CHAPTER TWO

Delegation and Agency Problems

Collective Action and Delegation

Congress makes policy in an ever-growing number of issue domains. The federal budget it oversees has grown from less than one million dollars in 1789 to over one trillion dollars today. The organizational problems that confront members of the 101st Congress, however, are much the same as those that confronted members of the First. Little can be accomplished in Congress without collective action. But as revealed in the extensive literature on social choice—or by a cursory glance at the human condition—collective action is fraught with difficulties.

The most familiar collective action problem is the prisoner's dilemma. It takes its name from the simple two-person game, but the social contexts in which most human interaction takes place tend to make n-person prisoners' dilemmas the more pervasive phenomenon. The crux of the dilemma is that individuals, in seeking to maximize their self-interest, have incentives to behave in ways that are inimical to the interests of the community as a whole (Hardin 1968). A good example of the dilemma is that of public goods (Olson 1965). The community would on net benefit from such a good, but those who do not contribute to its provision cannot be excluded from enjoying it. Everyone therefore has an incentive to free ride on the contributions of others. Even though the community may unanimously favor acquisition of the public good, little or no effort is expended to supply it. Rational individual choices produce irrational collective outcomes.

Collective action may also be stymied by a lack of coordination (Farrell and Saloner 1985, 1987; Crawford and Haller 1988). In contrast to the

prisoner's dilemma, where dominant strategies yield an inefficient equilibrium, other situations confront the community with multiple efficient equilibria. Members of the community are uncertain as to which strategies other members will pursue, and coordination may never be achieved. A simple coordination problem occurs when two cars enter an intersection simultaneously. Neither driver cares particularly who goes first; both are far more concerned about avoiding a collision. What frequently occurs, however, is a nerve-wracking *pas de deux* of false starts and sudden stops as the drivers make their way through the crossing. Even if everyone in the community would benefit from all alternatives under consideration, problems of coordination are exacerbated when different alternatives benefit some members relative to others.

Another obstacle to collective action is social choice instability (Arrow 1951). The decisions of a community to undertake collective action might cycle from one choice to another, for example, from choosing to build a park, a road, a library, and back to a park again. The community might devote resources to one alternative, then to another, but never accomplish any of its objectives. An important implication of social choice instability is that one or more members of the community can, by acting strategically, manipulate the decision-making process to their advantage (Satterthwaite 1975; Levine and Plott 1977; Riker 1986). Voters can theoretically defend themselves from agenda manipulation by behaving strategically themselves, but the actual voting procedures used in Congress and most other legislatures allow for agenda manipulation even under strategic voting (Ordeshook and Schwartz 1987). Agenda manipulation can yield choices that advantage a small minority of the membership at the expense of the majority. This not only leads to the collapse of collective action, but may also threaten the continued existence of the community itself.

According to property rights theorists, the best response to collective action problems is to minimize their occurrence, something that is accomplished by relegating as much human activity as possible to the realm of the marketplace. Adam Smith argued long ago that the well-being of a community is better realized through individual market transactions than through the schemes of even the most benevolent planner. Much social benefit can also be derived from simple patterns of reciprocity (Axelrod 1984). But there are limits to what can be achieved through voluntary trade and cooperation; uncoordinated, unorganized activity will get a community only so far. In most cases, the benefits of collective action are realized through organizations. It is in the context of organizations that collective action is most effectively coordinated, that prisoners' dilemmas are most readily overcome, and that stable social decisions are most likely to be reached.

The organizational bases of collective action are many—firms, bureaucracies, associations, committees, leagues, representative assemblies, to name a few. What the most prominent forms of organization have in common, however, is the delegation of authority to take action from the individual or individuals to whom it was originally endowed—the principal—to one or more agents (Mirrlees 1976; Holmström 1979; Grossman and Hart 1983).[1] One major organizational theorist, in fact, defines organizations as "networks of overlapping or nested principal/agent relationships" (Tirole 1986, p. 181). Delegation from principals to agents is the key to the division of labor and development of specialization; tremendous gains accrue if tasks are delegated to those with the talent, training, and inclination to do them. This, when all is said and done, is what allows firms to profit, economies to grow, and governments to govern.

