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## Organisation Theory: The Principal-Agent Perspective

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# Organisation Theory: The Principal-Agent Perspective

Jan-Erik Lane

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## I. INTRODUCTION

The principal-agent model offers yet another framework for analysing the organisation of human activities (Ross, 1973; Grossman and Hart, 1983; Sappington, 1991; White, 1992; Ackere, 1993; Althaus, 1997). Its strength is that it underlines incentives more than rules as in many organisation approaches. The focus is upon the *web of contracts* that link people together in an organisation, analysing them with the newly developed concepts of in the economic theory of information (Bircher and Butler, 2007).

Looking at relations between actors as contractual links between principals and agents has proved insightful with regard to understanding employment/sharecropping in agriculture, the work of attorneys, the doctor-patient relationship or investor-broker interaction as well as the entire business of insurance. Yet, there has been great reluctance to apply the principal-agent model to politics, because the key concepts do not seem to capture the essence of politics in well-ordered societies, namely to safeguard the national interest or common good of citizens.

Human beings have developed great skills in organizing activities so that an ever increasing output of

goods and services is possible. Thus, organisations of various kinds play a major role in social life every day. Organisation theory and management studies have contributed lots of studies with numerous insights into the operations of organisations, market based as well as non-market organisations. This intense research has resulted in a number of theoretical approaches. These frameworks underline a variety of factors in or aspects of organisations: e.g. planning, strategy, internal organisation – external relations, hierarchy, division of labour, bounded rationality and institutionalisation.

The aim of this paper is to raise the question *CUI BONO?* in relation to organisations. It is hardly an exaggeration to say that organization theory and management approaches have been much concerned with efficiency, meaning the successfulness of the organization. Also the big branch of organization studies that deny the possibility of efficiency is occupied with the same perspective: outputs, outcomes, resources, strategy, leadership, etc., although underlining the relevance of so-called garbage can patterns of organization and management. The quest for efficiency of organizations in both classical management theories and public administration approaches and its rejection in the bounded rationality perspective upon organizations, launched by H. Simon and J. March, has resulted in an intense debate about the nature of organizations and the limits of management. But neither of these two theoretical perspectives entails much for the crucial question about organisations, namely: *Cui bono?* Even the most radical approach to organisation, denying completely the relevance of concepts like effectiveness and productivity to understand real life management, preferring to talk about organised foolishness, myths and institutional legacies (Olsen, 2010; Brunsson, 1985), does not touch the fundamental *Quid pro quo* questions in organisations: Who gains?

Interestingly, the rational choice approach in the social sciences has been accused of being linked logically with the efficiency focus. If people are summed to act so as to maximise their goals in a rational manner, then arguable they would do the same when managing organisations. However, the entailment does not hold. The management of an organisation involves collective decision-making among a group of people – the managers. Each of them may pursue their goals according to the requirements of individual rationality, yet when combined these individual decisions may lead

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to suboptimal decision-making and even chaos or foolishness.

The quid pro quo question in relation to organisations leads to the emphasis upon contracting, asking the following: What have people agreed upon to? Against what pay? With what effort? How are the outputs to be measured? And what is involved in the evaluation of performance: firing, bonus, new contract, etc? The content of any contract is its consideration, meaning the expectations that the parties bring to the agreement. The organisation is a WEB of contracting and management is the handling of these contracts, from the beginning – ex ante – to its fulfilment – ex post.

Studying organisations as webs of contracts and their management, the principal-agent framework from recent advances in game theory appears most promising. Thus, we ask:

1. Why it is easy to organise lots of taxi services in a huge capital like Yangon?
2. How come the remuneration of CEO:s is out of hand?
3. How can politicians become super-rich?

#### a) *The Stylised Principal-Agent Model*

According to Rasmusen (2006), the principal-agent model includes a principal searching to maximise the value of some output(s)  $V$  by means of contracting with a set of agents, remunerating them for their efforts in producing the output. The payment of the agents derives from the value of the output of the agents, meaning that the principal-agent contract must involve considerations covering the *ex ante* to the *ex post* stages. With a considerable time lap between the making of the contract and the fulfilment and its evaluation, problems of asymmetric information and transaction costs arise (Rao, 2002).

