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G U I D E P O S T

THE THEORY OF AGENCY REDUX

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The theory of agency has found applications across the social sciences as well as in management fields; there are literally thousands of papers that employ it. Unlike many popular theoretical approaches in social science, however, the theory of agency has no standard citation. Most applications to date have employed variations on the economic theory of agency, with the most cited article being Jensen and Meckling (1976). Most literature using agency has featured the assumptions, terms, logics, and domain common to approaches in economics. But agency theory did in fact have a distinct origin: it was first proposed, independently, by Mitnick (1973, 1974, 1975), beginning the institutional stream, and by Ross (1973, 1974), for the economics stream. Revisionist work on agency theory has taken for granted that the task involves extensions and repairs to the economic theory of agency. The present Guidepost essay argues that many of the criticisms do not necessarily apply to institutional agency theory. Work should return to an institutional approach that focuses on incentive relations rather than incentives; relationships of control, such as authority and responsibility, not just decisions; attention to how the inevitable imperfections of agency are managed, not just how they are corrected; the exploration of complex motivation, including terminal values; the influences of social norms on agency; and the design and functioning of systems of assurance that permit imperfect institutions to remain credible.

The theory of agency has spread across the social sciences. It has had so many applications—thousands—that many articles omit citations to any originating source (e.g., Enos & Hersh, 2015); it has become part of the common language of social science.

Moreover, unlike many approaches in social science, the theory of agency has no standard origin citation. The correct citation should be Mitnick (1973, 1974, 1975b), which introduced the institutional stream of work on agency, and Ross (1973, 1974), which first clearly proposed development of an economic theory of agency. But, confusion over the origin of agency theory—and its assumptions, terms, logic, and domain—is common. Though the most influential work in the area, Jensen and Meckling (1976), is sometimes given origin credit, some scholars cite Berle and Means (1932) and even Adam Smith (1776/1994) (see Dalton, Hitt, Certo, & Dalton, 2007).[1]

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[1] But, Jensen and Meckling (1976) never claimed its origin, citing earlier works (see their footnote 7). Spence and Zeckhauser (1971), an important work on the effects of differing risk, and Alchian and Demsetz (1972), who proposed a model of the firm based on a "monitor" (e.g., a manager) of team production who retains the residual benefit from the monitoring, are sometimes credited, although neither actually proposed the creation of a general theory of agency nor began explicit work on such a theory. And Berhold (1971), despite its use of now-familiar terms, was primarily a work in the incentive contracting/sharecropping literature. Though noting that his approach might apply in other situations of incentive contracting, Berhold neither proposed a general theory of agency nor actually dealt with the logics of *relationships* of "acting for" beyond discussion of ways to optimally share rewards when the agent makes an "appropriate decision." Mitnick (1973) and Ross (1973), independently, named the approach the "theory of agency." The first application of the institutional stream of agency from Mitnick's work was by Banfield (1975); the first application of the economic theory of agency from Ross was by Heckerman (1975). On the origin of the theory of agency, see Mitnick (2019). On the law of agency, see American Law Institute, DeMott (Reporter) (2006).

As a result of the confusion, several streams of work on "agency theory" strongly influenced by work in economics on information economics, incentive contracting, and the theory of the firm have dominated. I argue, in this Guidepost essay, that the dominance of approaches from economics has severely limited what was always the promise of agency theory—to give us a way to explain the myriad societal cases in which one party is acting for another.

AGENCY AS RISK, INCENTIVES, AND A NORMATIVE THEORY OF THE FIRM

The theory of agency abstracts and generalizes the relationship between an agent and a principal. Relationships of agency are ubiquitous as formal roles in organizations and society in general, as well as in such informal behaviors as altruism and helping relationships. Work on agency finds similarities in such apparently diverse contexts as employee–manager, lawyer–client, and director–shareholder relationships, and even in caretaker–patient relationships in hospices in which the patient is unable to express their preferences (see Shapiro, 2016).

An important influence on agency theory came from information economics, including the effects of differing risk preferences and information. Arrow (1985) distinguished agency problems of "moral hazard," when the agent is rewarded whether or not they take care of the principal's interest, and of "adverse selection," when the principal, who acquired an agent because of some disability regarding their own performance of the task, cannot determine whether the agent is acting optimally on behalf of the principal. While such problems are endemic and often critically important, the theory alone tells us little about behavior outside the decision.

