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

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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
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