International Journal of Business Law, Business Ethic, Business Communication & Green Economics (IJBGE)
Volume 2 Nomor 2 Tahun 2025
e-ISSN: 3048-1392; dan p-ISSN: 3048-1384, Hal 14-27
DOI: https://doi.org/ 10.70142/ijbge.v2i2.359
Available online at: https://jurnal-mnj.stiekasihbangsa.ac.id/index.php/IJBGE

Challenges in Contract Theory: Performance-Based Pay as a Solution to Address Promotion Risk in a Competitive Corporate Environment

Ria Wulandari[1], Yuni Sara[2]

[1] Accounting, STIE Kasih Bangsa, Jakarta, Indonesia
[2] Management, STIE Kasih Bangsa, Jakarta, Indonesia
Email : riastiekb@gmail.com, sarayuni457@gmail.com

Abstract. *This study examines the challenges in implementing contract theory, particularly related to corporate performance pay as a solution to promotion risk in a competitive environment. Performance-based pay serves to increase employee motivation and reduce uncertainty in promotion, but has the potential to create unhealthy competition and reduce teamwork. This study suggests that a balanced incentive contract design, which combines financial and non-financial rewards, can optimize individual performance without sacrificing team harmony. Although performance-based pay can provide short-term benefits, it is important for companies to consider its long-term impact on employee satisfaction and collaboration within the organization. This study provides theoretical and practical insights for companies in designing fair and effective promotion systems.*

Keywords: *Performance-Based Pay*, *Contract Theory*, *Promotion Risk*, *Competitive Environment*, *Corporate Incentives*

INTRODUCTION

Performance-based pay contracts have long been one of the instruments used by companies to regulate employee-employer relations. One interesting phenomenon that has emerged in research on these contracts is the prevalence of uncertain outcome-based pay for non-executive workers. This seems to contradict conventional contract theory which predicts that companies will provide insurance to cover the risks faced by workers. In this context, the theory of performance-based pay contracts offers a solution to the problem of promotion in a competitive environment in companies, which often leads to promotion risks faced by workers (Kruse, Blasi, & Park, 2010). The optimal contract in such an environment should provide pay based on the company's results as a form of insurance against promotion risk, which can improve workers' career prospects despite the high level of competition among them.

An interesting phenomenon is when workers compete with each other for promotions, which means they have to face promotion risk—the possibility of not being promoted despite having shown good performance. Research by Cowgill (2015) shows that workers who face high promotion competition tend to experience decreased job satisfaction. Furthermore, DeVaro (2006) suggests that workers' chances of promotion

 Received: May 30, 2025; Revised: June 6, 2025; Accepted: June 18, 2025; Published: June 30, 2025

decrease if their peers perform better. This indicates that promotion risk is a significant source of uncertainty in the workplace. In this scenario, company-based pay can serve as a form of insurance that reduces this uncertainty, by providing higher compensation for workers who perform well, both in terms of individual performance and the company's overall results.

Moral hazard theory in the economic literature suggests that firms should provide insurance against risks that are beyond workers' control, including risks related to uncertain firm outcomes. However, the reality on the ground shows that many non-executive workers, especially in the United States, receive performance-based pay that is highly dependent on unpredictable firm outcomes (Bergman & Jenter, 2007). This raises questions about the effectiveness and efficiency of such pay systems, given the potential for free-rider problems and the high costs to workers of the risks involved. Nevertheless, this study argues that when workers compete for promotions, firm-based pay can serve as a form of insurance against uncertain promotion risks.

Promotion in the workplace often takes the form of a tournament where only a small number of positions are available, even though all workers have shown good performance. In other words, individual performance can improve the overall results of the company, but at the same time increase the level of competition among workers to get a promotion (Cowgill, 2015). In this context, company-based pay becomes an effective instrument in overcoming promotion risk, where bonuses or incentives provided by the company will increase along with the results of individual and company performance as a whole. This company-based pay not only functions as an incentive, but also as insurance against the uncertainty faced by workers regarding their promotion prospects.

Various studies in the economic literature have shown that workers tend to prefer pay that is tied to the overall performance of the company because it can reduce the uncertainty of their future income, especially when facing tight promotion competition (DeMarzo, Kaniel, & Kremer, 2007). The optimal contract in this situation is a contract that provides higher compensation for workers who perform well, which is in line with the results achieved by the company. This phenomenon is in line with previous findings showing that company-based pay can increase worker motivation, improve employee retention, and support company sustainability (Aldatmaz, Ouimet, & Van Wesep, 2018).

