

LECTURE 6.2

PRINCIPAL-AGENT THEORY

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Principal-agent theory:

- builds on neoclassical theory and emphasises incentives
- considers separate role for workers, managers within a firm
- highlights conflicts defined by asymmetric information

Owners cannot contract manager to maximise profit, but must use incentive schemes to align interests.

PRINCIPAL-AGENT THEORY

Strengths:

- Enriches neoclassical model by recognising relationships in firm
- Acknowledges challenges of resolving conflicts within firm

Weaknesses:

- Provides limited insight into boundaries of the firm.

We are going to examine principal-agent theory in more detail later this semester when we cover incentives.