

# Insight into principal agent theory



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Governments now use a number of principal-agent or funder-provider type models to deliver policy or provide services (both between governments and from governments to the community). Why were these models chosen, what has been the effect and what are the strengths and weaknesses of such models?

Next section outlines agency theory as it has applied in private markets and the role of transaction costs. The emergence of public choice theory when combined with agency transaction costs theory and

## **Principal-agent theory**

Principal-agent theory was initially developed within the economics discipline to better understand and resolve dilemmas associated with so called 'information asymmetries' between two sets of players - principals and agents - who frequently have divergent motivations, goals and attitudes to risk. A necessary assumption required for the theoretical ideal of perfect competition is perfect information between buyers and sellers in an exchange. As economists readily attest, this assumption rarely holds in reality, providing an avenue for opportunistic behaviour where one party to a transaction - the agent - has an information advantage over the other - the principal.

The agent is employed or contracted by the principal to provide a good or service that has some value, for which the agent is remunerated by the principal. The problem is in essence a contracting problem concerning how much of the value created should go back to the agent by way of remuneration (Lane, 2003a: 2). Due to asymmetric information the agent

knows more than the principal about the desired good or service required, providing prospect for self-interest-motivated opportunistic behaviour on the part of the agent. This gives rise to two distinct problems for the principal:

Adverse selection which occurs where goods and services being bought are not of the quality expected (for example, sellers of used cars behave opportunistically by not revealing known defects unobservable to the buyer) or may involve misrepresentation of ability by the agent (such as overstating experience or qualifications at a job interview); and

Moral hazard whereby information agents possess cannot be monitored or challenged providing an incentive to behave either dishonestly or in ways which might not provide the full benefit to the principal (for example, once insured, a car owner might take more risks as a driver or less care in ensuring the vehicle is securely parked and locked).

Thus adverse selection is a pre-contractual problem requiring effort on the part of the principal in discovering the suitability of the agent prior to forming a contract whereas moral hazard occurs after the contract has been made requiring monitoring of effort and performance of the agent during the contract period. Principals, in addressing both these problems, incur ' transaction costs' associated with selecting appropriate agents, negotiating contracts and in monitoring and evaluating performance and delivery. Such costs lead to economically inefficient outcomes and are a source of potential market failure.

However principals know they are at an information disadvantage so utilise a variety of incentives in an attempt to align the interests of the agent with

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their own, such as commissions, profit sharing and efficiency wages. In contract negotiations this typically involves specifying an 'outcome-oriented contract' (Shapiro, 2005: 265) combining elements of monitoring and motivation designed to minimise the transaction costs encountered by the principal, while maximising the value generated to both parties.

Contestability within markets - that is competition or the threat of competition - can also assist with alignment of interests, minimising opportunistic deviation from stated goals and minimising transaction cost. As Skoussen (2008: 64) observes, private firms 'compete in order to collaborate.' That is competition at each stage of the production process, or 'inrastage competition' can align interest of providers who have a vested interest in gaining certainty for the sale of their own productive output through a guaranteed buyer, providing them some assurance in making necessary longer-term business investment decisions. Principals, in drawing up contracts, can thus utilise competition among agents since their interests will often be more congruent with those of the principal (Shapiro ..).

Transaction costs represent a kind of 'economic friction' which reduces efficiency of the market but does not necessarily result in market failure. Transaction cost analysis is based on the efficiency concept that it is the cost of transacting business that determines organisational structure. Firms either 'make or buy' intermediate inputs to their production processes based on an assessment of the relative costs, associated with outsourcing an activity (including risk of a botched job or sub-standard quality etc) versus performing the task oneself. Thus a firms structure is determined by comparative costs of these make or buy decisions.

While the nature of agency problems and transaction costs dictates that the value generated under a contractual arrangement will be sub-optimal or a second-best solution when compared to the theoretical ideal of a ' free market', the principal-agent relationship is nevertheless beneficial to both parties. And more efficient than monopoly provision

Connecting sentence...

