

# Theoretical from the perspective of principal agent theory management essay



Theory in the natural sciences is the rigorous testing of predictive theorems or assumptions using observable and comparable data. The tested and verified hypotheses constitute the foundation of theories. And theories derived from this process usually serve as a highly reliable direction for behavior.

Theories in the social sciences, including public administration, implies the sequence of factual material (history, events, cases, stories, measures of opinion, observations) presented in definitions, concepts, and metaphors to promote understanding. The rigorous and the intuitive observation of social behavior, patterns of communication, and culture is the basis to this theory.

The last meaning of theory in public administration is the theories of what should to be. These theories compose the bridge between public administration, political science, and philosophy. The theorists aim at discovering theories that account for, explain, or describe observable trends in behavior and to evaluate the normative cues of such behavior.

“ It is often true that public administration theorists use a mix of the second and third definition of theory.” And there is no doubt that “ theory is the bedrock of understanding of public administration” (Frederickson and Smith, 2003). If manuscripts contain no theory, their value is suspect (Whetten, 2000).

Hence, an important mission of scholars and educators in the areas of management, health, education, and social work is, on the one hand to conduct researches that contribute knowledge to a scientific discipline, and to apply that knowledge to the practice of management as a profession, on <https://assignbuster.com/theoretical-from-the-perspective-of-principal-agent-theory-management-essay/>

the other (Simon, 1967). To do this well, we need to design our research so that it provides an intimate understanding of the practical problems facing the profession. Equally important, we need to appreciate and strengthen our skills in developing good theory so that research conducted about these problems will advance the knowledge that is relevant to both the discipline and the profession (Van DE Ven, 1989).

Therefore, this paper aims at discussing what is theoretical from the perspective of principal-agent theory. It is consisted of four sections: 1) What is Principal-Agent Theory; 2) What's the theoretical contribution of Principal-Agent Theory; 3) Limitations of Principal-Agent Theory; 4) Conclusion.

## **Principal-Agent Theory**

One day Deng Xiaoping decided to take his grandson to visit Mao. " Call me granduncle," Mao offered warmly. " Oh, I certainly couldn't do that, Chairman Mao," the awe-struck child replied. " Why don't you give him an apple?" suggested Deng. No sooner had Mao done so than the boy happily chirped, " Oh thank you, Granduncle." " You see," said Deng, " what incentives can achieve." (Capitalism, 1984)

According to Arrow (1971) and Wilson (1968), during the 1960s and early 1970s, economists investigated risk sharing among individuals or groups. The risk-sharing problem, described in this literature, arises when collaborating parties have different standpoints toward risk. Principal-Agent theory expanded the risk-sharing literature to include what is called agency problem. And agency problem occurs when cooperating parties have different goals, information, and division of labor (Jensen & Meckling, 1976).

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Specifically, principal-agent theory concentrates on “ the ubiquitous agency-relationship, in which one party (the principal) delegates work to another (the agent), who performs that work in behalf of the principal” (Eisenhardt, 1989). And principal-agent theory seeks to portray this relationship using the metaphor of a contract (Jensen & Meckling, 1976).

As a consequence, the central dilemma explored by principal agent theorists is how to stimulate the employee or contractor (agent) to behave in the best interests of the principal (the employer) when the employee or contractor has an informational advantage over the principal and has different interests from the principal. From the agency perspective, “ most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals” (Jensen and Meckling, 1976). The basic premise of the theory is that “ if both parties to the relationship are utility maximisers, there is good reason to believe that the agent will not always act in the best interests of the principal” (Jensen and Meckling, 1976).

In determining the most efficient contract, principal-agent theory brings up certain hypotheses about people, organizations and information. It assumes that agents and principals will act in their self-interest to maximize their own welfare. Agents possess more information than their principals possess. As a result, it identifies two impediments to effective contractual performance: moral hazard and adverse selection. Moral hazard refers to that the agent doesn't put agreed-upon efforts to the tasks. That is, the agent is shirking. Adverse selection refers to “ the misrepresentation of ability by the agent” (Eisenhardt, 1989). The agent may claim to have certain skills, experiences, or capabilities when he or she is hired. Adverse selection arises because the <https://assignbuster.com/theoretical-from-the-perspective-of-principal-agent-theory-management-essay/>

principal cannot completely verify these skills, experiences, or capabilities either at the time of recruitment or while the agent is working (Eisenhardt, 1989).

