ORGANISATIONS AS WEBS OF PRINCIPAL-AGENT CONTRACTING

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Abstract
Men and women engage often in organising activities in order to make an increasing output of goods and services feasible. Thus, organisations of various kinds play a major in everyday social life. Organisation theory and management studies have contributed lots of studies with numerous insights into the operations of organisations, market based as well as non-market organisations. This intense research has resulted in a number of theoretical approaches, focusing upon a variety of factors in or aspects of organisations: e.g. planning, strategy, internal organisation – external relations, hierarchy, division of labour, bounded rationality and institutionalism. The aim of this paper is to raise the question CUI BONO? in relation to organisations. The quid pro quo question in relation to organisations leads to an emphasis upon contracting.

Keywords: contracting, webs of contracts, counter-veiling agents, incentives, quid pro quo, cui bono, asymmetric information, demos versus politicians and public officials, remuneration and value of output.

INTRODUCTION
The principal-agent approach offers a useful framework for analysing the variety of organising of human activities, based upon contracting and incentives (Ross, 1973; Grossman and Hart, 1983; 1991; Sappington, 1991; White, 1992; Ackere, 1993; Althaus, 1997). Its strength is that it underlines human interaction more than formal rules, as with several organisation theories. The focus is upon the web of contracts that link people together in an organisation, analysing them with the newly developed concepts in the economic theory of information (Bircher and Butler, 2007), like the role of asymmetric information in contracting.
Viewing relationships between actors as contractual links between principals and agents has proved insightful with regard to understanding work in agriculture, lawyers’ effort, doctor-patient relationships or investor-broker interaction as well as the entire business of insurance. Yet, there has been hesitance to apply the principal-agent approach to politics, because the key concepts do not seem to capture the essence of politics in well-ordered societies, namely the old Edmund Burke idea that politics is about how to safeguard the national interest or the common good of citizens.

The typical search for efficiency of organizations in both classical management theories and public administration approaches and its rejection in the bounded rationality perspective upon organizations, launched by H. Simon and J. March, has resulted in an intense debate about the nature of organizations and the limits of management. But neither of these two theoretical perspectives entails much for the crucial question about organisations, namely: *Cui bono*? Even the most radical approach to organisation, denying completely the relevance of concepts like effectiveness and productivity to understand real life management, preferring to talk about organised foolishness, myths and institutional legacies (Olsen, 2010: Brunsson, 1985), does not touch the fundamental *Quid pro quo* questions in organisations, like e.g.: Who gains?

People are linked in organisations through webs of contracting. The content of any contract is its *consideration*, meaning the expectations that the parties bring to the agreement. The organisation acts through the management or handling of these contracts, from the beginning – *ex ante* – to its fulfilment – *ex post*. Studying organisations as webs of contracts and their management, the principal-agent framework, emerging from recent advances in game theory (Rasmusen, 2006), appears most promising. Thus, we ask:

1) Why it is easy to organise lots of taxi services in a huge capital like Yangon?
2) How come the remuneration of CEOs in firms is out of hand?
3) How can politicians and high bureaucrats become superrich?

One can analyse these highly relevant problems today with one framework of analysis, namely the principal-agent approach, originating in recent game theory advances.

**THE STYLISED PRINCIPAL-AGENT MODEL**

The general principal-agent model (Macho-Stadler and Pérez-Castrillo, 1997) assumes (1) a principal searching to maximise the value of some output(s) $V$ and (2) contracting with a set of agents, remunerating $R$ them for their efforts in producing the output. Moreover, (3) the payment of the agents derive from the value of the output of the agents, meaning that the principal-agent contract must involve considerations covering the *ex ante* to the *ex post* stages. With a
considerable time lapse between the making of the contract and the fulfilment and its evaluation, (4) problems of asymmetric information (Birchler and Bütler (2007) and transaction costs arise (Rao, 2002).

