Transaction Costs and Power Abuse in the Employment Relation: Economic Origins of Authority*

Björn Bartling[a)], Ernst Fehr[b)] and Klaus M. Schmidt[c)]

November 27, 2011

Abstract

Employment contracts assign authority to the employer, implying that the employer can decide which tasks the employee must execute. An authority contract allows the employer to adjust the tasks quickly to different states of the world, but the employer may also abuse this flexibility to exploit the worker. Here, we show experimentally that the emergence of viable authority relationships depends on the players' fairness preferences and on an employer's ability to build a reputation for not exploiting his workers. Our results inform the theory of the firm by showing how behavioral forces shape an important cost of integration – the potential abuse of authority.

Keywords: theory of the firm, transaction cost economics, authority, power abuse, employment relation, fairness, reputation
JEL: C91, D23, D86, M5

*) Financial support from the Deutsche Forschungsgemeinschaft through SFB-TR 15, the Excellence Initiative of the German government though MELESSA, the Swiss National Science Foundation (project number 101312-103898/1), and the Research Priority Program on the "Foundations of Human Social Behavior" at the University of Zurich is gratefully acknowledged.
a) Björn Bartling, Department of Economics, University of Zurich, Blümlisalpstrasse 10, CH-8006 Zurich, Switzerland, email: bjoern.bartling@econ.uzh.ch
b) Ernst Fehr, Department of Economics and Laboratory for Social and Neural Systems Research, University of Zurich, Blümlisalpstrasse 10, CH-8006 Zurich, Switzerland, email: ernst.fehr@econ.uzh.ch
c) Klaus M. Schmidt, Department of Economics, University of Munich, Ludwigstrasse 28, D-80539 Munich, Germany, email: klaus.schmidt@LMU.de