Identity and the Economics of Organizations
By George A. Akerlof and Rachel E. Kranton, Journal of Economic Perspectives—Winter 2005

In this paper, Nobel prize winner George Akerlof, well known for his Theory of Lemons, and Rachel Kranton, present a principal-agent model that incorporates the notion of identity. Employees may have identities that lead them to behave more or less in concert with the goals of their organizations. With such an identity, workers are willing to put in high effort. Identity is an important supplement to monetary compensation. Monetary incentives remain a blunt instrument. First, compensation schemes can be based only on variables (such as output or profits) that are observable to management. But such variables are most often imperfect indicators of individual effort, as when—for example—output derives from workers' collective efforts in a team. Moreover, many monetary incentive schemes create opportunities for workers to game the system. For example, most jobs involve multiple tasks. In this case, workers will have incentive to overperform on the tasks that are well rewarded and to underperform on the tasks that are poorly rewarded. Tournaments, where pay depends upon relative performance, reduce the need for information, but create another problem because workers may try to sabotage one another. So, to function well, an organization should not rely solely on monetary compensation schemes. The ability of organizations to place workers into jobs with which they identify and the creation of such identities are central to what makes organizations work.