The principal-agent framework has enjoyed far reaching success in modelling interaction between persons where one works for the other over time. This interaction is to be found in many settings, such as agriculture, health care, insurance and client-lawyer (Ross, 1973; Rees, 1985: Laffont and Martimort, 2002). Typical questions concerning principal-agent interacting arise whenever there is a long-term interaction between two groups of people, involving the delivery of an output (V) against remuneration (R), to be paid from V, as well as a time span – months or years - between the making of the contract and the ending of the relationship with the final delivery of the output, The principal-agent problematic is inherent in any employment relationship where one person works for another, who pays this person by means of the value of the output, monitoring the performance of these agents. Whenever people contract with others about getting something done, there arise some very pertinent questions that organisations – simple or complex - must be able to answer:

1) What is the *quid pro quo* between the principal and the agent – the contractual considerations?
2) How can the principal check the agent with regard to their agreement – the monitoring problem?
3) Who benefits the most from the interaction between principal and agent – who takes the surplus?

Let us apply this conceptual framework to three kinds of organisation in order to illustrate that it illuminates some key aspects of the pattern of interaction between people.

**SIMPLE CONTRACT: Organisation of Taxis in Yangon**

1) Principal: Owner of the cars, with goal to maximise profits from taxi services; providing cars against a guarantee against accidents;

2) Agents: Renting the car for 12 $ a day with a guarantee of 300 $ for damages as first down payment. All running costs are born by the agent and the car is checked in detail at every round of contracting period. More costly repairs> 300 will be paid off successively.

3) Risk: Almost all risk is carried by the agent; the principal, who is risk avert, provides the car but the agent has to pay repairs, either with the down payment or additionally through a loan from the principal.
Outcome: The agent will drive the care as long as he/she can raise every day > 12 $ plus the running costs and the repair costs. This contract is attractive for people whose reservation salary is very low or zero. It is also incentive compatible, as the driver gains more by being active and careful. Since unemployment is high in Yangon, the remuneration of agents can be kept as low as possible, resulting in a nice profit to the principal, who bears little risk. This organisation tends to be stable.

COMPLEX CONTRACTING: “Aktiengesellschaft”

Besides the trillions of daily on-spot contracts in the markets, there occur several forms of principal-agent contracting, introducing organisation into social life. In the private sector, firm organisation varies from small partnerships to giant enterprises with more than one hundred thousand employees. It is all based upon contracting between principals and agents. Thus, lawyers loom large here, i.e. experts on contracting, meaning private law.

Web of contracts: Firm Organisation

1) Principal: Owners of the shares: a few big owners plus an ocean of small owners with the goal of maximising the value of their holdings of stock, which is the future value of the outputs;

2) Agents: The CEOs, who are risk avert, receiving a fixed salary plus yearly bonuses, decided usually at discretion. The CEO can be fired at any moment but receives a so-called golden handshake. He/she employs the other employees on standard wage contracts – internal organisation – or on the basis of contracts in outsourcing. All the agents are paid by means of the market sales of the output of the firm, where the CEOs maximise their remuneration in total.

3) Risk: CEOs are risk avert, as they wish to be paid no matter what; the principal, or the shareholders, are risk prone, seeing opportunity where others see risk.

Outcome: The owners will need lots of monitoring to find out what is going on and whether the CEOs make an effort. Thus, they wish to list the firm on the bourse, harbouring instantaneous evaluation. The risk of the owners is the occurrence of asymmetric information, both ex ante (adverse selection) and ex post (moral hazard). This organisation tends to be unstable, as the CEOs manage to use various strategies to push up their remuneration almost to the level of looting. The CEOs pretend (ex ante) that they have a high reservation price and they refer to their effort constantly, despite shirking (ex post).

The instability in the firm organisation shows up in the constantly increasing remuneration packages of the CEOs, where the spread to other employees have multiplied
several times during the last 50 years. This is true of both the fixed salary and the yearly bonuses, which tend to be paid more or less automatically. It has happened that bonuses become permanent remuneration whatever the result of the firm is.