The underlings in an organization are obviously agents of their superiors, but the heads of organizations, such as coaches, firm managers, party leaders, are agents, too (Fama 1980). Indeed, it is the delegation of authority to a central agent to lead or manage the organization that is the key to overcoming problems of collective action. Agents performing as leaders or managers must be endowed with the resources they need to discharge their duties effectively. In the case of congressional parties, leaders can exploit the prominence of their position to identify a focal point, thus solving problems of coordination by rallying support around one of possibly many acceptable alternatives. Their ability to structure the voting agenda, moreover, can overcome social choice instability (Aldrich 1988). As Calvert (1987) explains in his analysis of legislative leadership, any power or influence a party leader has is a consequence of delegation from the membership: "The leader can only 'influence' members who want to be influenced, and exercises 'power' only as long as he uses it to provide them with what they want" (p. 47).

In such a relationship the agent seeks to maximize his or her return subject to the constraints and incentives offered by the principal. The principal, conversely, seeks to structure the relationship with the agent so that the outcomes produced through the agent's efforts are the best the principal can achieve, given the choice to delegate in the first place. There is, then, a natural conflict of interest between the two. In economic settings this conflict is often over the amount of effort expended by the agent. In political settings it is more likely to be over the course of action the agent is to pursue. The policy agenda of agency bureaucrats, for example, can be quite at odds with the preferences of the elected officials who oversee them (Pertschuk 1982). As a consequence of this conflict of interest, the principal always experiences some reduction in welfare. First, he suffers agency losses that result from the agent behaving in

ways other than those that best serve his interests. Second, the principal incurs agency costs in undertaking efforts to mitigate agency losses. Agency problems may be so great that they exceed the benefits to be derived from collection action, in which case the delegation should not occur.

The opportunistic behavior that is at the root of agency problems is by no means confined to principal/agent relationships. Individuals involved in market transactions have similar incentives to behave in a less than noble manner (Kintner 1978). Certain conditions that are generally present in principal/agent relationships, however, make it a particularly congenial environment for opportunism. These are the conditions of hidden action, hidden information, and a form of strategic vulnerability on the part of the principal that we refer to as Madison's dilemma.

Hidden Action and Hidden Information (Abfunt)

In a wide variety of agency relationships, the agent possesses or acquires information that is either unavailable to the principal or prohibitively costly to obtain. The agent has incentives to use this information strategically or to simply keep it hidden—a situation referred to variously as the problem of truthful revelation or incentive incompatibility. In a firm, workers have information that is not available to management, such as how fast the assembly line can run before quality is compromised. They would prefer not to reveal this information, however, because they would rather not work at a breakneck pace. Another type of information that agents often have and principals do not is the agent's type (for example, knowledge of whether the agent is hardworking or lazy, talented or untalented, risk-averse or risk-acceptant). This variation on the hidden information problem is referred to as adverse selection.[2]

Situations in which agents acquire information that is unavailable to the principal pervade public policy-making. The basis of Niskanen's (1971) argument as to how bureaus maximize the size of their budgets is that bureaucrats are privy to information about service delivery costs that is not available to elected politicians. Through their investigations, congressional committees uncover information that is not available to other members of the chamber. Individual members, similarly, have better information than do congressional party leaders as to whether or not supporting the party's position might cause them trouble back home (Sinclair 1983).

The second problem, that of hidden action, manifests itself in a variety of situations. Stockholders cannot observe whether the actions that firm managers take are in their best interest. Voters cannot observe whether the actions of elected representatives—their agents—are in their best interest. Hidden action is especially problematic when the agent's actions only partially determine outcomes, as in the case of team production or committee decisions, or when outcomes are partially determined by chance. In such cases, the principal is unable to infer the appropriateness of the agent's actions even from observed results.

Madison's Dilemma

Arguing for the separation of powers specified under the new Constitution, Madison wrote in *Federalist 51*, "In framing a government to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself." Whatever their views about the document that was ultimately produced, members of the Constitutional Convention were keenly appreciative of Madison's observation. They had seen that under the Articles of Confederation the federal government had not been delegated enough authority to accomplish much of anything. Yet they feared that a government powerful enough to govern effectively would necessarily be powerful enough to oppress them.

