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Abstract

The canonical principal-agent model motivates a risk-averse principal to share risk. The standard solution summarizes experimental findings. Experimental subjects were routinely able to achieve efficiency in agent effort levels *without* inefficient risk-sharing. These experimental outcomes, while anomalous from the standpoint of principal-agent theory, are quite consistent with other experimental data testing notions of trust-based implicit contracting. Such contracting within a hierarchy may allow an outcome preferred, by both principal and agent, to that deemed possible by principal-agent theory. If this is true, then the lessons to be learned from principal-agent theory are all the wrong ones. Concentrating on incentives can crowd out the very qualities in a relationship that make social efficiency possible.



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1.

1. In a number of ways, the language of principal-agent theory has been borrowed by political science without coming to grips with its real meaning. In essence, principal-agent theory has come to be simply a metaphorical synonym for 'hierarchical'. This article achieves two proximate goals: to evaluate the principal-agent's empirical power in its canonical form (hence the Dixit and Nalebuff example), and to extend the theoretical environment of principal-agent to reincorporate both older and more recent strains of literature with perhaps greater importance for the study of public bureaucracies.

- 2.
2. Actually, the theory does not require strict risk neutrality on the part of the principal — merely *less* risk-aversion than for the agent. As long as that is the case, the principal is still the efficient bearer of risk.
- 3.
3. An outcome ‘pareto dominates’ another outcome if it is preferred by both principal and agent.
- 4.
4. This article focuses on an interpretation of trust that is based on reciprocity. For other conceptions of trust, see Braithwaite and Levi (1998) or Cook (2001).
- 5.
5. The experiment is based on an illustration in Dixit and Nalebuff (1991: 302-6).

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