Biased Managers as Strategic Commitment*

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Abstract

This paper analyzes a model in which owners of competing firms can hire biased managers for strategic reasons. We show that independent of the mode of competition, i.e., price or quantities, owners hire aggressive managers. This result contrasts with the classic literature on strategic delegation.

Keywords: Strategic Delegation, Biased Expectations, Aggressiveness, Product Market Competition

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1 Introduction

The importance of the top executive’s person(ality) for firm performance was already stressed by Drucker (1967). Various empirical studies have established that there seems to be a strong connection between individual managers’ attitudes and corporate policies. The studies by Bertrand and Schoar (2003), Bennedsen et al. (2007), and Graham et al. (2008) show that the person(ality) of a top-executive has in itself substantial influence on her firm’s policy and performance. Recent evidence indicates that in particular a candidate’s aggressiveness seems to be an important characteristic in the hiring choice for CEO positions. For example, Kaplan et al. (2012) provide evidence that firms tend to systematically hire managers who are classified as relatively aggressive. The aim of this paper is to provide a rationale for this fact in the context of the strategic delegation literature.

We consider a model in which two firms compete on the product market. Before competition takes place the owner of each firm hires a manager, and the manager’s type corresponds to his potentially biased expectation of market profitability. These profitability expectations translate into aggressive or conservative behavior in product market competition; aggressive (conservative) managers set lower (higher) prices or produce larger (smaller) quantities than would be justified by objective market facts. This implies that firms can commit to more or less aggressive behavior by hiring a biased manager.

We show that in such a setting, owners hire aggressive managers independent of the mode of competition, i.e., prices or quantities. This is in contrast to the classic contractual strategic delegation literature, e.g., Fershtman (1985), Fershtman and Judd (1987), Sklivas (1987), and Vickers (1985). These papers consider settings in which firms can strategically base their managers’ compensation contracts not only on profits but also on sales or costs. Under price competition firms induce more conservative manager behavior via these contracts, e.g., by putting a penalty on own sales, and vice versa under quantity competition. The reason is that via doing so they induce less aggressive behavior by their rivals.¹

By contrast, in our setting, via hiring a manager of a certain type, the owner of firm i does not only influence the behavior of his manager in the product market but also the

¹Note, that Vickers (1985) already introduces an “agent appointment game” related to the one in this paper where owners can hire different types of managers, profit-maximizing or non-profit-maximizing. The classic strategic delegation literature has recently been extended to settings in which elements of both price and quantity competition are present, see e.g., Kräkel (2005) or Kopel and Riegler (2006). These papers show that in such settings the main results are still driven by the relative strength of either mode of competition. Alternative elements, like a commitment to corporate social responsibility policies, have been introduced into the analysis of strategic delegation decisions, too. A recent example is Kopel and Brand (2012).
expectation that the rival manager holds about the market demand of firm $i$. If firm $i$’s owner hires a manager who has high expectations about firm $i$’s profitability, this may intimidate the rival firm’s manager and let him choose a low price. But this strategic effect has negative consequences on firm $i$’s profitability implying that it is optimal for firm $i$’s owner to employ a manager with lower expectation although this manager behaves more aggressively in the product market. We show that this effect dominates the standard effect found in the strategic delegation literature.

Our setting avoids the well-known problem of the classic literature on strategic delegation, that common knowledge of the employed incentive contracts is necessary to allow strategic commitment. By contrast, we build on the assumption that managers can be of different types and that the type of a manager is commonly observable. This assumption is a natural one in imperfectly competitive markets with only few firms since there are only few potential managers whose characteristics are presumably well-known. For evidence on this, follow the business press where the implications of managerial personnel decisions for a firm’s future are broadly discussed.

