Benefits of Broad-Based Option Pay*

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Abstract

This paper examines the optimal structure of a firm's aggregate wage bill. Rents promised to employees drive a wedge between total firm output and the share received by the firm's owners, thus distorting the owners' exit (i.e., liquidation, sale) decisions. In an optimal contracting framework, we show that the unique optimal aggregate wage structure is to grant all employees an option on the firm's cash flow. Broad-based option pay minimizes the firm's total wage cost in states where the firm is only marginally profitable, thus minimizing the wedge between total output and the owners' share of it in exactly those states where, e.g., a fixed wage would lead the firm's owners to (inefficiently) exit. If there is a subsistence requirement, employees additionally receive a base wage.

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