Agency in economics has also been seen, simply, as a formal theory of incentives (e.g., Gibbons, 1998, 2005). Berhold (1971) focused on the problem from the "sharecropping" literature on setting an optimal compensation-sharing scheme between two actors. Ross (1973), created a model—represented as the "principal's problem"—for optimal incentive compensation between principal and agent, under certain conditions. Again, however, there is little in the model that relates to descriptive or behavioral characters of humans or organizations or contexts.

Jensen and Meckling (1976) created an economic agency model of the firm. Self-interested agents serve under metaphorical contracts (the firm is a "nexus" of contracts); shareholders as principals are assumed primary. Agency costs exist for monitoring agents, for bonding agents to the agency, and a residual loss when the principal is not perfectly served.

Jensen and Meckling (1976) is a *normative* model of the firm that is also a poor *description* of corporate governance—while the assumption of shareholder primacy creates a powerful model, it is completely at odds with the law regarding corporate control in the United States (see, e.g., Stout, 2012; Lan & Heracleous, 2010), and far too simplistic. Thus, we have a literature that has featured persistent confusion in treating agency theory as a particular theory of the firm, as an economic theory of incentives, or as an approach to modeling risk.

As agency theory migrated into the management literature, it remained strongly influenced by these streams of work on economic agency, including its limiting terms and logics. Eisenhardt's (1989) widely cited review article presents agency theory as "broadened" from the risk sharing literature in economics, but it remained largely an economic theory.[2]

The criticism, when it came, held this agency model and its assumptions to be inaccurate representations of managerial motivation, under-socialized and not reflective of the societal and normative settings in which organizations operate, poorly descriptive of behavior in as well as of the legal status of the firm, and suggestive of undesirable and ineffective managerial policy.[3]

A stream of revisionist work followed. Agency was a theory about economizing and risk and control whose assumptions needed relaxation and whose variables needed extensions.

Thus, critics introduced "behavioral" factors, while still focusing on risk-taking in economic agency (Wiseman & Gomez-Mejia, 1998), and made claims, incorrectly, that agency theory had been limited to self-interest and so was innovatively going to be expanded to consider mixed motives—that is, both self- and other-interests (Cuevas-Rodriguez, Gomez-Mejia, & Wiseman, 2012; Martin, Wiseman, & Gomez-Mejia, 2016; Wiseman, Cuevas-Rodriguez, & Gomez-Mejia, 2012). More realistic agents now acted with "bounded self-interest" affected by norms of reciprocity and fairness (Bosse & Phillips, 2016; Bosse, Phillips, & Harrison, 2009), and attention was drawn to the role of other social norms

[2] Eisenhardt (1989) cites Mitnick (1986 [published in 1992]) as a scholarly use in political science. This is mistaken. The paper cited is in management (organization theory), not in political science at all, and Mitnick (with Ross) was the originator of the theory of agency, not author only of an application of it. Eisenhardt's treatment of the origin of agency is not correct.

[3] Examples of this critical literature include Blair and Stout (2001, 2008); Davis, Schoorman, and Donaldson (1997); Donaldson (1990); Ghoshal (2005); Heracleous and Lan (2012); Hirsch, Michaels, and Friedman, 1987; Kaufman and Englander (2005); Lan and Heracleous (2010); Lubatkin (2005); Lubatkin, Lane, Collin, and Very (2007); Perrow (1986); Spender (2011); Stout (2012); cf. Husted's (2007) analysis.

(Casadesus-Masanell & Spulber, 2005; Lubatkin, 2005; Lubatkin et al., 2007).[4] Such work extended economic agency theory, but the institutional theory of agency began in 1973 with few such limitations.

AGENCY REDUX AS THE MANAGEMENT OF IMPERFECTION

So, what is—or should be—the theory of agency and its contributions? The theory of agency is not a theory of the firm and is not tied to the context of corporate governance. It originated as a sociological theory of relational acting for others and is multilevel.[5]

The economic theory of agency framed agency as an incentives-dominated theory of correction—of how compensation systems and monitoring systems bend behavior back toward perfection, from the principal's perspective. But if agency, despite the corrective mechanisms, is in general not perfect, we are asking the wrong question: rather, we need to know *how systems are structured to be successful even when they are not perfect.* It turns out that imperfect agency can even be highly functional—indeed, essential—in organizations, because organizations themselves may be viewed as solutions—as social means created to tell agents what to do.