In addition to problems of hidden action and hidden information, this third problem, one we call Madison's dilemma, is a potential pitfall in all institutions that rely upon delegation. The essence of the problem is that resources or authority granted to an agent for the purpose of advancing the interests of the principal can be turned against the principal. Although the problem is a general one of agency, it has long been recognized in liberal political theory as being of paramount importance when the agents involved are those in a position of leadership. Madison's dilemma is not a consequence of agents taking hidden action or acquiring hidden information, although these conditions can certainly make matters worse. Rather, it arises from agents exploiting the favorable strategic situation in which they have been placed.

In seeking to solve collective action problems, members of the community must be prescient in their delegation of authority to a central agent. If not, they may find that that they would have been better off continuing to endure their problems than they are living with the solution their agent has achieved.

Collective Principals and Collective Agents

Problems of hidden action, hidden information, and Madison's dilemma are endemic to all agency relationships. There are additional hazards to delegation, however, when either collective principals or collective agents are involved. Specifically, the very same collective action problems that delegation is intended to overcome—prisoners' dilemmas, lack of coordination, and social choice instability—can reemerge to afflict either the collective agent or a collective principal. A collective principal may be unable to announce a single preference over its agent's actions or to offer a single contract governing compensation for the agent. A subset of the membership may strategically manipulate the decision-making process of the collective principal. Similarly, agents who are delegated management or leadership roles may use their agenda powers to do the same thing, thus leaving the collective principal vulnerable to a form of Madison's dilemma. A related consideration is that in appointing a new individual to a collective agent, such as a production team or a committee, that person's abilities and preferences cannot be evaluated in isolation. The principal must consider instead how the new agent will interact with existing members of the team or committee.

Distinct from the problems of collective principals and agents are problems specific to multiple principals and agents. An agent attempting to serve multiple principals often finds that any action he or she might take to benefit one principal injures another. As Moe (1984) observes, federal agencies are buffeted by conflicting pressures from their departments, the president, the courts, their interest group clients, as well as several congressional committees and subcommittees. Second, when there are multiple agents it is possible that they will collude against the principal (Tirole 1986). This can occur in a number of ways. Workers who break the curve, for example, are likely to be castigated by their fellow workers. The essence of "iron triangle" or "subgovernment" theories of public policy formation is that collusion between two sets of agents—federal agencies and the congressional committees that ostensibly oversee them—serves to undermine the welfare of the general public (their ultimate principal) rather than to promote it.

Overcoming Agency Problems

Agency losses can be contained, but only by undertaking measures that are themselves costly. There are are four major classes of such measures: (1) contract design, (2) screening and selection mechanisms, (3) monitoring and reporting requirements, and (4) institutional checks.

Contract Design

Any contract between a principal and agent must satisfy the participation constraint. The agent's compensation must be at least as great as his or her opportunity costs, but less than the marginal benefit the principal derives from the actions of the agent. If this condition is not met, one side or the other will not be made better off by entering into the relationship and will decline to do so. Assuming that the participation constraint is satisfied, the principal's goal is to delegate tasks and responsibilities and to specify a corresponding schedule of compensation in such a way that the agent is motivated to best serve the principal's interests. Such contracts may specify negative rewards, or sanctions, particularly when the agent is capable of taking actions that are very harmful to the principal. In some situations, particularly when noncompliance with the principal's directives is hard to detect, the sanctions required to effect compliance are far greater in magnitude than the benefits that the principal derives from compliance (Holmström 1979).

