Agency Relationships in Marketing: A Review of the Implications and Applications of Agency and Related Theories

Agency and related theories have proven useful as theoretical frameworks for examining relationships between principals and their agents in many disciplines. However, though marketing involves a wide array of agency relationships, agency-based research has only recently begun to be reported in the marketing literature. The authors therefore attempt to clarify the marketing implications of agency theory by describing its major constructs, the two different types of models embedded within the theory, and some closely related theoretical structures. They also critically review past and potential agency-based research in marketing and suggest ways in which marketers might contribute to improving its validity and usefulness.

Agency theory has spawned a large amount of recent research in economics, finance, accounting, organizational behavior, political science, and sociology. Its proponents prophesy that a revolution is at hand, that agency and related theories can greatly improve our understanding of why organizations exist and how they work (Hesterly, Liebeskind, and Zenger 1990). Some scholars, however, are troubled by these theories’ underlying assumptions about human behavior and organizational processes (Donaldson 1990). A few detractors brand them minimalist, tautological, trivial, and even dangerous (Hirsch, Michaels, and Friedman 1987; Perrow 1986). The true significance of agency theory probably is somewhere between the key to universal truth promised by its fans and the total lack of usefulness suggested by its critics. What is clear, though, is that the theory addresses issues of particular relevance to marketing management. For that reason it warrants a critical inspection.

Agency Relationships Pervade Marketing

An agency relationship is present whenever one party (the principal) depends on another party (the agent) to undertake some action on the principal’s behalf. Hence, any employment relationship is an agency relationship. The hiring firm, or a manager representing the owners’ interests, is the principal and the employee is the agent. Given that most marketing departments consist of multiple employees at various organizational levels (product managers, salespeople, etc.), developing and implementing marketing strategies and programs necessarily involves managing agency relationships.

In addition, marketers rely heavily on independent “facilitating agencies” to perform some of the work involved in implementing marketing programs. Facilitating agencies are specialists—such as advertising agencies, research suppliers, or public warehouses—
whose services are contracted on a fee-for-service or commission basis. Each of these contractual arrangements involves an agency relationship.

At a more fundamental level, agency relationships are pervasive in marketing because the essence of marketing is exchange, and "the agency relationship is . . . a significant component of almost all [exchange] transactions" (Arrow 1985). This is particularly true because most goods and services are distributed through intermediaries—such as wholesalers, retailers, or franchisees—who act as agents (in an agency theory sense) of the manufacturer or franchisor. In addition, the ultimate customer also can be viewed as engaging in an agency relationship as he or she attempts to gain accurate product information and desired product benefits from a supplier who may be viewed as his or her agent (Coughlan 1988; Devinney 1988).

**But Agency-Based Research in Marketing is Limited**

In spite of the fact that marketing is rife with agency relationships, agency-based research has only recently begun to be reported in the marketing literature. Why have marketing scholars and researchers been relatively slow to embrace this new theory? Perhaps the location and nature of its early development in the economics and finance literatures made it somewhat inaccessible for many of us. The technical style and formal modeling structures of many of the early articles tend to obscure the rather straightforward constructs that are the essence of agency theory. To make matters worse, the formal agency literature incorporates two different but related types of models, one of which focuses on precontractual and the other on postcontractual issues. There is also a "positive branch," which is primarily concerned with the design of appropriate intraorganizational governance and control mechanisms. These multiple foci can make it difficult for the uninstructed to determine exactly what the theory is all about.

**Purpose**

When stripped down to its essentials, however, agency theory provides a useful framework for examining and gaining new insights into a wide range of marketing issues. The primary purpose of our review is to cut through the methodological fog, describe the basic content of agency theory, and critically review its past and potential future applications in marketing.

We first describe the conceptual framework of agency theory, examining the theory's basic terms and constructs, the two types of models embedded within it, and its differences from the closely related framework of transaction cost analysis. Next, past applications of agency theory with relevance for marketing are discussed. Though space limitations preclude an exhaustive review of agency research in other functional areas, we do incorporate findings from other disciplines—particularly economics—that are germane to marketing issues. Finally, we discuss some potential extensions and new applications of agency theory in marketing, examine some of its limitations, and suggest ways in which marketing researchers might help to improve its validity and usefulness.