Neither economic decision theory nor management theory has any clear explanation of the tendency of the CEOs to prevail considerably in firm organisation. The only credible explanation is that shareholders are easily manipulated by the CEOs due to the enormous asymmetric information plus the large room for the CEO’s to manoeuvre by making coalitions with board members, like first and foremost collusion with the chairman of the board of the company. As effort is not observable and costly to enforce, shareowners chose to believe in the story of the CEO, often until it is too late.

There is no remedy to this advantage of the agent. Making the CEO part owner of the firm has been proposed but the future price of his stock options tends to be set extremely low. A radical solution is that the big owners become the CEOs, but this is only feasible for some firms, like e.g. HM.

The remuneration of CEOs could skyrocket when various forms of commissions are added to the salary, for instance when company activities are sold or bought. The remuneration of the CEO of NOKIA before it was sold to MICROSOFT is an excellent example. Firms that are owned by the consumers themselves, like COOP, are exceptionally vulnerable to the claims of CEOs, when excessive and when promised output is not forthcoming.

It is an often stated and debated fact that the total remunerations of agents has gone up astronomically over the last decades in the firm organisation, resulting in rapidly increasing inequality in both Western societies and Eastern or South East Asia (Stiglitz, 2013). The basic reason is hardly a shortage of CEOs or a dramatic increase in management skills, but simply the instability inherent in the principal-agent interaction in firm organisation due to asymmetric information. When the CEOs are hired, there is the adverse selection problem of failing to recognize pretending and when they have been hired, there is the moral hazard problem of shirking.

The shareholders tend to be afraid of these two major difficulties- pretending and shirking - in firm management so that they are prepared to throw almost any amount on money upon them, although a high R must reduce V for them. It has happened that the CEO:s capture almost all the profits of a joint-stock company in the form of bonuses: It would be better for its shareholders to sell this company (Husqvarna) to these CEOs! Public joint-stock companies with the state as the owner are run with the same principal-agent interaction: the CEO agents on top. The process of incorporation of traditional public enterprises all of Europe has resulted in huge increases in their remuneration, like Swedish Vattenfall.
THE STATE: Multiple Objectives and Counter-veiling Agents

Political organisation:

1. Principal: demos, citizenry, electorate, population;
2. Agents including counter-veiling ones: politicians, parties, legislators, judges, Ombudsman, bureaucrats, officials, agencies, boards, etc.
3. Incentives and risk: What drives the agents – self-interests or the public interest? And do they really improve for the principal, i.e. the value V of their output? The political contract between the electorate and the politicians just as the administrative contract between politicians and public officials puts most of the risk with the principal, except when agents engage in explicitly and verifiable illegal activities.

The state is a much more complex organisation than the firm. It likewise involves lots of laws and regulations, i.e. public law. Political science teaching often starts with the observation that roughly 50 per cent of all existing countries today have a democratic regime of some sort while the rest of the countries either are authoritarian regimes or so-called failed states, i.e. countries in anarchy. This distinction between democracy and non-democracy has been a central research topic since after the Second World War, especially as the number of democracies has increased during the last decades. A large number of factors have been examines. In the modernisation approach, the focus is upon exogenous factors, like the economy, social structure and fragmentation, ethnicity, religion, openness of the economy, historical legacies, etc. In the institutional approach, the endogenous factors are central: constitutions, institutions and political culture.

A completely different starting-point is to pose the quid pro quo question. In non-democracies, the remuneration of politicians tends to be much higher than in democracies. And in failed states, the predicament of anarchy opens up for the looting strategy, which may pay off handsomely for rebels, jihadists and drug traffickers, at least in the short-run. In kingdoms or sultanates, the existence of patrimonial authority implies that imperium and dominium, public authority and private ownership are fused. Thus, e.g. the Saudi family is the owner of the oil riches of the country. Moreover, the sultan of Oman, Qaboos bin Said Al Said receives all state revenues as his, thereafter writing checks to the public budget – public budgeting as private gifts.

In authoritarian one-party states, the political leadership forms a most wealthy click, like in the Khanates and China. Why start a transition to democracy when so much of wealth is at stake for the economic fortunes of the rulers? in a non-democratic regime, there are few if any cushions for the losers in a power struggle. Thus, the power holders stand to gain much from rejecting regime change as well as are likely to lose considerably from regime transition. In
failed states, political agents have only one consideration, namely their own safety, not that of the principal (Hobbes: *homo homini lupus*).