The core logic of agency theory—that makes it interesting as a social theory—as introduced by Mitnick (1973, 1974, 1975b) is that it often does not pay the principal to invest in perfection; the net gains are so often not worth the costs (cf. Alchian, 1965). So both principals and institutions are constrained—and designed—to devise means to manage imperfect agency. It is all about managing, and managing around, imperfection. As a result, agency is fundamentally a *theory of the management of imperfection.*[6]

Consider how the economic theory of agency and the institutional theory of agency would treat the problem of hiring new employees for the firm. The risk-based approach of economic agency would focus on the problem of adverse selection—that the applicant would be incentivized to conceal their true fitness for the position, with firm managers potentially unable to discern the agent's true quality; after all, a reason they may need the agent is that they lack the skills the agent brings, so cannot evaluate the quality of those skills.

But the institutional approach would argue that it is often not desirable to invest in searching for and purchasing the most perfect agent. The organization exists to provide economical instruction to originally imperfect agents, thereby permitting continual adjustment to meet changing technological and market demands.[7]

So, if the theory of agency is not necessarily a normative theory of the firm, did not originate solely in economics with its common limiting assumptions, and does not necessarily suffer from the criticisms levied at its most common applications, where does that leave us, moving forward? We therefore see the potential of a theory of agency redux that is:

- *Not a theory of incentives, but of* ***incentive relations***. Agency is a relationship, not a decision setting or calculus regarding contingent rewards. Figure 1, from Mitnick and Backoff (1984), reproduces a generalized sorting of the motivational structure of an incentive relation.[8] Contrary to the recent literature that has claimed novelty in broadening motivation beyond self-interest (e.g., Bosse & Phillips, 2016; Wiseman et al., 2012), this 35-year-old article on the incentive relation in agency makes no assumption of self-interest.[9] We can study incentive relations by mapping them, comparing across organizational levels, boundaries, types, societal embeddedness, communication variations in incentive message sending and receipt, and so on.
- *Not a theory solely of decisions and the costs of control, but of the* ***relationships of control***. Figure 2 reproduces a sorting of authority relationships and operative norms from the original

[4] But see substantially earlier work on norms of agency and exchange from Stinchcombe (1986 [1975]) and Mitnick (1973, 1974, 1975a, 1975b, 1976a); cf. Arrow, 1963.

[5] Agency can be modeled as multilevel: any social actor may be in a relationship of agency with another social actor, at any level. That is, we can model agents for individuals, organizations, systems, or any collective as principal.

