Principal Agent Models of Legal Institutions

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CSLS Miniseries on
Empirical Research Methods

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Major themes

Style of thinking in principal-agent (PA) models

PA theory is a family of models, not one overarching theory

Empirical content: Is there any pattern that some PA model cannot explain?

Normative and positive issues

Basic Components of a Principal-Agent Model

- Agent. Takes an action that affects the principal's utility. Does not imply a fiduciary duty. Rooted in common law of agency, but not much conceptual relationship anymore.
- Principal. Takes an action that affects agent's preferences over possible actions.
- Preferences. Goals that the principal and agent are trying to achieve. P-A theory places no inherent requirements on them. Usually interesting if they can possibly conflict.
- Information. What A observes about variables that affect P's utility from A's possible choices, what P observes about A's choices
- Contract. The relationship between A's actions and P's response. Some define P-A model as one where P commits to this irrevocably at start of game, some don't.
- Extensive form. Sequence of moves. The language of institutions in game theory
- Equilibrium. Actions in which P and A each do as well as they can (in light of preferences), given the action of the other

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A Simple (-istic?) Archetype: Pure Moral Hazard

- A is a politician, spends b on behalf of P, "the public".
- P only likes spending on government services g, but A likes spending on rents r. Assume $r + g = b$.
- P observes A's spending, can re-elect A or replace with an identical agent. The stage game repeats indefinitely. A wants to maximize lifetime rents.
- P sets a standard for g, reelects if A meets it. If P sets standard too high, A would prefer big r in short run over very small stream of r in future. So P must moderate its demands of A to get compliance: Agency loss
- Equilibrium: A exactly meets standard every period, is never defeated. P is indifferent about keeping or rejecting.

A pure moral hazard (better: uncontrollable actions) model of elections. A takes an action P cannot fully control, P's preferences are not based on private information A observes before acting, P has a sanction to influence A's action.

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Another Archetype: Adverse Selection and Delegation

- A observes a state of the world $\omega \in \{1, 2, 3, 4, 5\}$. P only knows each state is equally likely.
- Policy x is a number. P wants $x = \omega$, A wants $x = \omega + 1$. P loses 1 jolly for each unit between x and ω.
- P decides whether to choose x itself, or delegate to A.
- An adverse selection (better: hidden information) problem. A observes information, P wishes to base a decision on A's information. Needs to induce A to use or share its information. That's what delegation does.
- Simple case of standard model of delegation in political science & economics (Holmstrom 1984; Epstein and O'Halloran 1994, 1999; cited all over law & political economy)

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How Does Delegation Help P?

ω	P's choice	$-\lvert x-\omega\rvert$	A's choice	$-\lvert x-\omega\rvert$
1	3	-2	2	-1
2	3	-1	3	-1
3	3	0	4	-1
4	3	-1	5	-1
5	3	-2	6	-1

By delegating, P ensures that A's information is used in making the decision.

Info. is not used exactly as P would use it, but x tracks ω perfectly.

P incurs a cost (relative to "1st best") from obtaining A's information — or information rent.

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Obtaining too much information?

Since information is costly, P might not want all of it.

Suppose P can limit A's choice of x to a subset of numbers. Why let A choose policies that P knows it never wants chosen? Let A choose from $\{1, 2, 3, 4, 5\}$.

ω	A's unconstr. choice	$-\lvert x - \omega \rvert$	A's constr. choice	$-\lvert x - \omega \rvert$
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By limiting delegation, P reduces the amount of information conveyed by A's choice.

But P also thereby limits information rents.

Delegation $\uparrow$ when variance of ω $\uparrow$, preference conflict $\downarrow$.

In administrative law: Delegation or abdication?

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Suppose P can limit A's choice of x to a subset of numbers. Why let A choose policies that P knows it never wants chosen? Let A choose from $\{1, 2, 3, 4, 5\}$.

ω	A's unconstr. choice	$-\lvert x-\omega\rvert$	**A's constr. choice**	$-\lvert x-\omega\rvert$
1	2	-1	**2**	**-1**
2	3	-1	**3**	**-1**
3	4	-1	**4**	**-1**
4	5	-1	**5**	**-1**
5	6	-1	**5**	**0**

By limiting delegation, P reduces the amount of information conveyed by A's choice.

But P also thereby limits information rents.