Two types of problems are especially relevant. One is the “agency problem” which arises from the conflicting goals of the principal and the agent and from the difficulty/expense involved in verifying the agent’s behavior (Eisenhardt, 1989). The second is “the problem of risk-sharing” which arises from the different attitudes toward risk on the part of the principal and the agent. The different risk preferences between the principals and agents are likely to lead to different actions. Therefore, the theory concentrates on the contract between the principal and the agent and “the ways in which the contract can be made most efficient from the point of view of the principal” (V. Nilakant, 1994).

Besides, the theory makes two assumptions: that goal conflict exists between principals and agents and that agents have more information than their principals, which results in an information asymmetry between them (Waterman and Meier, 1998).

Goal Conflict. “In the marketplace, principals and agents clearly have different goals and/or preferences” (Waterman and Meier, 1998). Commonly, agents want to make as much money as possible, however principals want to pay as little as possible for services. The same as in the public sector. The government wants to produce as more public goods as possible, while the contractor agents expect to decrease the cost as much as possible.

Therefore, in a contract relationship, maximum principals’ interest couldn’t

inevitably contribute to the maximum of agents' interests. It could even reversely worsen agents' advantages, such as less compensation or profit. As a consequence, how to encourage agents to accomplish principals' goals at a minimum cost has become a great challenge.

Information Asymmetry. " As we already have noted, the information asymmetry is a critical assumption of the principal-agent model. The information asymmetry is simply the claim that agents possess more information than their principals possess." (Waterman and Meier, 1998)

When the distribution of information between principal and agent is asymmetric, the " classic" principal-agent problem arises. The problem brought up here is how to avoid information asymmetry so that principals know to what extent the agents have achieved the principals' goals, what agents are doing, and what are not done. With these information, principals could better monitor the contract relation and working process to improve organizational performance.

" In addition to the assumption that partial goal conflict is inherent in any principal-agent relationship, principal-agent theory also presumes that information about the agent is a commodity that can be purchased." (V. Nilakant, 1994) Table 1 presents an overview of principal-agent theory, including key idea, unit of analysis, human assumptions, organizational assumptions, information assumptions, and contracting problems.

## **Theoretical Contribution of Principal-Agent Theory**

Principal-Agent theory has been contributing a lot to organization theory and incentive theory. " Principal-Agent theory has been the basis for an

extensive set of studies relating bureaucracy to elected officials. It also has been extended to presidents' decisions to use force and to the Supreme Court and its relationship to lower courts." (Waterman and Meier, 1998) Before discussing the theoretical contribution of principal-agent theory, I'd like to talk about what is a good theory.

Above all, a good theory is the theory appropriately used. " All theories are false." " They are, after all, just words and symbols on pieces of paper, about the reality they purport to describe"; they are not that reality. So they simplify it. " This means we must choose our theories according to how useful they are, not how true they are." (Mintzberg, 2005) Obviously, principal-agent theory is not omnipotent to explain or solve all problems in an organization. It is true only when it is appropriately used.

Furthermore, a good theory is practical precisely. " A theory to be useful, should accurately describe or depict a real world event or phenomenon." (Frederickson and Smith, 2003) The first section has demonstrated that principal-agent theory fits this requirement. Scholars devoted to this theory have explicitly described what principal-agent is and what it could explain in the real world.

Finally, a good theory is insightful and predictive. " Theory is insightful when it surprises, when it allows us to see profoundly, imaginatively, unconventionally into phenomena we thought we understood...theory is of no use unless it initially surprises-that is, changes perceptions." (Mintzberg, 2005) From this perspective, principal-Agent theory may not dramatically

change perceptions, but it really brings in some new thinking about organizations and incentives.