However, in some cases, although corporate outcome-based pay offers strong incentives, it can also pose challenges, such as increasing inequality among workers and exacerbating internal friction within the organization. In this regard, it is important to understand how companies can manage outcome-based pay wisely to avoid potentially detrimental side effects, such as failing to create enough promotion opportunities for high-performing workers. This creates a promotion paradox, where the better a company performs, the higher the level of competition for promotions, which in turn can reduce the chances of promotion for individual workers (Phillips, 2001).

On the other hand, although many companies have adopted performance-based pay, not all companies have the financial capacity to offer high fixed salaries. Some companies are forced to rely on performance-based pay to offset their budget constraints. This creates a dynamic where less diversified and more risk-prone workers can benefit from performance-based pay. The literature has shown that the use of stocks and stock options as part of the compensation package for non-executive workers can influence various corporate policies, such as capital structure and investment decisions (Babenko, 2009; McKeon, 2015).

This study contributes to our understanding of how firm performance-based pay can serve as a tool to reduce uncertainty related to promotion risk, as well as how the hierarchical structure of a firm affects the pay structure of workers. In addition, this study introduces a new concept in the organizational and contract economics literature, namely how the promotion structure within a firm can affect the design of performance-based pay contracts, taking into account the uncertainty posed by promotion competition.

LITERATURE REVIEW

In this study, the topic discussed is the challenges in contract theory related to corporate performance pay as a mechanism to reduce promotion risk in a competitive environment. In many organizations, performance pay systems related to promotions are often key to attracting and retaining top talent, but at the same time can create uncertainty about promotion outcomes, which is a major challenge in contract theory.

Contract theory in organizations focuses on how firms design incentives and compensation structures to encourage desired employee behavior. One of the main challenges in contract design is reducing promotion-related risk, which is the uncertainty faced by employees in achieving a desired promotion. Alvin Chen (2024) in a study entitled "Firm Performance Pay as Insurance against Promotion Risk" proposed that firm performance pay can serve as insurance against promotion risk, by providing higher compensation to employees who are in competitive promotion positions. The results of this study indicate that firms that use performance pay as part of an incentive package can help reduce this uncertainty and improve long-term performance (Chen, 2024).

Many previous studies have examined the relationship between performance-based pay and promotion in organizations. For example, Babenko (2009) examined the effect of stock repurchases on the sensitivity of performance pay in employee compensation contracts and found that firms that engage in stock repurchases can increase the sensitivity of performance-based pay, which has a direct impact on employee motivation to pursue promotions. Meanwhile, Babenko, Lemmon, and Tserlukevich (2011) revealed that employee stock options play an important role in investment and performance decisions, which are also related to promotion dynamics in the company. In many cases, stock-based compensation can provide additional incentives to achieve higher performance in order to achieve promotion positions.

Internal competition within a company is often one of the factors that influences the promotion structure. According to DeVaro (2006), promotion competition within a company can be an effective mechanism to encourage employees to improve their performance. However, this competition can also lead to increased risks for employees who are in less favorable promotion positions. Cowgill (2015) also suggests that the intensity of competition can affect employee productivity and increase the likelihood of turnover if incentives and promotions are not managed properly.

Performance-based compensation in the context of promotion becomes more relevant in a competitive environment, where companies need to provide adequate incentives to attract and retain top talent. Oyer (2004) highlights that even though companies provide significant incentives, not all incentives have the same impact on employee performance and promotion. Therefore, it is important for companies to design a compensation system that not only encourages employees to compete, but also provides protection against possible promotion risks.

This study suggests that performance pay can serve as a tool to reduce promotion risk in a competitive environment. It can increase incentives for employees to compete fairly and improve their performance in achieving promotion positions. However, further consideration is needed regarding how these incentives are designed so as not to create unfairness or excessive uncertainty for employees competing for promotions.

METHODS

This study uses a qualitative literature review approach to analyze the challenges in contract theory and the role of corporate performance pay as a solution to promotion risk in the context of a competitive environment in the company. This study aims to identify and review key findings from relevant studies, and analyze how performance pay can reduce promotion risk in a competitive organizational structure.