Under conditions that usually exist in principal/agent relationships—hidden information and hidden action—designing compensation schedules is a tricky business. Examples abound of compensation schemes that create incentives for agent behavior other than that intended by the principal. If not otherwise constrained, brokers receiving a commission on trades churn through their clients' portfolios. Ford factory managers, no less creative than their celebrated Soviet counterparts, often met their quotas by surreptitiously building large numbers of automobiles prior to the official start of the production run (Halberstam 1986). Governmental agencies have an especially difficult time designing appropriate compensation schedules. Medicare administrators, for example, came to realize that simply reimbursing hospitals for all "reasonable" costs incurred in treating patients contributed to rapidly escalating claims. In 1982 they won congressional approval for a new system under which hospitals receive a fixed fee for treatment based upon the diagnosis related group (DRG) to which the patient has been assigned. In short order the system began to experience "DRG creep"; elderly Americans were succumbing to increasingly expensive diseases that often could be diagnosed only with the most advanced (and expensive) medical technology.[3]

The problem of inappropriate incentives in compensation schemes can be mitigated by giving agents a residual claim on output. The compensation received by corporate executives, for example, is often in the form of profit sharing or other bonuses linked to the performance of the firm. Another example of this arrangement is sharecropping. Instead of charging a fixed rent, the landlord leases land to a tenant in return for a percentage of the crop. Compensation contracts of this form can be used in the public sector as well. In previous centuries, the king of France and other European monarchs garnered much of their revenue from "tax farmers," that is, individuals who were given the right to collect taxes in a particular geographic area so long as they surrendered an agreed-upon amount of the proceeds to the crown. The state of Ohio actually implemented this method for garnering revenue at the end of the Civil War; counties and cities were permitted to engage "tax inquisitors" who

were empowered to find concealed taxable holdings (usually stocks and bank deposits) in return for a percentage of the proceeds.

Although such profit-sharing arrangements can help mitigate agency losses, they are hardly a panacea. They can be very expensive to the principal and do not necessarily remove all inappropriate incentives.[4] In the realm of public policy, awarding agents a residual claim on output can have particularly obnoxious consequences; the interested student should be able to surmise why the institution of tax farming fell out of favor.[5] Even if it were desirable to motivate public servants with a piece of the action, most important policy outputs are impossible to measure. How, for example, could the military establishment be awarded an incentive bonus that hinged upon whether or not they had had a good year?

Given the difficulties involved in designing optimal contracts prior to the establishment of an agency relationship, an alternative strategy for the principal may be to simply offer a compensation contract and, conditioned on the agent accepting it, to see how well he or she works out. There is, after all, no better information about how well an agent performs than his or her actual performance. Most employment contracts specify an initial probationary period (ranging from three or four days for waiters to three or four years for professors) and provide for periodic reviews after that. The principal can minimize the risk associated with this strategy by initially assigning an agent a modest set of tasks and responsibilities at a modest level of compensation. Those who perform well are rewarded by increasing the range of their authority and responsibility and, concommitantly, the level of their compensation.[6] Agents who perform poorly will not similarly advance, or may even be demoted or dismissed. Like other strategies available to the principal, this one works best when agents can be induced to compete with each other. One of the major rationales for hierarchy in organizations is that it means there are more people seeking promotion to the next level than there are opportunities available.

Screening and Selection Mechanisms

A policy of hiring first and adjusting compensation later does nothing to address the problem of adverse selection discussed earlier; the offer of a given level of compensation attracts only those applicants whose opportunity costs are lower than the offer. This is not a damaging critique, however, because there is little that can be done about adverse selection simply by altering the terms of the compensation contract.[7] The more telling problem is that information revealed by the agent's on-the-job performance, as valuable as it is, can be exceedingly expensive to obtain. Spence (1974) details several reasons why it can be so costly to sort out good agents from bad after they have been hired and why it pays both principals and agents to invest time and effort into avoiding bad matches in the first place:

> One might ask why the employer would not simply hire the person, determine his productivity, and then either fire him or adjust his wage or salary accordingly. There are several reasons why he will not do this. Frequently, he cannot. It may take time (even a long time) for the individual's real capabilities to become apparent. There may be a specific training required before the individual can handle certain kinds of jobs. There may be a contract and a contract period within which the individual cannot be fired and his salary cannot be adjusted. All of these factors tend to make the hiring decision an investment decision for the employer. Certain costs incurred in hiring and in the early period of employment are sunk and cannot be recovered if the investment turns out badly. (p. 14)

To the extent they share in the benefits of minimizing agency losses and agency costs, both sides are better off if principals are able to identify those individuals who possess the appropriate talents, skills, and other personal characteristics prior to the establishment of the principal/agent relationship. The greater the investment entailed in the hiring decision, the more critical screening and selection mechanisms become. Thus Spence's arguments apply with even more force in the public sector than in the private. Congressional members appointed to committees do not serve a probationary period to see how well they work out. Civil Service employees, for all practical purposes, cannot be fired. And as incumbent presidents typically point out when running for reelection, the Oval Office is no place for on-the-job training.

But how are principals and agents able to find suitable matches when they lack the requisite information? Principals cannot observe agents' actual performance until after the commitment to hire them has been made. Potential agents, similarly, cannot know exactly what the job is like until they start doing it. This problem is compounded by the fact that both potential principals and potential agents frequently have an incentive to misrepresent their abilities and preferences. According to Spence, this informational gap is bridged by observing properties of each other that are reliable signals of the underlying qualities of interest. Many signals that employers attend to in the labor market are beyond the applicants' control, such as race, age, or gender, and for that reason can be illegitimate sources of discrimination. Other signals, however, the applicant has at least partial control over, such as appearing on time for the job interview, presenting a neat personal appearance, and expressing enthusiasm for the job.[8]

Signaling is an important phenomenon in the political world as well. Congressional candidates who have served in an elected office before are far more likely to get elected than those who have not. A major reason for this is that their previous success signals to potential contributors that they are high-quality candidates (Jacobson and Kernell 1981). Congressional parties also tend not to name freshmen to the House Appropriations Committee. According to Fenno (1966), this is because freshmen have not been around long enough to demonstrate that they are the type of *homme sérieux* who has traditionally served on the committee—hardworking, respectful, and, whatever their ideological predilections, responsive to the needs of the party.

Monitoring and Reporting Requirements

Once a principal and agent have entered into a relationship, the most straightforward way to eliminate the conditions of hidden action and information would seem to be to institute procedures requiring agents to report whatever relevant information they have obtained and whatever actions they have taken. After all, hidden information is no longer hidden if you make the agent reveal it. On the basis of information provided by the agent, the principal can presumably tie the agent's compensation more directly to his or her actual conduct. As before, to the extent both sides share in a reduction in agency losses and agency costs, both principal and agent can be made better off.

In fact, reporting requirements are ubiquitous in both the private and public sectors. Employees fill out weekly progress reports for their supervisors, who in turn report to their supervisors on the status of their operations. Every year congressional committees, regulatory agencies, and executive departments report millions of pages of material on their hearings, investigations, and policy recommendations.

There are, however, costs entailed both in the agent's provision and in the principal's consumption of information (Williamson 1975). If nothing else, the transfer of information deflects time and attention away from tasks that they would otherwise be performing. Rather than require agents to report all relevant information, their reports should be at an optimal level of "coarsification" (Demski and Sappington 1987). Unfortunately, this is difficult to modulate; a principal can either be starving for information or, more often, drowning in a sea of it. That hundreds of millions of dollars are invested annually in the design of management information systems attests to the difficulty of this problem.

The more serious drawback to reporting requirements, however, has already been broached, and that is the problem of truthful revelation or incentive incompatibility. The agent has incentives to shade things, to make reports that reflect favorably upon himself, or to reveal information in some other strategic manner. Employees may discover that energy, skill, and creativity applied to their weekly progress reports pays off much more handsomely than actually doing the job. Even if agents can somehow be constrained to be truthful in their reports, the principal will still not know what they are not reporting. For that reason principals typically supplement these requirements with what McCubbins and Schwartz (1984) have dubbed "police patrol" oversight—audits, investigations, and other direct methods of monitoring. To be effective, monitoring policies should be applied stochastically so as to preserve the element of surprise (Kanodia 1985). Direct monitoring can cost the principal a great deal of time and effort. Anyone who has ever worked on a factory floor can attest to the fact that constant supervision is also demeaning and corrosive to the morale of both supervisor and supervisee.

