- **The Principal–Agent Problem**

If monitoring the productivity of workers were costless, the owners of a business would ensure that their managers and workers were working effectively. In most firms, however, owners can't monitor everything that employees do—employees are better informed than owners. This information asymmetry creates a principal–agent problem.

• principal–agent problem arising when agents (e.g., a firm's managers) pursue their own goals rather than the goals of principals.

The agent is the person who acts, and the principal is the party whom the action affects. A principal–agent problem arises when agents pursue their own goals rather than the goals of the principal. In our example, the manager and the workers are the agents, and the owners of the firm are the principals. In this case, the principal-agent problem results from the fact that managers may pursue their own goals, even at the cost of lower profits for the owners.

The Principal–Agent Problem in Private Enterprises

Most large companies are controlled by management. Individual stockholders, who are not part of management, typically own only a small percentage of the equity of these companies, and thus they have little or no power to fire managers who are performing poorly. Indeed, it is difficult or impossible for stockholders to even learn much about what the managers are doing and how well they are performing. Monitoring managers is costly, and information can be expensive to gather. The result is that managers can often pursue their own objectives, rather than focusing on the objective of the stockholders, which is to maximize the value of the firm.

The Principal–Agent Problem in Public Enterprises

The principal–agent framework can also help us understand the behavior of the managers of public organizations. These managers may also be interested in power and perks, both of which can be obtained by expanding their organization beyond its "efficient" level. Because it is also costly to monitor the behaviour of public managers, there are no guarantees that they will produce the efficient output. Legislative checks on a government agency are not likely to be effective as long as the agency has better information about its costs than the legislature has.

First, managers of government agencies care about more than just the size of their agencies. Indeed, many choose lower-paying public jobs because they are concerned about the "public interest." Second, much like private managers, public managers are subject to the rigors of the managerial job market. If public managers are perceived to be pursuing improper objectives, their ability to obtain high salaries in the future might be impaired. Third, legislatures and other government agencies perform an oversight function. For

example, the Government Accounting Office and the Office of Management and Budget spend much of their energy monitoring other agencies.