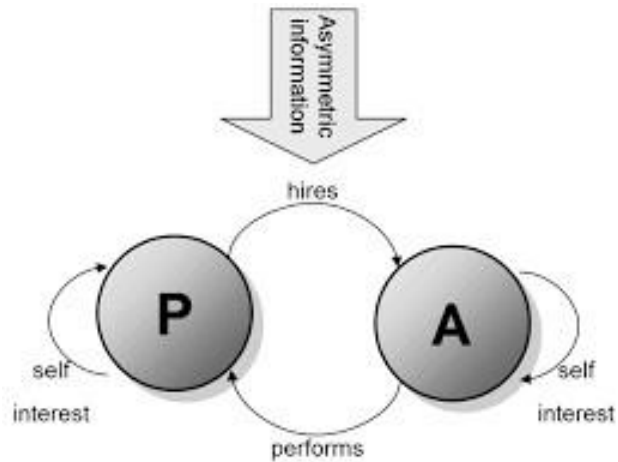


On the Principal-Agent Problem

Principal-Agent Problems persist in multiple relations starting from employer/ employee relations over to shareholders/ management relations up to problems between companies and their agents (distributors). To slim down the subject, I would like to focus only on the latter. A pre-requisite to tackle the Principal-Agent Problem is to understand the existence of the firm and its market environment.



Understanding the firm

The question of the existence of firms can simply be answered with transaction cost theory which stipulates that firms (as hierarchical organizations) are often more efficient in organizing resources than the market. This may not be the case in an ideal world with open and transparent markets, full competition, and instantaneous information. However, in the real world with high levels of uncertainty and asymmetric information a hierarchal organization seems best equipped against lengthy negotiations, moral hazard and opportunistic behavior.

So is this how the story ends? Not quite. Firstly, firms cannot expand endlessly and those who attempt very often become too bureaucratic or lose managerial control. Secondly, firms have competitive advantages in specific fields only. When they enter new markets they may well find themselves in a less prominent position. Thirdly, many firms rely on Agents as they seek access to additional knowledge – knowledge of a market, a customer or a specific resource that they do not possess.

The Problem

This finding again leads us directly to the Agent and the attached Principal-Agent Problem. While the Principal is looking to appoint an Agent for the described market knowledge, the Agent often has the tendency to hide his (full) knowledge and follow his own interest. This is of course a protective mechanism as knowledge, unlike other goods, is more difficult to trade and secure. Sharing it openly, may leave him vulnerable as the Principal may try to bypass him. Moreover, maintaining a knowledge lead usually translates into higher returns for the Agent. As Akerlof describes in his famous article “The Market for Lemons”, the lack of knowledge of product characteristics enables a seller to overcharge a buyer. The same holds true for Agents that maintain a knowledge lead over the Principal.

The way out

The way out of this dilemma comes with time and trust.

Time is usually favoring the Principal as performance gaps of an Agent become more evident. In a long-term relation this enables the Principal to take counter-measures and adjust his expectations towards the appointed Agent. Time will also allow for the establishment of routines and a common understanding between Principal and Agent which generally reduces transaction costs. Moreover, the expanded time-horizon means that the Agent shifts towards optimization of his long-term return as opposed to short-term profit-maximization. If he is too greedy in the short-term, the Principal may walk away and deprive the Agent of future revenues. After all, the prospective search for alternative Agents is one of the biggest leverages for the Principal. As the old saying goes: "Shame on you if you fool me once, shame on me if you fool me twice".

Trust is the second key ingredient for a successful relation between Principal and Agent. Trust and positive attitude will encourage the same behavior in the Agent. Else, the logic of game theory will apply. Start with cooperative behavior and mimic the behavior of the other party. It is all tit-for-tat strategy here.

A personal note

Last but not least out of my experience I recommend following procedure with Agents (distributors):

1. Avoid romance: Conduct a thorough screening process prior to appointing an agent. Usually references and past performances are a good indication of what you are going to get.
2. Be clear: Decide and communicate your expectations clearly and regularly. Be sure to set measurable and reachable targets as positive incentives work better than negative ones.
3. Be committed: Set the stage for a long-term partnership. This will not only reassure the distributor of your expectation but it will also reduce his fear that he may lose out if he shares his knowledge openly.
4. Be authentic: Be prepared to openly discuss the concerns of your Agent without losing yourself.

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