

A Theory of Authority

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- ▶ The need for legitimacy serves as a constraint.
- ▶ This paper: explores the implications of such constraints.

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- ▶ Cost to the firm: greater bureaucracy.

Introduction: Related Literature

- ▶ **Persuasion:** Prendergast and Stole (1996); Hermalin (1998); Majumdar and Mukand (2004); Van Den Steen (2009).
- ▶ **Limits to Authority:** Shapiro and Stiglitz (1984); Wernerfelt (1997); Marino, Matsusaka, and Zabochnik (2009); Van Den Steen (2010).
- ▶ **Low-powered versus high-powered incentives:** Holmstrom and Milgrom (1991).

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 2. Orders: θ .

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- ▶ Agent has outside option that yields payoff of 0.

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The Principal's Problem

- ▶ Maximize π subject to:
 - ▶ (PC), (IC-authority), (AM)
- OR
- ▶ (PC), (IC-no authority), (no AM)

A Simple Model

Solution to Principal's Problem:

1. L high:

- ▶ $\theta = a_1^{FB}$.
- ▶ low-powered incentives: $w(h) = w(l)$.

2. L intermediate:

- ▶ $\theta = L$.
- ▶ low-powered incentives: $w(h) = w(l)$.

3. L low:

- ▶ eschew authority.
- ▶ high-powered incentives: $w(h) > w(l)$.

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- ▶ That is, he chooses how much to bolster (b).
- ▶ Cost of bolstering: $k(b)$.
- ▶ The principal's authority is given by: $L = L_0 + b$.

Bolstering Authority

Solution to Principal's Problem:

1. L_0 high:

- ▶ maintain authority/low-powered incentives.
- ▶ no bolstering ($b = 0$).

2. L_0 intermediate:

- ▶ maintain authority/low-powered incentives.
- ▶ bolster ($b > 0$).

3. L_0 low:

- ▶ eschew authority/high-powered incentives.
- ▶ no bolstering ($b = 0$).

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- ▶ One might hire B rather than A (a costly action taken to bolster authority).
- ▶ Examples: dislike of "overqualified" workers (Bewley); family firms.

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- ▶ Suppose the principal has more (less) authority over workers than a supervisor.
- ▶ This might lead to under-delegation (over-delegation).
- ▶ Examples: Gouldner's Gypsum Company (under-delegation); Ostrom on detrimental effects of forest nationalization (over-delegation).

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- ▶ Example: problems associated with merging firms with different cultures (see Buono, Bowditch, and Lewis (1985)).

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- ▶ It may be optimal to pay an efficiency wage: that is, set a wage for which (PC) is non-binding.

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- ▶ To what extent are persistent performance differences across firms (PPDs) explained by differences in authority?
- ▶ Relatedly, is variance in firms' management practices due to differences in managerial skill or authority?
- ▶ Is lack of legitimate authority an important reason for underdevelopment (see Basu (2015))?