
An Assessment of Agency Theory in the Context of Higher Education Institutions

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Abstract

The rationale of this concept paper is to describe the application of Agency Theory in higher education institutions. The theory focused on the relationship between the principal and agent. Within the relationship, the most important problems that arise are informational asymmetries and goal conflicts. This is due to the incomplete information and different behaviour in the actions by the agents. Agency Theory needs to be further explore and testing to create valuable tool for research study especially in the context of higher education institutions. Within this perspective, research and the structure of this theory is applicable as a conceptual framework for the study related to the relationship between government and public funded universities.

Keywords: *Agency Theory, higher education institutions, goal conflicts, informational asymmetries*

Introduction

In the context of modern higher education today, the government has made dramatic changes to institutions size, structure, funding arrangements, and focus in order to address public concern and compete in the global market. It encompasses the relationship with the intention of creation, acquisition, sharing, and transmission of knowledge to underpin effective teaching and learning, and research and development for the benefits of stakeholder. In support to those activities, the government has granted institutional with funding from the taxpayer money. The notion that the agents have to be more accountable to produce a certain level of public output and make information available to the public (Leruth & Paul, 2006) to fulfill its mission in line with the government objectives and strategic planning (Lane & Kivistö, 2008). Nevertheless, for Higher Education Institutions (HEIs) autonomy, accountability, governance, market pressure, and lack of funds becomes pressures for them in performing the principal strategic plan. In response to these competitive pressures, institutions should focus on the development of performance measurement system that is consistent with the government objectives. The ultimate aims of implementing these methods are to provide standard measurement for the institutions. However, conflicts arise when agent and principal have different objectives and therefore it is difficult for the principal to monitor the report and actions need to be taken by agents (Lane & Kivistö, 2008; Milgrom & Roberts, 1992). As a result, the effectiveness and efficiency used of resources and funds to the activity performed by agent is inconsistent with the desired outcomes that should in delivering their educational services. Therefore, Agency Theory provided a framework as an alternative way of assessing the relationship between principal and agent with the intention to reduce the agency problem (Kivistö, 2005, 2008).

Agency Theory

Strehl et al., (2007) have highlighted the important key features of theoretical framework and concept that are appropriate to describe, analyse, and explain on effect of the changes government funding to the HEIs. Indeed, they have come out with seven components of theories that are applicable in this context of the study:

- É New Public Management;
- É Governance;
- É New Institutional Economics;
- É Strategy;
- É Marketing;
- É Resource Allocation Mechanisms; and
- É Organisation Behaviour.

This paper discusses into the perspective of New Institutional Economics or Economic Institutional Analysis, which underlines three main concepts, called: (1) Principal-Agent Theory; (2) Theory of Property Rights; and (3) Theory of Transaction Costs. At its most basic, this theory attempts to analyse the institutions social, economic, and political phenomena (Furubotn & Richter, 2005; Ménard, 2008; Menard & Shirley, 2005). Nevertheless, the intention of this research is on the application of Agency Theory as the primary object to analyse the relationship between the principal and the agent. According to

Klein (1998) this theory often applies in various fields ranging from economics, law, organisation theory, political, sociology, and anthropology. Meanwhile, in the context of HEIs, this theory can be applied to study the relationship between government and institutions and has significant contribution to the body of literature (Hodgson, 1998; Menard, 2001). In agreement with that, Auranen and Nieminen (2010) argued that the main justification for the shift of public policies to the output/outcome alignment and the use of performance funding mechanisms relates to the Principal-Agent Theory dilemma and the concepts of New Public Management.

The originality of Principal Agent Theory (PAT) or Agency Theory applied in the fields of economics (Coase, 1998; Williamson, 1985) to assess the difficulties associated with approach between principal and agents to accomplish a specific task (Rauchhaus, 2009). In accordance to that, Kivistö (2005) point out that this theory is not and has never been exclusive property of any fields. Jensen and Meckling (1976) defined an Agency Theory as:

“A contract under which one or more persons (the principal) engage another person (agent) to perform some service on behalf which involves delegating some decision-making authority to the agent”

