



# Promotion, turnover and preemptive wage offers

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## Abstract

**Purpose** – The reason for writing the paper is to cast doubt on the claim that the informational asymmetries uncovered by Bernhardt and Scoones constitute a market failure.

**Design/methodology/approach** – The main method used is to quote these authors, and then critically comment upon their views. The theoretical scope of the paper is the premise that markets are efficient, effective and ethical.

**Findings** – It was found in the course of the work that Bernhardt and Scoones were in error in their contentions.

**Research limitations/implications** – Suggestions for future research; this paper is but the tip of the iceberg in terms of claims that markets perform badly, and are hence in need of governmental rectification. This entire literature cries out for more critical analysis.

**Practical implications** – The public policy and practical implications emanating from this paper is that laissez-faire capitalism is the best way to organize an economy.

**Originality/value** – What is new in the paper is that the work of Bernhardt and Scoones on informational asymmetries has not before been subject to critical analysis from the perspective of advocates of the free enterprise system. This is valuable, in that, when claims are subject to critique, they become more reliable. It is only through dialogue and debate of this sort that one can get that in closer to the truth.

**Keywords** Promotion, Information control, Employees, Jobs, Pay

**Paper type** Conceptual paper

## Comment on “Promotion, turnover and preemptive wage offers” by Dan Bernhardt and David Scoones

Bernhardt and Scoones (1993 p. 771) examine the strategic promotion and wage policies of employers and claim to have discovered a new market failure: “... An employer has an incentive to exploit its private information about an able worker by not promoting the worker as quickly or often as is socially optimal” [1]. Why? Because there is an asymmetry of information[2]. Employer A, presumably, knows far more about his own employee, a, than alternative employer B, potentially competing for this employee. A cheap way for B to ascertain a’s quality is to note whether or not a is promoted, given a raise, entrusted with greater responsibilities, etc.

In an ideal world, according to Bernhardt and Scoones, A would deal with a without considering B; that is, A would promote or give a raises solely in accordance with his productivity. A would not reward a more than a deserved – that way lies bankruptcy; nor



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would A unduly penalize a – otherwise A would risk losing his employees. But in the real world, assert Bernhardt and Scoones (1993, p. 771), A must always look over his shoulder to make sure that his treatment of a is not exploited by B: “. . . Employers balance the gain from placing able workers efficiently against the wage cost of revealing their abilities”.

Ostensibly, Bernhardt and Scoones (1993, p. 771) examine this “market failure”[3] under conditions where a is more valuable to B than he is to A. Actually, however, this scenario is not as problematic as when a is equally valued by A and B, or when A values a more than B does. For in the former case it is in some sense efficient that a leave A and go to work for B. If this is done as the result of A promoting a or giving him a raise, and in this way making a more attractive to B, it would appear no cause for alarm, at least on grounds of welfare economics. In the present comment, then, we ignore the example where “employees may be more valuable to competing firm”, and concentrate on the other two cases.

The problems with the Bernhardt and Scoones thesis are three[4]. First, they ignore several other strategies that could be adopted by employer A in order to make employer B’s job of ascertaining the quality of employee a more difficult. Secondly, and somewhat paradoxically, their thesis is “too good.” It can be applied to numerous markets other than that for labor; that is to say, it is vulnerable to the *reductio ad absurdum* argument. Third, their claim that “social optimality” is disrupted by this “demonstration” phenomenon is by no means as clear as they seem to think. Let us take up these three critiques in that order. We conclude in section 4.

#### 1.

Which strategies are open to an employer A, who knows full well that if he promotes (well deserving employee) a, he risks losing him to competing employer B? At the very least, an employer A with an inordinate fear of losing a to B can borrow a leaf from stock market practice and engage in the “poison pill” strategy. That is, he can promote employees who are totally undeserving of this accolade, in the hope that B will snatch them up – and lose out thereby. He can do this without suffering too much loss of productivity in the interim period between the promotion of this “false” a promotion and B’s raid of this “bait,” by seeing to it that the newly promoted a is given a big office and an impressive sounding title – but no real responsibilities[5]. On the reasonable assumption that A knows far more about his own operation and personnel than does B, it is likely that B will be fooled[6]. If successful, this strategy[7] will impose great costs on B if he swallows the “bait.” Even if he does not, in this one case, he will no longer be able to rely so heavily on Bernhardt and Scoones’ demonstration effect[8].

Another strategy would be to offer big raises, but not ostentatious promotions (large offices, etc.), on the grounds that it is easier to hide the former than the latter[9].

A third possibility is to take the bull by the horns: even though there is this danger of “signaling” to other employers the higher productivity value of the newly promoted employee, there is also the risk of failing to take this action. For if A does not promote a, he risks alienating his entire labor force. If he does, on the other hand, his “promotion from within” strategy may well reduce his own quit rate. This might be the best way to promote employee loyalty, and to add to the inertia which typically tends to make one’s present employer seem more safe than any alternative.