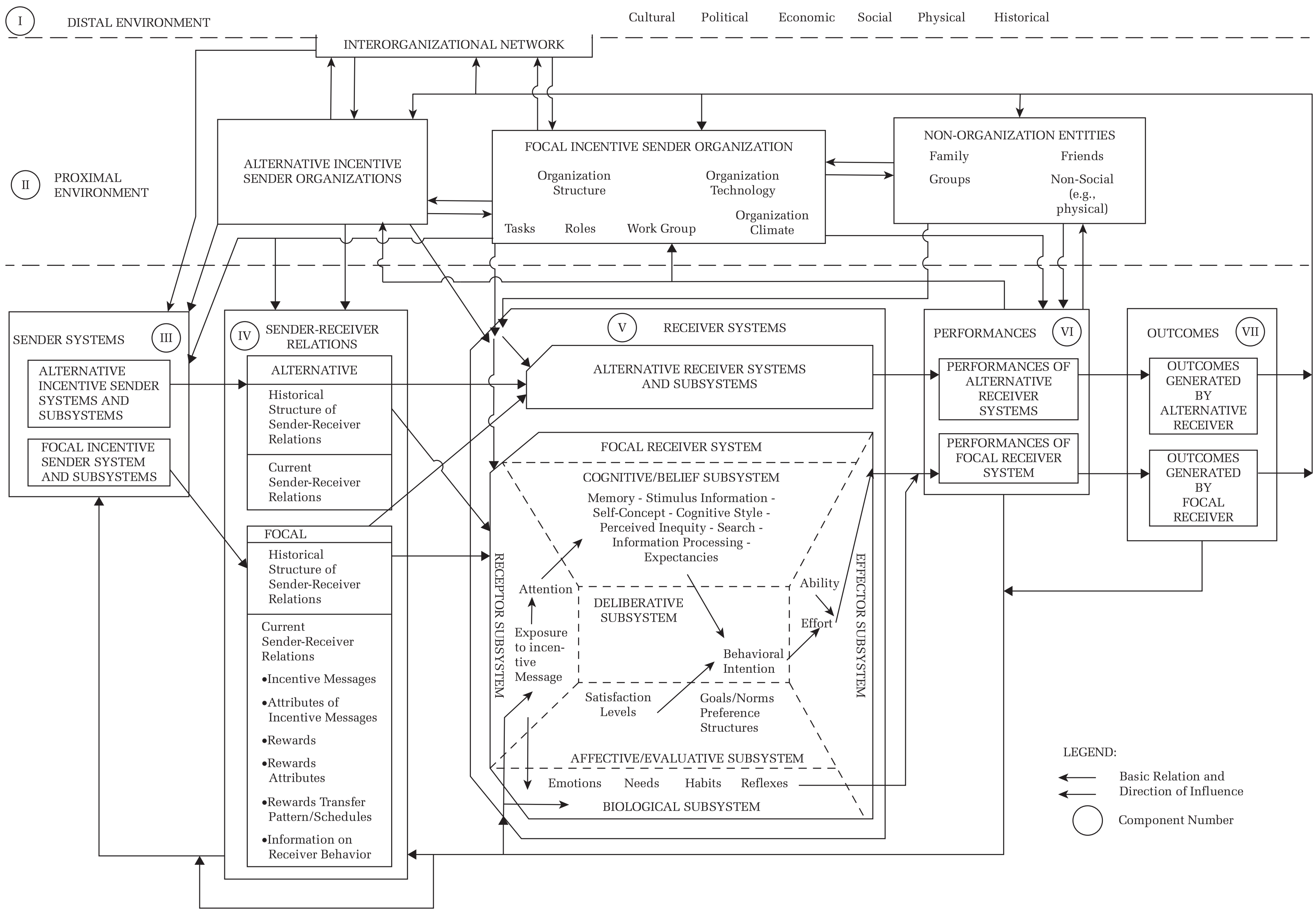
[6] That the theory of agency is a theory of the management of inevitable imperfection was recognized almost immediately. Banfield (1975), using Mitnick's theory of agency, proposed that corruption in government as agency should be seen as endogenous—as an unavoidable, almost baked-in feature resulting from the incentives, structure, and setting of the public sector.

[7] For example, the classic problem of adverse selection in the risk-focused literature on agency takes on new forms across organizational boundaries: adverse selection divides into "adverse claims," as agents conceal their imperfection when applying to organizations for membership, and "adverse performance," as their behavior is observed and iteratively directed or corrected once inside the organization (on delegation in organizations as agency, see Mitnick, 1994a, 1994b; on agency problems, see Mitnick, 1984).

[8] Figure 1 focuses on the motivational setting, and is not intended to be a general model of the range of variables that affect the general agency relationship.

[9] See also, for example, Mitnick (1975b, 1976a); for other applications of incentive relations in agency, see, for example, Backoff and Mitnick (1981) on incentive relations in higher education; Mitnick (1980a, 1980b, 1982, 1991) on incentive relations in government regulation.

FIGURE 1
Individual-Level Model of the Basic Incentive System



Source: Mitnick and Backoff (1984); regarding the "incentive; relation", see also Backoff and Mitnick (1981); Mitnick (1980a, 1980b, 1991). Reproduced from original source.

FIGURE 2
Typology of Agency

Chart II: Typology of Agency

Agency			
State of agreement regarding agent's acts:	Contractual	Non-Contractual: Symmetric-Consensual	Non-Contractual: Asymmetric-Consensual
Common behaviors:	Contractual Trusteeship Authority: Post-contractually specified, with extremes: Sales Relation Contractual Slavery According to discretion: Type I Authority Type II Authority	Consensual Autonomous Agency Altruism Non-Contractual Reciprocity Consensual Directed Agency, or the Consensual Imperative	Coercion
Sample norms:	Norms of contractual obligation: Fiduciary Obedience to Authority Opportunism Reciprocity under Contract	Norms of non-contractual obligation: Giving Helping Reciprocity (Non-Contractual)	Resistance to Non-Consensual Direction

Source: Mitnick (1974, 1976a). Reproduced from original source.

papers on the theory of agency (Mitnick, 1973, 1974, 1976a). Though this sorting is far from an exhaustive treatment of alternative relationships in agency, it illustrates what was already part of institutional agency over 45 years ago. In economic agency, we ignore organizational relationships such as authority and responsibility, focusing on simple decision points and assignment of the rights to make decisions. The older literature studied patterns of authority (e.g., Eckstein & Gurr, 1975), and I suggest that the comparative empirical study of authority patterns and of responsibility systems in and among organizations might be productive.