Firstly, “ Principal-Agent theory reestablishes the importance of incentives and self-interest in organizational thinking. It reminds us that much of organizational life, whether we like it or not, is based on self-interest.” (Eisenhardt, 1989) Both principal and agent are usually assumed to be attempting to maximize their own utilities. Agents would not voluntarily produce desires of principal and it is usually hard or expensive for the principal to investigate what the agent is actually doing. Hence, it is significant for principals to provide incentives to agents which lead to an alignment of goals between principal and agent, in order to assure that the agents act for principals’ aims. That is to maximize principals’ interests rather than impair principals’ efficiency through agents’ over possession of information.

Secondly, Principal-Agent theory also makes important contributions to organizational thinking, “ the most important of which is the treatment of information”. (Eisenhardt, 1989). In principal-agent theory, information is considered as merchandise: it has a cost, and it can be exchanged and purchased. “ The implication is that organizations can invest in information systems in order to control agent opportunism”, an illustration of which is the executive compensation. And one of the important factors such compensation requires is information systems. It is assumed that “ richer information systems control managerial opportunism and, therefore, lead to less performance-contingent pay”. Board of directors is considered as one particular relevant information system to monitor executive behaviors. “  
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When boards provide richer information, compensation is less likely to be based on firm performance. Also, when boards provide richer information, top executives are more likely to engage in behaviors that are consistent with stockholders interest." (Eisenhardt, 1989) Besides, to break agents' superiority status on information is of great significance to keep balance between principals and agents and to improve agents' performance.

Moreover, profit sharing has been widely used as an attempt to give employees more opportunities to involve into and to get pleasurable emotion from the organization and to make employees feel they are part of the organization; to increase employees' sense of commitment to organization; to increase sense of co-operation between management and subordinates; and to ensure employees benefit from organization profitability. In the public sector, administrators should frequently involve into policy-making process. Participatory management could be an efficient approach to get an alignment of goals of the management and subordinates and to motive employees' performance consciousness.

In addition, Principal-Agent theory could be used to elucidate hierarchical control of organizations as well (Moe, 1984). Difficulty in monitoring the actions of subordinates/agents, asymmetric information superior status of subordinates/agents, or transactions costs in supervising and verifying the actions of subordinates/agents all can give agents opportunities to escape from principals' goals by maximizing agents' interests. " Typically, principals find means to ameliorate these problems, for example, by relying on signals that warn them when agents step outside certain bounds." (Song, Segal, and Cameron, 1976)

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## **Limitations of Principal-Agent Theory**

Principal-Agent theory, which characterizes relationships that develop and evolve, is supposed to be a dynamic, rather than a static theory (Waterman and Meier, 1998). It provides insightful and predictive theoretical contribution to organization and incentive theory development. Principal-agent theory “ provides a unique, realistic, and empirically testable perspective on problems of cooperative effort (Eisenhardt, 1989)”. Besides its theoretical contribution, however, principal-agent theory needs further improvement as the following:

Principal-Agent Theory merely displays a partial aspect of the real world, although it is valid, and it also ignores a great amount of organizational complexity. Additional perspectives could contribute to attain the more important complexity (Eisenhardt, 1989). According to Ogden (1993), “ the highly simplified model of organizational conflict and the contrasting complexity of the mathematics required to provide solutions to the agency problem have been frequently cited as limitations to principal-agent theory”.

In addition, principal-agent theory could be developed to a richer and more complicated range of contexts. Principal-agent theory studies the relationship between the principal and the agent which is defined by contract, resting on a basis in economics. Under this theory, relationship problems are explained from a contractual perspective; and solutions derives from the change of contract. However, noneconomic considerations should be emphasized as well, such as cultural, social, psychological, and political. And some scholars have already argued to look at important non-contractual

aspects of principal-agent relationship. So, to study principal-agent relationship from non-contractual perspectives is demanded and valuable.

## **Conclusion**

Starting from an introduction to what is the principal-agent theory and the importance of the theory in public administration, we conclude that the principal-agent theory has contributed a lot to the development of organization theory and incentive theory. Although theoretical significant, principal-agent theory still has its limitations, such as simplified model and ignorance of non-economic factors, which leaves a long way for future development.

Nevertheless, this term paper merely provides a short review and summary of principal-agent theory and its theoretical contributions. It is far from a comprehensive and deep study on principal-agent problems and solutions. Much more works are needed to elaborately review this theory.