Extended Abstract

This thesis consists of three independent essays which contribute to the literatures on organizational and regulatory economics.

In the first part of the dissertation, I address questions related to the optimal incentive provision in hierarchies. In particular, I investigate how the choice of the optimal compensation policy of an organization is affected by the workers’ psychological preferences for reciprocity. This essay relates to a recent strand of theoretical and empirical research that studies how the presence of reciprocity concerns impacts on the optimal organizational design (See e.g., Dohmen et al.m 2009, Englmaier and Leider, 2012, Englmaier et al., 2015).

The second part of the dissertation concerns the optimal design and regulation of a hierarchical organization in the presence of capture concerns. In many organizations the task of evaluating an agent’s performance is delegated to a third party, a supervisor, who can opportunistically misreport information. The question of how the provision of incentives in hierarchies is affected by the supervisor’s opportunism has long been studied in economics.\(^1\) Addressing this research question is of great importance since it can improve our understanding of the internal organization of firms and can have broad applications to regulatory design.

Chapter 1: Friends or Foes? Optimal Incentives for Reciprocal Agents

In this Chapter I investigate how the choice of the optimal compensation policy of an organization is affected by the workers’ psychological preferences for reciprocity. In the baseline version of my model, the principal of an organization employs two identical agents to exert some productive effort. Agents are reciprocal towards each other and preferences for reciprocity are modelled following Dufwenberg and Kirchsteiger 2004. Each agent makes a non-verifiable effort choice. Production is technologically independent, performance indicators are uncorrelated and satisfy the monotone likelihood ratio property.

As agents exhibit preferences for reciprocity, the incentives provided by a contract are not restricted to the monetary compensations explicitly envisaged. Interdependent compensation

\(^1\)Tirole (1986) was the first to highlight the loss of efficiency engendered by the possibility of collusive agreements between the agent and the supervisor.
schemes provide some implicit psychological motives linked to the externalities produced by an agent’s effort choice on his coworker’s material payoff. Two kind of interdependent compensation strategies can prove optimal: (i) a relative-incentive strategy which induces negative reciprocity and intra-team competition and (ii) a joint-incentive policy which induces positive reciprocity, cooperation and friendship among coworkers. I find that the final choice of the principal depends on a non-trivial interplay between the workers’ psychological preferences and their attitude towards risks. In particular, the optimal incentive scheme implements a high-powered relative-incentive policy if agents are not too risk-averse while it implements a low-powered joint-incentive policy if they are sufficiently risk-averse. The paper thus complements the standard agency theory arguments about the optimal incentive provision, stressing the role played by psychological preferences in a multiple agent setting. It also provides a new perspective to a long-lasting debate raised by the management literature by identifying conditions under which an organization should emphasize competition or friendship among coworkers. In an extension of the model I show that the interplay between risk and reciprocal attitudes continues to hold when agents are involved in some form of group production.

Chapter 2: The Threat of Extortion and the Optimal Supervisory Task

In this chapter we examine the problem of the optimal timing of inspection. We consider a setting in which the agent’s effort can be inspected before (monitoring) or after (auditing) the outcome of the organization is observed. We highlight a fundamental tradeoff between the two alternative supervisory tasks in the presence of corruption concerns. Monitoring better tackles corruption provided that the principal requires the supervisor to send the report before the outcome realization. By doing so, the principal can design a compensation scheme which induces truthful reporting by taking advantage of the supervisor’s uncertainty about the state of nature. By contrast, auditing reduces the cost of supervision as it enables the principal to defer the choice of inspecting the agent’s performance until after the outcome is observed. Whenever the outcome realization conveys enough information about the compensation due to the agent, the supervisor will not be hired and, as a result, the cost of inspection will be saved. We show that the ultimate choice between monitoring and auditing depends on the supervisor’s ability to falsify information without the agent’s cooperation and the cost of performing an inspection. While in the model we focus on the organization of a firm, our insights can be applied to a broader range of contexts, such as a regulatory setting. This essay is currently at the resubmission stage to the Journal of Economic Behavior and Organization.

Chapter 3: Flexible and Mandatory Banking Supervision

In the wake of the recent financial crisis most countries have implemented tighter regulation and more powerful supervision. Notable examples are the Dodd-Frank Act in the United States and the Capital Requirements Directive IV in Europe. Although the new rules may imply pos-

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2This chapter is the result of a joint work with Alessandro De Chiara (Central European University).
3This chapter is the result of a joint work with Alessandro De Chiara (Central European University) and Jorge Ponce (Banco Central del Uruguay).
itive welfare effects, many commentators have stressed that a closer interaction of supervisees with more powerful supervisors and the reliance on supervisory information which is difficult to be verified by third parties may backfire, paving the way for the capture of the supervisor by banks. In this paper we propose a supervisory mechanism that dramatically reduces the social cost of implementing efficient bank regulation. More precisely, we prove that this mechanism allows to obtain the same outcome in terms of social welfare than in the case in which supervisory capture is not a concern. The mechanism consists of providing each bank with a menu of two alternative supervisory regimes. One of them involves direct supervision of the banks which then are regulated according to the outcome of the supervisor’s assessment. We call this regime mandatory supervision. The other regime, called flexible supervision, allows the banks to directly choose a certain regulatory contract, thereby bypassing supervision. The optimal design of the supervisory regimes implies that only those banks which would otherwise have incentives to capture the supervisor decide to bypass supervision, while the others prefer mandatory supervision. Therefore, the mechanism overcomes supervisory capture by reducing the interaction between supervisors and supervisees. Moreover, the bank’s choice of the supervisory regime reveals its private information. Hence, implementing flexible supervision does not entail any loss of information with respect to the case in which supervision is always mandatory.

References


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4David Beim (*Report on Systemic Risk and Bank Supervision*, 2009) argue that the Federal Reserve Bank of New York was overly deferential to the banks being supervised and that such attitude could be seen as a (weak) form of supervisory capture (see David Beim’s Testimony "Before the Senate Committee on Banking, Housing and Urban Affairs Financial Institutions and Consumer Protection Subcommittee", November 21, 2014). Recent recordings of conversations among New York FED officials show that supervisors continue to adopt a non-confrontational style with the industry and are unwilling to speak up (see, for example, "New Scrutiny of Goldman's Ties to the New York Fed after a Leak" on The New York Times, November 19, 2014).

5On this respect, we build on the recent paper by Burlando and Motta (2015). In the context of the optimal organization of a firm, the authors show that outsourcing can be the optimal organizational response to the threat of internal collusion when the principal cannot observe the agent’s type.