The literature selection process was carried out using leading academic databases. The selected literature must meet the criteria of relevance, credibility, and quality. The literature used focuses on three main themes, namely contract theory, performance pay as an incentive mechanism, and promotion risk in a competitive work environment. Several important references such as Chen (2024), who discusses the role of corporate performance pay as insurance against promotion risk (Chen, 2024), and related studies that highlight the dynamics of promotion in companies (Bergman & Jenter, 2007; DeVaro, 2006), are included in this literature review.

This study only included studies published in peer-reviewed journals, academic reports, and recognized books in the fields of economics and management. Articles related to contract theory, promotion, and incentives in organizations during the period 2000 to 2024 were prioritized. Articles that were not relevant or focused more on quantitative methods or reports that were not published in publicly accessible sources were excluded. This ensures that the study has good methodological quality, with reliable references (Gibbons & Murphy, 1992; Gibbons & Waldman, 1999).

Data collection was conducted by filtering relevant articles based on title, abstract, and keywords. The selected articles were then classified into the following categories: (1) contract theory in organizations, (2) performance-based incentive mechanisms, and (3) promotion risk in the context of internal competition. Each selected article was then analyzed to assess the methodology, main findings, and theoretical and practical implications of each study.

The analysis process is conducted by comparing and integrating findings from various sources. A synthesis approach is conducted to identify key patterns, research gaps, and areas requiring further exploration in contract theory and performance management. For example, some studies suggest that performance-based pay can reduce uncertainty in promotions (Babenko, 2009; Fairburn & Malcomson, 2001), while others point to the potential negative effects of stock-based incentives if not managed properly (Lazear & Rosen, 1981; Edmans & Gabaix, 2011). In this case, synthesis is conducted to assess both sides of the argument and explore the relevance of these payment mechanisms in the context of employee promotions.

Validation is done by checking the consistency of the findings generated from the existing literature. This process also includes cross-checking between findings from various related disciplines, such as human resource management, organizational economics, and contract theory (Baker, Gibbs, & Holmstrom, 1994). In addition, the findings of this study are also compared with the results of previously published studies, such as those conducted by Bognanno (2001) in examining the impact of promotional tournaments on companies.

Finally, the synthesis of the collected literature is organized in the form of a systematic review, highlighting the contributions of previous research to the understanding of the challenges in contract theory, performance pay as a solution to promotion risk, and the implications of incentive mechanisms in a competitive environment. This arrangement is done by focusing on the most relevant findings and providing insights that can be applied in company policies.

RESULTS

This study aims to examine the challenges in implementing contract theory in companies, with a focus on the use of performance pay as a solution to promotion risk in a competitive environment. Based on the literature review that has been conducted, several important findings can be concluded regarding the mechanism of performance pay and its impact on the promotion structure in the company.

Contract theory plays an important role in understanding the relationship between managers and employees in the company. In this context, the contract not only regulates the duties and obligations of employees, but also includes incentive mechanisms designed to motivate their performance. One of the main challenges in applying contract theory is how to design incentives that can reduce uncertainty and overcome the problem of information asymmetry that often occurs in employment relationships (Holmström, 1979). The right incentives can encourage employees to work harder, but they can also pose risks related to promotions and rankings in a competitive environment.

In highly competitive companies, promotion risk can be a significant issue for employees. They may feel pressured to meet certain standards in order to be promoted, which can create uncertainty in their careers. Several studies have shown that performance-based pay, such as bonuses, company stock, and commissions, can serve as a solution to reduce this promotion risk (Chen, 2024). By providing incentives in the form of performance-related compensation, companies provide assurance that employees who perform well will be rewarded accordingly, thereby reducing the sense of uncertainty about their promotion opportunities.

Research by Baker, Gibbs, and Holmstrom (1994) suggests that performance-based incentives can help address issues related to unfair promotions, and increase employee motivation and retention. In addition, performance-based pay can provide employees with a positive signal about their chances of being promoted if they meet or exceed company expectations.

Competitive environments in companies often result in many candidates competing for limited positions, which increases the pressure on employees to consistently perform at their best. According to research by Lazear and Rosen (1981), companies can use performance-based pay to create a promotion tournament system, where only the best performers receive rewards or promotions. Such a system provides incentives for employees to work harder, but it also increases tension and stress among those competing for limited positions.