Application to the Public sector

Why in the PS - history

The emergence of public choice theory and New Public Management in the UK ( ) new institutionalist economics in NZ ( ) and Reinvented government in the US (Ferris and Graddy, 1996) that led to the application of principal-agent theory to the public sector

The rise of the welfare state in the post-war decades coupled with a principles of universal access and provision through government run monopolies and nationalised industries resulted in growing dissatisfaction with the bureaucratic service delivery model which was seen to have become ' monolithic, authoritarian, paternalistic, inflexible and slow' (Wanna, et. al. 2010: 24).

Following initial moves by the Thatcher government to privatise public assets in the UK ation - realisation that competition not ownership (whether public or private) led to greater resource allocation

Why in the PS - rationale

NPM reforms have several key features including: letting public sector managers be 'free to manage'; setting explicit standards and measures of performance; placing greater emphasis on results or outputs rather than procedures or inputs; the disaggregation of units in the public sector; a shift to greater competition in the public sector; emphasis on private sector styles of management (Hood, 1991) – in Hood's view NPM represents 'a marriage of two different streams of ideas' – the new institutional economics (built on public choice theory, transactions cost theory and agency theory) and business-type managerialism. The adoption of NPM in different countries

Althaus (1997) analyses the way that agency theory has underpinned public sector reform in the UK and New Zealand – she advances some significant reservations about the extent to which theories of private exchange can be applied to public sector activities

Appreciation of the power and limits of the principal-agent model gained by understanding its relationship with public choice theory, transaction cost analysis and property rights theory.

### Public choice theory

Public choice theory argues that public servants often act in their own self-interest and may work against the public interest in order to protect or inflate their budgets and resources. This theory highlights a principal-agent problem whereby political principals are at an information disadvantage and face potential moral hazard in overseeing the activities of bureaucratic agents (Moe, 1984; Gains and John, 2007). Proponents of public choice theory

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Public choice linked to capture where "... an agency whose existence is inextricably linked to the continuation of existing policy is likely to be biased in favour of existing policy - that is, the agency is ' captured' (Treasury 1987: 75) -recommended solutions to public choice include minimising the role of the state, reducing public monopolies, contracting out and organisational separation of roles to overcome such capture.

A premium has been placed on getting better return on public sector resources - New Public Management (UK) and reinventing government (US) -

Applied where in the PS

A range of models and reforms have been implemented around the globe in response to agency theory. Purchaser-provider separation (Aulich, 2002; Steffens et. al 1998; Street 1994), compulsory competitive tendering (Aulich, 1999), decentralisation of fiscal relationships (Tommasi and Weinschelbaum, 2007) and performance contracts and performance-based budgeting (Ferris and Graddy, 1996) are all synonymous with potential principal-agent problems.

Who is the principal

who is the principal? Only in countries with democratically elected governments is it true that the principal is the citizenry and the elected government the principal.

Lane looks upon politics as a succession of principal-agent games, starting with the electoral contract, i. e. of voting in a new national assembly and government in order to end up in the setting up of implementation agencies

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working under a contract with government. Thus, politics is basically contracting, which raises the issues of consideration and quid pro quo, which issues tend to be resolved differently in democracies on the one hand and authoritarian regimes on the other hand. Yet, all politics involves contractual opacity and the serious risk of a mismatch between promises and outcomes, due to the long intertemporal nature of the electoral or administrative contracts

Ultimately consumers have no effective sanction over purchaser behaviour, and given that consumers cannot easily vote with their feet, there are few incentives for purchasing authorities to be innovative and responsive to consumer preferences (Street, 1994, p. 7)

Steffens et. al (1998) purchaser-provider structures adopted in QDPI as a means of introducing competition and increasing accountability and transparency in the delivery of services – rate relative success as due to the establishment of a business-to-business network with a mix of cooperation and competition, rather than competition alone.

