Origin of the Theory of Agency

An Account by One of the Theory’s Originators

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The first scholars to propose, explicitly, that a theory of agency be created, and to actually begin its creation, were Stephen Ross and Barry Mitnick, independently and roughly concurrently. Ross is responsible for the origin of the economic theory of agency, and Mitnick for the institutional theory of agency, though the basic concepts underlying these approaches are similar. Indeed, the approaches can be seen as complementary in their uses of similar concepts under different assumptions. In short, Ross introduced the study of agency in terms of problems of compensation contracting; agency was seen, in essence, as an incentives problem. Mitnick introduced the now common insight that institutions form around agency, and evolve to deal with agency, in response to the essential imperfection of agency relationships: Behavior never occurs as it is preferred by the principal because it does not pay to make it perfect. But society creates institutions that attend to these imperfections, managing or buffering them, adapting to them, or becoming chronically distorted by them. Thus, to fully understand agency, we need both streams -- to see the incentives as well as the institutional structures.

In economic agency, the problem is one of selecting a compensation system that will produce behavior by the agent consistent with the principal’s preferences. Thus the focus is on the nature of the incentive system and the contracting system that guides the distribution of those incentives, as well as the conditions of risk and information that condition the choices of the actors. With his typical elegance, Ross lays out the problem with great clarity as well as brevity in a paper he delivered at the December 1972 economics meeting and which was published in the AER Proceedings issue in May 1973. He clearly identifies the agency problem as generic in society, not merely as a problem in the theory of the firm. This sets his work apart from the existing stream on the theory of the firm (e.g., Baumol 1959, Marris 1964, Williamson 1964, Alchian and Demsetz 1972) as well as the more general formal approaches on decision making under risk or uncertainty, and under different information states (e.g., Arrow 1963, Spence and Zeckhauser 1971, Marshak and Radner 1972), though it drew much from this work. Ross had recast the problem in terms of agency relationships, and clearly identified the key problem and the key variables. After Ross’s paper, scholars would see agency problems and incentive mechanism design issues within agency relationships; the frame of inquiry was refocused.

For Ross, however, the problems are still within the realm of decisions and sequences of decisions regarding incentives; the contexts that actually constitute the agency relationship are removed from the analysis and are reduced to their contributions of incentives or contractual constraints or risk/uncertainty conditions to decisions. Working independently of Ross, Mitnick followed parallel, if overlapping lines of literature that were more institutional in character. Barnard (1938) had noted that in the employment relation supervisors and workers observed a zone of discretion or indifference within which the worker was permitted to make choices. Simon had written about employment as a relation and with March (1958) had developed an inducements-contributions model that worried explicitly about managerial issues in the relationship, such as decisions to join and stay in the relationship. Simon’s work straddled both economics and public administration, and it was not surprising therefore that, in political science, Clark and Wilson (1961) developed an incentives model of organizations. Thus both relational and incentives-based arguments had developed within, or migrated to, the parallel literature.

On the economics side, Williamson’s managerial discretion model (1964) recalled, at least superficially, some features of Barnard’s old argument about the discretionary zone of managers’ behaviors, but it introduced an elegant utility tradeoff in which managers could survive while making allocation decisions that benefited themselves as well as giving receivers
of profit consequently less than maximal returns. Recalling the classic work of Coase (1937), Williamson (1975) then introduced a new approach to why hierarchies could be superior to market contracting. This transaction cost approach suggested that institutions could form because they were a better means of dealing with such costs, given other conditions such as the nature of the assets, technology, opportunism, and so on. But although Williamson with others applied this approach to the employment relation, his transaction costs model (1975) was based on a new view of exchange – that is, it existed as a contrast to traditional models of market exchange – and was not offered as a model of control. His firms, though nominally hierarchical and subject to issues of corporate control by the owners, were understood functionally more in terms of exchanges – transactions – rather than of true hierarchical behavior in which some actors are modeled as acting for others. The existence of costs of control, however, suggested to Mitnick that a theory of control centered on agency – not just a theory of exchanges – might generate new insights into common social institutions.

