Crushing the Competition: the Pro-Competitive Effects of Relative Performance Evaluation

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Abstract

Relative Performance Evaluation (RPE) is a feature of executive compensation contracts that benchmarks a manager's performance against that of a group of competitors. Economic theory predicts that firms who adopt RPE will display more aggressive product market conduct (i.e. charge lower prices). The extent of RPE adoption and its product market effects remain disputed: firm filings suggest that RPE is common, yet mangers' pay does not correlate with competitors' performance. We study the product market effects of RPE, using a general equilibrium oligopoly model with ultra-realistic managerial incentives, which we discipline with granular data from over 60,000 executive compensation contracts. We find that RPE adoption is widespread and increasing. However, pay remains largely tied to absolute rather than relative objectives, and relative performance is often measured against the broader stock market rather than a few close rivals. These adoption patterns significantly dampen the product market effects of RPE, thus reconciling the seemingly contradictory evidence. Counterfactual simulations suggest that RPE could enhance competition and consumer welfare by lowering markups and increasing output, but these effects remain muted under current adoption patterns.

JEL Codes: D2, D4, D6, E2, L1, L2, M1, M5, O4

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