The principal-agent framework has enjoyed far reaching success in modelling interaction between persons where one works for the other. This interaction is to be found in many settings, such as agriculture, health care, insurance and client-lawyer (Ross, 1973; Rees, 1985; Laffont and Martimort, 2002). As a matter of fact, the principal-agent problematic is inherent in any employment relationship where one person works for another, who pays this person by means of the value of the output. Whenever people contract with others about getting something done, there arise the typical principal-agent questions:

1. What is the *quid pro quo* between the principal and the agent – the contractual considerations?
2. How can the principal check the agent with regard to their agreement – the monitoring problem?
3. Who benefits the most from the interaction between principal and agent – who takes the surplus?

These questions concerning principal-agent interacting arise whenever there is a long-term interaction between two groups of people, involving the

delivery of an output against remuneration as well as a time span between the making of the contract and the ending of the relationship with the final delivery of the output, Let us apply this conceptual framework to three kinds of organisation in order to demonstrate that it illuminates the pattern of interaction.

## II. TAXI SERVICES IN YANGON: THE PRINCIPAL ON TOP

Powerful forms of connecting people may result from very simple contracts between principals and agents, like in sharecropping. They may last long and need not even be formalised in written agreements. They may involve hundreds of people working as agents for one single principal, owning the assets involved in the production of services.

#### a) *Taxi Organisation:*

1. *Principal:* Owner of the cars, with goal to maximise profits from taxi services;
2. *Agents:* Renting the car for 12 \$ a day with a guarantee of 300 \$ for damages as first down payment. All running costs are born by the agent and the car is checked in detail at every round of contracting period.

*Outcome:* The principal, who is risk avert, provides the car but the agent has to pay all repairs, either with the down payment or additionally through a loan from the principal. The agent will drive the care as long as he/she can raise every day > 12 \$ plus the running costs and the repair costs. This contract is attractive for people whose reservation salary is very low or zero. It is also incentive compatible, as the driver gains more by being active. This organisation tends to be stable. Since unemployment is high in Yangon, the remuneration of agents can be kept as low as possible, securing a nice profit to the principal, who bears little risk.

## III. THE JOINT-STOCK ORGANISATION: AGENTS ON TOP

Besides the trillions of daily on-spot contracts in the markets, there occur several forms of principal-agent contracting, introducing organisation into social life. A simple principal-agent contracting was described above, but there are others forms than one to one, like one to many, many to one and many to many. In the private sector, firm organisation varies from small partnerships to giant enterprises with more than one hundred thousand employees. It is all based upon contracting between principals and agents, which is why law and lawyers loom so large, i.e. private law.

#### a) *Firm Organisation:*

1. *Principal:* Owners of the shares: a few big owners plus an ocean of small owners with the goal of maximising the value of their holdings of stock;

2. *Agents*: The CEO:s, who are risk avert, receiving a fixed salary plus yearly bonus, decided usually at discretion. The CEO can be fired at any moment but receives a so-called golden handshake. He/she employs the other employees on standard wage contracts – internal organisation – or on the basis of outsourcing. All the agents are paid by means of the market sales of the output of the firm, where the CEO:s maximise their remuneration in total.

*Outcome*: The owners will need lots of monitoring to find out what is going on and whether the CEO:s make an effort. Thus, they wish to list the firm on the bourse, harbouring instantaneous evaluation. The risk of the owners is the occurrence of asymmetric information, both *ex ante* (adverse selection) and *ex post* (moral hazard). This organisation tends to be unstable, as the CEO:s manage to use various strategies to push up their remuneration almost to the level of looting.