In a 1965 review of theories of the firm, Alchian remarked in analyzing Williamson (1964) that “unfortunately for the owners, there are costs of detecting and policing [the manager’s] actions …. Once these costs are recognized, it is obviously better to avoid some of these costs if the profits saved are less than the costs” (Alchian 1965: 35). Mitnick realized that Alchian’s observation was a perfectly general one – that it was true across the host of agency relationships, not merely as a characteristic of corporate governance. In essence, it would be productive to create a vertical theory of control as well as a horizontal one of exchange. We are then led to focus on the mechanisms, and costs, of specifying what the agent is to do, as well as the costs of observing and policing him or her. The approach becomes vertically relational, as institutions are created to instruct and manage agents, and to deal with the inevitable (and sometimes rationally tolerated) imperfections of control.

Like Ross, Mitnick first presented his work in a conference paper, which was given at a regular panel of the American Political Science Association Meeting in 1973. The APSA does not publish selected papers in a journal issue, as does the AEA, but at that time it did put panel papers into microfilmed proceedings that were generally available (as dissertations have been), from what was Xerox University Microfilms and its corporate heirs.

Both Ross and Mitnick were at the University of Pennsylvania (as was Williamson); Ross was a young faculty member in economics; Mitnick was a doctoral student in political science interested in public choice, bureaucracy, and political economy. Mitnick developed his work on agency in the Fall of 1972, writing the long paper that became the central analytic part of his dissertation and his 1973 APSA paper over a period of months up to the 1973 meeting. After his comprehensive examination in early 1973, Prof. Stephen Elkin asked him what the topic of his dissertation would be. Mitnick described his agency thesis, and Elkin said that he should talk to Ross, who had recently presented a paper on what he called the theory of agency. Mitnick said that he had also come to that name, having studied the law of agency for his paper and because of simple common usage of the term “agency.”

Mitnick did not see Ross’s paper until it was published in the May 1973 _AER Proceedings_, however. At that point (perhaps June 1973), he did go to speak with Ross, and had a brief exchange about the difficulty of creating a formal model of “acting for.” Ross had a wonderful term for it that stuck in Mitnick’s mind – the “ice cream cone problem” – the agent’s problem of selecting what the principal wants without knowing the principal’s preferences. Ross saw the problem as essentially insoluble as a pure choice problem without greater information on those preferences. Mitnick believed that institutions and social mechanisms exist to guide such
behaviors. People make decisions based on things like norms, information with social origins, and what more recent literature terms cognitive heuristics or biases. In essence, information can be gathered indirectly – or created – to solve or remove the ice cream cone problem. Mitnick put a brief summary and critique of Ross’s paper in his own 1973 paper since Ross’s paper appeared before the APSA meeting, but the two works were created quite independently.

Ross’s 1973 paper was tightly focused on the formal analysis of the principal’s problem of selecting optimal compensation for the agent, and has only the briefest mention of the societal contexts and relevance of a theory of agency. He published a second conference paper in a proceedings in 1974 that focused on the formal principle of similarity. In contrast, Mitnick’s 1973 paper and 1974 dissertation (1974a) presented an extensive study of many aspects of the theory of agency. It made the case for developing a general theory, presenting a detailed set of agency concepts and sorting them in typologies, identifying types of agency relationships as well as a language for describing agency and for developing theoretical explanations for behavior in agency.

For example, Mitnick’s work identified the fiduciary norm as a common social norm and noted how such norms economized on agency costs. It also developed a theoretical logic about agency in general that permitted the generation of theory in a wide variety of social contexts. In other words, it actually began developing an institutional theory of agency. Mitnick presented applications to such social relationships as advisers and clients, lawyers negotiating with one another, diplomats negotiating with foreign governments and one another, the behavioral patterns of legislative representatives, the advocacy of interest groups, regulators as agents subject to policing by public observers, regulatory incentive systems (with a specific application to regulation of power plant siting), and so on. He took the Clark and Wilson (1961) incentive system model and modified it to make it systematic and applicable to agency relationships.

It was not unusual in the formal work on economic agency to see a focus on normative theory: For example, researchers asked such questions as, is there an optimal fee schedule that would align the agent and principal under certain conditions? Approaches of this type often seek to derive general principles from assumptions about initial conditions, abstract relationships among variables, and so on, via formal proofs. Having derived the principle, some researchers may then search for empirical evidence consistent with the abstract result. In contrast, from the beginning Mitnick’s institutional approach focused on developing the core theory logics of agency that made it possible to generate statements about behavior in the real world, i.e., descriptive theory: How can we explain a series of diverse but commonly observed contexts of agent-principal relationships using the logics of agency theory? For example, under what conditions are lawyers, acting as advocates in conflict, more or less likely to reach settlement? Why do critics of the performance of public agencies focus on preventing self-enriching behavior by public employees rather than on the problem itself, relatively poor outcomes for the public interest? This emphasis on descriptive theory continued over the years. For example, Mitnick’s more recent theory of testaments (Mitnick 1996/1998, 1999, 2000), a component of his institutional agency approach, addresses such questions as, why do selective colleges limit the number of recommendation letters from applicants? Why do organizations hire imperfectly trained employees? Why do incumbents have advantages that challengers do not, and what factors generate greater advantage than others? All of these apparently diverse circumstances can be understood by applying the logics of institutional agency theory.

