Principal-Agency Relations in Organizational Networks

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ABSTRACT

The authors introduce the application of agency theory within organizational networks in order to offer some new insights for organizational and economic sciences. Previous research has neglected the presence of agency problem in these relatively new structures in favor of examining the nature of principal-agent relationship from behavioral and economic side. They emphasize the constraints such relationship can cause in networks and offer adequate propositions to solve it, referring to present solutions in agency theory. A set of new implications was derived from the theory as well as from case study about impact of agency problem on different network types. Case study method was chosen due to the lack of secondary data on this subject. A network was chosen and studied through interviews, observation, and field reports. This paper achieves originality with the fact that such a study of the two theories hasn’t still been made. Therefore, the added value of this paper is in the common application of the two theories within a single case, and in the implications retrieved from it.

KEYWORDS
Agent, Bonding Cost, Centralized Organization, Decentralized Organization, Inter-firm Collaboration, Monitoring Cost, Network Governance, Organizational Networks, Principal, Residual Loss

INTRODUCTION

Principal-agency theory and theory of organizational networks have both been studied separately in scientific literature for decades. Their significance has been recognized in sociology, economy, law, organizational behavior, etc. However, attention was not paid that much to the combination of the two.

Theory of principal-agent relationship has been focused on solving the problems in hierarchical order of our society and organizations, mostly by designing adequate measures to combat this problem. On the other hand, organizational network theory has focused on improving network efficiency, and combating network problems.

Now it is no longer useful to study these important theories separately in relation to companies. Reasons for this are numerous; they start from the fact that today’s companies have to pay attention to the way they are organized internally, and the way they interact with their environment at the same time. This is because companies that act on a global scene face consequences of internationalization such as diversity in consumer preferences, dynamism in development of mixed technologies, and many others (Hakansson, 2006). As a result of the mentioned changes in the global view of the markets, companies have been experiencing the principal-agent problem in more intense way.

Traditionally, inter-firm collaboration has been organized through market exchange. Functioning of market was based on pricing mechanism which regulated the relationships between those companies just enough. What we witness today is a shift to other structures for inter-firm interaction. One of
those structures is network which is characterized by much denser relationships among companies. This implies that companies in a network could have closer relationships which should prevent from shirking and dishonesty problems. Intention of this paper is to investigate whether companies in organizational networks still encounter agency problem. And if yes, how can this problem be addressed and solved?

**LITERATURE REVIEW**

In order to analyze relationships in organizational networks in the light of principal-agent theory, we should first stress out the meaning of the main term which will be used throughout this research paper. Organizational networks should not be considered as vertically organized hierarchies but rather as organizational forms. These forms use flexible, dynamic communication linkages that connect organizations and people into new entities that create products or services (Contractor, Wasserman, & Faust 2006). As Contractor et al. (2006) points out “these new forms are responsive and are constantly adapting as new links are added and dysfunctional ones dropped. Thus, the evolving, emerging network form is the organization”. Further on, according to Emirbayer and Goodwin (1994), organizational networks in the light of the relationships that comprise it, should be examined through relations in culture, agency, and social structure.

Now coming back to the connection between organizational networks and principal – agent theory it would be useful to analyze networks through its cooperating actors. This means that, individuals cooperate to undertake a certain process or employment. And here we come to the question of dealing with “agency costs” that arise from such cooperation. Agency costs arise in any situation involving cooperative effort (such as the co-authoring of this paper) by two or more people even though there is no clear-cut principal-agent relationship (Jensen and Meckling, 1976).

Typical view of the agency theory from the economist’s side fails to recognize the agency problem in the scope of inter-human relationships. Criticism arises from the fact that agency theory should be approached from another perspective, and not only the economic one, observing the inter- and intra-organizational relationships in the light of also behavioral sciences. Organizational networks have been subject to sociological studies where it has been recognized as Emirbayer (1994) asserts, that network analysis will be one of the most encouraging new developments in the sociological discipline (as written in Homans 1986).

Networks have been recognized to be an important way of multi-organizational governance (Keith & Provan, 2007). Multi-organizational governance is gaining more and more attention as a way of substituting for market ineffectiveness where actors agree to transact for reasons other than just value (Fruin, 1998). Therefore, the added value of this paper will be in giving final propositions regarding agency relations within networks.

**INTRODUCTION TO PRINCIPAL-AGENCY THEORY**

Principal-agent theory, also called the “agency theory”, has been studied by scholars in different fields, such as accounting, economics, finance, marketing, political sciences, organizational behavior, and sociology. And despite to that it has been surrounded by controversy, where proponents argued that theory of organizations has already been “put in place” (Eisenhardt, 1989). However, the significance of the theory has been proved to be of great importance in organizational sciences over decades of research, especially on the firm-level. The aim of this article is to investigate whether this theory has significance what so ever in inter-firm collaborations. In order to investigate our dilemma, we shall study the principal-agent relationship as follows: firstly, we will introduce the reader to the very concept of P-A theory (principal-agent theory) in its grounds; secondly we will show the significance of the theory when applied on the firm-level; and finally we will try to apply P-A theory to the concept of inter-firm collaboration.
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