Another thing to remember is that a is not an innocent bystander. Workers can and often do move from job to job. If A does not promote a, then a can leave to work for B. In white-collar labor markets especially, there are well developed “head hunters” who facilitate exactly this kind of movement.

## 2.

The postulate of Bernhardt and Scoones is “too good” in that it can be made to apply to a whole host of phenomena besides the labor market. What their view comes down to, we shall show, is that there is something akin to market failure in all of these cases. To generalize the Bernhardt and Scoones theory, they claim that whenever anyone makes a decision choosing one thing and setting aside another[10], this constitutes a signal to his competitors that the thing he has chosen has more value than the competitor would have been aware of had this choice not been made. Therefore, the chooser necessarily undermines himself, by giving more power to his competitor than would otherwise be true.

The problem with this is that there are so many cases that seem to fit this bill[11]. For example, whenever a consumer buys peas instead of carrots, he thereby signals to other, competing consumers, that peas are “better” than carrots. This undermines the party of the first part, since if others act on this “signaling” of his, and copy him by also purchasing peas instead of carrots, the terms of trade will turn against the first consumer; that is, he will have to pay more for his beloved peas. Similarly, if Bank A lends money to borrower a, it “signals” to Bank B that a, who it might otherwise have turned down, might have more creditworthiness than it, B, had first supposed. Also, we can turn the Bernhardt and Scoones illustration on its ear. They talk in terms of employers signaling other competing employers about the productivity of employees; we can turn this around by considering the signaling of employees about employers. For example, if employee a agrees to work for employer A, he thereby “signals” to employee b, who might have contemplated working for B, that A actually constitutes a better option than he, b, had first supposed. Then of course there is the marriage market. When John asks Sue to marry him, he signals to George that Sue is actually a better marriage partner than he, George, had initially thought. John thereby “unleashes the whirlwind,” provoking the very competition that he might be supposed to be most concerned to quell.

Again, as in our critique of Bernhardt and Scoones’s own illustration, we can posit attempts to “hide” the true state of affairs, so as to obviate the unwelcome attention engendered by his original decision. For example, “secret” pea buying, “hidden” lending, “surreptitious” jobs.

There is, however, a silver lining. As far as the marriage market is concerned, this premise may well go part way toward explaining several sociological phenomena. For example, consider the following sociobiologically (Wilson, 1980) inspired scenario: a man and a woman meet; she is attracted to his Alfa Romeo, which indicates wealth and potential support for her and her future children; he is attracted to how she looks in a bikini. However, their marriage “signals” additional attractiveness to potential competitors for each. As a result, after the marriage, he tells his wife to dress more modestly, thus making her less attractive to other men, and she insists that he trade in his sports car for something more sedate, and thus become less appealing to other women. This may also, in part, explain the tendency of newly married couples to gain weight: each partner has an incentive to fatten up the other, so as to dampen just the sort of signals implied by Bernhardt and Scoones.

## 3.

As can be seen by the foregoing, there may be a kernel of truth in the Bernhardt and Scoones supposition. Yes, it is subject to a reductio, but it undoubtedly has a degree of explanatory power, nevertheless. However, even if it sheds light on some otherwise puzzling sociological phenomena, the claim that it constitutes a market failure of some sort is still problematic.

What sort of evidence for this latter claim is provided by these authors? Only the fact that all action is, to some extent, self-defeating, in that it sets up “signals” which tend to undermine the initial choice. One might as well label this a “market failure” as the fear of some environmentalists that all economic action uses up some resources, and hence is self-defeating in that there will be fewer assets left for further action. In like manner, every economic act has an alternative cost; it implies that there is an opportunity foregone; that, but for the given action, something else might have been undertaken. All of this is very regretful, to be sure. But to label any of this as not “socially optimal” as do Bernhardt and Scoones (1993, p. 771), would be at least highly misleading[12].

Indeed what they describe, if it exists at all, may not be socially inefficient in the least. Suppose workers reservations wages fall after they get a job. This means that an employer could slow down pay/promotion without losing employees, but it is not inefficient to do so. This merely alters the distribution of the gains from trade in favor of the employer, but does not alter the allocation of resources in any way.

There is a possibility as well that slower rates of promotion may be a correction for a “market failure” of sorts that can occur in the hiring process. If you envision the hiring of a worker as a type of auction, then it may be subject to the winner’s curse (Thaler, 1994). When a worker’s true worth is unknown, it is entirely likely that the winning bidder (i.e. the successful employer) will have overestimated his worth and paid too much. Slowing rates of promotion may be an *ex post facto* means to bring a worker’s pay in line with this true marginal worth to the firm.

