

# Which decision rights should be delegated to lower hierarchy?

## ABSTRACT

This study investigates how the principal's delegation of decision rights to an agent affects compensation contracts; it also specifies the conditions under which the principal delegates to the agent. Further, this study not only considers the delegation of contracting rights, but also analyzes whether the principal delegates the setting of non-financial targets, with which we measure the ideal effort level as set by the target setter.

To illustrate this situation, we model the case in which agents have an organizational identity and suffer from disutility when there is a gap between the target and actual effort levels. The study uses a linear-exponential-normal model and extends the work of Heinle et al. (2012) to a multi-agent setting in which one agent is superior to the other and the senior agent offers compensation contracts as well as sets the target level.

The main results of the study can be summarized as follows. First, when there is no target setting, the incentive rate for the senior (junior) agent under centralized contracting is lower (higher) than that under decentralized contracting. Second, when there is no target setting and the agents are identical, the contract is more efficient under the decentralized case than under the centralized case. Third, when there is target setting or an organizational identity, the higher the organizational identity, the more efficient the contract. Fourth, when there is target setting and the agents are identical, the contract is the most (in)efficient under decentralized (centralized) contracting and centralized (decentralized) target setting.

**Key Words:** Compensation Contracts; Target Setting; Decentralization; Organizational Identity

**JEL Classification:** D86; D90; M41