The existence of persistent biases in expectation formation is also one of the best documented behavioral traits in the psychological literature; see, e.g. Svenson (1981) or Lehman and Nisbett (1985). Many people tend to be systematically too optimistic or pessimistic about future events without sufficiently adjusting to new or commonly available information. Several studies document that executives are particularly prone to display persistently biased expectations, see for example Langer (1975), Larwood and Whittaker (1977), Weinstein (1980), or March and Shapira (1987). See Van den Steen (2004) or Santos-Pinto and Sobel (2005) for models how to rationalize the existence of persistently biased agents by just foregoing the common prior assumption.2

The succession of Steve Ballmer to replace Bill Gates as Microsoft’s CEO in 2000 can be seen as an example of our argument. Ballmer was famous for his “frighteningly enthusiastic style” and “blatant arrogance”. At that time, Microsoft was at the brink of losing its antitrust law suit following its web-browser war with Netscape and was even threatened to be split up into two separate companies. At the same time, the free operating system Linux became increasingly important and gained market share especially amongst professional users. Thus, Microsoft was challenged on its core market for operating systems, the basis of its dominant market position. In the face of the antitrust lawsuits it was hard for

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2See Bolton et al. (2013) for a leadership based explanation why employing persistently biased managers might be optimal for firms. Kyle and Wang (1997) employ a similar idea to ours with overconfident traders in a financial market. Goering (1996) studies a setting where “management style” or beliefs - captured by the conjecture parameter $\theta_i = \frac{\partial q_j}{\partial q_i}$ - play a role.
Microsoft to use observable contracts to commit to fight hard for its dominant position as the courts could take offence of that. However, relying on Steve Ballmer’s aggressive personality was a viable option.

The rest of the paper is organized as follows. Section 2 sets out the model. Section 3 presents the results for price competition and Section 4 the results for quantity competition. Section 5 concludes.

2 The Model

We consider a duopoly in which each firm $i = 1, 2$ has an owner and a manager. The two firms play a two-stage game. In the first stage, the owner of each firm hires a manager. In the second stage, the hired managers simultaneously make the relevant decisions, that is, they either set a price in the product market if firms are in Bertrand competition, or they choose a quantity if firms are in Cournot competition.

There is a representative consumer (or a unit mass of identical consumers) with utility function(s)

$$U(q_1, q_2) = \sum_{i=1}^{2} \left( q_i - \frac{1}{2} q_i^2 \right) - \gamma q_1 q_2 + I,$$

subject to the budget constraint $I + \sum_{i=1}^{2} p_i q_i = M$. Here $I$ is a composite good with marginal utility normalized to 1 and $M$ is income.\(^3\) The maximization problem of the representative consumer is then

$$U(q_1, q_2) = \sum_{i=1}^{2} \left( q_i - \frac{1}{2} q_i^2 \right) - \gamma q_1 q_2 - \sum_{i=1}^{2} p_i q_i + M.$$

Differentiating with respect to $q_i$, $i = 1, 2$, yields the inverse demand system

$$p_i(q_i, q_j) = 1 - q_i - \gamma q_j, \quad i = 1, 2, \quad i \neq j,$$

with $1 > \gamma \geq 0$. Here, $\gamma$ represents the degree of substitutability between firms’ products. If $\gamma \to 1$, firms produce perfect substitutes, whereas if $\gamma = 0$, products are independent from each other. Firms are symmetric and each firm has constant marginal costs of $c < 1$.

Managers are (potentially) biased in the sense that they evaluate the size of the market incorrectly. This is expressed in the following way: If the owner of firm $i$ hires a manager

\(^3\)This demand system goes back to Bowley (1924). For a detailed discussion, see e.g., Vives (2000).

\(^4\)Note that all our results hold for a more general model with an inverse demand system of the form

$$p_i(q_i, q_j) = \alpha - \beta q_i - \gamma q_j, \quad i = 1, 2, \quad i \neq j,$$

with $\beta > \gamma \geq 0$ and $\alpha \neq 1$ and asymmetric cost structure, $c_i \neq c_j$, too.
of type $k_i$, this manager believes that the inverse demand function of firm $i$ is given by

$$p_i = k_i - q_i - \gamma q_j, \quad i = 1, 2, \quad i \neq j.$$  \hspace{1cm} (1)

$k_i < 1$ corresponds to the manager supposing that the market is too small compared to its correct size, while for $k_i > 1$ he believes the market to be too large. The manager is unbiased if $k_i = 1$.\(^5\) As mentioned above, this formulation captures the idea that managers can be of different types, where some will behave aggressively while others will behave more conservative.

