Agency Theory in a Nutshell

Agency Theory explains **how to best organize relationships** in which one party determines the work while another party does the work. In this relationship, the *principal* hires an *agent* to do the work, or to perform a task the principal is unable or unwilling to do.

Agency theory assumes both the principal and the agent are motivated by self-interest.

- This assumption of self-interest dooms agency theory to inevitable inherent conflicts. Thus, if both parties are motivated by self-interest, agents are likely to pursue self-interested objectives that deviate and even conflict with the goals of the principal. Yet, agents are supposed to act in the sole interest of their principals.

The concept of **agency loss** is refers to the difference between the best possible outcome for the principal and the consequences of the acts of the agent. For instance, when an agent acts consistently with the principal’s interests, agency loss is zero. The more an agent’s acts deviate from the principal’s interests, the more agency loss increases.

Research on agency theory shows that **agency loss is minimized** when two particular statements are true.

1) that *the principal and the agent share common interests*. Essentially, this means that both the principal and the agent desire the same outcome. (Why we put so much energy into designing incentive systems.)

2) that *the principal is knowledgeable about the consequences of the agent’s activities*. In other words, the principal knows whether their agent’s actions serve in the principal’s best interest. (Why we put so much energy into measuring outcomes.)

If either of these statements is false, it follows that agency loss is therefore, likely to arise.

One objection to agency theory is that it “relies on an assumption of self-interested agents who seek to maximize personal economic wealth” (Bruce et al., 2005). The challenge is therefore, to get agents to either set aside their self-interest, or work in a way in which they may maximize their personal wealth while still maximizing the wealth of the principal. Thus, a standard of agency duty and action is necessary, not because agents are universally selfish, but because the potential for differences between the principal’s and the agent’s interests exists.

In agency relationships, the agent has a **moral responsibility** for her actions, which she cannot dismiss simply because she acts as an agent for another.


Reference: