

# ORGANIZATIONAL ECONOMICS THEORIES: AGENCY THEORY, AGENCY AND TRANSACTION COSTS

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## AT A GLANCE

Modern organization theory gave birth to the system theory of organization, in which approach, organizations are open systems taking into account cause and effect of their environments of operation. This approach consists of social and management aspects. That, the organization should have relationships with the environments within which they operate and outside entities, necessitated further examination of the classical economic theory, galvanising a new role of economics in organizations called organizational economics. Organizational economics, first presented by [1] in his first article entitled "The Nature of the Firm," stipulates that firms should be envisaged not only as endogenous entities to the economic system, but whose existence is justified only in the presence of transactions costs to production. Firms and other economic/academic organizations and institutions, in effects, exist because agents find it a useful manner of minimizing transactions costs. Some notable contributors to the theory of organizational economics are Michael Jensen, William Meckling, John Locket, Jean Locke, Jean-Jacques Rousseau, Oliver Williamson, Paul Rubin, Jay B. Barney, and Willaim G. Ouchi.

Components of organizational economics are agency theory, property rights theory and transaction cost theory. Agency theory centers around the relationship between principals (owners) and agents (managers and other employees) and the costs associated with making both groups to work collectively to accomplish the ultimate goals of the organization [3]. The theory of property rights deals with the allocation of costs and rewards among the participants (principals and agents) in an organization. Transaction cost theory focuses on the costs of maintaining the principal-agent relationship, how to minimize the costs, and the effect of transaction costs on management costs [10]. Underlying principles are that, people are opportunistic and have conflict interests; impossible to completely eliminate every form of opportunism or cheating. There are three levels of application, namely, overall structure of the organization; operating parts of the organization; and human resource management.

Agency theory has been viewed as an important concept in organizational economics. System analysis and game theory are essential quantitative mechanisms for understanding the relationship of agency costs in the overall organization goal [6]. There are many dependent variables affecting agency costs and reconnoitring agency theory would continue into the future, especially research focusing on identifying factors affecting agency costs. The mathematical model for agency costs is an ongoing research. Agency theory has affected the incentives for agents to execute their responsibilities to the principal in a judicial manner. There are concerns as to the level of incentives vis-à-vis expectancies and productivity. The fall of the dot-com companies and several multinational and reputable corporations is a manifestation of the application agency theory.

The agency theory has relationship with the theory of property rights and transaction cost theory. Since, it is the goal of the firm to minimize agency costs; the agency theory is also very highly connected with system theory. It is to be noted that, agency theory should be applied with caution, because, if it is not properly implemented, it may result in the collapse of the firm due to over incentives to the agent.