Hagan and Bredt (2009), the reforms to date have largely focused on the producer-side of the market with emphasis on increasing competition and cost minimisation. There has been much less consideration given to consumer (including industry) behaviour and the intended outcomes of vocational training. In short, expenditure on vocational education and training has been considered a cost to be minimised rather than an investment in human capital to be maximised



Multiple principals - cross jurisdictional boundaries - restrictions imposed on states by Commonwealth - VET reforms State Purchaser as agent of the Commonwealth government is principal to state based training providers - different rules and incentives apply to the different funding streams

Street (1994) examined then proposed p-p separation arrangements aimed at correcting structural inadequacies in the national health system

Contracting process is likely to entail high transaction costs- associated with assessing needs, inviting tenders, awarding contracts and monitoring performance..

. And an adversarial element into the health system

“ under purchaser-provider arrangements, the purchaser aims to determine both the price and volume of services prospectively”

## **Pros and cons Strengths and weaknesses**

Governments aim to implement its favoured set of programmes which are intended to generate social value; however while programmes generate value to society, the value of the public sector cannot be readily measured - no market evaluation of output and there is no residual owner of the output (Lane)

Priority setting - governments are seeking to maximise creation of public value, not necessarily interested in cost minimisation - potential trade-off where delivery through lowest price purchaser-provider arrangements might deny access to certain citizens.

Efficiency gains may be offset by poorer quality, equity or effectiveness - efficiency-quality trade-offs (eg., in human services such as aged care) or efficiency-equity trade-offs

Constraint on the principal is that the set of public programmes to be delivered are to be funded through taxation or direct user charges - higher taxes reduce popularity of the government.

Second constraint - has received less consideration in the literature but growing recently - is elector satisfaction with access to and the quality and timeliness of government service delivery. Citizens limited in capacity to exert their role as principal until elections are called

Central planning of service delivery around has been a dominant feature of government purchasers, particularly in social services such as health (Street, 1994, p. 3), education (West et al 2009) and vocational training (Hagan and Bredt, 2009, p. xx)

Quasi-markets p-p split where providers have not had sufficient autonomy to make investment decisions to improve service delivery (Qld Transport Call centres constrained by the Department -purchaser who owned the outdated equipment utilised by the provider Ryan et. al.) similar situation exists in Qld TAFE institutes who have no autonomy over capital budgets to upgrade buildings and facilities

Price (Kamarack, 2007, p129-30) governments attempting to inject greater degree of market forces typically get the price wrong

Bid on partial costs only - in VET and education, tuition costs only - related to capital expenditures and government policy to preserve role of public provider

Concerns raised that quality is likely to be a casualty of competitive tendering (see for example Street, 1994) -

Jeopardise access

Central agencies such as Treasury and Finance, while driving the purchaser-provider reforms, have posed the major constraint by insisting that capital management decisions be centralised with all significant investments or revenues from asset sales required to go through consolidated revenue.

Gailmard (2010) identifies 'public service motivation' as one such source of alignment of interests which principals need to develop and exploit, since only policy-motivated agents "are willing to substitute the pursuit of policy goals for material compensation" (p. 39).

Tommasi and Weinschelbaum (2007) - trade-offs between centralised versus decentralised public service provision - specifically, the internalisation of externalities under centralised decision making versus 'accountability' advantage under decentralisation - citizen as principal and government as agent - argument is that it is easier to resolve information asymmetries through

Miller and Whitford argue that while principals may succeed in inducing extra effort to overcome moral hazard, the efficiency loss in the bureaucratic environment will be significant. "the job of the street-level bureaucrat is a

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very difficult one, made more difficult by inadequate resources, hostile clients and unclear performance standards. The net result is that many such bureaucrats accommodate to the job by hiding behind red tape and routine; the effort required to increase the probability of success with a given client can be costly". M&W appear to confuse ' transaction costs' - the additional costs incurred with outsourcing with the normal production costs associated with the business model for in-house

In some circumstances the costs associated with writing and monitoring contracts outweighs the benefits, in which case hierarchy may be more efficient than contractual networks - transaction costs must be compared with agency costs.

