The Endogenous Emergence of Authority

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Abstract

Why do we observe employment relationships in which an employer has authority over his worker? And why do we observe that similar transactions are governed by contracts for work in the market? We use a novel experimental design to analyze the roles of fairness and reputation for the endogenous emergence of different modes of governance. A market governed contract for work can result in inefficiencies due to incomplete information at the time of contracting. Employment contracts can improve efficiency because they give the employer the authority to demand an efficient task from the worker once new information arrives. The employer can, however, also abuse his authority and demand an inefficient task that is beneficial for the employer but very expensive for the worker. We show how the emergence of viable authority relationships depends on the players' fairness preferences and on the employer's ability to build a reputation for not exploiting his workers. Our experimental results inform the theory of the firm by showing how behavioral forces shape an important cost of integration: the abuse of authority.