The instability in the firm organisation shows up in the constantly increasing remuneration packages of the CEO:s, where the spread to other employees have multiplied several times during the last 50 years. This is true of both the fixed salary and the yearly bonuses, which tend to be paid more or less automatically. It has happened that bonuses become permanent remuneration whatever the result of the firm is.

Neither economic decision theory nor management theory has any clear explanation of the tendency of the CEO:s to prevail to significantly in the firm organisation. The only credible explanation is that shareholders are easily manipulated by the CEO:s due to the enormous asymmetric information plus the large room for the CEO's to enter collusion by making coalitions with board members, like first and foremost the chairman of the board of the company. As effort is not observable and costly to enforce, shareowners chose to believe in the story of the CEO, often until it is too late.

There is no remedy to this advantage of the agent. Making the CEO part owner of the firm has been proposed but the future price of his stock options tends to be set extremely low. A radical solution is that the big owners become the CEO:s, but this is only feasible for some firms, like e.g. HM.

The remuneration of CEO:s could skyrocket when various forms of commissions are added to the salary, for instance when company activities are sold or bought. The remuneration of the CEO of NOKIA before it was sold to MICROSOFT is an excellent example. Firms that are owned by consumers themselves, like COOP, are exceptionally vulnerable to the claims of CEO:s, when excessive.

It is an often debated fact that the total remunerations of agents has gone up astronomically over the last decades in the firm organisation, resulting in rapidly increasing inequality in both Western societies

and Eastern or South East Asia. The basic reason is hardly a shortage of CEO:s or a dramatic increase in management skills, but simply the instability inherent in the principal-agent interaction in firm organisation due to asymmetric information. When the CEO:s are hired, there is the adverse selection problem of failing to recognize pretending and when they have been hired, there is the moral hazard problem of shirking. The shareholders are so afraid of these two major difficulties in firm management that they are prepared to throw almost any amount on money upon them. It has happened that the CEO:s capture almost all the profits of a joint-stock company in the form of bonuses: It would be better for its shareholders to sell this company (*Husqvarna*) to these CEO:s! Public joint-stock companies with the state as the owner are run with the same principal-agent interaction: the CEO agents on top. The process of incorporation all of Europe has resulted in huge increases in their remuneration, like Swedish *Vattenfall*.

#### IV. THE REMUNERATION OF POLITICIANS

Political science teaching often starts with the observation that roughly 50 per cent of all existing countries today have a democratic regime of some sort while the rest of the countries either are authoritarian regimes or so-called failed states, i.e. countries in anarchy. This distinction between democracy and non-democracy has been a very central research topic since after the Second World War, especially as the number of democracies has increased during the last decades. A large number of factors have been examined, exogenous as well as endogenous ones, like the economy, social structure, ethnicity, religion, openness, historical legacies, etc.

A completely different way of approaching this research issue in the social sciences, economics and politics is to start from the *quid pro quo* question. In non-democracies, the remuneration of politicians tends to be much higher than in democracies. And in failed states, the predicament of anarchy opens up for the looting strategy, which may pay off handsomely for rebels, jihadists and drug traffickers. In kingdoms or sultanates, the existence of patrimonial authority implies that imperium and dominium, public authority and private ownership are fused. Thus, e.g. the Saudi family is the owner of the oil riches of the country. Moreover, the sultan of Oman *Qaboos bin Said Al Said* receives all state revenues as his, thereafter writing checks to the public budget, as signs of generosity.

In authoritarian one-party states, the political leadership forms a most wealthy click, like in the Khanates and China. Why start a transition to democracy when so much of wealth is at stake for the economic fortunes of the rulers? In his detailed enquiry in the fate of African states after the coming of

independence from the Europeans, British historian Meredith documents an almost incredible list of rulers who enriched themselves through embezzlement. No wonder that many of them attempted to stay on as long as possible, even for 2-3 decades! The political agents will try to capture as much as possible of the value  $V$  of the game, i.e. the country GDP, unless hindered by competing agents or guardians like courts or the Ombudsman (Public Protector).

b) *Political organisation:*

*Principal:* demos, citizenry, electorate, population

*Agents:* politicians, parties, legislators, judges, Ombudsman, bureaucrats, officials, agencies, boards, etc.

