“Externalities” and Partner Pay

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Economists are interested in “externalities” –effects that are incidental to a transaction that go uncaptured by markets and that affect others than the parties to the transaction. Pollution is the classic example – the purchase of electricity by homeowners from power companies takes no account of the reduction in the quality of the air others breathe or the harm to distant forests from acid emissions that travel on the wind.

Externalities can be positive as well. I like to think of universities as large cultural power plants which emit over their communities, inexpensive concerts and lectures, nice ethnic restaurants, bookstores and the like. A visit to Ann Arbor, Palo Alto or Madison should confirm this view. If universities were able to capture some of the gains they bring to university towns, perhaps tuition fees would be lower than they are.

Indeed efficiency calls for bringing external effects into market transactions whenever possible – that is why we have the trading of emission permits, for example.

The senior members of a law firm partnership have direct effects that are usually captured in the determination of their payout – bringing in the business, doing it and succeeding at it. But the indirect effects can be important too. Certain partners who build their reputation by professional writing and speaking burnish the firm’s brand as well as their own.

Others who recruit excellent associates for their teams thereby build the next generation of partners for the firm as a whole. And there are partners so expert or so smart that their intelligence spills over to the practice as a whole. All these attributes and others need some recognition if the firm’s incentives are to be well aligned with its objectives – excellence and growth. Does this mean that partner pay ought to be hypercomplex with a host of factors to take account of?

Of course not.

Rather than trying to catalog and measure a host of different activities, we need only focus generally on the magnitude of contributions to the firm, the practice and perhaps the office. If these accomplishments are recognized somehow in partner pay decision-making, that will "internalize the externalities" or (in English) that will create the right incentives to encourage actions whose benefits spill over to others.

The mechanics of pay determination apart from profit calculations are limitless in variety from the strictly formulistic to the entirely informal. The compensation committee can make determinations on their own or use surveys of one sort or another to learn more. The mistake to avoid is to leave external contributions unrecognized and unrewarded.

If you are a reader who is accustomed to occupying the high moral ground you may – with justification – see a contradiction in my focus on the incentives to reward generous behavior inside a partnership. Partnership, you may say, implies acting for the good of the whole without being bribed to do so. I don't deny it but like most economists I believe that nudging human nature along with the right incentives can't hurt and will likely get you more of what you want in the end.