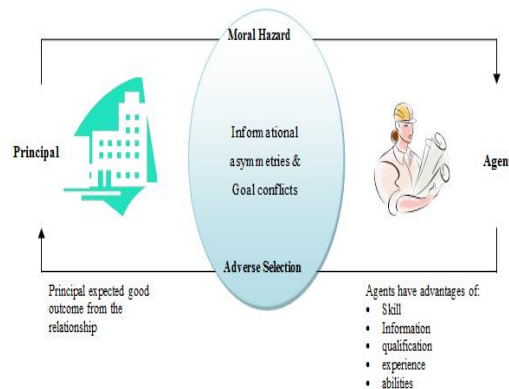


Figure I: Agency Theory Relationship

The classic example of Agency Theory applied in the interaction between patient and doctor, defendant and lawyer, landlord and tenant, and employer and employee. With that, the agency relationship derived from the contractual agreement between principal and agents in the expectation that the agents will take actions to produce outcomes (see Figure 1) as expected by the principal (Moe, 1984; Waterman & Meier, 1998). Furthermore, the basic reason of agency relationship is because of the agent possess skills, information, qualification, experience and abilities to perform specific task to undertake that will more likely lead to good outcomes for the principal (Bendor et al., 2001; Kivistö & Hölttä, 2008). He added that, the relationship context can be arranged from single-principal-single-agent to multiple-principal-single-agent or single-principal-multiple-agent which is turn out to be more complex. However, in performing the relationship the basic features of agent problem take place because of: (1) the principal knows less than the agent does; and (2) conflict of goals in delegation of the task in view of the fact that the principal cannot observe the action taken by the agents.

Assumptions Under Agency Theory

The main assumption and perspective of Agency Theory focuses on goal conflicts and informational asymmetries:

- i. Goal conflicts
 As a situation where the principals and agent's desires and interests concerning certain ends are in conflict with each other and that, they would therefore prefer different course of action.
- ii. Informational asymmetries
 Agent possesses more or better information about the details of individual task assigned to him, his own action, abilities, and preferences compared to principal.

Indeed, Agency theory is also based on several other behavioural assumptions concerning the principal, the agent and the agency relationship (Kivistö, 2007). These are summarised in the table below.

Table 1: Summary of Assumptions Underlying Agency Theory

Assumption	Explanation
Self-interested actors	<ul style="list-style-type: none"> • The individual is a rational, self-interested actor who only wants to maximise their own preferences (Judith, 2002).
Utility maximisers	<ul style="list-style-type: none"> • Both economics and political science PAT consider the principal and the agent as self-interested utility maximisers (Lane & Kivistö, 2008) • This assumption is important for a mathematical approach that oriented the principal-agent researchers that are based on logic and proof (Kivistö, 2007; Rungfamai, 2008)
Risk preferences	<ul style="list-style-type: none"> • Degree of an actor's preference for adventure over security (Kivistö, 2007) • Risk preferences are part of the self-interest aspect (Fama & Jenson, 1983) • Occurs in situations where the principal and agent have different attitudes to the risk associated with the action taken (Wiseman & Gomez-Mejia, 1998)

Assumption	Explanation
Types	<ul style="list-style-type: none"> • One of the most important and generally accepted assumption is that the agents differ according to their types (Kivistö, 2007) • Kivisto further explain that the types could be refer to whether the agent is -careful versus careless, -trustworth versus untrustworth, and -industrious versus untalented
Bounded rationality	<ul style="list-style-type: none"> • Is an effect of the constraints of incomplete information between the principal and agent to solve the problem (Michael, 1994) • Positive agency theory literature shares this assumption with transaction cost theory (Kivistö, 2007)
Rational actors	<ul style="list-style-type: none"> • A rational actor is one who can identify what he or she wants, is capable of ordering those wants from most preferred to least preferred, and acts in ways that he or she believes will maximise satisfaction of preferences (Albanese et al., 1997)

Agency Theory In Higher Education Informational asymmetries

Informational asymmetries concern on interaction between principal and agent in performing specific task. In practice, this problem could not be avoided because most often agent has access to superior information about the details of delegated tasks compared to principal. As the consequences, the principal not have the full access of information and these characteristics of problem become an opportunity for the agent to gain by keeping certain information inaccessible to the principal. As a result, information may not be distributed equally between principal and agent due to conflicting of interest about something important known only to the agents. This may cause the circumstances where the agents is cheating, given inadequate information, and bounded rationality in general (Perrow, 1993).

The previous research have demonstrated that informational asymmetries exist in the operation of HEIs (Jongbloed, 2006; Kivistö & Hölttä, 2008) and it is relevant in the study of higher education system (Liefner, 2003; Smart, 2001). In relation to that Liefner(2003) research study focus more on resource allocation in HEIs in the context of the universities performances. In practice, HEIs will impose their skills, information, qualifications, experiences and abilities to provide education services available to public. However, Liefner(2003) and Kivistö and Hölttä(2008) argued that in reality it is hard for the principal to observe the quality of T&L, and R&D outcomes produced by the HEIs. This is due to the limited understanding of how organisations operate (Lambert, 2001) and this factor lead to the information asymmetries because the principal is difficult to monitor the agents competencies and actions in the real environment (Saam, 2007).