In what follows we denote a manager as aggressive when he produces a larger quantity or sets a lower price than the one justified by the market conditions. We do so because both moves, producing a large quantity and setting a low price, reduce the competitor’s residual demand. This implies that with quantity competition hiring an aggressive manager means hiring a manager with $k_i > 1$. As is evident from (1), this manager overestimates the demand intercept, leading him to produce a larger quantity. By contrast, in price competition hiring an aggressive manager implies hiring a manager with $k_i < 1$. Here, a manager who believes that the demand intercept is lower than the one justified by the market condition will set a lower price. A conservative manager is therefore associated with $k_i < 1$ in quantity competition and $k_i > 1$ in price competition.

An important assumption is that each owner can choose to hire a more or less aggressive manager. As argued above, the type of a manager is observable. We consider this a natural assumption in the market for managers. Since it is public information who is the manager of each firm, the type of the manager is also observable to the manager of the rival firm which is important in the market competition stage.

An important assumption concerns the expectation that firm $i$’s manager holds about the demand intercept of firm $j$. Since the type of the rival manager is observable to firm $i$’s manager, it is natural that his belief about firm $j$’s intercept is related to $k_j$. To simplify the exposition we assume that manager $i$’s expectation about firm $j$’s intercept is the same as the one of manager $j$, i.e., $k_j$. Towards the end of next section we show that our insights continue to hold in an extended version where the expectation is a weighted average between $k_j$ and $k_i$ if sufficient weight is put on $k_j$.

We will now proceed to determine the optimal manager types $k_i$, $i = 1, 2$, that owners hire in the first stage. In the second stage each manager maximizes the firm’s profit given the demand function that he believes the firm faces. This is tantamount to assuming that

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\(^5\)Note that an equivalent interpretation of these assumptions is that managers have (differing) beliefs on the degree of vertical differentiation between products. They might feel too (little) insulated from their competition.
the manager is compensated according to firm’s profit, i.e., he receives a fixed payment plus some share of firm’s profits. The solution concept we employ is subgame perfect Nash equilibrium.

3 Price competition

We start with the case in which firms compete in prices. Using backward induction we first look at the second stage. Inverting the demand system (1) and using that manager $i$’s expectation about the rival firm’s intercept is $k_j$, we obtain

$$q_i(p_i, p_j, k_i, k_j) = \frac{k_i - p_i - \gamma(k_j - p_j)}{1 - \gamma^2}, \quad i, j = 1, 2, i \neq j. \quad (2)$$

Therefore, firm $i$’s manager maximizes

$$\Pi_i^m(p_i, p_j, k_i, k_j) = \frac{(p_i - c)(k_i - p_i - \gamma(k_j - p_j))}{1 - \gamma^2}, \quad i = 1, 2, j \neq i,$$

with respect to $p_i$. Determining the reaction function of manager $i$ yields

$$p_i(p_j) = \frac{k_i + c + p_j \gamma - k_j \gamma}{2}. \quad (3)$$

Solving for the Nash equilibrium in prices we obtain

$$p_i(k_i, k_j) = \frac{2(k_i - \gamma^2) - \gamma k_j - c(2 + \gamma)}{(2 - \gamma)(2 + \gamma)}, \quad i = 1, 2, j \neq i. \quad (4)$$

The optimal price of firm $i$ is increasing $k_i$ and decreasing in $k_j$. The reason for the first result is that with a larger $k_i$, the manager considers the market size as larger which renders higher prices optimal. The reason for the second result is that firm $j$ finds it optimal to sell a larger quantity if $k_j$ is larger. Thus, if firm $j$ hires a manager with a large $k_j$, this has an intimidating effect on firm $i$’s manager who will react by reducing $p_i$.

Turning to the first stage, the profit function of firm $i$ is given by

$$\Pi_i^o(k_i, k_j) = \frac{(p_i(k_i, k_j) - c)(1 - p_i(k_i, k_j) - \gamma(1 - p_j(k_i, k_j)))}{\beta^2 - \gamma^2},$$

where $p_i$ and $p_j$ are given by (4). The owner maximizes this profit function with respect to $k_i$. Determining the reaction function we obtain

$$k_i(k_j) = \frac{\gamma k_j(8 - 5\gamma^2 + \gamma^4) + (1 - \gamma)(2 + \gamma)(2 - \gamma)\gamma(2 - \gamma^2) + c\gamma^2}{4(2 - \gamma^2)}.$$

