



Principals' preferences for agents with social preferences

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ARTICLE INFO

Article history:

Received 5 August 2010
 Received in revised form 26 January 2012
 Accepted 30 January 2012
 Available online 18 February 2012

JEL classification:

L14
 D23
 G30
 M14

Keywords:

Agency
 Ethics
 Corporate governance
 Social preferences
 Social identity
 Motivated agents

ABSTRACT

This study explores a nested representation of ethical, moral, social identity, motivated, opportunistic and reciprocal agent preferences to characterize screening contracts in a principal–agent model under adverse selection. This leads to a ranking of the type of social preferences that principals should seek in agents, based upon the information rents associated with each agent type. When moral hazard is introduced the ranking further depends upon the interaction of limited liability with self-selection. These results are interpreted in light of the 2010 Dodd-Frank Act and principal–agent experiments.

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1. Introduction

The decade 2000–2009 has come to be regarded as ‘The Noughties;’ primarily for the economic and financial crises brought on by a breakdown in corporate ethics, laissez-faire regulation and limited liability in leveraged securitization. A rogue’s gallery of corporate misbehavior in this era would likely include executives at Adelphia, Enron, Fannie Mae, Freddy Mac, Goldman Sachs, Madoff Investments, Tyco and WorldCom. Table 1 shows that those who were convicted of corporate wrongdoing received sentences that were often far longer than the average number of years given for a murder conviction in the US. Personal consequences aside, the crises of the early and late Noughties brought on the destruction of untold wealth via two major recessions.

The canonical approach to the study of corporate governance in financial economics – agency theory – was created in recognition of the potential for opportunistic behavior in organizations characterized by principal–agent relationships. Yet (rightly or wrongly) the conventional wisdom is that high-powered compensation packages based on this theory were at the root cause of unprincipled behavior such as revenue smoothing; backdating options; mark-to-magic accounting; the lend-to-securitize criterion for subprime mortgages; and the warehousing of collateralized debt obligations (owing to limited liability). Indeed, with the context of the early Noughties clearly in mind, a founding father of the agency-theoretic approach to corporate governance, Jensen (2007), has identified agent *integrity* as a key element for successfully operationalizing the agency framework. For example, Jensen points out that without integrity agents with stock options that are in-the-money

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Table 1
Penalties for unprincipled behavior during the ‘Noughties’.

Violator	Firm	Sentence	Average murder sentence in state courts
Bernie Ebbers	WorldCom	25 years	13 yrs
Dennis Kozlowski	Tyco	8–24 years	
Kenneth Lay	Enron	20–30 years ^a	
Bernie Madoff	Madoff Investment Securities	150 years	
Timothy Rigas	Adelphia	20 years	
Richard Scrushy	HealthSouth	6.8 years	
Jeffrey Skilling	Enron	24 years	

^a Lay passed away before appealing or serving his sentence.

would have little reason to report the truth when their firm’s stock is currently overvalued. For Jensen, integrity is a positive rather than normative concept and is itself not inconsistent with the agency theoretic approach to corporate governance. Consequently, if agent behavior reflects a preference for integrity this can potentially mitigate some of the unintended consequences associated with pay-for-performance.¹ This then raises the greater issue of what types of agent preferences serve to enhance a firm’s value? As firms are social organizations they are a natural environment for social preferences to be expected to arise.

The positive examination of the implications of an agent’s social preferences for contract design is currently somewhat of a growth industry. An incomplete list of social preferences that have been considered includes ethical, inequity averse, intrinsic, mission-oriented, moral, motivated, reciprocal, social identity, social norm and virtuous. What all of these preferences have in common is that they are examples of what Jensen (2008) calls the positive analysis of normative values. To wit, just as economics has traditionally focused on the positive analysis of alternative institutional structures, it can also shed light on how normative values reflected in standards of behavior affect the management of conflicts of interest. In this way, the present study steps away from a situation of *de gustibus non est disputandum* with respect to agents’ preferences and evaluates a subset of the aforementioned preferences within a screening environment where the principal is uninformed about an agent’s social preferences or lack thereof (adverse selection). As Delfgaauw and Dur (2007) note, what separates this environment from one in which the principal is uninformed about an agent’s ability/productivity is that intrinsic motivation affects an agent’s willingness to work even in the absence of productivity differences.

The aforementioned social preferences reflect intrinsic concerns about opportunistic behavior.² Examples of such intrinsic concerns include an agent’s own behavior with reference to a social standard or the type of firm with whom they are employed. In particular, consider an exogenously determined standard of effort, e^* . Some agents may experience intrinsic disutility if e^* is not met. Depending upon the functional form of this disutility, the agent can be said to possess moral preferences (Casadesus-Masanell, 2004); social identity preferences (Akerlof and Kranton, 2008); or ethical preferences (Stevens and Thevaranjan, 2010). In a certain respect there is nothing preventing any firm from expressing a standard for effort, yet opportunistic agents and the firms that employ them are rarely modeled within this context. Alternatively, opportunistic agent behavior can be subject to a social constraint, as is the case for the virtuous agents in Carlin and Gervais (2009). Instead of facing an incentive compatibility constraint, virtuous agents set their level of effort equal to the maximum allowed. This is consistent with viewing ethical behavior as socially constrained behavior (e.g., Arce, 2004). Another type of social preference that falls into this category are agents who prefer to work for certain firms because either the work itself achieves a social purpose or the firm’s output fulfills a social purpose. These are known as (intrinsically) motivated agents or mission-oriented firms. In particular, Besley and Ghatak (2005) and Makris (2009) consider the case in which agents are motivated by how the firm’s mission serves a social purpose; e.g., public hospitals, public universities and nonprofits. Alternatively, Delfgaauw and Dur (2007) consider agents who are socially motivated by the work (effort) itself. Perhaps the work is fun or the agent lives by the adage, any job worth doing is worth doing well. For example, workers at the internet shoe giant Zappos.com purportedly adhere to a “work hard, play hard” mentality.

A commonly invoked defense of the assumption of agent opportunism is that not all agents are opportunistic, but one has to account for those agents who are. Such an accounting therefore connotes adverse selection in agent types. By contrast, the studies cited above primarily focus on the contractual implications of social preferences under moral hazard, even though adverse selection is a natural context for accounting for agents with (non-)opportunistic preferences. Indeed, uncertainty over an agent’s type introduces contractual distortions even in the absence of moral hazard. Moreover, the fixed component of a contract reduces the opportunity cost of ethical/socially concerted behavior (Osterloh and Frey, 2004; Arce, 2011); and what is observed is an emphasis on the fixed component of pay as compared to the contract offered to opportunistic agents. Within the context of the Noughties, our results are consistent with the way in which Treasury Department pay czar Kenneth Feinberg has unilaterally cut incentive compensation in favor of raising the fixed (salary) component of pay

¹ Readers interested in the literature on the unintended consequences of pay for performance are encouraged to consult Brennan (1994), Donaldson (2002), Bebchuck and Fried (2004), Ferraro et al. (2005, 2009), Kulik (2005), Arce (2007), Khurana (2007) and Harris and Bromily (2007).

² An alternative category of social preference, which is not under consideration in the present study, consists of preferences that reflect distributional concerns (e.g., fairness). Examples include an agent that is inequity averse (Itoh, 2004; Fehr et al., 2007) or agents that judge their effort relative to the average of their peers (Fischer and Huddart, 2008).

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