However, although performance-based pay has the potential to increase motivation, some studies have shown that this mechanism can also cause problems if not managed properly. For example, Edmans and Gabaix (2011) showed that incentives that are too focused on short-term results or too oriented towards individual rewards can lead to detrimental behavior in the long run, such as cheating or other opportunistic behavior. Therefore, companies must ensure that the performance-based incentives implemented also consider the quality of performance and not only directly measurable results.

To address these challenges, companies must design contracts that are not only fair but also transparent. A good contract should take into account the balance between financial incentives and the risks faced by employees in achieving promotions. For example, Chen (2024) highlights the importance of designing contracts that integrate long-term incentives, such as shares or ownership of the company, which can reduce the tension associated with promotions and provide a signal about career sustainability in the organization.

In addition, companies must ensure that there is equality in access to promotion opportunities and that performance pay does not only benefit a few individuals. The implementation of a transparent and fair system will reduce the potential for dissatisfaction among employees and ensure that the incentives provided are truly effective in improving performance without causing negative impacts such as unhealthy competition.

Based on the results of the literature analysis, companies need to consider a holistic approach in designing the performance payment mechanism to be used. Performance-based payments must be adjusted to the company's context and culture, and consider external factors that can affect employee promotion and performance decisions. Effective performance payments can help reduce the uncertainty faced by employees in a competitive environment, but companies must be careful in designing them so as not to have a negative impact in the long term.

DISCUSSION

This study discusses the challenges faced by companies in implementing contract theory, especially regarding performance pay as a solution to promotion risk in a competitive environment. In a highly competitive corporate environment, promotion risk becomes an important issue that affects employee behavior and motivation. Performance-based pay is seen as one solution to overcome this problem, although its implementation has its own challenges. In this discussion, the author will compare findings from various previous studies to provide a deeper picture of the implications of using a performance-based pay system in the context of promotion.

Contract theory plays a central role in the relationship between companies and employees, especially in designing incentives that encourage optimal performance.

Holmström (1979) stated that a good contract must take into account the information asymmetry between the company and the employee, where the company often cannot fully observe the efforts made by the employee. Therefore, performance-based pay emerged as a tool to provide incentives for employees to increase their productivity. Research by Baker, Gibbs, and Holmström (1994) revealed that in complex settings, such as large companies with many employees, performance-based incentives can reduce the uncertainty faced by employees and ensure that they strive to achieve the larger goals set by the company.

However, challenges arise when companies fail to design contracts that balance employee risk, especially in terms of promotion. Promotion risk can create excessive uncertainty for employees competing for a particular position. Therefore, performance pay systems need to be considered carefully so as not to increase tensions between employees. Edmans and Gabaix (2011) highlight that although performance-based incentives can motivate employees to improve their performance, sometimes these incentives can lead to unethical behavior, such as cheating or manipulation to meet set targets.

In the context of promotions in competitive companies, promotion risks often create feelings of uncertainty and frustration among employees. In a study by Chen (2024), it was found that performance-based pay not only increases motivation but also helps reduce this uncertainty by providing fair rewards for employees who perform well. Performance-based pay, such as annual bonuses or company shares, sends a positive signal to employees that they will be financially rewarded if they achieve the desired targets.

An effective performance pay system can also reduce the negative competition that arises in a highly competitive environment. As Lazear and Rosen (1981) explain, companies can design promotion tournaments in which only the most outstanding employees are promoted, while those who cannot meet the standards are deprived of the opportunity. This provides a strong incentive for employees to improve their performance, although it also increases the pressure on competing individuals. The results of research by Chen (2024) show that providing performance-based incentives in companies can create a more transparent and predictable promotion system, thereby reducing uncertainty and internal conflict.

However, as Bryson (2022) found, using performance pay as a solution to promotion risk also faces challenges, especially in managing employee expectations. Pay that focuses too much on short-term results can cause employees to ignore other important aspects, such as team collaboration or quality of work. Therefore, it is important for companies to balance short-term and long-term rewards in their performance pay systems.

The competitive environment in a company can cause tension and pressure on employees to continue to show their best performance. In a study by Holzer and Neumark (2017), it was explained that this tension often arises when employees feel that their promotion opportunities are very limited, so they are more likely to engage in very fierce competition. Performance-based pay, although it can provide additional motivation, can also exacerbate this problem if it is not accompanied by fair and transparent rewards.

