Agency Theory: Problem Addressed

- How to develop optimal design of an organization in the context of:
  - Conflict of interest between principal and agent
  - Different risk preferences between P and A
- Basic concern: Understanding decision making and control in organizations where there is a potential conflict of interest between those making decisions and those whose wealth position are affected by those decisions (“The Agency Problem”)

Builds on Hayek’s concerns about how best to organize society to exploit diffuse information. Their twist is that diffuse info also involves agency costs.

Focus on role of information in “metering” inputs and outputs to deal with agency costs.
Origins and Applications

- Roots:
  - Information economics
  - Organization theory and management literature
- While most of the more formal modeling follows style and assumptions of info-econ models discussed up to now, more informal discussion often assumes some form of bounded rationality (E.g., Fama and Jensen’s “specific information”).
- Applied to sociology, political science, etc. as well as economics and management

Post Coasian in that

- It looks at the internal organization of firms and other organizations rather than treating them as a black box
- Argues that the organizational form that is most efficient in dealing with agency problems will give the organization a competitive advantage and hence dominate in a certain domain of activity.
Basic Premise: The Organization is a Nexus of Contracts

- Cf. Coase, which called the firm the realm of resource allocation by fiat. Alchian and Desetz say this is “delusion.”
- For agency theorists, essence of an organization is “teamwork” (a superadditive production function), which leads to a more difficult problem of “metering” performance
  - For Coase, the essence of the firm is the suppression of the price mechanism
  - For agency theorists, the organization (firm) is just a shell within which other markets exist (for labor, capital, decision skills, etc.) The key issue is how to structure these contracts to deal with trade-off between risk sharing and agency costs.

The Organization is a Nexus of Contracts

- How to keep the monitor from shirking? Central role of residual claims
- Analysis focuses on the functioning of these internal markets or contracts as way of disciplining agents and sharing risk.
General problem addressed by Fama and Jensen

- How to benefit from risk benefits of separating role of getting residual claims from decision management (initiating and implementing ideas) in the presence of agency costs
- General solution: Identify mechanisms that vest decision control (idea ratification and monitoring) with residual claimants and decision management in hands of those best informed and capable to handle it.

Agency Theory - Key articles in economics:

- Alchian and Demsetz (1972). Focus is on nature of teamwork and the “metering” problem. Fixed vs. residual claims
- Jensen and Meckling (1976). Focus is on how ownership structure aligns incentives
- Fama (1980) – Corporate finance and role of efficient capital and labor markets in disciplining behavior. Irrelevance of concept of “ownership.” Just look at nature of claims.
Role of efficient capital and labor markets to monitor the agent

- Role of management labor markets
  - Incentives for creation of private information systems
- Role of capital markets
  - Stock prices and hostile takeovers

Design of the Agent’s Contract

- Focus on behavior-based vs. outcome-based contracts. Example:
  - Salary vs. stock options
Propositions: Outcome vs. Behavior-based Contracts

- When the contract between P and A is outcome-based, the agent is more likely to behave in the interests of the principal.
- When the P has information to verify the behavior of the A, the agent is more likely to behave in the interests of the principal.

Propositions: Outcome vs. Behavior-based Contracts

- Information systems are positively related to behavior-based contracts and negatively related to outcome-based contracts.
- Outcome uncertainty is positively related to behavior-based contracts and negatively related to outcome-based contracts.
Propositions: Outcome vs. Behavior-based Contracts

- Degree of risk aversion of the agent is positively related to behavior-based contracts and negatively related to outcome-based contracts.
- Degree of risk aversion of the principal is negatively related to behavior-based contracts and positively related to outcome-based contracts.

Propositions: Outcome vs. Behavior-based Contracts

- Degree of goal conflict between P and A is negatively related to behavior-based contracts and positively related to outcome-based contracts.
- Task programmability is positively related to behavior-based contracts and negatively related to outcome-based contracts.
Propositions: Outcome vs. Behavior-based Contracts

- Outcome measurability is negatively related to behavior-based contracts and positively related to outcome-based contracts.
- The length of the agency relationship is positively related to behavior-based contracts and negatively related to outcome-based contracts.