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Abstract

The canonical principal entives to motivate a risk-averse agent to take a costly, unobservable action that improves the principal’s payoff. The standard solution requires an inefficient shifting of risk to the agent. This article, however, summarizes experimental research that throws doubt on the validity of this conclusion. 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-agency 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-agency theory. If this is true, then the lessons to be learned from principal-agency 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-agency theory has been borrowed by political science without coming to grips with its real meaning. In essence, principal-agency theory has come to be simply a metaphorical synonym for ‘hierarchical’. This article achieves two proximate goals: to evaluate the principal-agency’s empirical power in its canonical form (hence the Dixit and Nalebuff example), and to extend the

theoretical environment of principal-agency 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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