



Delegation versus an approval process and the demand for talent

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Abstract

In many organizations, a principal uses simple decision rules or decision processes, as opposed to complete contingent monetary contracts, to regulate a more informed agent's behavior. This paper models two such rules: delegation and an approval process. We determine the principal's preferable rule under different conditions and characterize the optimal demand for talent. In addition, we describe the agent's expected welfare under these rules and characterize how different talent might sort into the rules. If the decision process is not a choice or if the principal chooses approval for private gain, the demand for talent can be tied to the magnitude of loss in the worst state, rather than the degree of discretion given to the manager. However, if the principal has discretion over the decision process and proper incentives, then more talent is demanded under delegation.

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1. Introduction

Many organizations use simple decision rules to mitigate incentive problems as opposed to using complete contingent compensation contracts with full delegation. The principal precommits to a decision process which can impose some control on the decisions of an agent with better information or hidden action. More control over the agent's behavior can produce benefits for the principal, but it can also generate costs by affecting the agent's transfer of information to the principal, the agent's incentive to gather information, or the agent's

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implementation of tasks. A large and growing literature has analyzed the costs and the benefits arising when the principal chooses among delegated decision processes and centralization of decision making. The overall aim of this research is to better understand the economic and behavioral consequences of these different organizational rules. In view of the fact that many organizations do not use complete contingent contracts and instead use decision processes, it is important that we enhance this understanding.

One aspect of this problem that has not been given sufficient attention is the principal's optimal selection of talent or ability level which can accompany the selection of a process or can follow, in a hierarchy, a handed down process. That is, the principal may have the ability to choose the agent type, within a given decision process, or to choose both the process and the agent type simultaneously. This paper will take a first step in analyzing this decision in the context of a hidden information model that admits the possibility of distortion of information with more centralization of decision making. We model two alternative decision processes that are prominent and commonly used, delegation and an approval process (the principal has veto power over the agent's decisions), and we allow the principal to endogenously choose the talent level for each process. Our specific goal will be to characterize conditions under which one process might be preferred to another and to study the optimal talent demand under each process.

It is common for those who think about organizational problems to conjecture that a principal would demand more talented individuals in a delegated decision process than in one in which decision making is more centralized. Our paper shows that this simple and intuitive conjecture is not entirely correct. We show that, if the decision process is fixed, the principal's demand for talent is not always greatest when the agent has the most discretion. We find that if the more centralized approval process leads to a pooling equilibrium in which a manager observing an unacceptable project mimics the spending proposal of a manager observing a high quality project, then more talent is optimally demanded than what would be true under delegation. In this comparison, the higher demand for talent is not generated by the degree of discretion given to the agent, but instead by the fact that the approval pooling equilibrium results in the greatest loss of all equilibria. This worst case scenario is the result of the manager implementing an unacceptable project at a scale appropriate for a high quality project. More talent helps the principal avoid this undesirable situation. This might be thought of as a "trouble avoidance" explanation of the demand for talent. Generally, we show that the demand for talent is highest when the approval process pools, second highest under delegation, and lowest when the approval process separates.

If we allow the principal to have choice over talent and the decision process, then we show that an equilibrium in which the approval process pools would be avoided because it produces a lower level of expected returns than does delegation. On the other hand, if the approval process has a separating equilibrium, then approval would be chosen over delegation as it generates greater expected returns for the firm. These results along with the ranking of the demands for talent then generally show that delegation results in greater demand for talent than does approval if the approval process separates.

It follows then that if (i) the principal has complete choice over both the process and talent and (ii) the principal has the firm's returns as an objective, more talent is demanded under delegation, confirming common beliefs. However, there are situations where conditions (i) and (ii) are not met. In top-down organizations such as highly rigid firms, government bureaucracies, regulated entities or due to law, a principal in a hierarchy may not have the flexibility to choose the decision process (especially in the short-run) but may have hiring authority. In such cases (i) is violated. There may also be circumstances which induce the principal to adopt a different objective than the firm's returns as pointed out by [Prendergast \(1995\)](#). Here an agency problem

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