-1}, \pi^{t-1}(\hat{\theta}^{t-1}, \tilde{v}^{t-1})) \right) (1 - \delta) U^o$$

where $\pi^{t-1}(\hat{\theta}^{t-1}, v^{t-1})$ denotes the history of cash flows that obtains when, given the reports $\hat{\theta}^{t-1}$ and the noise terms v^{t-1} , in each period $s \leq t-1$, the agent follows the behavior described by (20).

As argued in the main text, it is easy to see that if the mechanism Ω is incentive compatible and periodically individually rational in the original environment where the agent is free to choose his effort after misreporting his type, it must also be in this fictitious environment, where he is forced to choose effort according to (20).

Next note that the assumption that ψ is differentiable and Lipschitz continuous implies that \mathcal{U} is totally differentiable in θ^t , any t , and equi-Lipschitz continuous in θ^∞ in the norm

$$\|\theta^\infty\| \equiv \sum_{t=1}^{\infty} \delta^t |\theta_t|.$$

Together with the fact that $\|\theta^\infty\|$ is finite (which is implied by the assumption that Θ is bounded) and that the impulse responses $J_s^t(\theta^t)$ are uniformly bounded, this means that this fictitious environment satisfies all the conditions in Proposition 4 in Pavan, Segal, and Toikka (2011). The result in that proposition in turn implies that, given any mechanism Ω that is incentive compatible and periodically individually rational, the value function $V^\Omega(\theta_1)$ associated with the problem that consists of choosing the reports and then selecting effort according to (20) is Lipschitz continuous and, at each point of differentiability, satisfies

$$\frac{dV^\Omega(\theta_1)}{d\theta_1} = \mathbb{E}_{\tilde{\theta}_{>1}^\infty | \theta_1} \left[\sum_{t=1}^{\infty} \delta^{t-1} J_1^t(\theta_1, \tilde{\theta}_{>1}^t) \frac{\partial \mathcal{U}(\tilde{\theta}^\infty; \tilde{\theta}^\infty)}{\partial \theta_t} \right]$$

where $\partial \mathcal{U}(\theta^\infty, \tilde{\theta}^\infty) / \partial \theta_t$ denotes the partial derivative of $\mathcal{U}(\theta^\infty, \tilde{\theta}^\infty)$ with respect to the true type θ_t under truth-telling. Condition (19) then follows from the fact that

$$\frac{\partial \mathcal{U}(\theta^\infty; \theta^\infty)}{\partial \theta_t} = \mathbb{E}_{v^\infty} \left[\kappa_{t-1}(\theta^{t-1}, \pi^{t-1}(\theta^{t-1}, \tilde{v}^{t-1})) \psi'(\xi_t(\theta^t, \pi^{t-1}(\theta^{t-1}, \tilde{v}^{t-1}))) \right]$$

along with the independence between $\tilde{\theta}^\infty$ and \tilde{v}^∞ .

Going back to the primitive environment, we then conclude that, given any mechanism Ω that is incentive-compatible and periodically individually rational, the firm's expected profits from each manager it hires are given by

$$\mathbb{E}_{\tilde{\theta}^\infty, \tilde{v}^\infty} \left[\left. \begin{aligned} & \sum_{t=1}^{\infty} \delta^{t-1} \kappa_{t-1}(\tilde{\theta}^{t-1}, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1})). \\ & \left\{ \begin{aligned} & \tilde{\theta}_t + \xi_t(\tilde{\theta}^t, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1})) + \tilde{v}_t - \psi(\xi_t(\tilde{\theta}^t, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1}))) \\ & - \eta(\tilde{\theta}_1) J_1^t(\tilde{\theta}^t) \psi'(\xi_t(\tilde{\theta}^t, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1}))) - (1 - \delta) U^o \end{aligned} \right\} \end{aligned} \right] \\ + U^o - V^\Omega(\theta),$$

or, equivalently, denoting by $\tau(\theta^\infty, v^\infty) = \inf\{t : \kappa_t(\theta^t, \pi^t(\theta^t, v^t)) = 0\}$ the stochastic length of the employment relationship,

$$\mathbb{E}_{\tilde{\theta}^\infty, \tilde{v}^\infty} \left[\sum_{t=1}^{\tau(\tilde{\theta}^\infty, \tilde{v}^\infty)} \delta^{t-1} \left\{ \begin{aligned} &\tilde{\theta}_t + \xi_t(\tilde{\theta}^t, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1})) + \tilde{v}_t - \psi(\xi_t(\tilde{\theta}^t, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1}))) \\ &\quad - \eta(\tilde{\theta}_1) J_1^t(\tilde{\theta}^t) \psi'(\xi_t(\tilde{\theta}^t, \pi^{t-1}(\tilde{\theta}^{t-1}, \tilde{v}^{t-1}))) - (1 - \delta) U^o \end{aligned} \right\} \right] (21)$$