**The Conceptual Framework**

Agency theory uses the metaphor of a contract to describe relationships in which one party delegates work to another (Jensen and Meckling 1976). The focus of the theory is on determining the most efficient contract to govern a particular relationship given the characteristics of the parties involved and the fact that environmental uncertainty and the costs of obtaining information make it impossible for the principal to monitor the agent completely.

Though most of the agency theory literature addresses explicit, formal contracts—such as a compensation plan for a company's salesforce—the theory can also be applied to any "mutual agreement governing some aspect of subsequent behavior" (Mitnick 1987, p. 17). Hence, the theory can be used to evaluate implicit "social contracts"—such as social norms, peer pressure, and peer acceptance—as well as explicit legal contracts (White 1985).

It is important to note that most agency models define efficiency from the principal's point of view. The assumption is that the principal is the dominant party in the relationship. Thus, an efficient contract is one that brings about the best possible outcome for the principal given the constraints imposed by the situation, rather than one that maximizes the joint utility of both principal and agent.

**Two Types of Agency Problems**

A principal faces two distinct kinds of problems when entering a relationship with an agent. First, precontractual problems arise before the principal decides to offer an agent a contract. The major issues here are whether a particular agent has the characteristics the principal is seeking and what strategy the principal
should employ to find out. These are the kinds of problems marketers face when recruiting new salespeople or marketing personnel, selecting dealers for their distribution channels, and choosing advertising agencies or research suppliers.

Second, postcontractual problems emerge after the principal and agent engage in a relationship. The major issues here are how the principal should evaluate and reward the agent's performance so he or she will be motivated to behave in a manner consistent with the principal's goals and what information strategy should be employed to make such evaluations. Marketers commonly face such problems when designing compensation and incentive programs for marketing executives, salespeople, middlemen, and facilitating agencies.

We refer to precontractual problems as problems of "hidden information" and to postcontractual issues as problems of "hidden action." Regardless of what labels are used, the important point is that these two sets of problems are addressed by two different types of agency models. The variables incorporated in both models are diagrammed in Figure 1 and discussed in the following sections. Because the hidden action model addressing postcontractual problems has received the greatest attention in marketing, we examine it first.

### The Hidden Action Model

#### Exogenous Variables

Hidden action models involve several assumptions about the principal and agent. First, both are usually assumed to be motivated by self-interest. Because most models center on economic relationships, such self-interest typically translates into goals of maximizing profits (or utility). This assumption provides a useful starting point and probably reflects the goals underlying many agency relationships in marketing. However, the theory can also accommodate relationships in which one or both parties pursue broader social goals, as when a principal seeks support for a new art museum in order to improve the cultural climate of a community (Mitnick 1987).

Another underlying assumption of hidden action models is that principals labor under conditions of incomplete information. Though the principal is assumed to know something about an agent's characteristics and abilities, his or her knowledge about that agent's actions on the job is neither perfect nor complete. In contrast, the agent has information that the principal would like to obtain. For example, though a manager may know from call reports how many calls a salesperson made last week, that salesperson has additional information about how much effort he or she expended preparing for each call and the quality of the presentations made. Such information asymmetries—when one party has information the other desires but does not have—characterize most agency relationships. The problem is that self-interest often makes the agent reluctant to share the information with the principal, or may even motivate the agent to send the principal false information.

A third assumption in hidden action models is that realized outcomes are partly determined by environmental factors—such as economic conditions in the

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1. Much of the agency literature refers to precontractual problems as problems of "adverse selection" and to postcontractual issues as problems of "moral hazard." However, we use the terms "hidden information" and "hidden action" as suggested by Arrow (1985), because they are more descriptive of the issues involved. An overview of the differences in perspective and content of the models addressing the two types of problems is given by Hart and Holstrom (1987). However, the two types of problems need not be considered in isolation. Some recent models attempt to address hidden information and hidden action problems simultaneously (Davis 1991; Picard 1987).

