

Key Takeaways

The principal-agent problem is an important topic in both economics and organizational theory.

Two Parties:

- **Principal:** The party that delegates a task or decision-making authority.
- **Agent:** The party tasked with executing on behalf of the principal.

Misaligned Interests:

- While the principal and the agent might have some overlapping objectives, their interests aren't fully aligned. This can lead to conflicts of interest.

Information Asymmetry:

- One of the central problems is that the agent often has more information about the task at hand or their own actions and intentions than the principal. This imbalance can give the agent an advantage and can lead to adverse selection (bad choices made by the principal due to lack of information) and moral hazard (risky behavior by the agent because they bear less of the consequences).

Risk Preferences:

- The principal and agent might have different attitudes toward risk. For example, an employee (agent) might prefer a stable salary, whereas a business owner (principal) might be more willing to tie compensation to performance.

Monitoring and Enforcement Costs:

- Even if the principal wants to ensure that the agent acts in the principal's best interest, monitoring the agent's actions can be costly and difficult. Even with monitoring, it might be challenging to determine if an agent is genuinely

acting in the best interest of the principal.

Residual Loss:

- Despite attempts to align interests (e.g., through contracts or incentive schemes), there might still be some inefficiency or loss due to the divergence of interests between the principal and agent.

Contract Design:

- How a contract is designed can influence the agent's actions. For instance, a fixed salary might not give an employee much incentive to exert extra effort, while performance-based pay might. However, performance-based pay might also incentivize the wrong kind of behaviors if not properly structured.

Time Horizon Differences:

- The principal and agent might have different time horizons in mind. An agent might focus on short-term gains, potentially at the expense of the principal's long-term interests.

Effort Unobservability:

It can be hard for the principal to observe the effort the agent is putting into a task, leading the agent to potentially shirk responsibilities.

Revision #1

Created 14 January 2024 21:20:21 by Christian Nasulea

Updated 14 January 2024 21:20:45 by Christian Nasulea