

AGENCY THEORY

Authored by
mohammad looti

November 12, 2025

RECOMMENDED CITATION

mohammad looti (2025). *AGENCY THEORY*. PSYCHOLOGICAL SCALES. Retrieved from <https://scales.arabpsychology.com/?p=68264>

AGENCY THEORY

Primary Disciplinary Field(s): Financial Economics, Organizational Management, Corporate Governance

Proponents: Michael C. Jensen, William H. Meckling, Stephen A. Ross

1. Core Principles

Agency Theory is a fundamental doctrine in financial and organizational processes that describes the relationship between two parties: the **principal**, who hires or commissions work, and the **agent**, who carries out that work on the principal's behalf. This theory frames the organizational structure not merely as a hierarchy, but as a nexus of explicit and implicit contracts between self-interested individuals. At the core of the doctrine is the logical economic presumption that both the agents and principals are rational actors who will inevitably attempt to optimize their individual resources, often leading to divergent objectives.

The central hypothesis of Agency Theory dictates that the principal delegates decision-making authority to the agent, creating an inherent risk due to the potential for goal incongruence. Since principals and agents typically aim to maximize their utility--which may involve maximizing financial return for the principal and maximizing leisure or salary for the agent--the relationship is prone to friction. This friction, known as the **Agency Problem**, surfaces whenever the concerns of principals and agents are not congruous, or whenever principals have limited data concerning the operations of said agents, creating a situation of information asymmetry.

To mitigate these inherent conflicts, the theory suggests that the principal must incur costs to ensure the agent acts in the principal's best interest. These costs, collectively termed **Agency Costs**, include expenses related to structuring contracts, monitoring agent behavior, and bonding activities undertaken by the agent to signal trustworthiness. The fundamental goal of studying Agency Theory is to identify the most efficient contractual structures and governance mechanisms that minimize the divergence of interests at the lowest possible cost, thereby maximizing organizational efficiency and value.

2. Historical Development

The intellectual roots of Agency Theory can be traced back to earlier works in economics addressing incomplete contracts and asymmetrical information, but its formalization as a distinct body of work occurred primarily within the field of finance. The conceptual framework was significantly advanced by the seminal 1976 paper, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," authored by Michael C. Jensen and William H. Meckling. This work provided a robust economic foundation for analyzing the separation of ownership

(principals/shareholders) and control (agents/managers) in modern corporations.

Prior to Jensen and Meckling, classical economics often viewed the firm as a single, unitary entity seeking profit maximization. Agency Theory challenged this monolithic view by breaking the firm down into a set of contractual relationships, emphasizing that managerial decisions are driven by personal utility functions rather than solely by shareholder value. This shift allowed academics to better explain phenomena such as executive excess, corporate inefficiencies, and varying capital structures across different companies, providing a powerful new lens for corporate governance research.

The rise of Agency Theory paralleled the increased complexity of global organizations and the growing recognition of the impact of information economics. By the 1980s and 1990s, the theory became a dominant paradigm in organizational studies, influencing not only finance and economics but also legal studies, political science, and accounting. Its enduring relevance stems from its ability to model and predict behavior in situations where delegation is necessary, and perfect information is unattainable, making it crucial for understanding contemporary management challenges.

3. Key Concepts and Components

Agency Theory relies on several interlocking concepts to define and analyze the principal-agent relationship and the resulting conflicts:

The Principal: This party delegates authority, typically owning the asset or bearing the risk associated with the outcome. Examples include shareholders, business owners, or patients seeking professional advice. The principal seeks to maximize returns or satisfaction from the agent's work.

The Agent: This party acts on behalf of the principal, utilizing their specialized skills, time, or resources. Examples include corporate managers, employees, or legal counsel. The agent seeks to maximize their own welfare, often through compensation, job security, or perquisites.

Information Asymmetry: A critical component of the Agency Problem, this refers to the situation where the agent possesses more or better information than the principal regarding the actions taken, the effort exerted, or the environmental factors influencing the outcome. This imbalance makes it difficult for the principal to verify if the agent is acting optimally.

Moral Hazard: Occurs when the agent alters their behavior after the contract has been signed, often resulting in less effort or risky behavior because the principal cannot perfectly observe their actions. For instance, a manager might shirk responsibilities if their pay is guaranteed regardless of performance.

Adverse Selection: Occurs before the contract is signed. It describes the difficulty principals face in selecting the right agent because potential agents have private information about their true abilities or intentions. This leads to the risk of selecting a low-quality agent who misrepresented their capabilities.

Agency Costs: The sum of all costs incurred to manage the principal-agent relationship. These include **monitoring costs** (e.g., audits, performance reviews), **bonding costs** (e.g., contractual guarantees or insurance provided by the agent), and the **residual loss** (the remaining value lost due to continued suboptimal decisions despite monitoring and bonding efforts).