Delegation $\uparrow$ when variance of ω $\uparrow$, preference conflict $\downarrow$

In administrative law: Delegation or abdication?

Commitment Power Helps P Obtain Information Cheaply

What if P has oversight powers and can change A's choice of x at will after it's made?

In a game, A would anticipate this in equilibrium.

Assume A has unconstrained authority & doesn't mind revision *per se*. Will it still reveal ω perfectly through choice of x?

- If so, P observes A's choice, learns ω for sure, and revises to $x = \omega$.
- But A is just as happy choosing (*e.g.*) $x = 2$ if $\omega = 1, 2, 3$, and $x = 4.5$ if $\omega = 4, 5$. But now P doesn't learn ω for sure.
- And if A is a risk-taker about getting its ideal policy, it strictly prefers the 2nd arrangement to the 1st.

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The Power of Weak Incentives

P may be better off if it commits not to revise A's choice.

If it cannot commit, A knows its policy choice is "cheap talk".

If P can commit to delegation, A knows it gets policy benefits from using its information. If P cannot commit, A knows its information will be used in P's best interest, so it reveals less.

Fewer instruments to "control" an agent may be beneficial for P.

So when we see an "out of control" agent, we cannot conclude the institutions work against P's interests.

Many agency models elaborate this point into an explanation of why strong incentives are not in P's interests, or present a mixed blessing. This happens when P cannot commit to give A incentives to act in P's interests on every action which A takes.

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Judicial Review and Distortions of Agency Effort (Bueno de Mesquita and Stephenson 2007)

- A can regulate or not, and can exert effort to improve its regulations
- All effort is costly for A, but A also prefers higher quality regulations
- P is a court that can uphold or reject. P prefers higher quality regulations. P can observe some types of A's effort, not others.
- P will uphold if the quality it expects from A's regulation exceeds the value to P of the status quo.
- P's expected quality increases in observable effort.
- So P's review induces A to shift effort away from unobservable, toward observable
- Makes both P and A worse off than if P could observe all effort
- A may even be dissuaded from issuing regulations, when both A and P agree it's better than s.q.

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Summary: The Logic of Principal-Agent Models

P-A models come in many flavors. "The" theory is really a family of models.

No one model purports to describe every situation. The models do not assume the actors are selfish or venal.

Adverse selection models turn on A observing variables P would want to observe, but can't. Costs of information extraction imply it is limited in eq.

Moral hazard models turn on A making choices that P would like to control, but can't. Costs of control imply it is limited in eq.

Models give implications for the extent of agency loss, and choices principals should make to mitigate it.

When P's have imperfect commitment or limited instruments to control A's choices, they may be better off not controlling some actions at all.

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The Nexus of Theory and Empirics

Two types of approaches

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1. Testing:
   - Specify preferences, information, extensive form. Deduce predictions about how P should interact with, attempt to influence, or control A. Test predictions.
   - What is learned if the predictions are wrong? Not a test of "the" theory – only a test of the particular specification.
   - Variant: Identify whether assumptions of a specific PA model match assumptions of a specific context.
   - What if they don't? Is anything learned about describing interactions in P-A terms?
2. Explaining & Interpreting:
   - Identify patterns of interaction between P and A. Deduce preferences, information asymmetries, extensive form, and contracting limitations that make this pattern optimal for P. NOT necessarily more descriptively accurate assumptions.
   - "Interpretive formal theory." Empirical content?

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- Responding to theories of Congressional "abdication." Observational equivalence of abdication and congressional dominance; anticipated reactions by agencies
- Identifies committees in Congress as key principals of (independent) agencies: monopoly policy domains, constituency interests, MC self-selection
- Identifies mechanisms for committees to control agency policy choices: budgets, oversight, appointments
- Data and method: FTC regulation, 1964-1977, as a function of committee ADA scores
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- Responding to theories of Congressional "abdication." Observational equivalence of abdication and congressional dominance; anticipated reactions by agencies
- Identifies committees in Congress as key principals of (independent) agencies: monopoly policy domains, constituency interests, MC self-selection
- Identifies mechanisms for committees to control agency policy choices: budgets, oversight, appointments
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Type 1: Principals, Bureaucrats, and Responsiveness in Clean Air Enforcement (Wood, APSR 1988)

