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Asymmetry in information versus asymmetry in power: Implicit assumptions of agency theory?

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Abstract

The hypothesis of this article is that agency theory makes implicit assumptions on the power relation between principal and agent. It implicitly assumes an asymmetry in power in favour of the principal. The bases of power approach [French Jr., J.R.P., Raven, B.H., 1959. The bases of social power. In: Cartwright, D. (Ed.), Studies in Social Power. University of Michigan, Ann Arbor, pp. 150–167; Raven, B.H., 1992. A power/interaction model of interpersonal influence: French and Raven 30 years later. Journal of Social Behavior and Personality 7, 217–244] of social psychology is used to prove this argument. Surprisingly, the social power perspective does not only reveal this implicit assumption. It also paves the way for a new mechanism that resolves agency problems that had not yet been discovered by agency theory: identification systems.

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1. Introduction

Together with transaction cost economics and the property rights approach, agency theory forms the new institutional economics (Furubotn and Richter, 1991). In the centre of analysis are those institutions in which economic exchange takes place, like markets, organizations, and legal norms. The aim of institutional analysis is to explain the structure of institutions, their influence on individual action, their efficiency, as well as the change of institutions. Although it is mainly spread in economics and looked at as an economic theory, its explanatory power advances to the classical domains of social psychology and sociology: the new institutional economics defines itself as a theory of interaction based on rational choice behaviour.

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White (1985) has elaborated the historical reach of principal-agent relations. Three agency relations have been of continuous interest: the relation between employee and employer, between shareholder and manager, and between creditor and stockholder. In recent years, agency has been applied in analysing research fields as diverse as the ownership structure of the firm (Short et al., 2002; Chen, 2001; Wright et al., 2001a,b; Jensen, 2000; O'Sullivan, 2000), incentive problems in accounting, foreign aid, or between shareholder and policyholder (Martens et al., 2002; Krishnaswami and Pottier, 2001; Lambert, 2001; Hubbard, 2000; Laffont, 2000), executive compensation (Hermalin and Wallace, 2001), organizational forms and the transformation of corporate forms (Bento and White, 2001; Zey and Swenson, 1999; Zey and Camp, 1996), corporate governance (Beyer and Hassel, 2002), changing interorganizational patterns in supply chains (Senter and Flynn, 1999), profit and nonprofit boards (Miller, 2002; Sapienza et al., 2000; Ott, 2000), the analysis of union leaders' behaviour (Bemmels and Lau, 2001), state policy implementation (Kiser, 1999), nonmajoritarian institutions (Majone, 2000), the relationship between constituents and legislators (Lord, 2000; Strom, 2000; Longley, 1999, 1998), control of the executive (Franchino, 2000), civil–military relations (Feaver, 1998), and boundary organizations between politics and science (Guston, 1999). Critical contributions to agency theory as applied to political and administrative science have come from Miller and Whitford (2002), Eisner et al. (1996), and Worsham et al. (1997). A reexamination of agency theory assumptions and extensions on the base of behavioural theories have been presented by Wright et al. (2001a,b). Breton (1995) has elaborated the common features and the complementarity of agency theory and public choice and put forward the hypothesis that their integration could generate a general theory of bureaucratic organizations. In sum, agency theory has become an inspiring and integrating theory perspective to many at first sight very different fields of research.

My hypothesis is that agency theory makes implicit assumptions on the power relation between principal and agent. Especially, I will prove that agency theory implicitly assumes an asymmetry in power in favour of the principal (Section 3). The bases of power approach (French and Raven, 1959; Raven, 1992) of social psychology is used to prove this argument. Surprisingly, the social power perspective does not only reveal this implicit assumption. It also paves the way for a new mechanism that resolves agency problems that had not yet been discovered by agency theory (Section 4). In the following, Section 2 will give a short overview on agency theory.

2. Agency problems and solution mechanisms—the traditional view

There is a wider and a more narrow definition of the agency relation among its classical writers: Jensen and Meckling define an agency relationship "as a contract, under which one or more persons (the principal(s)) engage another person (the agent), to perform some service on their behalf which involves delegating some decision making to the agent" (Jensen and Meckling, 1976, p. 308). This definition makes delegation explicit. There is a division of labour between principal and agent, and "delegated choice" (Rees, 1985, p. 3). Its formal structure is applicable to an even wider class of problems, "where no formal delegation relationship is explicitly involved" (Rees, 1985, p. 3). This definition is given by Arrow (1985, p. 37): there are ". . . two individuals. One (the agent) must choose an action from a number of alternative possibilities. The action affects the welfare of both the agent and another person, the principal. The principal, . . ., has the additional function of prescribing payoff rules."

There are three main differences respectively asymmetries in the relation between principal and agent. Agency theory explains the realization of the division of labour between both actors by these differences. (1) *Informational asymmetries*. It is rational for both principal and agent to enter