Relative Performance Evaluation and Strategic Competition

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Review of Financial Studies，2025

Abstract

We examine how relative performance evaluation (RPE) affects industry competition--a question relevant for corporate boards interested in incentivizing executives. Using U.S. airline data, we estimate a dynamic game of competition between heterogeneous firms in an oligopolistic market, with managers incentivized by RPE contracts. While RPE can induce a firm to compete more intensely by smoothing compensation, it also amplifies a firm's cost efficiency relative to its peers and can weaken competition from inefficient firms. The first effect dominates in small markets and the second in median-sized markets. RPE has little effect in large, highly profitable markets.