Externalities, communication and the allocation of decision rights

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Abstract The assignment of authority entitles the decision maker to undertake decisions that impose externalities on the payoffs of other members of the organization. This paper studies how the optimal allocation of decision rights depends on the preferences of the organization’s members. It adopts a mechanism-design approach to show how the communication of private information affects the efficient allocation of authority. An extension to multiple decision areas shows that decentralized control rights may enhance organizational efficiency unless there exist strong complementarities between different decisions.

Keywords Authority · Decision rights · Externalities · Incomplete contracts · Imperfect information · Theory of the firm

JEL Classification D23 · D82 · L22 · P14

1 Introduction

The most important decisions in an organization affect not only the decision maker but also other members of the organization. The decision maker therefore exerts an

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externality on other stakeholders of the organization. This point is already observed by Simon 1951, p. 302 who notes that in the employer–worker relationship

“the worker has no assurance that the employer will consider anything but his own profit in deciding what he will ask the worker to do.”

Because the party holding the decision right will opportunistically select a decision in its own interest, it will typically fail to internalize the concerns of other stakeholders. In this paper we study how such externalities affect the optimal allocation of decision rights in an organization. We first show that the efficient assignment of authority depends on a simple general criterion, which is related to the monetary value of the externalities generated by the decision maker. This criterion then allows us to derive the optimal allocation of decision rights in a number of different organizational environments.

In a world of complete contracts, the members of an organization could simply write a comprehensive contract to implement those decisions that maximize their joint surplus. In line with the Coase Theorem, the benefits and costs of the different members would be fully internalized by monetary transfers under the organization’s compensation scheme. Yet, as Grossman and Hart (1986), Hart and Moore (1990) and Hart (1995) point out, it is typically impossible to specify all the organization’s future decisions in advance in a legally binding way. This is so because the details of different decisions are often not verifiable to outsiders and the courts or prohibitively costly to specify ex ante.

This paper follows the emerging literature on control rights by assuming that only decision rights are contractible ex ante, because decisions are neither ex ante nor ex post verifiable (see, e.g. Aghion and Tirole 1997; Aghion et al. 2002; Bester 2002; Hart and Holmstrom 2002; Baker et al. 2006). It contributes to this literature by addressing the following issues: (a) How does the efficient allocation of decision rights depend on the benefits and costs of the organization’s stakeholders? (b) How does asymmetric information about benefits and costs affect the efficient allocation of authority? (c) Should decision rights be centralized or decentralized in different sections of an organization? To answer these questions, this paper derives general results and provides examples to illustrate the underlying problem.

A straightforward insight of the above-mentioned literature is that authority should be assigned to the party whose preferences are most closely aligned with the organization’s objectives. This is the party that cares most about the decision. In Sect. 2, we use this insight to show how the optimal governance structure depends on the preferences of the organization’s members. In a number of interesting cases, it is straightforward to identify the optimal allocation of authority from the structure of preferences. For example, in the employer–worker relationship it is indeed efficient that the employer controls the firm as long as decisions have a higher impact on the firm’s revenue than on the worker’s disutility of work. In the case of quadratic utilities, which are often considered in the literature, it turns out that the second derivative of the utility

1 This feature distinguishes this approach from the earlier literature on the property rights theory of the firm (Grossman and Hart 1986; Hart and Moore 1990), in which decisions are ex ante non-contractible but ex post contractible.