But more. These authors focus on the negative repercussions which boomerang against employer A in his decision to promote or otherwise reward his employee a. These external diseconomies, as it were, are perpetuated by the (possible) actions of B, the alternative employer. What Bernhardt and Scoones forget is that the negative implications for A give rise to positive ones for B. After all, the harm to A is no dead weight loss; on the contrary, it is of help to B, who now has further information about a furnished to him. In classifying this as non “socially optimal,” Bernhardt and Scoones are implicitly claiming that the harm to A is greater than the benefit to B. But this they cannot do without resorting to unwarranted interpersonal comparisons of utility (Rothbard, 1977; Hoppe, 1993).

There is an implication here for the marriage market. The Bernhardt and Scoones theorem implies an over-optimal divorce rate – due solely to the demonstration or signaling effect[13] of this institution. Yes, each spouse who marries signals to all competitors that his or her mate has better characteristics than would have otherwise been apparent had they not chosen matrimony with this person. This is indeed a negative. But there is also a positive: new information has thereby been released. In order for their (implicit) claim of over-optimality of divorce to be sustained, it must be argued that the losses to the married couple swamp the informational gains to the rest of society. And this, again, cannot be done without utilization of invalid interpersonal comparisons of utility.

#### 4.

The goal of Bernhardt and Scoones has been to demonstrate a new instance of “market failure” that at least implicitly calls for governmental action to “correct” it. Our objective has been to show that their case is logically and empirically flawed. To wit, we have established that their argument is problematic on three grounds. One, they fail to come to grips with inertia, poison pill strategies, and the fact that the extant employer almost necessarily knows more about his employee than does another firm

which is now at best only a potential employer. Two, we have subjected the Bernhardt and Scoones thesis to devastating *reductio ad absurdum*. Third, we have dealt with their claim regarding “social optimality.” To wit, that it would otherwise have been attained in the absence of this signaling phenomenon. What is this “social optimality” of Bernhardt and Scoones? It is equivalent to what is commonly called “economic welfare” (Rothbard, 1977). These authors maintain that “economic welfare” or “social optimality” is retarded, or reduced, by their signaling problems. Our conclusion is that they have failed to demonstrate this.

How does our paper address an aspect of ethics and social/economic theory? This should be clear. According to Bernhardt and Scoones, it is unfair to employees that employers will give them lower wages than they would otherwise have been paid for fear that competing firms will attempt to hire workers who get raises. In contrast, it is our view that there is nothing at all untoward about this necessary aspect of the competitive process. Every time, without exception, whether it is in the labor market, or in the marriage market, whenever any choice is made, a signal is sent out that what was chosen was more desirable to at least one person than would have been the case did he not make that decision. If this is “unfair,” then life is unfair. Bernhardt and Scoones should get used to this phenomenon. It is here to stay.

### Notes

1. Unless otherwise identified, all page notations refer to Bernhardt and Scoones (1993).
2. On the importance of information and knowledge in economics, see Kirzner (1973), Hayek (1948), Choudhury (2004), Sowell (1980).
3. This market failure amounts to plan discoordination. For further analysis of this phenomenon, see Anwar (1999), Bagwell and Ramey (1994), Boettke, (2001), Garrison (1994), O'Driscoll (1977a, b). For a critique of Bagwell and Ramey (1994), see Block (2003).
4. But there is a silver lining in the clouds of the second, as we acknowledge below.
5. We have here an entirely different explication of the “Peter Principle”: promoting people until they achieve incompetence.
6. On the other hand, it may be more difficult to protect against lowered morale in firm A, when the other employees see the unworthy a being promoted ostensibly above them.
7. For the treatment of an analogous phenomenon, the principle agent problem, see McGarrity *et al.* (1999).
8. In army war games, typically, each side fires blanks at the other. In some cases, however, 1 in 500 or 1 in 1,000 bullets is “live,” spread out equally amongst the two halves of the army, and unidentifiable by the soldiers. This is done to make sure the new recruits follow the sergeants' advice and “keep their heads down.” Seeding false a's in and among the good a's promotion wise – in unknown proportions – can likewise be expected to have similar effects on B.
9. But again, this would have internal repercussions.
10. And of what else does economic action ever consist? (see Mises, 1966).
11. Ultimately, it might be claimed, all (of economic) action comes within the reach of the Bernhardt and Scoones thesis.
12. Happily, these authors do not take the further step, as is usual in such cases, of calling for government action to ameliorate the “market failure.” They are wise in thus forbearing, for there is such a thing as “government failure” which is typically far more serious than any problem emanating from the marketplace.

13. So as to be clearly understood, all other claims about socially over-optimal divorce rates, e.g. no fault divorce laws, are strictly irrelevant to our present discussion.

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