*Incentives:* What drives the agents? And do they really improve for the principal?

The state is a much more complicated organisation than the firm. It likewise involves lots of laws and regulations, i.e. public law. Perhaps this is why the principal-agent approach has not been applied systematically? In any case, one needs to ponder on how the interaction is to be modelled with the variety of players. Principal-agent interaction in constitutional democracies is very different from that of non-democracies. A number of models have been launched: Barro, 1973; Ferejohn, 1986; Weingast, 1989; Rao, 2002; Besley 2006; Helland and Sørensen, 2009. Yet, the central question is the following: How do constitutional democracies reduce the upper hand situation of political agents in non-democracies?

## V. CONSTITUTIONAL POLITICAL ORGANISING

The following assumptions appear the most likely to be adequate for modelling principal-agent games in a constitutional democracy:

1. The principal of the democratic state is the demos, or the electorate – *body politic*;
2. The set of political agents covers three groups: governments and its bureaucracy, the legislators and the judiciary – *trias politica*;
3. Politicians offer the voters alternative policy packages about how the state may improve upon society, or total value  $V$ ;
4. The remuneration of the political agents are separated from the resources of the *fiscus*, the state coffers;
5. The remuneration of politicians is fixed, including pensions, in order to avoid the appropriation of the *fiscus*;

These maxims of constitutional democracy seem enough to introduce the distinction between the public and the private, which was so confused in all forms of oriental despotism, as well as solve the *appropriation problem* in politics and public administration, as Max Weber conceived it (Weber,

1978). The modern bureaucracy and its superior performance to patrimonial administration is only feasible when officials are paid predictably, meaning that they are little incentive to *appropriate* the recourses of Bureaux or engage in looting in society.

However, we need a few more maxims:

6. The principal will only be able to control the set of political agents when they are set in competition with each other;
7. Political competition is as vital to democratic politics as firm competition is to the market;
8. Political competition favour the interests of the demos, pitting the three branches of constitutional government against each other;
9. Political entry in competition must be open so that the authoritarian politicians cannot exercise political monopoly;
10. The judiciary operates on the principles of due process of law, to be found in either Common Law or Civil Law.

In order to tame the political agents and diminish their advantages, the principal has supported the evolution of distinct institutional mechanisms that restrain the political agents: viz. rule of law and the political market place. The hope is that the actions and decisions of politicians will enhance societal value, like for instance affluence and wealth.

## VI. REMUNERATION AND VALUE IN PRINCIPAL-ACTION GAMES

It is an axiom in the principal-agent model that the agents are paid from the value of the output they deliver for the principal, who is the residual claimant. The principal wants to maximise that value, but he/she must present the agents with an incentive compatible contract, paying more for higher effort. As there is no guarantee that higher effort will actually be forthcoming or succeed in baking a bigger cake, principal-agent contracting is replete with failure, which could leave the principal pay all the value to the agent – the case of looting. In the worst case scenario, the principal pays for high effort but the agents employ the strategies of pretending and shirking to deliver a meagre output, resulting in a loss to the principal, as the value of the output does not cover the remuneration of the agents.

This is, of course, the fundamental *quid pro quo* problematic in all forms of contracting, private or public. In the organisation of taxi services above, the contract favour the principal, pushing the risk upon the agents. In firm organisation, it is the other way around. What about politics?

The state and political leadership concern an entire country, or nation, Thus, the value of the output of the political agents is their contribution to the total value in society, or the GDP. Moreover, the political agents are paid through taxes and charges upon the GDP. What is

the logic of the *quid pro quo* requirement, the consideration of the public contracts?

The most profound answer to this question is to be found in the theory of public finance, focussing upon the allocation to society of so-called public or semi-public goods (Musgrave and Musgrave, 1980). A country has a strong need for goods and services that are non-rival or non-excludable as well as joint in supply. As the market cannot supply these, only the public sector or the state can be relied upon. Market failure is the reason of the state.

