

Abstract:

We study an organization with limited commitment. In our model, although the principal can commit to the hierarchical structure of the organization, she cannot make a long term commitment to the transfers to the agents. Our findings are as follows. When it is much more likely that the agents are of high-efficient type (low-efficient type), the optimal hierarchical structure is "horizontal" with separating (pooling). When such likelihood is in intermediate range, however, our analysis reveals that the optimal hierarchical structure is "vertical" -- the principal can mitigate dynamic incentive problems with a vertical hierarchy. We also provide a new economic interpretation of "promotion" within an organization.