A Theory of Authority

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Introduction: Motivation

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- Legitimacy matters for two reasons.
  1. Agents motivated by sense of duty to follow rules/orders when they are seen as legitimate.
  2. Agents are also motivated to punish and/or report violations.
- The need for legitimacy serves as a constraint.
- This paper: explores the implications of such constraints.

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- Peele's orders seen as illegitimate; faces resistance.
- Firm's solution: delegate less to Peele, have central o ce set more rules.
- Cost to the rm: 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 Zabojnik (2009); Van Den Steen (2010).
- **Low-powered versus high-powered incentives:** Holmstrom and Milgrom (1991).

A Simple Model

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- Principal observes an imperfect measure of a_1: $\theta \in \{h, l\}$.
- $Pr(\theta = h) = a_1 + \lambda a_2$.
- Principal has two tools for incentivizing the agent:
    1. High-powered: $w(\theta)$.

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- $D(q)$: cost of disobedience.

- We assume the order is considered legitimate only when $q \leq L$, where L parameterizes the principal's legitimacy.

- Disobedience is only costly when the order is legitimate:
$$D(q) = \begin{cases} \infty, & q \leq L \\ 0, & q > L \end{cases}.$$

- Agent has outside option that yields payoff of 0.

A Simple Model

Authority Maintenance: $q \quad L$.

The Principal's Problem

- Maximize p subject to:
  - (PC), (IC-authority), (AM)

    OR

A Simple Model

Solution to Principal's Problem:

1. L high:
   - $q = a_1^{FB}$.
   - low-powered incentives: $w(h) = w(l)$.

2. L intermediate:
   - $q = L$.
   - low-powered incentives: $w(h) = w(l)$.

3. L low:
   - eschew authority.
   - high-powered incentives: $w(h) > w(l)$.

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- Suppose the principal can bolster authority at a cost.
- 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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   - Suppose agent A is a better worker than agent B but agent B considers the principal's authorit02577Sws102577SwsB but agent B considers the principal's authorit02577Sws102577SwsB but agent B

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1. **Who is the receiver of orders?**

   - Suppose agent A is a better worker than agent B but agent B considers the principal's authority more legitimate.

   - One might hire B rather than A (a costly action taken to bolster authority).

   - Examples: dislike of "overquali ed" workers (Bewley); family rms.

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2. **Who is the giver of orders?**

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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 Gympsum 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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   - Suppose paying a higher expected wage increases the principal's legitimacy ($L = L_0 + E(w)$).

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

Concluding remarks

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