$$+ U^o - V^\Omega(\underline{\theta}).$$

Step 2. Consider now the “relaxed program” that consists of choosing the policies $(\xi_t(\cdot), \kappa_t(\cdot))_{t=1}^\infty$ so as to maximize the sum of the profits the firm expects from each manager it hires, taking the contribution of each manager to be (21), and subject to the participation constraints of the lowest period-1 types $V^\Omega(\underline{\theta}) \geq U^o$.

To see that the policies ξ^* and κ^* of Proposition 3 solve the relaxed program defined above, we then proceed as follows. First, fix an arbitrary effort and retention policies ξ and κ and note that for any $(\theta^\infty, v^\infty)$, any $t < \tau(\theta^\infty, \tilde{v}^\infty)$, the flow virtual surplus

$$\begin{aligned} &\theta_t + \xi_t(\theta^t, \pi^{t-1}(\theta^{t-1}, v^{t-1})) + v_t - \psi(\xi_t(\theta^t, \pi^{t-1}(\theta^{t-1}, v^{t-1}))) \\ &\quad - \eta(\theta_1) J_1^t(\theta^t) \psi'(\xi_t(\theta^t, \pi^{t-1}(\theta^{t-1}, v^{t-1}))) - (1 - \delta) U^o \\ \leq &\theta_t + \xi_t^*(\theta^t) + v_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1) J_1^t(\theta^t) \psi'(\xi_t^*(\theta^t)) - (1 - \delta) U^o. \end{aligned}$$

This follows immediately from the fact that, for any t , any $\theta^t \in \Theta^t$, the function

$$\theta_t + e + v_t - \psi(e) - \eta(\theta_1) J_1^t(\theta^t) \psi'(e) - (1 - \delta) U^o$$

is maximized at $e = \xi_t^*(\theta^t)$, where $\xi_t^*(\theta^t)$ is as in Proposition 3.

Next let κ' be any retention policy that, given the effort policy ξ^* , in each state $(\theta^\infty, v^\infty)$ implements the same retention decisions as the original rule κ . That is, denoting by $\pi^{*t-1}(\theta^{t-1}, v^{t-1})$ the equilibrium history of cash flows under the effort policy ξ^* , κ' is such that, for any $t \geq 1$, any (θ^{t-1}, v^{t-1})

$$\kappa'_{t-1}(\theta^{t-1}, \pi^{*t-1}(\theta^{t-1}, v^{t-1})) = \kappa_{t-1}(\theta^{t-1}, \pi^{t-1}(\theta^{t-1}, v^{t-1})).$$

It is then immediate that the firm’s intertemporal expected profits under the policies (κ', ξ^*) are weakly higher than under the original policies (κ, ξ) . In fact, while the separation decisions are the same under the two policies κ and κ' , for each manager the firm hires, and for each state $(\theta^\infty, v^\infty)$, the virtual surplus in each period t prior to separation is higher under the effort policy ξ^* than under the policy ξ .

Next, observe that, starting from the pair of policies (ξ^*, κ') , if the principal were to switch to the pair of policies (ξ^*, κ^*) of Proposition 3, then the firm’s expected profits would be higher. This follows from the fact that the flow virtual surplus

$$\theta_t + \xi_t^*(\theta^t) + v_t - \psi(\xi_t^*(\theta^t)) - \eta(\theta_1) J_1^t(\theta^t) \psi'(\xi_t^*(\theta^t)) - (1 - \delta) U^o \quad (22)$$

that the firm obtains from each manager it hires after any length t of employment and for each productivity history θ^t is the same under (ξ^*, κ') as it is under (ξ^*, κ^*) , along with the fact that, by construction, the retention rule κ^* of Proposition 3 maximizes the firm's intertemporal payoff when the flow virtual surpluses are given by (22).

We conclude that the policies (ξ^*, κ^*) of Proposition 3 solve the relaxed program defined above. In turn, this implies that whenever there exists a compensation scheme x^* that implements these policies and gives the lowest period-1 type an expected payoff $V^\Omega(\underline{\theta})$ equal to his outside option, then the firm's payoff cannot be improved by switching to any other mechanism, including those where the effort and retention policies possibly depend on realized cash flows.