2. For an excellent elementary discussion of the theory underlying hidden action models and a detailed bibliography, see Kreps (1990, ch. 16). Surveys of applications of hidden action models include those of MacDonald (1984), Arrow (1985), Pratt and Zeckhauser (1985), and Hart and Holstrom (1987).
market, competitors’ actions, and technological changes—in addition to the agent’s behavior. Unfortunately, environmental uncertainty is present because such factors change over time, are difficult to predict, and are beyond the control of either principal or agent. This uncertainty not only makes it impossible to write a contract that foresees and provides for all possible contingencies, but also forces principals and agents to keep in mind the resulting risk—together with their own risk preferences—when making contractual choices.4

Problems arise in agency relationships when the principal and agent have different risk preferences and conflicting goals, which lead them to prefer different courses of action. Risk preference can be thought of as the degree of an individual’s or firm’s preference for adventure rather than security (Arrow 1974; Pratt 1964). A risk-averse individual prefers security and therefore seeks some guarantee of the attainment of desirable outcomes or insurance against the occurrence of undesirable outcomes. A risk-neutral individual is indifferent to adventure or security.

In most hidden action models the principal is assumed to be risk neutral—or at least more neutral than the agent—whereas agents are typically assumed to be risk averse.5 The rationale is that agents, who are less able to diversify their employment, are likely to be more risk averse than principals, who can diversify their investments.

**Contractual Variables**

In the basic hidden action model, the agent attempts to maximize his or her own utility by choosing the best action available. Given the incompatible goals and risk preferences of the two parties, though, actions the principal would like the agent to perform are often relatively costly for the agent to undertake (i.e., they require more time, effort, or other resources from the agent). Hence, the agent may try to “shirk” on such actions.

To motivate the agent to engage in desired actions and to reduce the likelihood that he or she will shirk, the principal must decide between two courses of action. First, the principal might collect more information about the agent’s behavior by investing in monitoring activities and systems, and could then write a contract that bases the agent’s rewards on information about his or her behavior. Alternatively, the principal might write a contract that evaluates and rewards the agent on the basis of realized outcomes, but one that includes incentives appropriate to motivate the agent to pursue outcomes compatible with the principal’s goals.

*Monitoring systems and behavior-based contracts.* Systems for monitoring agents’ behavior are common in marketing. In a sales context, for instance, monitoring systems include requiring call reports, field observations by a sales manager, narrow spans of control, and the use of behaviorally anchored rating scales for periodic review of the salesperson.

When such systems are in place, the principal might write a contract specifying that the agent will be evaluated and rewarded on the basis of information about his or her actual behavior. For example, raises in salary and future promotions might be based on salespeoples’ ratings. Unfortunately, there are problems with this behavior-based approach. Collecting detailed information about the agent’s behavior can be very costly. Also, even an extensive monitoring system cannot completely overcome the information asymmetries between principal and agent. A sales manager might monitor the number of presentations a salesperson makes by analyzing his or her reports, for instance, but would still not know how much effort and ability that salesperson devoted to preparing and making those presentations.

Despite such problems, in some conditions behavior-based contracts are more appropriate than the kind of outcome-based contracts we discuss next. Eisenhardt (1985, 1989) and others, using an approach consistent with the positive branch of agency theory, have developed some propositions about such conditions. These propositions are summarized in Table 1.

*Outcome-based contracts.* The second option available to the principal is to evaluate the agent’s actions on the basis of realized outcomes. The principal could write a contract whereby the agent’s rewards are determined by performance outcomes, such as sales volume. In a selling context, the extreme form of an outcome-based contract is a straight commission compensation plan. Under the right circumstances, such

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4 Most hidden action models use Von Neumann–Morgenstern expected utility maximization as the framework for modeling the impact of uncertainty on the participants’ decisions, but other approaches for coping with decision making under uncertainty might also be used. See Kreps (1990, ch. 3) for a discussion of this issue.

5 Some models have relaxed the assumption that the agent is more risk averse than the principal (e.g., Harris and Raviv 1979; Picard 1987). This useful extension may increase the external validity of hidden action models because research suggests that people vary widely in their risk preferences (MacCrimmon and Wehrung 1986).