It is straightforward to check that the second-order condition is fulfilled. It is evident that managers’ types are strategic complements in the firms’ hiring decisions. That is, if firm $i$ hires a more aggressive manager, firm $j$ wants to follow suit. The reason is that if
the manager of one firm becomes more aggressive, he charges lower prices. Since prices are strategic complements, it pays off for the other firm to also hire a more aggressive manager. Solving for the Nash equilibrium of the first stage yields

\[ k_i^* = k_j^* = k^* = \frac{4 - 2\gamma - (2 - c)\gamma^2 + \gamma^3}{4 - 2\gamma - \gamma^2 - \gamma^3}. \]

We can now determine whether a firm hires an aggressive or a conservative manager. We obtain that

\[ k^* - 1 = \frac{(1 - c)\gamma^2}{4 - 2\gamma - \gamma^2 + \gamma^3} < 0, \]

where the inequality stems from the fact that \( c < 1 \) and \( \gamma < 1 \). Therefore, we obtain the result that both firms want to employ aggressive managers where this behavior is achieved by hiring types with \( k_i < 1 \):

**Proposition 1** In the game with price competition both firms hire an aggressive manager, that is \( k_i^* < 1 \) for \( i = 1, 2 \).

This result is in contrast to the previous literature which obtains that if firms compete in prices, managers' contracts are such that they behave less aggressively. The intuition for our opposing result is as follows: Employing a manager with \( k_i > 1 \) implies an upward bias in the expectation that firm \( j \)'s manager holds about firm \( i \)'s demand. This can be seen from the direct demand function of firm \( j \). From (2), this demand function is given by

\[ q_j = \frac{k_j - p_j - \gamma(k_i - p_i)}{1 - \gamma^2} \]

The third term in the numerator shows that \( q_j \) decreases in \( k_i \). As explained above, this intimidates firm \( j \)'s manager and so he is inclined to reduce \( p_j \). This can be seen from the price reaction function of manager \( j \), which is given by

\[ p_j(p_i) = \frac{k_j + c + p_i\gamma - k_i\gamma}{2}, \]

implying that \( \partial p_j/\partial k_i = -\gamma/2 \). But since this reduces firm \( i \)'s profit, the owner of firm \( i \) has an incentive to hire a manager with \( k_i < 1 \). This effect dominates the well-known effect that a manager with a \( k_j > 1 \) acts less aggressively which is helpful for the firm from a strategic perspective. Therefore, in the terminology of Fudenberg and Tirole (1984), we obtain that owners choose a "lean-and-hungry" strategy to make the manager tough. By contrast, in standard models with upward sloping reaction functions, owners follow a "puppy-dog" strategy to keep prices high.

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6It is straightforward to check that the second-order conditions are fulfilled and that there is a unique equilibrium.
Inserting the equilibrium values for $k^*$ into the prices, we obtain that equilibrium prices are

$$p_i^* = p_j^* = p^* = \frac{2(1+c) - 2\gamma - \gamma^2 + \gamma^3}{4 - 2\gamma - \gamma^2 + \gamma^3}.$$  

The equilibrium profits of each firm are then

$$\Pi_i^* = \Pi_j^* = \Pi^* = \frac{2(1-c)^2(1-\gamma)(2-\gamma^2)}{(1+\gamma)(4 - 2\gamma - \gamma^2 + \gamma^3)^2}.$$  

We can now compare these prices to the benchmark case in which managers are unbiased (or owners compete directly without employing a manager). In this case we obtain that equilibrium prices are $p_{bm} = (1+c - \gamma)/(2 - \gamma)$ and equilibrium profits are

$$\Pi_{bm} = \frac{(1 - \gamma)(1-c)^2}{(1+\gamma)(2 - \gamma)^2}.$$  

Comparing this with our equilibrium we obtain

$$p_i^* - p_{bm} = -\frac{\gamma^2(1-c)(1-\gamma)}{(2 - \gamma)(4 - 2\gamma - \gamma^2 + \gamma^3)} < 0$$  

and

$$\Pi_i^* - \Pi_{bm} = -\frac{\gamma^3(1-c)^2(1-\gamma)(4\gamma - 2\gamma^2 + \gamma^3)}{(1+\gamma)(4 - 2\gamma - \gamma^2 + \gamma^3)^2(2 - \gamma)^2} < 0.$$  

Therefore, we obtain the following result:

**Proposition 2** *Equilibrium prices and profits are lower in the delegation game than in the case in which managers are unbiased.*

Given the preceding analysis, the result is intuitive. Since each firm’s manager is aggressive, he sets a lower price than an unbiased manager. Overall equilibrium prices are therefore lower than in the case without delegation, leading to lower equilibrium profits. Thus, a prisoners’ dilemma situation occurs: Both owners individually prefer to hire an aggressive manager but they would jointly be better off, when committing to an unbiased (or even conservative) manager.