In his detailed enquiry in the fate of African states after the coming of independence from the Europeans, British historian M. Meredith (2013) documents a long list of rulers, who enriched themselves through embezzlement (R) or squandered the riches of the country though pillage (V). No wonder that many of them tried to prolong their rule unconstitutionally, even for 2-3 decades! The political agents will try to capture as much as possible of the value V of the game, i.e. the country GDP, unless hindered by counter-veiling agents, i.e. competing agents or guardians like courts or the Ombudsman (Public Protector).

Principal-agent interaction in constitutional democracies is very different from that of non-democracies, mainly due to the existence of counter-veiling agents, political competition and political markets, i.e. elections. A number of models have been launched: Barro, 1973; Ferejohn, 1986; Weingast, 1989; Rao, 2002; Besley 2006; Helland and Sörensen, 2009.

**CONSTITUTIONALITY IN POLITICAL ORGANISING**

The following assumptions appear the most likely to be adequate for modelling principal-agent games in a constitutional democracy:

1) The principal of the democratic state is the demos, or the electorate – *body politic*;

2) The set of political agents covers three counter-veiling groups: governments and its bureaucracy, the legislators and the judiciary – *triaspolitica*;

3) The political market place: Politicians offer the voters alternative policy packages about how the state may improve upon society, or total value V;

4) The remuneration of the political agents are separated from the resources of the *fiscus*, the state coffers;

5) The remuneration of politicians is fixed, including pensions, in order to avoid the appropriation of the *fiscus*;

These maxims of constitutional democracy seem enough to introduce the distinction between the public and the private, which was so confused in all forms of oriental despotism, as well as sole the *appropriation problem* in politics and public administration, as Max Weber conceived it (Weber, 1978). The modern bureaucracy and its superior performance to patrimonial administration is only feasible when officials are paid predictably, meaning that they are little incentive to *appropriate* the recourses of bureau or engage in looting in society.

However, we need a few more maxims:
6) The principal will only be able to control the set of political agents when they are set in competition with each other;
7) Political competition is as vital to democratic politics as firm competition is to the market;
8) Political competition favour the interests of the demos, pitting the three branches of constitutional government against each other;
9) Political entry in competition must be open so that the authoritarian politicians cannot exercise political monopoly;
10) The judiciary operates on the principles of due process of law, to be found in either Common Law or Civil Law.

In order to tame the political agents and diminish their advantages, the principal has supported the evolution of distinct institutional mechanisms that restrain the political agents: viz. rule of law and the political market place. The hope is that the actions and decisions of politicians will enhance societal value, like for instance affluence and wealth.

R AND V

The fundamental *quid pro quo* problematic in all forms of organisation as basically contracting, private or public. In the organisation of taxi services above, the contract favour the principal, pushing the risk upon the agents. In firm organisation, it is the other way around. What about politics?

The state and political leadership concern an entire country, or nation. Thus, the value of the output of the political agents is their contribution to the total value $V$ in society, or the GDP. Moreover, the political agents are paid remuneration $R$ through taxes and charges upon the GDP. What is the logic of the *quid pro quo* requirement, the consideration of the public contracts?

The most profound answer to this question is to be found in the theory of public finance, focussing upon the allocation to society of so-called public or semi-public goods (Musgrave and Musgrave, 1980). A country has a strong need for goods and services that are non-rival or non-excludable as well as joint in supply. As the market cannot supply these, only the public sector or the state can be relied upon. Market failure is the reason of the state.