The first regular, non-proceedings journal article on agency as a general theoretical approach was published by Mitnick (1975b) in Public Choice in the Winter 1975 issue (end of
1975). The widely-cited work by Jensen and Meckling (1976) that proposed an agency theory of the firm was not published until almost a year later. In 1976 Mitnick published another article (1976a) that made use of his agency approach, this time applied to agency in the public sector, specifically in the context of the public interest and the use of public interest rhetoric in advocacy. Mitnick also presented several papers on agency during this period. He was invited by Oliver Williamson to present parts of his dissertation at Williamson's Organizations Workshop in October 1974 (Mitnick 1974b). He also presented papers on agency at the American Sociological Association meetings in 1975 and 1976 (Mitnick 1975a, 1976b).

The distinguished political scientist Edward C. Banfield served on Mitnick's dissertation committee. Banfield passed away a couple of years ago, but two active members of the committee, the dissertation chair, Russell Hardin, now at New York University, and Stephen Elkin, now at the University of Maryland, are aware of Mitnick's dissertation work. Hardin is generally considered one of the leading political philosophers in the world today, known for his work in public choice, collective action, and trust; Mitnick was his first doctoral student. Elkin is a distinguished scholar in urban and political economy who was one of the founders of a prominent organization of political economists in the U.S., and remains one of its central figures.

At the dissertation defense in the Spring of 1974, Banfield asked if this theory of agency might be applied to analyze corruption. Mitnick responded with a discussion of how it could, indeed, be so used. Banfield then wrote a paper comparing public and private and using Mitnick’s general approach to agency theory to argue that corruption is, as per the article title, virtually a feature of public organizations. Banfield's paper was the lead paper in a 1975 NBER conference and was published in the Journal of Law and Economics late that year in a special issue. Banfield asked Mitnick to review the manuscript of the paper, and Mitnick suggested a number of corrections, which Banfield adopted. Banfield acknowledged Mitnick and his agency theory in the published paper, but the draft paper for the conference did not contain the acknowledgments. Thus, although a group of well-known economists were introduced to institutional agency theory at the conference, it is not known if any were aware that the work they heard was stimulated and informed in part by Mitnick's work.

Thus, by the time the classic paper by Jensen and Meckling appeared in print in late 1976, Ross's economic theory of agency was widely known in economics, and Mitnick's institutional theory of agency had been published in two articles, used in a third by another scholar, and been presented at major meetings in three of the social sciences: economics, political science, and sociology. Although the Jensen and Meckling paper has had enormous influence in the literature, its occasional citation as the primary originating paper in agency theory is incorrect. Indeed, it actually originated a variant of an agency theory of the firm, not agency theory in general.

Of course, the theory of agency did not appear, whole cloth, in the works of Ross and Mitnick in 1973. As noted above, key concepts were developed by scholars in economics, political science, and elsewhere in a variety of streams on the firm, on organizations, and on incentives and information, and were later incorporated into the agency approach. In addition, agent-principal language was employed in a number of works across the social sciences well before an explicit theory of agency was proposed. Thus it is important to both acknowledge the earlier work and recognize that it waited for the primary work by Ross and by Mitnick for the frame of reference to center on agency theory per se. For example, in the accounting and control literature, Cooper (1949, 1951) discussed agents inside the firm; in economics Downs (1957) referred to agents in his economic theory of democracy and Arrow (1963) referred to agents and
to delegation to agents in his discussion of characteristic problems in medical care and the
response of institutions to those problems; in political science, Pitkin (1967) and Tussman (1960)
used agent-principal language in works on political philosophy; and, in sociology, Swanson
(1971) described collective society using such terms. But in none of these works or in any other
before Ross and Mitnick was there an explicit proposal for, or an actual theory of, agency.