6 The taxonomy of behavior-based versus outcome-based contracts that we use to organize the following discussion was originally developed by Eisenhardt (1985, 1989). Note, too, that most contracts do not cluster into only two dichotomous types. Instead, they are along a continuum ranging from behavior-based to outcome-based. Thus, though a contract that compensates a salesperson by commissions and bonuses is largely an outcome-based contract, some of the salesperson’s bonus might be tied to specific behaviors, such as the number of new account presentations made during the period. Also, for an example of the formal agency literature’s treatment of monitoring, see Amershi and Hughes (1989).

7 Classic works related to the topics in this section include those of Ross (1973), Mirlees (1976), Holstrom (1979), and Grossman and Hart (1983).
contracts can motivate the agent to engage in the kinds of actions desired by the principal via a co-alignment of the two parties’ objectives. The development of such efficient contracts is the primary concern of most formal hidden action models.

For an outcome-based contract to be effective at inducing an agent to pursue actions consistent with the principal’s objectives, however, it must be designed with that agent’s personal goals and decision processes in mind. It must meet the requirement of individual rationality: that is, the contract must be interesting enough to the agent that he or she will want to undertake the project. Each agent is assumed to have some minimum reservation utility—the value to the agent of the best alternative opportunity outside a relationship with a given principal. Consequently, the agent may refuse to work for the principal if the potential payoff from the contract is not at least as attractive as what he or she can obtain elsewhere.

Obviously, too, the contract should be designed so that the actions with the highest payoff to the agent are also the actions that are most appropriate from the principal’s point of view. This requirement is known as incentive compatibility (Hurwicz 1972). When a contract is not incentive compatible, the agent may shirk or undertake actions of less value to the principal. For instance, if a firm’s objective is to increase sales volume, offering a large commission would be one way to make increased volume a more incentive-compatible outcome for the salesperson.

The principal’s goal, then, is to design a contract that will obtain the “constrained best” outcome that is incentive compatible for the agent. The principal’s problem is that such outcome-based contracts shift risk from the principal to the agent, and—assuming a risk-averse agent—behavior-based contracts become relatively more efficient.

Outcome-based contracts shift risk from the principal to the agent. When uncertainty and risk are high, the costs to the principal of transferring risk to the agent can also be high.

As an agent becomes less risk averse, the cost to the principal of transferring risk to that agent via an outcome-based contract declines.

### TABLE 1

<table>
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<th>Proposition</th>
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<td>1. As the cost of monitoring an agent’s actions decreases, the greater is the efficiency of behavior-based contracts in relation to outcome-based contracts</td>
<td>As the costs of monitoring an agent’s behavior fall below the costs associated with shifting risk to the agent and his or her potential shirking, behavior-based contracts become more efficient from the principal’s perspective than outcome-based contracts.</td>
</tr>
<tr>
<td>2. The greater the difficulty of measuring the outcomes of an agent’s task, the greater is the efficiency of behavior-based contracts in relation to outcome-based contracts</td>
<td>When the agent’s task requires a long time to complete, involves a team effort, or produces outcomes that are difficult to evaluate objectively (e.g., creative advertising), the difficulties and costs involved in administering outcome-based contracts increase.</td>
</tr>
<tr>
<td>3. As the level of goal conflict between a principal and an agent decreases, the greater is the efficiency of behavior-based contracts in relation to outcome-based contracts</td>
<td>As goal conflict decreases, the agent is more likely to behave in accordance with the principal’s wishes regardless of the incentives built into the contract. Thus, there is less motivational imperative for outcome-based contracting. The issue reduces to the difference in risk preferences between the parties, and—assuming a risk-averse agent—behavior-based contracts become relatively more efficient.</td>
</tr>
<tr>
<td>4. As environmental uncertainty increases, behavior-based contracts become more efficient in relation to outcome-based contracts</td>
<td>Outcome-based contracts shift risk from the principal to the agent. When uncertainty and risk are high, the costs to the principal of transferring risk to the agent can also be high.</td>
</tr>
<tr>
<td>5. As an agent’s aversion to risk decreases, the greater is the efficiency of outcome-based contracts in relation to behavior-based contracts</td>
<td>As an agent becomes less risk averse, the cost to the principal of transferring risk to that agent via an outcome-based contract declines.</td>
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*Adapted from material reported by Eisenhardt (1985, 1989).*
then have less incentive to put forth substantial sales effort. In other words, a commission structure may be necessary to make it incentive compatible for the salesperson to expend the level of effort desired by the firm.