Public or semi-public goods include law and order, peace and war, infrastructure, common pools, etc. In order to provide these services, political communities – governments at various levels – contract with a set of political agents to deliver them. What will be their remuneration $R$ for their achievements in allocating public services, i.e. the value $V$ of their output?
1) Patrimonialism: From the point of view of human known history, patrimonialism is the most frequently occurring structure of political leadership, at least until 1900. The remuneration of the political tends to go very high, at the same as there is constant struggle among contenders to the patrimonial assets. To stabilize the rulership, political leaders engages in huge aggrandizement project, which both deliver public goods and underlines their own position. When the subjugation of the principal, the population, becomes too excessive, spontaneous uproars follow, It takes a long for patrimonialism to accept the distinction between crown and realm – the so-called “King’s Two Bodies” (Kantorwicz, 1957). At the core of all forms of patrimonialism whether in Europe, Americas, Africa or Asia is the consideration: How can the principal call upon the agents to deliver goods and services that further their interests, when opposition is met with arbitrary arrest, detentions and incarcerations?

2) The authoritarian one-party state: Patrimonilism (l’etatc’estmoi: Louis Xiv) was replaced by populist regimes that promised to fulfil the General Will of the principal, but in reality created the origins of totalitarian democracy (Talmon, 1952). Populist authoritarianism has occurred in several versions since 1800, but its key foundation is the manipulation of asymmetric information. The principal is deceived into supporting the agenda of the authoritarian elite by means of ideology and its myths: France – la gloire (Napoleon), the international proletariat (Lenin, Stalin, Mao), German nationalism (Hitler), Roman grandeur (Mussolini), Great Serbia (Milosevic), Kim Dynasty (North Korea), Zaire (Mobutu), etc. The remuneration of the authoritarian elite tends to be extremely high, including the taking of the babies of opponents (Argentina). Yet, the indirect costs may be much larger, as the rulers do not hesitate to put the entire country at risk. They may also be so cruel as to destroy society when threatened in power, like Mengistu in Ethiopia or Pol Pot in Cambodia. The authoritarian set of agents cannot accept any challenge from outsiders and does not hesitate to employ torture, sudden disappearances and assassinations to remove challengers or critiques.

3) The Constitutional democracy: To keep remuneration of political agents within reasonable bounds, the quid pro quo problem is here solved by very strict rules about the public budget - transparency. And to hinder that political elites replace their commitment to the welfare of the country with their own goals, there is detailed specification of rules of election and re-election – political markets. However, the direct and indirect costs of the politicians have certainly gone up in the last decade. Moreover, the costs of party operations keep escalating, creating a big grey zone where corruption may be suspected.
The indirect costs of the mistakes of political agents may be large, also in constitutional
government. Thus, for instance the US population has had to bear enormous costs – in
personnel and resources - for the failed Operation Cobra (Iraqi Freedom). Now, as a result
of the Allied invasion, the Middle East is in total Hobbesian chaos: bellumomnium contra omnes.
Similarly, the Putin policy against the Ukraine has proven very costly for his principal, the
Russian peoples.

In the political markets, the costs of election may be extremely high in some countries.
This is the problem of campaign funds and its quid pro quo. Two questions: Can they be used
as remuneration for the politicians? Do they involve a tacit contract to the effect that the
politician (political party) is supposed to deliver outputs that favour the contributors (Peltzman,
1998)? The financing of the campaign expenses of political parties and individual politicians
constitutes a grey zone between legality and corruption.

CONCLUSION
Powerful forms of connecting people may result from very simple contracts between principals
and agents, like in sharecropping. They may last long and need not even be formalised in
written agreements. They may involve hundreds of people working as agents for one single
principal, owning the assets involved in the production of services. A simple principal-agent
contracting was described above, but there are others forms than one to one, like one to many,
many to one and many to many.

The principal-agent model assumes that the agents are paid (R) from the value of the
output (V) they deliver for the principal, who is the residual claimant. The principal wants to
maximise that value, but he/she must present the agents with an incentive compatible contract,
paying more for higher effort. As there is no guarantee that higher effort will actually be
forthcoming or succeed in baking a bigger cake, principal-agent contracting is replete with
failure, as in politics where V could be negative. In authoritarian states or failed states, the
remuneration R could go as high as V, leaving little for the citizens. In democratic polity, R
keeps going up like the remuneration for CEOs, but the value of the output of politicians may not
be high or even positive, as for instance with the developments of EU in the last decade or so.

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