In particular, the central argument from Kivistö and Hölttä in the context of higher education raising because stakeholders indicated strong interest in information and reporting in order to monitor organisations activities and performance. These include information on of the quality of higher education, academic, and research performance. Lane and Kivistö(2008) pointed out that the purposed of monitoring behaviour is to decrease the information asymmetry. In relation to Kivistö and Hölttä first criteria, initally prospective students and parents receive information from market signal to make decision and the transactions are not always complete in immediate process. In that sense, the educational system was nominally responsive from the market behaviour and during this time lag, there might be delay in transactions, coordination, and decision making from customers. In most cases, the problem occurs when there is information mismatch between institutions and students. Kivistö and Hölttä explained the reason to the problem is because of there is lag between the time of purchase (enrolment behaviour, resource allocation) and the consumption (learning experiences, rate of return to higher education). Therefore, the only way to resolve this problem is by forcing institutions to make the information available in order to strengthen their relationship with stakeholders and finally reduced the informational asymmetries.

The second criteria refer to different types of buyers and consumers entities that purchase goods and services in market. With many goods and services available, consumers have to make decision before making any purchasing for their own satisfaction. In general, HEIs provided services to the customers to enhance local human capital development as one of the important pillars. As perceived, direct return of higher education is normally associated with greater contribution to economic opportunities. However, in the perspective of informational asymmetries, Kivistö and Hölttä explain that the significant question arise either customers have more or less the same understanding on their needs and preferences regarding higher education. Despite the fact that, the system of higher education acquire funding from the government. However, in practice the principal do not have the access of institutional actual performance. To reduce the probelm institution should focus on the actual performance in order to be more accountable to public. They should provide real time information available to customers in order for them to make a right decision.

Finally, higher education produces a complex mix of public goods that might vary in time and it is difficult for the customers to describe the difference. In addition, Kivistö and Hölttä argued that academic work (teaching and research) surrounded by high informational asymmetries starting from its core substance, knowledge. This is because to meet perceived market needs, academic systems are by now highly differentiated in most countries (Altbach, 2007). There seems to be the increasing practical importance for the effectiveness of the higher education and research system in order to reduce this problem. With rapid increase in the numbers and variety of institutions today, it is crucial to define the nature and scope of their services to the public. Thus, to understand the marketplace and different customer segments, institutions should balance the information available for meeting their expectations.

Kivistö and Hölttä(2008) argued that another factor contributed to information asymmetries is the complexities in the production of universities. Here, universities performance on teaching and research are the main core functions to meet social goals. As describe, HEIs

produces a complex mix of public goods from different types of input for teaching and research. This process might differ according to time spent on different function, technology, method and facilities that the universities have. In agreement with Gautier and Wauthy(2007), it is hard to see what happens exactly to evaluate the quality of teaching and research even evidences from suggest that university perform in research also perform well in teaching. For this reason, Kivistö & Hölttä(2008) have pointed out that in practical it is difficult to stakeholders to know the true difference between the allocated funding and the actual minimum costs of delivering the desired level of teaching and research output in universities.

Jacobs and Van Der Ploeg(2006) argued that information asymmetries instigated problems in funding systems, governance, selection of students, appointment of academic staff, and the regulation. Due to information problems, as usual, government intervention is warranted whenever market failure are present (Bebczuk, 2002). In the meantime, several public institutions incorporate capitalist element in their day-to-day operation as important ways to generate funding (Bleiklie & Kogan, 2007). But by nature, the government at most time are unable to monitor and control the behaviour of universities (Schiller & Liefner, 2006). However, to address these issues the principal can influence the effort level of institutions by providing incentives and monitoring system.