Frequently an agent's actions affect individuals who are not a party to the original principal/agent contract. These individuals may be the intended beneficiaries of the agent's actions, as when an employee supplies a service to a customer on behalf of the firm's owners, or when bureaucrats deliver benefits to constituents on behalf of members of Congress or the president. Because affected third parties have an incentive to observe and to influence the actions of the agent, opportunities arise for oversight that is potentially less costly and more reliable than "police patrols." Instead of examining a sample of the agent's activities (or, more typically, the agent's reports about his or her activities), looking for inappropriate actions or improper use of information, the principal instead obtains information from the affected third parties. This McCubbins and Schwartz refer to as "fire alarm" oversight.

Fire alarm oversight offers several advantages. First, it allows the principal to gather information at lower cost; even when it is as costly as police patrol oversight, much of the cost is borne by the affected third parties. Second, it can yield better information. Under a realistic police patrol policy the principal examines only a small sample of the agent's actions and is therefore likely to miss violations. Under a well-designed fire alarm system, third parties can bring to the principal's attention any serious violation by the agent. More important, the affected third parties have incentives that are in accord with the principal's interests and not, as in the case of the agent, in conflict with them. Third, it is usually difficult to specify a priori a contract with the agent that unambiguously covers all contingencies, and consequently it is hard to tell whether an agent has violated the contract. In this situation, complaints by the affected third parties give principals the opportunity to spell out their goals more clearly.

Often it is no easier for affected third parties to oversee the agent's

actions than it is for the principal. In such cases the principal can provide third parties with the means and the incentive to gather information and to report it to him. One common example is that of companies who post on the rear of their trucks an 800 number that motorists can call to report reckless driving by the vehicle's operator. Until 1874 the federal government awarded 25 percent of the fines and forfeiture collected to those who informed on fraudulent valuations by customs officers (Studenski and Krooss 1952, p. 170). Today several agencies of the federal government, including the Department of Defense, the Internal Revenue Service, and the Security and Exchange Commission, have taken similar measures by setting up fraud "hotlines" and advertising rewards for whistle-blowers. Although such programs have a number of operational problems, their deterrent effect may be substantial.[9]

Alternatively, principals can set up a fire alarm system by requiring agents to notify third parties of any actions that affect them. According to McCubbins, Noll, and Weingast (1987), this requirement is a key feature of the Administrative Procedures Act of 1946. To comply with this legislation, an administrative agency must announce its intention to consider an issue well in advance of any decision. It must solicit comments and allow all interested parties to communicate their views. The agency must explicitly address any and all evidence presented and provide a rationalizable link between the evidence and its decisions. Such procedures, of course, do not necessarily remove inherent biases in agency decision making.[10] But the mandated sequence of notice, comment, collection of evidence, and deliberation affords numerous opportunities for members of Congress to respond when an agency seeks to move in a direction that a key constituency group finds objectionable. This makes it very difficult for agencies to strategically manipulate congressional decisions by presenting a fait accompli, that is, a new policy with already mobilized supporters.

Institutional Checks

Most applications of the principal/agent framework in economics characterize the principal's problem as one of seeking to induce the agent to expend more effort. The assumption is that the harder they work, the more they produce. But agents are often in a position to do more harm to the principal than to simply withhold effort; embezzlement, insider trading, official corruption, abuse of authority, and coups d'etat are all testaments to this fact. Whenever an agent can take actions that might seriously jeopardize the principal's interests, the principal needs to thwart the agent's ability to pursue such courses of action unilaterally.

We refer to various countermeasures the principal may take in this regard as institutional checks. Operationally, institutional checks require that when authority has been delegated to an agent, there is at least one other agent with the authority to veto or to block the actions of that agent. The framers of the Constitution established many interlocking checks with the intention of constraining the more powerful central government they had created. Most firms also employ systems of checks. Large expenditures, for example, typically require the approval of both management and the comptroller. Some of the most check-laden institutions are universities. Granting tenure usually requires an overwhelmingly favorable vote in the department, the approval of the dean, the acquiescence of a university-wide ad hoc committee, and ratification by the trustees.