In the early 1970s, agency theory was, of course, unknown in political science and
sociology before Mitnick, and it was not possible to publish articles with this theory logic in
journals in these fields. Reviewers wrote that they had never seen anything like it, and thus it
clearly was not sociology or political science. As a result, Mitnick published his work on agency
in articles and books nominally focusing on other topics. As noted above, he used an agency
approach in part of his paper on the public interest in 1976. He applied agency to regulation
extensively. Among other applications of agency theory, his 1980 book introduced the study of
delegation as the creation of agents in government. His edited book on Corporate Political
Agency (1993) included both applications of agency theory and basic theory about agency
relationships developed in the context of corporate political activity.

Agency did not enter political science in a major way until Moe's article in 1984; did not
enter sociology similarly until Shapiro's article in 1987; and did not become prominent in
management work until after Eisenhardt's article in 1989. In all cases, Mitnick's work was cited,
bu it had appeared so many years before that these authors took their primary direction from the
then-popular streams on agency in economics. Moe had been aware of Mitnick's work as long
ago as 1978; Shapiro had many of Mitnick's papers and did make important use of them in her
article; Eisenhardt had many of Mitnick's papers, including his original papers, but apparently
did not consult them and actually cited Mitnick's work inappropriately as an application in
political science rather than as the origination of the field. Mitnick's original work on agency has
indeed been cited (e.g., Cook 1982; Galaskiewicz 1985; Spulber 1989; Spulber and Besanko
1992; Macey 1992; Waterman and Meier 1998; Krause 1999; there are many more), but it has
remained far less known, especially in economics, than the work that originated with Ross and,
later, continued with Jensen and Meckling.

Recently, in a major assessment in the Annual Review of Sociology, Shapiro (2005: 4.9,
4.12) noted that "a general theory of agency emerged in political science (Mitnick 1973) at the
same time that it did in economics (Ross 1973), apparently independently. … In a series of
papers spanning at least 25 years, political scientist Barry Mitnick broke the monopoly on
agency theory enjoyed by the economics paradigm and offered an alternative to the assorted
baggage that comes with it."

Mitnick continued to publish work using agency as a key theory logic, and to expand the
theory itself. Although he eventually secured a contract from Cambridge University Press to
publish his work on agency, the fact of his origination of the theory of agency seems to have
faded in academic memory even as works using agency theory became commonplace across the
social sciences. Because of the prominence of the Annual Reviews, Shapiro (2005) may begin a
pattern of recalling this work in other responsible reviews of the literature.

The literature’s uncertainty about the origins of agency theory is reflected in the fact that
there is no standard citation to its origin. When work using transaction costs is done, for
example, Oliver Williamson is cited appropriately as its modern originator. When applications of
agency theory are published, however, citations are inconsistent: Sometimes Jensen and
Meckling (1976) is cited, although what they originated was an influential application to the
theory of the firm, not the agency approach itself. Frequently, though not always, Ross (1973) is cited, although he deserves to be in every first footnote because of his critical role in originating economic agency theory. Mitnick (1973, 1975b) is cited far less frequently, although he originated the institutional theory of agency, including some of agency theory’s most basic and familiar concepts and logics, and was the first to actually make explicit applications of agency theory to social institutions. Often there are citations to scholars who advanced agency theory or who made contributions using agency in the field of the application. Sometimes there are citations to outstanding scholars who made basic contributions to some of the core logics that are frequently applied in analyses of agency relationships, such as formal analyses of the behaviors or effects of risk distributions, incentive systems, control failures, and the like (e.g., Holmström 1979). But there is an extensive history of work on such topics. The key argument missing from all earlier work is that a general, powerful theory that applies to agency relationships should be developed, and that such a theory can generate statements about behaviors across the institutional settings of this type, not merely in one case such as the business firm. And, in a surprising number of cases, there is no citation at all, as if after thirty-plus years the concepts of agency had passed into the common language of scholarship.

After Ross (1973), people thought in terms of modeling economic agency relationships, not just in terms of incentives or compensation systems, which were indeed part of Ross’s analysis, and which many scholars had, of course, written about in the past. Part of the logic of agency costs, including the adaptation of institutions to agency failures that may be rationally tolerated or worked around, can now be inferred, for example, in brief remarks in Alchian’s (1965) and Alchian and Demsetz’s (1972) works on the firm, but there is no recognition of this as a general component of the understanding of how agency institutions in general are designed and function until Mitnick’s work. No one had offered that a theory of agency, utilizing, combining, extending, and applying insights that had appeared across literature in economics, public administration, and political science would be a powerful, new way of viewing a very large class of social phenomena until Ross and Mitnick proposed just that.