- Pits control by principal vs. autonomy or power of agent
- EPA CAA implementation as effected by election of 1980: Reagan pushed for retrenchment at EPA, induced Congress to go along with budget reductions
- Multiple principals unified for retrenchment should lead to reduced EPA outputs
- Data & method: Monthly monitoring and abatement activity, parametric time series quasi-experiment model
- EPA enforcements *increased* after Reagan inauguration, decreased but quickly rebounded after 1982 budget reductions

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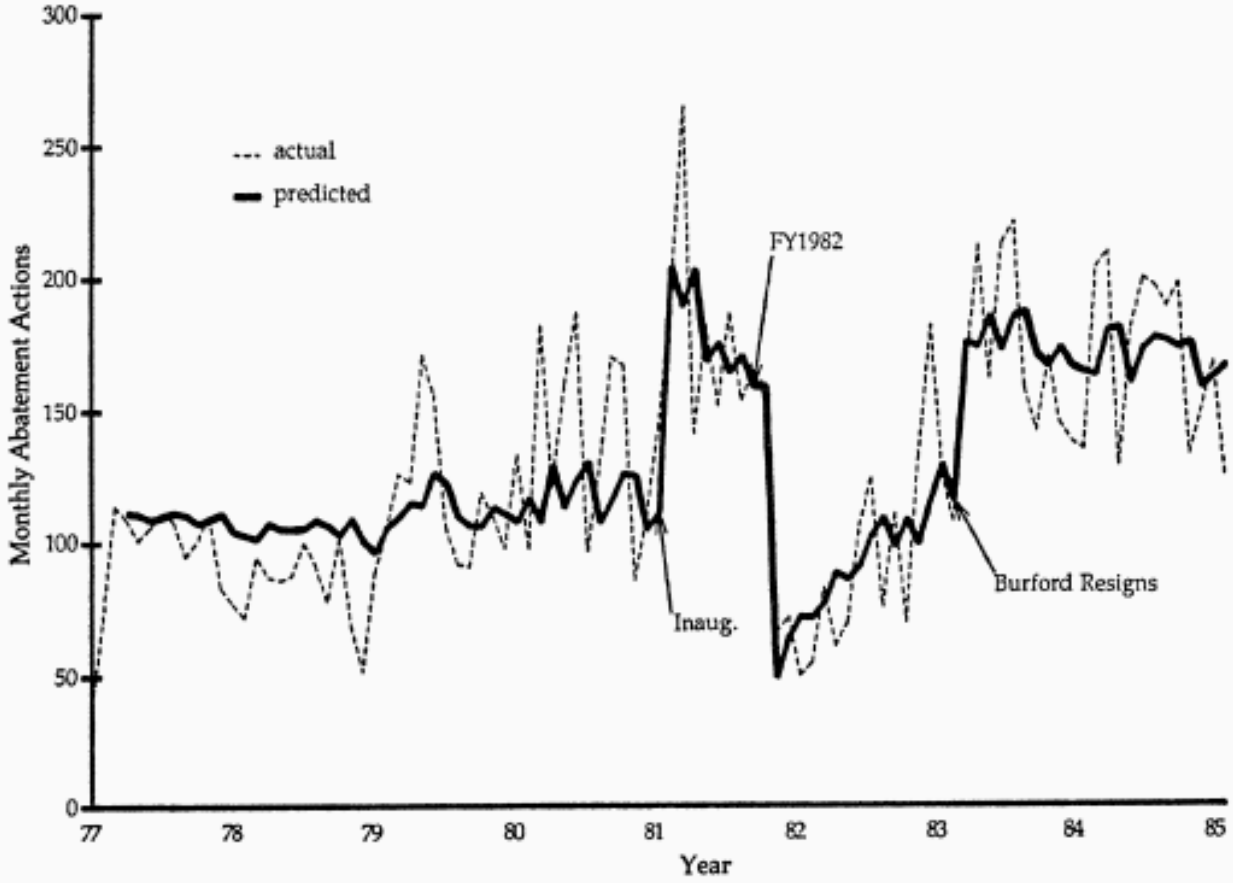
Figure 3. Model-Predicted EPA Abatement Activity (1977–85)



"All available tools of control were applied...EPA's actions were completely opposite of model predictions"