Britain's Next Steps reform program introduced by Margaret Thatcher's Efficiency Unit laid out a principal-agent contracting model comprising a chain of contracts - from minister to department to the chief executive of an agency - was heavily influenced by new institutionalist economics

Graham Scott - a key architect of the NZ reforms - new institutionalist economics to guide and integrate reforms - encouraged policy-makers to see public services not as production functions or firms, but as governance structures. Faced with a public policy problem, government should select the form of regulation with least transaction costs and the greatest capacity to meet parliament's objectives. Freed from the presumption that government must own and operate all public administration activities, Treasury could push for contracting on an unprecedented scale

“ It does not matter who provides the service, whether a public or private supplier, it is market contestability – that is competition, or the threat and potential of competition – rather than ownership of the enterprise that promotes efficiency” (Aurlich 2002: 39)

Agency theory, together with transaction cost analysis, were influential in what has become known as new institutionalist economics (Scott ...)

A contractual model implies a direct and personal exchange between principal and agent, between individuals and those supplying the services on behalf of the state. It presupposes choices are available, and that consumers have both preferences and the ability to act on their wishes. If these conditions are met, contracting offers the possibility of products tailored to particular needs, of customers purchasing from a range of providers rather than accepting a single, standardised form of public service delivery.

Not all government activity can avoid a mass production model

Miller and Whitford (2002) favour the reintroduction of a range of managerial considerations such as leadership that emphasises reciprocity with subordinates to foster greater productive effort over monitoring or offering financial incentives to motivate subordinates.

M&W, only consider principal-agent reforms internal to bureaucracies and have not considered reform model where

Alan Milburn led a radical reform of the UK's national health service to devolve decision-making, increase provider autonomy, diversify supply and empower patients. He is a proponent of citizen-centred public services.

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He will discuss how supply-side reforms including greater diversity in provision need to be coupled with demand-side drivers such as choice for users in order to make modern services better attuned to the needs of the individual citizen

A public service reduced to core functions, separation of policy from regulation and from service delivery, contracts between government agencies and service providers and contracts between superiors and subordinates (Barbara Sullivan)

' new public management' deregulation of markets, devolution of authority to managers within public bureaucracies, privatisation of many public assets and the introduction of commercial principles

## Conclusion

To date government reforms which have ushered in principal-agent restructuring have yielded mixed results but on the whole have failed to deliver the benefits expected. Reasons for the lack-lustre returns are varied – social policy more problematic than civil infrastructure services to business and industry. Reasons can be related to implementation- quasi-markets where agents not given sufficient autonomy to make critical business decision, particularly relating to capital investments ; principals setting price and quantity

Information asymmetry is a source of potential market failure but not a sufficient condition -markets through contracting, transaction cost minimisation continue to function albeit at a sub-optimal level (compared to

a theoretical perfect market). - therefore existence of info asymmetry a necessary but not sufficient condition to justify government delivery of a service - need better measures of full cost of government provision versus market provision - hence push for full accrual budgeting and accounting. Externalities sufficient condition for government funding but not necessarily government provision - pricing

Agent-providers need autonomy over capital investment decisions; contingency in budget allocations such that purchaser-principals have some discretion to manage public expenditures across the business cycle; competition where implemented needs to cover full cost of service provision (VET tuition costs only) to ensure viability of providers.

Public agencies don't allocate resources

Many of the shortcomings of p-a - falling short of expectations can be attributed to limitations in the way p-p models have been implemented - trade-off between accountability and efficiency. Limited by convention - and unlikely to change since central agencies keen to hold on to control

Partly to do with bureaucratic

This paper identified

Agency theory in itself is an internally incomplete theory

Five variations requiring further elaboration: many principals, many agents or the existence of a third party; heterogeneity in the parties; team production; long-term relationships; and oscillating, reflexive relationships

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where it is difficult to designate who is the principal and who is agent  
(Althaus p. 144)

Relationship blurred - between members of parliament and their  
constituents.

Benefits - forces consideration of issues such as information, power and  
asymmetry, self-interest and incentives, risk and uncertainty

Assumes principals know what actions or outcomes they want - not  
necessarily true in political life