We can now analyze how $k_i^*$ changes with $\gamma$ and $c$. Doing so yields

$$\frac{\partial k_i^*}{\partial \gamma} = -\frac{\gamma(1-c)(8-2\gamma + \gamma^3)}{(4 - 2\gamma - \gamma^2 + \gamma^3)^2}.$$  

Since $c < 1$ and $\gamma < 1$, the sign is negative. This implies that more aggressive managers are hired if there is closer substitutability between the goods. The reason is that the larger is $\gamma$, the larger is the effect described above, and so the more important it is, that managers set low prices.
We can also check how a change in costs affects the hiring decision. To do so we differentiate $k^*_i$ with respect to $c$. We obtain that
\[
\frac{\partial k^*_i}{\partial c} = \frac{\gamma^2}{4 - 2\gamma - \gamma^2 + \gamma^3} > 0,
\]
leading to the following result:

**Proposition 3** In the game with price competition the equilibrium degree of aggressiveness increases if products are closer substitutes and decreases in costs.

The reason for the comparative static result with respect to the degree of substitutability is that the larger is $\gamma$, the larger is the intimidating effect described above, and so hiring a manager with a larger $k_i$ becomes more important. The reason for the result concerning costs is that the larger are costs, the larger are equilibrium prices, implying that the incentives to strategically reduce prices are weakened.

So far we considered the case in which the expectation of firm $i$’s manager about firm $j$’s demand intercept is the same as the one of manager $j$. However, this expectation can also be influenced by the bias of manager $i$ himself. For that reason we now consider the case in which the expectation of manager $i$ is given by $(xk_j + (1-x)k_i)$, with $x \in [0,1]$.

Following the same steps as above, we obtain that in this case
\[
k^*_i = k^*_j = k^* = \frac{(1 - \gamma)(4 - 2\gamma - c\gamma^2) + \gamma(2 - \gamma)(2 - \gamma(1 - c))}{(1 - \gamma)(4 - 2\gamma - \gamma^2) + 2\gamma x(2 - \gamma)}.
\]
Solving $k^* - 1$ for $x$ we obtain the following result:

**Proposition 4** In case manager $i$’s expectation about the rival’s demand intercept are given by $(xk_j + (1-x)k_i)$, both firms hire an aggressive manager as long as $x > (1 - \gamma)/(2 - \gamma)$.

Thus, as long as $x$ is not too small, owners find it optimal to hire a manager with $k_i < 1$ to avoid intimidation of the rival. As a numerical example, if $\gamma$ equals 1/2, firms hire an aggressive manager for $x > 1/3$.

We conducted our analysis in a framework in which managers have biased expectations about the size of the market. It is important to note that a similar result would not obtain if managers were biased about firm’s costs. In this case, the effect laid out above, namely that hiring a manager with $k > 1$ intimidates the manager of the rival firm, and so an owner wants to avoid this, would not be present. With biased beliefs with respect to the costs, only the standard strategic effect is present, leading to $k^* > 1$ to reduce the manager’s aggressiveness. In this respect, our model applies particularly to managers with beliefs
about market conditions, e.g., managers with a business background, and probably less to managers with beliefs about unit costs, e.g., those with an engineering background.