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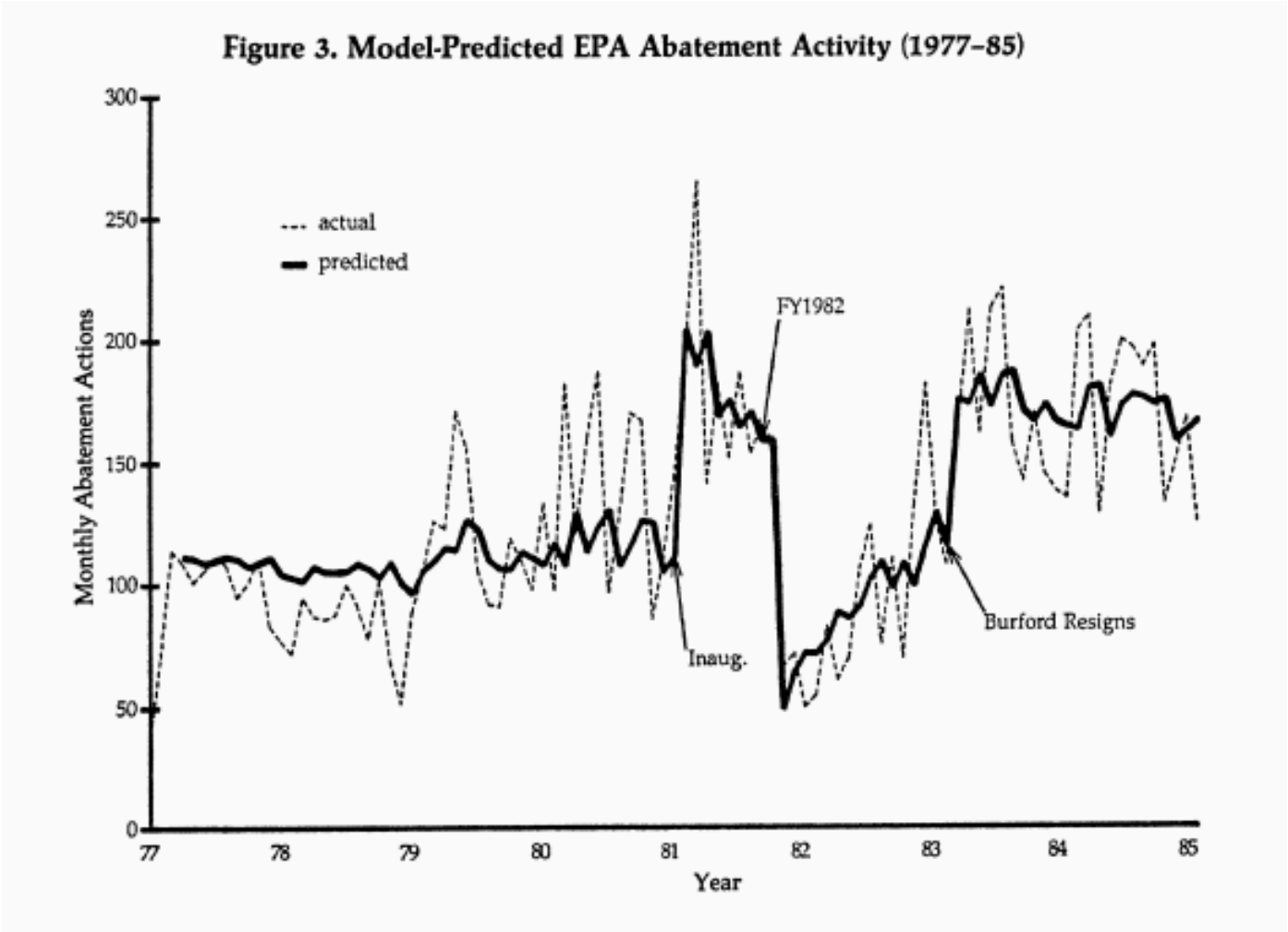

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Type 1: "Myopic Voters and Natural Disaster Policy" (Healy and Malhotra, APSR 2009)

- Voters reward politicians for disaster relief spending, but not disaster preparedness spending
- Leads to distorted investment: \$1 on preparedness is worth $\approx$ \$15 in damage reduction
- Citizens' psychological predispositions makes them incompetent to hold politicians accountable effectively