For the principal, then, the heart of the problem is to design a contract that provides an efficient trade-off between the costs associated with shifting risk to the agent and the agent's potential shirking. The most appropriate solution depends on the level of environmental uncertainty, the kinds of tasks the agent is expected to perform, and the characteristics of the two parties—particularly their goals and risk preferences.

The Hidden Information Model

The basic hidden information model addresses the problems that arise because of information asymmetries occurring before the principal enters into a contract with a given agent. The principal is assumed to know the nature of the tasks the agent must perform and the personal characteristics needed to perform those tasks successfully. The problem is that the principal does not know whether a particular agent whom he or she might hire has those desired traits. A principal can attempt to overcome this problem in at least three ways: screening, examining signals from potential agents, or providing opportunities for self-selection.

Screening

A principal must choose an information-gathering strategy to determine accurately a potential agent's true characteristics. He or she might collect additional information—over and above the signals sent by the agent—by various screening activities. A sales manager, for example, might observe potential salespeople through personal interviews, track down personal references, or administer a battery of aptitude tests. The problem, of course, is that such activities add costs to the hiring process.

Alternatively, the principal might forgo screening, hire agents on the basis of the imperfect information provided by their signals, and then learn from subsequent experience the true characteristics of the agents hired. Here the problem is that the principal may hire agents of the wrong type, and those hiring mistakes may lead to unsatisfactory performance outcomes. From the principal's perspective, then, the basic tradeoff is between the costs of acquiring better information through screening before offering a contract to an agent and the loss resulting from poor performance as a result of hiring an inappropriate agent.

Screening is most likely to be an efficient solution to the hidden information problem when it is relatively easy for the principal to obtain information about important personal attributes of potential agents. Hence, screening is most likely to be extensive when measures of agents' personal attributes have proven to be valid predictors of their future performance and when those measures can be obtained by the principal with relatively little effort or expense. These factors, for instance, may help to explain the increasing use of paper-and-pencil aptitude tests in hiring salespeople (Kern 1988).

Even when screening is very costly, however, it may still be the most efficient solution to the hidden information problem if the consequences of a hiring mistake would be even more costly to the principal. Such is most likely to be the case when differences in personal characteristics can result in wide variations in performance across agents and when variations in agent performance have a substantial impact on the principal's ultimate profit.

When screening costs and the costs of learning by experience are both high, the principal may have no choice but to assume that all available agents are undesirable types and to adjust the contract offer accordingly. This breakdown, known as the "market for lemons," suggests that hidden information problems can sometimes result in losses to both the principal and the agent (Akerlof 1970). Two possible solutions to this problem are signaling and self-selection.

The Agent's Actions—Signaling

Given that an agent knows he or she has certain desirable capabilities, and that it is to his or her advantage to be offered a contract, the agent may engage in actions aimed at signaling to the principal that he or she is the type of agent the principal is seeking. For example, a salesperson might enroll in an evening MBA program in order to attract an offer of a higher level, better paying job. The individual would take such an action in the belief that obtaining an MBA would improve his or her knowledge and skills and that it would also signal potential employers that the individual has desirable attributes such as a high level of mental ability and intrinsic motivation. For such an action to yield a worthwhile signal from the agent's point of view, however, it must meet the criteria of individual rationality and incentive compatibility. The action must make the agent better off than he or she would be by doing nothing and the benefits to be derived from the action must exceed its cost.

Unfortunately, an agent who realizes he or she does not have the characteristics a principal is looking for may nevertheless find it in his or her self-interest to send the principal false signals indicating that he or she is the type of agent the principal desires. This would
be the case if the benefits the agent can derive from duping the principal exceed the costs of engaging in the action necessary to send a false signal. Hence, for an action to provide a signal that is useful from the principal’s perspective, it must be more costly to pursue for agents with relatively little of the characteristic desired by the principal than it is for agents with more of the characteristic. In other words, it must not only be incentive compatible for agents of the desired type to undertake the action, but also incentive compatible for inappropriate types of agents to avoid the action. For example, attaining an MBA probably meets both requirements as a useful signal to potential employers because the personal costs (e.g., effort, opportunity costs) involved in attaining the degree are lower for individuals with relatively high mental abilities and motivational levels than for less intelligent and diligent individuals.