4 Quantity competition

We can pursue a similar analysis for the case of quantity competition. The problem of the manager of firm $i$ can be written as

$$
\Pi_m^i(q_i, q_j, k_i, k_j) = q_i(k_i - q_i - \gamma q_j - c), \quad i = 1, 2.
$$

Building the first-order conditions and determining the Nash equilibrium we obtain

$$
q_i = \frac{2(k_i - c) - \gamma(k_j - c)}{4 - \gamma^2} \quad i, j = 1, 2, i \neq j.
$$

(5)

In the first stage, each owner decides about the type of the manager to hire. Thus, the optimization problem of the owner of firm $i$ is

$$
\Pi_o^i(k_i, k_j) = q_i(1 - q_i(k_i, k_j) - \gamma q_j(k_i, k_j) - c), \quad i = 1, 2,
$$

where $q_i$ and $q_j$ are defined in (5). Again building the first-order conditions with respect to $k_i$ and

Using this and solving for the Nash equilibrium in the first stage yields

$$
k_i^\ast = \frac{4 - 2\gamma + c\gamma^2}{4 - 2\gamma + \gamma^2}.
$$

We can again determine if both firm hire an aggressive or conservative manager. We obtain that

$$
k_i^\ast - 1 = \frac{\gamma^2(1 - c)}{4 - 2\gamma + \gamma^2} > 0.
$$

This implies, as under price competition, that both owners want to employ aggressive managers since each manager produces a larger quantity with $k_i^\ast > 1$ than with $k_i^\ast \leq 1$. This yields the next result which shows that the direction of a manager’s bias is the same under price and quantity competition:

**Proposition 5** Also in the game with quantity competition both firms hire an aggressive manager.

As in the case with price competition, we compare these prices to the benchmark case in which managers are unbiased (or owners compete directly without employing a manager).
Inserting the equilibrium values for $k^*$ into the quantities and profits, we obtain that equilibrium prices and profits are

$$q_i^* = q_j^* = q^* = \frac{2(1-c)}{4+2\gamma - \gamma^2}.$$ and $$\Pi_i^* = \Pi_j^* = \Pi^* = \frac{2(1-c)^2(2-\gamma^2)}{(4+2\gamma - \gamma^2)^2}.$$ In the benchmark case we obtain that equilibrium prices are $q_{bm} = (1-c)/(2+\gamma)$ and equilibrium profits are

$$\Pi_{bm} = \frac{(1-c)^2}{(2+\gamma)^2}.$$ Comparing this with our equilibrium we obtain

$$q_i^* - q_{bm} = \frac{\gamma^2(1-c)}{(4+2\gamma - \gamma^2)(2+\gamma)} > 0$$ and

$$\Pi_i^* - \Pi_{bm} = -\frac{\gamma^3(1-c)^2(1-\gamma)(4+3\gamma)}{(1+\gamma)(4+2\gamma - \gamma^2)^2(2+\gamma)^2} < 0.$$ Therefore, we obtain the following result:

**Proposition 6** Equilibrium quantities are higher and profits are lower in the delegation game than in the case in which managers are unbiased.

So, as in the case of quantity competition, the hired aggressive managers sell a larger quantity, which is to the detriment of firms. Again, a prisoner's dilemma situation occurs in which both firms would be better off without delegation.

Finally, similar to the case of price competition, we perform a comparative static analysis of $k_i^*$ with respect to $\gamma$, $c_i$ and $c_j$. Doing so yields

$$\frac{\partial k_i^*}{\partial \gamma} = \frac{2\gamma(1-c)(4+\gamma)}{(4+2\gamma - \gamma^2)^2} > 0$$ and

$$\frac{\partial k_i^*}{\partial c} = -\frac{\gamma^2}{4+2\gamma - \gamma^2} < 0.$$ This yields the following result, which resembles the one we derived for the case of price competition:

**Proposition 7** The equilibrium degree of aggressiveness increases if products are closer substitutes and decreases in costs.

## 5 Conclusion

Our analysis has shown that in a strategic delegation context owners of competing firms will want to hire biased managers for strategic reasons. Independent of the mode of competition, i.e., price or quantities, it is optimal for an owner to hire a manager that behaves...
aggressive on the product market. This result contrasts with the classic literature on strategic delegation but is in line with recent empirical evidence that a candidate’s aggressiveness seems to be an important characteristic in the hiring choice for CEO positions (see, e.g., Kaplan et al. (2012)).

Our results are interesting for management strategy as they document the important strategic effects of personnel decisions. We show that not only ability but also other personality traits may have important effects on the strategic position of firms in competition. This is a particularly relevant channel, as it is also available in circumstances where firms, e.g. due to contractibility problems or regulatory restrictions, cannot effectively use distorted contracts to influence managerial behavior.

References