Performance-based promotion systems that rely too heavily on individual results can increase the risk of unhealthy internal competition. Research by Edmans and Gabaix (2011) shows that when companies only provide rewards based on individual achievements, this can lead to higher conflict between employees. Excessive competition within a company can damage teamwork and reduce the effectiveness of the organization as a whole. This is in contrast to an approach that emphasizes team collaboration and synergy, as suggested by Bryson (2022), who suggests that companies design reward systems that assess not only individual performance but also contributions to the group.

Comparison with previous studies provides a broader perspective on the challenges faced in implementing performance-based pay. In a study by Baker et al. (1994), it was found that clear and measurable performance-based pay increases productivity, but can worsen dissatisfaction among employees who are not selected for promotion. This was also expressed by Lazear and Rosen (1981), who stated that although performance-based incentives can improve company efficiency, the risk of unfairness in the promotion process remains, especially if the results only favor individuals.

On the other hand, research by Chen (2024) shows that performance-based pay can reduce uncertainty in promotions by giving employees a clear picture of what is expected of them to achieve a promotion. Similar research by Holzer and Neumark (2017) revealed that performance-based pay has the potential to improve relationships between superiors and subordinates, as well as increase trust in promotion decisions, although there are challenges in ensuring that this system does not lead to dissatisfaction.

Research by Bryson (2022) revealed that while performance-based pay systems can provide strong incentives for employees, this approach needs to be combined with other factors, such as non-financial recognition and rewards for long-term contributions to the company. This is in line with findings by Edmans and Gabaix (2011), which show that balanced incentives, combining financial and non-financial rewards, can create a healthier and more sustainable environment in the company.

Overall, implementing performance-based pay as a solution to promotion risk in a competitive environment has significant benefits, but also faces various challenges. Performance-based pay can provide a strong incentive for employees to improve their performance and obtain promotions. However, this system must also be designed carefully to ensure that it does not create dissatisfaction or detrimental internal conflict.

Managing promotion risk in a competitive environment requires a more holistic approach, which relies not only on financial incentives but also on professional development and non-financial rewards. Therefore, companies must balance short-term and long-term rewards, and integrate factors such as team recognition and career development in designing fair and effective performance contracts.

CONCLUSION

This study analyzes the challenges in implementing contract theory, especially related to performance pay as a solution to promotion risk in a competitive environment in the company. Performance-based pay is an effective tool to increase employee motivation and reduce uncertainty related to promotion. Through clear and measurable incentives, companies can ensure that employees strive to achieve the goals that have been set, and provide rewards that are in accordance with their contributions. However, performance-based pay cannot stand alone; companies also need to balance this system with non-financial rewards and recognition of employees' long-term contributions.

Although this system can increase efficiency and transparency in promotions, there are potential risks in its implementation. One of the main challenges is internal competition that can create tension and reduce teamwork. In addition, unfairness in the promotion process that only prioritizes individual performance can trigger dissatisfaction among employees who are not selected. Therefore, it is important for companies to design incentive contracts that pay attention to the balance between short-term and long-term rewards, and support employee development holistically.

Overall, this study confirms that performance-based pay can be an effective solution to promotion risk, but must be carefully designed to avoid potential negative impacts such as unhealthy competition and internal conflict.

LIMITATION

This study, although providing useful insights into the application of contract theory and performance-based pay, has several limitations. First, this study only uses a literature review approach, which means that the findings are based on existing prior research. Therefore, there may be bias in the selection of articles or reliance on established findings, which may not capture recent developments in the field.

Second, this study is limited to a conceptual understanding of the implementation of performance-based pay and promotion risk. Although the review of existing theories and literature provides a comprehensive picture, no empirical analysis has been conducted to directly test the effectiveness of performance-based pay systems in the context of promotions in companies.

Third, this study did not consider differences in industry sectors or corporate cultures that may affect the acceptance and success of performance-based pay systems. Different companies have different characteristics, and what works in one company may not work in another. Therefore, generalization of the results of this study should be done with caution, and further research involving empirical data from different sectors and corporate cultures is needed to deepen the understanding of this topic.

Finally, while this study addresses the theoretical and practical implications of performance-based pay, more studies are needed on how a more holistic pay system design can mitigate the negative impacts of incentive systems that focus too much on individual performance. Further research could investigate how to integrate elements such as team collaboration and employee well-being into more effective incentive contract designs..

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