Corporate Experimentation and the Market for CEOs

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Abstract

We study how self-enforcing repeated relationships between a principal and multiple competing agents form and evolve over time in the presence of learning. This work is motivated by the emergence of a large evidence of returning CEOs in major corporations. Examples of this business practice are widespread and include Apple, Starbucks, Pandora, Tinder, Google, Dell, Yahoo!, LinkedIn, and Reddit. The question often arises as to what extent and how the recurrence of CEOs affects managerial experimentation and innovation efforts. In this paper, we address the issue by proposing a repeated game where a principal (shareholders) hires agents (CEOs), one in each period, via a relational contract. The principal delegates to the selected agent the choice of the managerial policy for the period. The former combines transfers (compensation) and non-monetary tools (replacement threat) to motivate the agent to engage in costly experimentation with innovative activities. Agents know whether innovation opportunities are available in each period, whereas the principal does not. The principal would like the agent to experiment with new activities that have an uncertain but higher expected return. The conflict of interests arises because the agent bears a cost when implementing new tasks that are not in his routine. Monitoring is imperfect (and public), but agents' strategies are private. Successful experimentation reduces the information asymmetry and parties become better able to specify the details of their cooperation in a relational contract. We characterize optimal incentive provision in two distinct market configurations: a deep market, with many agents, and a narrow market, where only two agents are available. The theoretical interest of our model arises because we allow for private strategies in a repeated game of imperfect public monitoring, which makes the characterization of equilibrium behavior non-standard. Applications not only include managerial compensation and CEO rotation in innovative industries, but also moral hazard problems in political economy.

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