Thus, by the logic of discovery, Mitnick’s origination of agency is anchored in his original creation of the proposal to create a major, integrating theory with this focus, and to actually begin that work, with both presentations and publications of record. For years after it appeared, there was nothing in the literature that even remotely approached the explicit and extensive applications that were in his early papers and publications. His work was by far the first to introduce and develop many of the key institutional arguments by which we know it today, e.g., the argument that institutions are shaped by the rational choice of the principal to not create perfect agency, when such creation would not be worth it. He also was the first to publish a non-proceedings article in a regular social science journal explicitly on the theory of agency. And the record is clear that his work was spread even in its early days across three of the social sciences.

Notes

1. A similar argument appears in Alchian and Demsetz (1972), but in the context of monitoring team production in the firm, not as a feature of a generalized agency model. Mitnick’s insight was generated by the 1965 remark. In a particular context, Ross (1973) notes it may not be “economically viable” to monitor the agent, but this is not the same as offering the argument as a general way to understand how institutions manage agency.
2. Mitnick was also trained partly in economics, auditing the same year-long sequence in microeconomics taken by the economics doctoral students, with a parallel independent study in political science for a term that received the economics grade.

3. Although the law of agency had a role in the naming of the theory of agency, it would be many years before other scholars also applied materials from the law of agency to the social science theory of agency (see Robert Clark’s chapter in the Pratt and Zeckhauser (1985) volume). There is a very large literature now in law that makes use of the theory of agency or key concepts from it.

4. Cf. the later work of Easterbrook and Fischel (1991), who did not originate this view; also see the work of Stinchcombe 1975/1986 on the fiduciary norm, as well as related discussions by Arrow (1963) on trust and delegation in medical care and by Alchian and Demsetz (1972) on the functions of “loyalty.”

5. This article was later incorporated into Mitnick’s 1980 book on regulation as part of chapter four.

6. All the presentations during 1973-1976, in all three disciplines, economics, political science, and sociology, were very well attended, so knowledge of Mitnick’s original work in agency was introduced relatively widely at that time. Besides the meeting presentations, Mitnick gave at least 16 job interview presentations at research universities during the 1973-74 and 1977-1978 academic years. Thus, knowledge of his work on agency was spread fairly widely in the academic community.

7. In 1976, the economist Victor Goldberg published an important article in the Bell Journal of Economics that was based on a long working paper that employed agency language. Goldberg’s insight was to view the regulator's problem as having to serve as agent both for consumers and for producers. He exchanged papers with Mitnick and then referenced the theory of agency explicitly in the published work, citing Mitnick's papers.

8. The political scientist Morris Fiorina read Mitnick's book (1980; see especially chapter 6, pp. 326-337) while moving his research focus beyond legislatures (personal communication from Fiorina about 1981; Fiorina discussed this with Mitnick during a walk they took at the American Political Science Association meeting) and published a widely-cited article on delegation as agency that generated a whole subfield of work. Unfortunately, Fiorina did not cite the appropriate contributions of the original source, though a comparison of the two works shows the similarity of the basic ideas immediately. Most scholars who have done work in this field believe incorrectly that Fiorina's discussion of delegation as agency originated this approach (but see, e.g., Macey 1992). But no one in political science had used this language and approach before Mitnick, and Fiorina was indeed familiar with Mitnick’s writing on this.

9. Mitnick’s first academic position (1974) was in what was then called the School of Public Administration at Ohio State University, where most of the senior faculty were interested more in practitioner work than in abstract social science theory. In 1978, Mitnick moved to what is now the Katz Graduate School of Business at the University of Pittsburgh, where he was hired to teach and do research in regulation and in business and society, two areas that continue to figure in his work. But the academic personnel process (via explicit instruction from the then Dean) constrained him to publish in areas familiar to researchers in business and society in the
Academy of Management who would be his reviewers for tenure and promotion.

Still, most of the research Mitnick did over the years employed aspects of the institutional agency theory that he had pioneered. For example, a more recent addition to the theory is the theory of testaments (1996/1998), which seeks to explain the conditions under which the performance claims of prospective agents will be treated as credible, so that the agents will be incorporated by or into the principal actor or organization. Mitnick has so far made applications of this to the theory of the state (Mitnick 2000), the metrics of corporate social performance (Mitnick 1999), and other areas.

10. Work on this book continues.

References


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