- *Not a theory of the means by which perfection can be approached most efficiently, but a* ***theory of how inevitable imperfection can be managed*** *most practically and effectively*. Why is agency the means by which particular social action questions are addressed, especially given the persistence of imperfection?[10] How does the optimal level of agent perfection vary by setting under delegation? Is there a "Goldilocks" solution—an optimal level of imperfection—and, if so, how does it vary across institutional settings?[11] Empirical work can explore such questions as: How imperfect can organizations be, and in what respects, yet still perform satisfactorily? What mechanisms are in place in diverse

[10] On the rationale for agency, see, for example, Mitnick (1984) and Mitnick (1993: 90–124).

[11] Embedded in the logic of delegation is the moving target of an optimization model that depends on context and environment, with the front-end costs of investing in more-perfect agency balanced with the discounted future benefits of adaptable agency that, if not originally perfect, becomes closer to perfect just in time.

organizational settings that serve parallel functions of managing imperfection? What happens when the management of imperfection fails?

- *Not a theory of limited motivational capacity, emphasizing self-interest and opportunism, but a* ***theory of complex and often relational motivation*** *including the obligations of action for another.* Moreover, the terminal motivations barred from the black box of utility maximization in economics need to be resuscitated—we need to jettison 70-year-old assumptions about modeling human motivation that have dominated economics. People are not black boxes. The assumption of utility maximization remains useful but is not necessary in all theories once we can measure terminal values, as some work has suggested (see, e.g., Reiss & Havercamp, 1998; Schwartz, 2012). We can incorporate complex human motivation into agency theory (cf. the elements of the focal receiver system depicted in Figure 1; see also Mitnick, 1973, 1974, 1975a, 1975b, 1976a, 1976b, 1992). Using Reiss's validated instrument, can we explore experimentally how differing terminal values affect agency behavior in the same or differing agency roles?
- *Not a theory of isolated decisions and of who gets to make them, but a* ***theory of relationships embedded in social structures featuring social norms*** *that shape them and are shaped in turn.* For example, the original work on institutional agency identified the "fiduciary norm," socialized and exhibited in situations of high dependency of principals on agents (Mitnick, 1973, 1975a, 1975b, 1976a; Shapiro, 1987, 2005; Stinchcombe, 1986 [1975]). The fiduciary norm can generate high levels of service. Would experimental studies show service quality increasing with dependency? What conditions moderate or mediate such agency? Could such work help design highly reliable organizations? The other norms of agency also deserve systematic comparative empirical attention.[12]
- *Not an assumption of rational decision-making under risk, rationally assured via optimal contracts and incentives, but of a* ***theory of assurances*** *that statements regarding events and conditions in the past, present, and future in the social world are credible representations of those events and conditions.* If we accept that agency theory is all about the management of imperfection, we reach a troubling question: How is society able to sustain belief in a system that admittedly does not work the way it is supposed to? How do we come to accept—indeed, trust in and place reliance upon statements about pervasively imperfect systems as credible—as reliable and true? Via experimental work using the theory of testaments (see, e.g., Mitnick, 1999, 2000, 2009), can we, for example, determine how reports of past conditions or events are used preferably to claims about the present, or predictions about the future, to enhance credibility?

The theory of agency has the potential to be what it was at its start, not what it has become—a narrow caricature, the agency theory of the firm. Despite the value of the economic theory of agency, the theory of agency is not, and need not be, solely a theory of risk or incentives management. Its core logic is the difficulty—sometimes the irrationality and sometimes the impossibility—of creating and managing social organizations populated with perfect agents. Hence, the theory of agency is in fundamental ways a theory of the management of imperfection in the pervasive societal contexts in which one party is acting on behalf of another.

[12] Some of the agency literature has incorrectly claimed novelty in introducing such social norms to agency theory (e.g., Casadesus-Masanell, 2004, and Casadesus-Masanell & Spulber, 2005, which appeared about 30 years after norms were first explicitly discussed in the theory of agency in Mitnick, 1973, 1974, 1975a, 1975b; also see Stinchcombe, 1986, whose book incorporated his 1975 paper on norms of agency; see Shapiro, 1987, 2005; on the role of fiduciary duties, which have norm-like functions, see, e.g., Easterbrook & Fischel, 1991, 1993).

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