As Madison observed, ambition is best checked by ambition—agents positioned against each other should have countervailing interests. This is most readily accomplished by making the agents' compensation contingent on different standards, such as rewarding managers for increasing production but rewarding comptrollers for cutting costs. Checks can also be applied in information acquisition. Rather than striving for an unbiased source of information, a principal may do better obtaining biased reports from different agents who have conflicting incentives. The view that legal proceedings should be adversarial rather than administrative is based on the same logic. Conversely, checks are disabled when agents' incentives cease to be in conflict.

Checks are equivalent to what social choice theorists refer to as the presence of veto subgroups. The major theoretical results concerning the effects of veto subgroups are generally intuitive. First, the more veto subgroups (checks) there are, the harder it is to change the status quo. The status quo also becomes more difficult to change as preferences within veto subgroups become more homogeneous and as preferences between veto subgroups become more diverse (Cox and McKelvey 1984). Checks, then, inhibit the ability of agents to take actions that the principal considers undesirable, but necessarily retard agents from taking desirable actions as well; security comes at the price of flexibility. The desirability of imposing checks on delegated authority thus increases with the utility the principal derives from the status quo and with the amount of danger posed by inappropriate agency actions.[11]

Principal/Agent Relationships and Inherited Instability

Why are some methods for containing agency losses chosen and others not? In many instances it is a matter of feasibility; certain features of a situation simply preclude alternative methods. Once a professor has been granted tenure, a judge appointed to the bench, or a member of

Congress assigned to a committee, it is very difficult to remove them or to otherwise change their compensation contract. In these cases the principals involved rely heavily upon screening and selection procedures. Fire alarm oversight is an option only when there are affected third parties with the incentive and wherewithal to report actions they find unsatisfactory. Second, the costliness of agency control measures implies that they should be adopted only when justified by a large enough reduction in agency losses. In particular, the opportunity costs associated with institutional checks dictate that they should be instituted only when the potential losses of inappropriate agency action are great. When the costs of agency control mechanisms are too high, the principal should forego delegation altogether.

We also believe that innovations in delegation and in agency control measures occur in response to learning and adaptation. Agents seek out loopholes in their contracts. Principals counter by altering existing arrangements or by designing new ones. The classic statement of this point of view is Alchian's (1950). He argues that because of uncertainty and costly information, institutional arrangements (such as agency control measures) can be designed only imperfectly. They evolve through a process of trial and error. Observed uniformity among surviving institutional arrangements, such as hierarchy in firms, cost and output sharing in land rentals, or committees in legislatures, is thus the product of an "evolutionary, adoptive, competitive system employing a criterion of survival" (p. 31).[12] In economic settings the criterion for survival is market fitness. Innovations that capture important economic gains, such as economies of scale, a transfer of risk to those willing to bear it, or a reduction in transactions costs (of which agency losses are a major component), will survive and be imitated (Davis and North 1971).

In the legislative arena, however, Alchian's argument would seem problematic. Instead of the selection of efficient forms of organization through market competition, there is instead the instability and unpredictability of social choice. In any realistic choice setting, the core of majority rule voting or any other social decision-making procedure is empty; any alternative chosen can be defeated by some other alternative. If stable equilibrium choices are to emerge, they must be "induced" by restrictions on the ways in which alternatives are posed against each other (Shepsle 1979). But if the decision makers themselves choose these arrangements—which they do in democratic, majority-rule legislatures such as the U.S. Congress—and they are cognizant of what policy choices a particular arrangement will generate, then the choice over institutional arrangements will "inherit" the instability present in the choice over outcomes (Riker 1980). Take, for example, a situation in which there are three alternatives, A, B, and C, and a simple voting cycle exists: A defeats B, B defeats C, but C defeats A. The legislature, however, initially selects from three alternative voting procedures: procedure I pits A against B; procedure II pits B against C; procedure III pits C against A. Obviously a prior vote on which procedure to use would cycle in the same way as would voting on the alternatives themselves.

Despite the problem of inheritability, many political scientists have nevertheless constructed legislative models that assume a particular institutional arrangement, such as a system of committees with orthogonal, mutually exclusive jurisdictions, as a given (for a thorough review of this literature see Krehbiel 1988). This mimics the strategy of economic analysis, which has long differentiated the "short-run," where technology, markets, firms, and the like are assumed to be fixed, from the "long-run," where these features are themselves variables. The problem is that in a legislature there are no physical sources of "stickiness," such as an existing assembly line or distribution system.