Goal conflicts

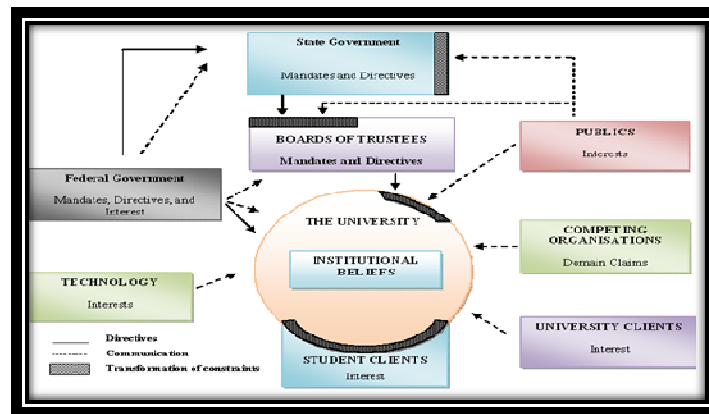
Agency Theory deals with goal conflicts that may arise during the delegation of authority from principal to agent. In order to achieve the principal desired outcome, this hidden action caused different attitudes towards risk on the relationship between principal and agent (Eisenhardt, 1989). The agency problems arise when the principal and agent have different risk preferences and conflicting goals. This typical problem leads them to prefer different courses of action (Bergan et al., 2009) because universities are large and complex organisation(Enders & Fulton, 2002; Rowley et al., 1997; Soguel & Jaccard, 2008) with different vision, mission and goals (Kivistö, 2007; Massy, 1996) and institutions sometimes can be classified according to their programme, knowledge, and the modes of delivery.

Yet, Thorley (1995) argued that HEIs mission is complex by a tradition of academic freedom in which individual academics develop autonomously and management style tends towards administrative rather than proactive leadership. In the meantime, universities would like to achieve as many different goals to move the organisation toward its vision and mission. They are increasingly turning to align education activities to institutional strategy, and to monitor performance toward strategic goals over time. The direction towards that is because goals and objectives move the organisation in the direction of its purpose and mission in short term (Tischler et al., 1993). However, because of the agents may not share the goals and task (Lassar & Kerr, 1996) in most situation contracting problems are difficult due to goal conflict, measurability, and observability (Van Slyke, 2007).

The central purpose of goals is to provide direction to the agents towards specific outcomes that must be achieved especially during the limited financial resources and demands for accountability where HEIs need to clearly clarify their purpose or goals more closely (McKelvie, 1986). Following this, two types of goals are: (1) official; and (2) operative. An official goal refers to general purpose of organisation that stated the organisation is trying to

achieve. Meanwhile, an operative goal is a specific actual day-to-day operating policy of the organisation. These goals provide specific measures of achievement that the organisation actually seeks to attain through its operating policies and activities (Perrow, 1961). Conrad (1974) characterised the operative goals in university as a function of constraints in establishes the direction and ongoing activities in the institutions. Here, the summarisation of these major constraints on university includes: (1) institutional beliefs; (2) state government and boards of trustees; (3) federal government; (4) competing organisations; (5) university clients; (6) publics; (7) student clients; and (8) technology. Models from Conrad explain the constraints of university operative goals depicted in Figure 2.

Figure 0: Constraints of University Operative Goals



In general, university operative goals constraints exist due to several factors, which are forces from internal and external environment, control and authority in the university, university does not have control over resource allocation, academic program, and courses and individual or groups apply different choices of criteria in determining the university importance policy. These interaction and engagement in various ways contributed to the internal and external constraints to the university responsiveness on the needs of stakeholders as described in figure above. Here, the institutional belief is one of the basic parameters for university operative goals. Meanwhile, constraints over university operative goals in relation with state government and federal government exist because of most funding resources come from government for university. Furthermore, this external constraints act as the regulative body that give mandate for the institutions. They often set rules and guidelines directed to the institutions performance and contributed to a cohesive effect on the universities operative goals. There are number of major constraints of university operative goals explained by Conrad. These include competing organisation, university clients, student clients, and technology. It is likely that, these constraints may have an impact on the supporting university strategic goals and this conflicts is likely to have negative effects to the overall organisation performance (Rizzo et al., 1970).

Meanwhile, Kivistö (2005) clarified that the assumption of goal conflict on both sides (government and HEIs) can be seen as realistic. Here he described the relationship as *the long but still ongoing “love hate-relationship” bounding governments and HEIs together is*

complex and it has multiple dimensions'. In this conditions, the approach to define a contract based on outcome can be viewed as mechanism to control the agent behaviour in order to minimise to goals conflict. In addition to contractual agreements between principal and agents, Kivistö suggested that when there is strong differences on goals, outcome based contracts could be used in controlling agent behaviour with the aims to ensure future growth and sustainable development of higher education to the nation. Indeed, government control through performance monitoring can become important mechanism at the university level. Under the performance based mechanism, funding level promotes better alignment of university goals and GOs. However, to get the benefit of it implementation, university must first have autonomy and financial freedom.

Conclusion

Agency Theory needs to be further explore and testing to create valuable tool for research study especially in the context of higher education institutions. Agency Theory offer unique explanations arising from the government and agents relationship since that the principal is unable to monitor the agent activities perfectly and one party lack of information. In addition, agency problem arise due to goals conflict and information asymmetry.

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