The Leadership Quarterly 28 (2017) 65–85

Contents lists available at ScienceDirect

The Leadership Quarterly

journal homepage: www.elsevier.com/locate/leaqua

A productive clash of cultures: Injecting economics into leadership research☆

Christian Zehnder [a,*], Holger Herz [b], Jean-Philippe Bonardi [c]

[a] University of Lausanne, Faculty of Business and Economics, UNIL-Dorigny, Internef 612, CH-1015 Lausanne, Switzerland
[b] University of Fribourg, Faculty of Economics and Social Sciences, Boulevard de Perolles 90, CH-1700 Fribourg, Switzerland
[c] University of Lausanne, Faculty of Business and Economics, UNIL-Dorigny, Internef 604, CH-1015 Lausanne, Switzerland

ARTICLE INFO

Article history:
Received 4 June 2016
Received in revised form 15 September 2016
Accepted 4 October 2016
Available online 14 October 2016

Keywords:
Leadership
Economics
Foundations
Emergence
Effectiveness

ABSTRACT

Research on leadership in economics has developed in parallel to the literature in management and psychology and links between the fields have been sparse. Whereas modern leadership scholars mostly focus on transformational and related leadership styles, economists have mainly emphasized the role of contracts, control rights, and incentives. We argue that both fields could profit from enriching their approach with insights from the other field. We review and synthesize the economics literature on leadership in organizations and discuss how leadership scholars in management and psychology can benefit from the detailed understanding of transactional methods that economists have developed. We link the contributions in economics to a broad set of topics including the foundations of leadership, leader emergence, and leader effectiveness. At the same time, we also point out limitations of the economic approach and outline how the integration of leadership research and economics would broaden the scope of future studies.

Introduction

Although leadership is not yet an established subfield of economics, elements of leadership feature prominently in some areas of economic research. At the same time, a vast literature on leadership exists in psychology and management. These two literatures have so far moved mostly in parallel to each other and links between the fields have been sparse, despite obvious commonalities. In light of the fact that much of the relevant work in economics most directly applies to leadership in organizations, we will restrict our attention to this type of leadership. Of course, we acknowledge that leadership applies more broadly and is also relevant in many other dimensions of human society, but it is mostly in the context of organizations, where we think that both economists and leadership scholars could benefit tremendously from a more intense exchange of ideas and insights. Whereas inter-disciplinary approaches are interesting in general, the complementarity of the two existing literatures makes this case particularly promising and fruitful. We identify three themes within which synergies between the fields seem obvious: (1) Why is leadership needed at all?, (2) Who emerges as a leader?, and (3) How can a leader be effective?

In the first part of our article we explore the foundations of leadership in the context of economic activity. In light of the omnipresence of leader-follower relationships in real-life organizations asking whether and why leadership is important in the economic context may seem superfluous. But this argument is misleading. From an economic point of view the question of why

☆ We thank Shelly Dionne (editor) and two anonymous reviewers for their constructive comments and Lino Eden for excellent research assistance.
* Corresponding author.
E-mail addresses: christian.zehnder@unil.ch (C. Zehnder), holger.herz@unifr.ch (H. Herz), jean-philippe.bonardi@unil.ch (J.-P. Bonardi).

http://dx.doi.org/10.1016/j.leaqua.2016.10.004
1048-9843/

leadership is needed at all is a highly interesting one. Economic theory implies that in the absence of frictions it is most efficient if economic transactions are governed by the price mechanism in a competitive market. In reality, however, we observe that a significant part of economic activity takes place in vertically structured, hierarchical organizations rather than in markets. So, how can this discrepancy be explained? The literature on the theory of the firm provides answers (Coase, 1937; Williamson, 1975, 1985; Alchian & Demsetz, 1972). Organizational economists have identified a number of reasons for why market mechanisms fail to operate properly in some situations. Among the main obstacles that reduce market efficiency are excessive transactions costs (Coase, 1937), exploitation (Williamson, 1975, 1985), lack of teamwork (Alchian & Demsetz, 1972), and distorted incentives (Holmstrom, 1999a). We will show that in all those situations the establishment of vertical, authority-based leader-follower relations within organizations can help to mitigate the problem. Thus, in general, the need for leadership in organizations is driven by the failure of the market. Moreover, each approach discussed in this section will reveal new elements that need to be added to the leader's task portfolio, creating a rich profile of leader responsibilities.