4. Mechanisms for Control

The primary utility of Agency Theory in practical management lies in its recommendations for reducing agency conflicts and minimizing agency costs. Department standards and organizational research generally recommend two key methods for aligning interests: restructuring contractual agreements (incentive alignment) and enhancing oversight (monitoring policies).

First, **Incentive Alignment** aims to restructure legal agreements or payment designs in such a way that agents retain an advantage to behave in the ideal interests of principals. This involves designing compensation packages that link the agent's rewards directly to the principal's outcomes. For corporate managers, this often involves offering stock options, performance bonuses tied to quarterly earnings, or equity stakes, which effectively turn the agent into a partial principal. By making the agent's personal financial success contingent upon the success of the organization, the natural self-interest of the agent is channeled toward behaviors beneficial to the principal.

Second, **Monitoring and Governance** refers to the processes and structures implemented to enhance observation and reduce information asymmetry. This includes detailed financial reporting, internal and external audits, the appointment of independent board members, and strict reporting protocols. While monitoring costs money and time, the investment is justified if the reduction in residual loss (the cost of agent opportunism) is greater than the monitoring expenditure. Effective governance structures--such as strong, independent boards of directors--are viewed as crucial external mechanisms for limiting managerial discretion and ensuring accountability to shareholders.

Furthermore, implicit controls, such as market mechanisms, also play a role. For example, the **Market for Corporate Control** (the threat of a hostile takeover) acts as a powerful, non-contractual monitoring device. If managers consistently fail to maximize shareholder wealth, the firm's stock price will fall, making it vulnerable to acquisition by new owners who will likely replace the underperforming management team. These manifold control mechanisms attempt to solve the fundamental difficulty that arises when one party delegates decision-making power to another

driven by potentially misaligned motives.

5. Applications and Examples

Agency Theory is widely applied across professional capacities, the majority of which concern formulated ways to boost the motivation of employees and improve their work quality. Its most profound impact is seen in the field of **Corporate Governance**, where it provides the primary framework for analyzing the relationship between shareholders (principals) and executive management (agents). Regulations such as Sarbanes-Oxley in the U.S. and various international governance codes are largely informed by agency concerns about managerial self-dealing and accountability.

Beyond corporate finance, the theory is highly relevant in understanding employment relationships. For example, in sales organizations, the contract between the management (principal) and the salesperson (agent) often uses a commission structure rather than a fixed salary. This incentive design directly addresses the moral hazard problem by rewarding the agent only when they produce a successful outcome for the principal. Similarly, in professional services, such as law or medicine, licensure and professional codes of conduct serve as bonding mechanisms, signaling commitment and quality to clients (principals).

In the public sector, Agency Theory helps analyze the relationship between elected officials (agents) and the citizenry (principals), or between government ministries (principals) and public agencies (agents). The inherent difficulties in monitoring the complex operations of government bureaucracies often lead to significant agency problems, which are addressed through parliamentary oversight, public disclosure laws, and term limits designed to improve accountability. Regardless of the domain--be it a small business contract or the structure of a global corporation--Agency Theory provides the language for diagnosing and solving problems related to delegated authority.

6. Criticisms and Limitations

While dominant, Agency Theory is subject to significant academic criticism, primarily centered on its underlying behavioral assumptions. The theory relies heavily on the concept of **homo economicus**, portraying both principals and agents as purely rational, self-interested, and opportunistic actors. Critics argue this view is overly simplistic and ignores other motivational factors, such as altruism, loyalty, professional ethics, and organizational culture.

A key limitation is that the theory tends to focus on formal, measurable contracts and mechanisms, often neglecting the role of trust, informal relationships, and intrinsic motivation. For instance, employees may be motivated by a sense of professional pride or commitment to a team, factors that incentive-based contracts (designed purely around self-interest) may ironically undermine.

Critics from organizational behavior disciplines suggest that excessive monitoring, a core solution proposed by Agency Theory, can erode trust and lead to defensive behaviors, thereby increasing the true complexity and cost of the relationship.

Furthermore, Agency Theory is often criticized for its static nature. It typically views agency costs as fixed constraints to be minimized, rather than dynamic elements that evolve through relationship building and learning. Alternative perspectives, such as Stewardship Theory, offer a counter-view, suggesting that under certain conditions, agents can be motivated to act as responsible stewards of the organization's assets, potentially aligning their interests with the principal's goals without the need for high-cost monitoring and complex financial incentives.

7. Further Reading

[Agency Cost \(Wikipedia\)](#)

[Principal-Agent Problem \(Wikipedia\)](#)

[Michael C. Jensen \(Wikipedia\)](#)

[Corporate Governance \(Wikipedia\)](#)