The types of delegation and agency control mechanisms we have discussed in this chapter are simply different forms of institutional arrangements. In delegating policy-making authority to one agent as opposed to another, or in selecting one configuration of agency control mechanisms instead of another, Congress would presumably alter the nature of the policies that ultimately emerged. Choices over delegation or over agency control mechanisms, then, would seem to inherit the instability properties of social choice in general.

We are sympathetic to Riker's argument. As we shall see in succeeding chapters, Congress frequently alters agency control mechanisms, whether internally with respect to its committees or externally with respect to the agencies and bureaus of the federal government. Occasionally the reforms or innovations made are substantial. But there are crucial considerations that generate preferences for patterns of delegation, agency control mechanisms, and other institutional arrangements that are distinct from and far more stable than preferences over the next set of outcomes that will emerge from those arrangements. First, members of Congress, in their creation of agency control mechanisms, are in pursuit of objectives that are much more far-reaching than that of getting the next few votes to come out right. These arrangements are not meant to assure the choice of a particular policy, but rather to prevent policy from being blunted and dissipated by agency losses. Much of the structure of the committee system and of executive departments can be analyzed and understood as resulting from efforts to mitigate a variety of agency problems. Another source of stability in preferences over institutional arrangements is the fact that most members of Congress have invested a substantial amount of time and energy in the institution as it is presently configured. They have a personal stake in a particular arrangement, for example, seniority, or the selection of the Speaker by the majority party, that is little fazed by how the next vote turns out. Such investment by participants in an institution often fosters far more support for its continuation than would otherwise make sense. This is true of even the most ridiculous of institutions. Participants in a Ponzi scheme, even if they are completely aware of what is going on, have tremendous incentive to keep it going.[13] Unfortunately, this is also true of the most coercive and pathological regimes in history.

Finally, in most organizations, including congressional parties, those who have been delegated leadership positions are able to use the resources available to them to protect their positions. They are also in a favorable strategic position relative to those who would upset the status quo. As Calvert (1987) argues:

> It is easy to see why one member, acting individually, has the incentive to cooperate. Going against the leader's wishes, on matters in which most members are inclined to follow the leader, requires organized action by a coalition of members in order for rebellious followers to achieve any better outcome. Such a rebellion faces the usual problem of collective action, exacerbated by the opposition of the leader and faithful followers. (p. 48)

There are, in short, a number of sources of "stickiness" in preferences over agency control mechanisms and other institutional arrangements. As a consequence, institutional rigidity is at least as troubling a prospect as institutional instability.

Delegation and the Abdication Hypothesis

According to the literature reviewed in the previous chapter, congressional decisions to delegate appear to have been motivated primarily by a desire to shed policy-making tasks that were too onerous, too likely to provoke controversy, or that were simply beyond the limited capabilities of either the congressional parties or the legislative branch as a whole. As this theoretical overview has shown, however, the delegation of authority and responsibility from principals to agents is crucial to the division of labor and development of specialization; tremendous efficiency gains accrue to principals and agents alike if tasks are delegated to those with a comparative advantage in performing them. We thus find it inconceivable that congressional parties or any other large organization could achieve their collective aims without engaging in prodigious amounts of delegation.

Certainly, the benefits derived from delegation come at a price. The principal suffers welfare losses caused by opportunistic behavior on the part of his or her agents. Even under the best of circumstances, agency losses cannot be eliminated. There is available to the principal, however, a large repertoire of mechanisms for reducing agency losses—screening and selection procedures, contract design (including both compensation schedules and sanctions for malfeasance), monitoring and reporting requirements, and institutional checks. These mechanisms are themselves costly to invoke, but the principal can choose the mix of mechanisms that is most effective and least costly. Under favorable circumstances, principals can transfer some of these costs to third parties. The most effective mechanisms for reducing agency losses are typically the least obtrusive. The degree to which the principal's strategies are effective should therefore never be inferred from the amount of time, energy, and attention the principal devotes to them.