In the second part of the paper we shift our attention to the problem of leader emergence. The leadership literature dedicated to this topic is mostly concerned with individual traits of people who emerge as leaders (Lord, De Vader, & Alliger, 1986; Judge, Bono, Ilies, & Gerhardt, 2002). In economics, in contrast, research related to leader emergence focusses on how features of organizational design (most importantly ownership structures and delegation decisions) shape incentives of particular individuals to become a leader (Aghion & Tirole, 1997). We will argue that there are important and interesting links between these two views. The strength of the economic approach is that it determines the conditions under which a motivated leader can and will emerge. If ownership is well defined, economic models analyze how knowledge dispersion and alignment of interest affect the owners' capability to effectively appoint desirable leaders. If ownership structures are vague, the theory identifies incentive structures to induce motivated leaders to step up voluntarily. However, the economic approach is somewhat agnostic regarding the origins of people's motivation to lead. In reality, it matters greatly for an organization whether the appointed or emerged leader is suitable for the task at hand. To design systems that ensure that the right person gets selected, it is therefore important to understand how appealing different incentive systems are to people with particular personality traits. We argue that the development of such general models of leader emergence requires that economists and leadership scholars share and combine their insights.

In the third and final part of the article we turn to leader effectiveness. We believe that the respective literatures on effectiveness exhibit even stronger complementarities than the ones on foundations and emergence. Effectiveness research in management and psychology has mostly focused on what has been termed the "new" leadership by Bryman (1992). This approach includes work on transformational and charismatic leadership, has a strong focus on value-based methods, and assumes that leaders motivate followers intrinsically (Burns, 1978 and Bass, 1985; House, 1977; Shamir, House, & Arthur, 1993). Proponents of this literature typically argue that effective leadership needs to go beyond purely transactional measures such as rewards and sanctions (House, 1977; Howell & Avolio, 1993). The literature in economics, in contrast, has essentially taken an opposite approach. Economists have extensively studied the optimal design of contracts and incentives and have developed a detailed understanding of the environmental conditions under which contract-based (i.e., transactional) leadership techniques work or fail (Jensen & Meckling, 1976, Hart & Holmström, 1987, Holmström & Milgrom, 1991).[1] The fact that leaders may also be able to use different, potentially softer channels to affect followers' behavior has been largely ignored by economists, however. We think that both approaches are too narrow. We argue that truly effective leadership means that the leader always chooses the leadership style best suited to the situation in which the leader needs to lead (see also, House, 1996). In some cases, a purely transactional approach may be best, in other cases, transformational tactics may be required.[2] Our review of the literature shows that the economic framework provides a very systematic and simple tool to distinguish situations in which a contractual solution based on rewards and sanctions is sufficient from those in which a more involved, transformational approach is needed. This allows us to present a simple characterization that hints at the optimal leadership style as a function of the environment and identifies environmental complexity as the central determinant. A simple rule of thumb is that transactional, incentive-based systems work better in simple environments. Investment-intense transformational approaches are likely to be most effective in complex situations in which incentives would either be ineffective or would even lead to unwanted distortions (Shamir et al., 1993). Building on recent developments in the literature on identity economics (Akerlof & Kranton, 2000, 2005) we propose a way to fully integrate the two approaches in a unified framework that will be able to provide insights beyond the limitations of each of the current approaches.

Our article is not the first one to provide a review of the economics literature on leadership. However, we believe that our approach to the topic differs in quite fundamental ways from what others have done before us. Most importantly, both Hermalin (2013) and Bolton, Brunnermeier, and Veldkamp (2013a) take the view that the literature on explicit performance pay is not part of leadership and concentrate on leader activities that go beyond contract design. Hermalin (2013) mainly focuses

[1] Note that the way we use the concepts of transactional and transformational leadership throughout the paper may not always perfectly coincide with the detailed definitions and operationalizations used in the leadership literature. The reason is that we aim at connecting two literatures with different traditions, frameworks, and models, so that some flexibility is needed. We are convinced, however, that we use the terms correctly at the conceptual level. Judge and Piccolo (2004), for example, state that transactional leaders "*focus on the proper exchange of resources*", whereas transformational leaders "*offer a purpose that transcends short-term goals and focuses on higher order intrinsic needs*". When translated to the language of economists the former corresponds to the design of contracts, incentive systems and proper organizational institutions and the latter is related to attempts to shape followers' preferences. We think it is most promising to start linking the literatures at this higher level, where it is easier to find connecting points. Contradictions in the details need to be sorted out once the common ground is understood.

[2] We are aware of the fact that the transactional-transformational dichotomy does not cover all aspects of leadership and that there exist other avenues such as expert-based approaches that rely neither on values nor on contracts (Antonakis & House, 2014). However, to keep things manageable in the context of this paper, we put our focus on the transactional-transformational part, but point out links to other approaches (such as instrumental leadership) when the context requires it.