Ostensibly, a rejection of P-A model premise that voters use whatever instruments are available to hold politicians accountable to their interests as best they can

Type 1 Variant: Assessing the Assumptions: A Critical Analysis of Agency Theory (Worsham, Eisner, and Ringquist, A&S 1997)

Summary and critique of "core assumptions common to much of agency theory"

- 1. Reductionism, rationality, methodological individualism
- 2. Preferences: Maximization of material returns. Votes for politicians, budgets for bureaucrats.
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Type 1 Variant: Beyond Principal Agent Theories: Law and the Judicial Hierarchy (Kim, NU Law Review 2011)

- Viewing the Federal judicial hierarchy in P-A terms. Chain of P-A relationships, blunt tools of control, adverse selection, some moral hazard too.
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What Have We Learned Here?

- Agency models: Some successes, some failures
- Successes imply situations where P-A model is at least one way to understand it. Not of course the only way. Not careful enough about causal inference.
- Failures tell us *something* useful. But do they imply that *some* P-A model is not a useful way to understand the situation?
- Since P-A models require no specific assumptions about goals, information, contracting possibilities, or even the action where P faces the greatest incentive problem with A, no test can rule out the whole family of models
- The "failures" may suggest that one needs a *different* PA model, as much as suggesting one needs no PA model at all

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From Testing to Explaining and Interpreting

Testing a specific model is inherently static in matching P-A theory to a given pattern of interactions between players

The 2nd type of approach, backing out a P-A model to account for observed patterns, goes to the opposite extreme

It offers P-A theory its best possible chance to explain a pattern

At best, it offers subtle insights into possible effects of institutional change. At worst, it is functionalist, Panglossian and defensive of status quo arrangements.

Not necessarily teleological — an institution can have the effects described in a P-A model, without being designed to have those effects

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- Congress wants to please interest groups for electoral reasons.
- "Deck stacking" — ensuring that favored interest groups have privileged access to agency proceedings. Notice and comment, intervenor funding programs, advisory committees, grants of standing.
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- "Autopilot" — ensuring that interests favored by "enacting coalition" are still favored after it fades from power. Institutions to create commitments. Byzantine agency proceedings, regulatory capture, bureaucratic inertia
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Type 2: Slackers and Zealots: Civil Service, Policy Discretion, and Bureaucratic Expertise (Gailmard and Patty, AJPS 2007)

- Existing empirical work has found agencies well insulated in their decisions from overhead control, staffed with "zealots"
- Some agents care about policy for its own sake, others don't
- Greater policy discretion in response to expertise (eg. property of delegation models) gives "incentive payment" to invest in it, but only to zealots
- Spoils rotation mitigates these incentives; civil service (stable careers) amplifies them
- If P values technical expertise, lacks pecuniary incentive contracts, and expertise is government-specific, civil service is preferable for P — despite agency loss it engenders in other dimensions

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- Whatever the Constitutional status of the "unitary executive," President's ability to ability to act on the theory requires good information — and the best comes from EOP
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- Delegation models: Information begets discretion.
- This model: Discretion begets information. If Presidents claim authority to act, Congress wants them to have information to use it wisely.
- For Pres. to heed information requires that he trust it.
- Best way to ensure Pres. trusts it: Let him pick it.
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- Most "interpretive" P-A modeling explains how a given institution solves an agency problem
- Berry & Gersen flip this orientation, argue that singular executive may be detrimental to public welfare
- 2 policy areas, two policies each — one good for voters, one good for lobbyists
- A singular executive can choose for the lobbyists on one dimension, and if the voters care enough about the other dimension, still get away with it
- One executive per policy area can't get away with choosing for lobbyists
- Singular executive faces weaker incentives $\leftrightarrow$ multiple choices, but only one instrument of control
- Plural executive faces (collectively) one instrument per choice: stronger incentives, to public's benefit

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Summary and Conclusions

PA models come in many flavors. Explicit ones emphasize costs to P of "getting its way," emphasize that it generally will not.

In political and legal institutions, PA models are interesting because they connect to the normative themes of legal and democratic theory.

Specific members of the PA family can be tested. The whole family cannot be.

Cases of empirical failure indicate specific models, usually of direct overhead control, do not organize observations well in some important instances.

Most any situation between titular "P" and "A" can be explained according to some PA model; we just have to find the right one.

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