Public or semi-public goods include law and order, peace and war, infrastructure, common pools, etc. In order to provide these services, political communities – governments at various levels – contract with a set of political agent to deliver them. What will be their remuneration for their achievements?

1. *Patrimonialism*: From the point of view of human known history, patrimonialism is the most frequently occurring structure of political leadership, at least until 1900. The remuneration of the political tends to go very high, at the same as there is constant struggle among contenders to the patrimonial assets. To stabilise the rulership, political leaders engages in huge aggrandizement project, which both deliver public goods and underlines their own position. When the subjugation of the principal, the population, becomes too excessive, spontaneous uproars follow. It takes a long for patrimonialism to accept the distinction between *crown* and *realm* – the so-called “*King’s Two bodies*” (Kantorowicz, 1957). At the core of all forms of patrimonialism whether in Europe, Americas, Africa or Asia is the consideration: How can the principal call upon the agents to deliver goods and services that further their interests, when opposition is met with arbitrary arrest, detentions and incarcerations?
2. *The authoritarian one-party state*: Patrimonialism (*l’etat c’est moi*: Louis XIV) was replaced by populist regimes that promised to fulfil the General Will of the principal, but in reality created the origins of totalitarian democracy (Talmon, 1952). Populist authoritarianism has occurred in several versions since 1800, but its key foundation is the manipulation of asymmetric information. The principal is deceived into supporting the agenda of the authoritarian elite by means of ideology and its myths: *France – la gloire* (Napoleon), the international proletariat (Lenin, Stalin, Mao), German nationalism (Hitler), Roman *grandeur* (Mussolini), Great Serbia (Milosevic), Kim Dynasty (North Korea), Zaire (Mobutu), etc. The remuneration of the authoritarian elite tends to be extremely high, including the taking of the babies of opponents (Argentina). Yet, the indirect costs may be much larger, as the rulers do not hesitate to put the entire

country at risk. They may also be so cruel as to destroy society when threatened in power, like Mengistu in Ethiopia or Pol Pot in Cambodia. The authoritarian set of agents cannot accept any challenge from outsiders and does not hesitate to employ torture, sudden disappearances and assassinations to remove challengers or critiques.

3. *The Constitutional democracy*: To keep remuneration of political agents within reasonable bounds, the *quid pro quo* problem is here solved by very strict rules about the public budget - transparency. And to hinder that political elites replace their commitment to the welfare of the country with their own goals, there is detailed specification of rules of election and re-election – political markets. However, the direct and indirect costs of the politicians have certainly gone up in the last decade. Moreover, the costs of party operations keep escalating, creating a big grey zone where corruption may be suspected.

The indirect costs of the mistakes of political agents may be large, also in constitutional government. Thus, for instance the Bush family has born none of the misery that Operation *Cobra (Iraqi Freedom)* resulted in for ordinary people and servicemen. Now the Middle East is in total chaos: *bellum omnium contra omnes*. Similarly, the Putin policy against the Ukraine has proven very costly for the principal, the Russian peoples.

In the political markets, the costs of election may be extremely high in some countries. This is the problem of campaign funds and its *quid pro quo*. Two questions: Can they be used as remuneration for the politicians? Do they involve a tacit contract to the effect that the politician (political party) is supposed to deliver outputs that favour the contributors (Peltzman, 1998)? The financing of the campaign expenses of political parties and individual politicians constitutes a grey zone between legality and corruption.

## VII. CONCLUSION

The principal-agent approach, developed in the economics of information and the game theory of successive moves in contracting (Rasmusen, 2006) may be employed to create a parsimonious theory of political organisation. It covers the essential aspects of principals versus agents, agent remuneration against the value of output to the principal, the monitoring of performance and conduct of political accountability as well as asymmetric information and its consequences for deception and manipulation.

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