When a given signal enables the principal to distinguish the characteristics of individual agents, it describes a “separating equilibrium.” Some signals, however, only separate a group of agents with a particular characteristic from another group without the characteristic. This kind of “pooling equilibrium” enables the principal to distinguish the two groups from each other, but differences among members within each group cannot be discovered (Spence 1973).

It is interesting to note the similarities between the problems a principal faces when attempting to classify and predict the behavior of “pooled” potential agents on the basis of their signals and those marketers face in defining and forecasting the behavior of market segments. This comparison suggests there may be substantial synergies to be gained from melding agency theory’s hidden information models with the segmentation techniques developed in marketing.

**The Principal’s Actions—Providing Opportunities for Self-Selection**

The principal need not be merely a passive receiver of signals from potential agents. He or she might also proactively construct choices that enable potential agents to signal their abilities and/or willingness to expend effort through self-selection. For example, a firm that desires a technically competent and knowledgeable salesforce might require a lengthy and rigorous training program for all new recruits. Potential employees who lack the necessary technical competencies or the motivation to acquire the desired knowledge (i.e., those for whom extensive technical training would not be individually rational or incentive compatible) could then self-select themselves out of a relationship with the firm by not applying for the job or by dropping out before completing the training.

**The Positive Branch of Agency Theory**

A separate stream of inquiry within agency theory, known as the positive branch, has much in common with the basic hidden action model. Both are primarily concerned with the design of appropriate governance and control mechanisms, though the positive branch has tended to be more narrowly focused on intraorganizational relationships, particularly those involving corporate managers. One difference in the positive branch, however, is that it has tended to adopt the assumption that agents are risk neutral rather than risk averse, an assumption that is also common in transaction cost economics (Williamson 1988). Moreover, the positive branch has differed from the rest of agency research in that it has been less mathematically formal in its approach.

The positive branch of agency theory affords insights relevant to marketing management issues, including the design of contracts and control structures that are most successful at inducing managers to behave in a manner consistent with the interests of the firm’s shareholders, and how the effects of those control mechanisms are mediated by environmental factors such as the labor market (e.g., Fama 1980; Fama and Jensen 1983a,b; Jensen and Meckling 1976). Thus, among other things, it provides some guidance about the design of effective compensation and incentive plans for marketing executives. For example, researchers have found empirical support for the notion that contingent compensation schemes—whereby a portion of the manager’s income comes from stock or option plans or from bonuses tied to corporate performance—motivate executives to behave in compliance with the firm’s strategic objectives and are related positively to shareholder wealth (Coughlan and Schmidt 1985; Murphy 1985).

**The Relationship Between Agency Theory and Transaction Cost Economics**

The potential usefulness of agency theory for examining marketing issues is strengthened by the fact that transaction cost analysis (TCA) has already been usefully applied in the marketing literature (e.g., Anderson 1985; Day and Klein 1987; Heide and John 1988; John and Weitz 1989) because the two offer closely related conceptual approaches. As Williamson (1988, p. 568) points out, “... these two perspectives are mainly complementary. Both have helped and will continue to inform our understanding of economic organization.” Both examine efficiency aspects of how firms organize functional relationships. Both assume that the parties involved in a relationship are motivated by
economic self-interest and will engage in opportunistic behavior. Moreover, though the two frameworks explicitly incorporate some different exogenous variables (e.g., asset specificity in TCA and risk preferences in agency theory), many of those variables have underlying commonalities. For example, the notion of information impactedness in TCA is similar to the problem of environmental uncertainty in the agency literature.

Despite their commonalities, the two approaches differ along several dimensions. One such dimension is the unit of analysis. Whereas the transaction is the basic unit of analysis in TCA, the individual agent is the elementary focus of agency theory. Both are microanalytic units and both imply a study of contracting. However, TCA's focus on the transaction has led naturally to an examination of the basic dimensions on which transactions differ (e.g., asset specificity) and the implications of those differences for designing appropriate governance structures—concerns that have received little attention in agency research. In contrast, agency theory's focus on the agent has led to greater attention to the impact of individual differences across agents. Note, for instance, the emphasis of the hidden information model on selecting agents with characteristics appropriate for the principal's purpose, and the concern of the hidden action model with tailoring incentives for agents whose goals and risk preferences differ from the principal's.

Another difference arises from the fact that TCA adopts an incomplete-contracting view of transactions between principal and agent. Thus, it emphasizes ex post transaction costs, which include (1) the maladaptation costs incurred when transactions drift out of alignment, (2) the haggling costs incurred if bilateral efforts are made to correct ex post misalignments, (3) the setup and running costs associated with the governance structures to which disputes are referred, and (4) the bonding costs of effecting secure commitments (Williamson 1988, p. 572). Reducing these ex post transaction costs by aligning transactions (which differ in their attributes) with appropriate governance mechanisms (the costs and competencies of which also differ) is the distinctive TCA orientation.

In contrast, agency theory adopts an ex ante view of relations between principal and agent. Its emphasis is on precluding or minimizing ex post costs through an ex ante alignment of incentives. Historically, agency theory has paid little attention to the possible problems of subsequent maladjustment other than to allow implicitly for the realignment of incentives to price them out.

Even some of these basic differences between agency theory and TCA have begun to blur, however, in recent years. For instance, as TCA has examined a wider range of "hybrid" governance mechanisms between markets and hierarchies, it has begun to pay more attention to the characteristics of individual agents and to incentives appropriate for different governance structures, such as characteristics and incentives that help build "trust" or "commitment" (e.g., Heide and John 1992). Similarly, recent work in agency theory has focused more attention on the incomplete-contracting problems involved in achieving an ex ante alignment of incentives between principal and agent (e.g., Grossman and Hart 1986).

Given that TCA and agency theory are concerned with similar issues and appear to be moving toward even more common conceptual ground, blending constructs and propositions from the two theories may further improve our understanding of marketing phenomena. For example, Anderson and Oliver (1987) compare and combine propositions from agency theory and TCA, as well as other perspectives, to gain insights about the appropriate conditions for the use of alternative compensation systems for controlling a salesforce. Their contributions add further weight to the argument that agency theory and TCA should be treated as complementary perspectives.

Agency Applications in Marketing

In recent years, researchers in marketing and related disciplines have employed agency theory to examine a variety of marketing issues, including (1) salesforce management, (2) channel coordination and control, and (3) promotion and other market signaling decisions. We discuss a representative, though not exhaustive, sample of the work in each of these areas. The applications are summarized in Table 2.

Though the surface has been scratched, many unanswered questions remain in each of the three topic areas. Consequently, the following discussion includes suggestions for extending and improving upon previous research. A subsequent section also examines other issues that, though amenable to the application of agency theory constructs, remain largely unexplored.

Salesforce Management

The relationship between sales manager and salesperson is an agency relationship, and many of the issues with which managers struggle when hiring, motivating, and controlling sales personnel can be examined with agency-based analyses. To date, however, most of the literature has centered on a single issue—determining the most appropriate type of sales compensation plan to offer under various conditions.

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*For a more detailed discussion of both the commonalities and the differences between agency theory and transaction cost analysis, see Williamson (1988).*
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<td>Mathewson and Winter (1984, 1986)</td>
<td>Promotional spillovers; retailer differentiation</td>
<td>Manufacturer's profits; resale price maintenance; exclusive territories</td>
<td>Hidden action model; many retailers; promotional spillovers; no uncertainty</td>
<td>Resale price maintenance—and under some conditions, exclusive territories—increase the manufacturer's profits when there are promotional spillovers across retailers</td>
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<td>Dutta, Bergen, and John (1991)</td>
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<td>Promotional spillovers; retailer differentiation</td>
<td>Manufacturer’s profits; two-part tariff; cooperative advertising allowances</td>
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<td>Brickley and Dark (1987)</td>
<td>Environmental uncertainty; observability of retailer behavior</td>
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<td>Norton (1988)</td>
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<td>Mathewson and Winter (1985); Lal (1990)</td>
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<td>Consumer Promotions Nelson (1974)</td>
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<td>For “experience” goods (i.e., those that are difficult for customers to evaluate prior to use), advertising can act as an efficient signal of product quality</td>
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Sales compensation plans. Agency models developed by Basu et al. (1985) and Lal and Srinivasan (1989) derive several propositions about the optimal mix of salary and commission components within a sales compensation plan under a variety of conditions. For example, these models suggest that the proportion of salary to commission compensation should increase as the amount of environmental uncertainty increases and as the salesperson’s aversion to risk increases.

A growing body of evidence provides some support for these propositions. For instance, using business-level data on compensation plans collected from a survey of 161 large manufacturing firms, John and Weitz (1988) found support for many of Basu’s propositions and, though others were not confirmed at statistically significant levels, the evidence was generally in the predicted direction.

In a related article, John, Weiss, and Weitz (1987) used data from the same survey to find support for several additional compensation hypotheses. For example, they found that as the proportion of nonselling activities required of the salesforce increases, higher proportions of salary tend to be offered.

Similarly, a recent study by Oliver and Weitz (1991) also provides mixed support for several agency-based propositions. In a cross-sectional survey of 367 salespeople from more than 100 companies, Oliver and Weitz examined respondents’ perceptions about the characteristics of their current compensation plan, risk preferences, the amount of uncertainty in the relationship between their selling effort and sales performance, and their motivation to expend effort on the job. As agency theory predicts, they found that risk-averse salespeople prefer (i.e., choose to work for firms that offer) compensation plans that have low levels of incentive compensation. In contrast, their results suggest that perceived uncertainty in the effort-sales relationship has only a marginal impact on preference for salary versus incentive compensation.

Lal, Outland, and Staelin (1990) explored a similar set of propositions, but at a more disaggregate level. By examining differences in sales compensation plans within three separate salesforces of a single *Fortune* 500 firm, they found significant support for those propositions.

Finally, Eisenhardt (1985) also tested several agency-based propositions about the relative efficiency of alternative control systems with data from 54 retail stores. She found that behavior-based control systems (i.e., a high proportion of salary) are more likely under conditions of high environmental uncertainty and when salesperson behavior is relatively easy to monitor.

**Potential extensions.** The agency studies are interesting first steps toward understanding the appropriate use of different sales compensation and control systems, but many questions remain unanswered. For instance, future models might examine the effects of additional exogenous variables such as:

- The differences in goals and risk preferences that occur across salespeople at different stages in their career cycles (Cron and Slocum 1986). For example, as the risk aversion of salespeople increases in the later stages of their career cycles, the theory suggests that the efficiency of salary-based compensation should increase. Indeed, a recent study by Coughlan and Narasimhan (forthcoming) based on survey results from 286 firms in 39 industries found that salesforce compensation is more heavily weighted toward salary in firms whose salespeople’s average years of service is relatively high. However, years of service in a particular firm is not a perfect indicator of a salesperson’s career stage. Also, the career stages model suggests that other psychological changes occur

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<td>Manufacturer’s short- and long-term profits; product quality</td>
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<td>Rao and Monroe (1991); Rao and Bergen (1991)</td>
<td>Quality consciousness of purchaser; perceived ability to evaluate quality objectively prior to purchase</td>
<td>Price premium paid above full-information, profit-maximizing price</td>
<td>Survey of 149 senior purchasing executives in a variety of industries</td>
<td>Higher price premiums are likely when purchaser is relatively price conscious and when product quality is relatively difficult to evaluate objectively</td>
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**Exogenous Variables**

- Quality consciousness of purchaser
- Perceived ability to evaluate quality objectively prior to purchase
- Repeat purchase rate
- Asymmetric information
- Manufacturer’s costs
- Asymmetric information

**Focal Contractual Variables**

- Manufacturer’s profit
- Relative price
- Volume of manufacturer’s advertising
- Hidden information model
- Repeated hidden action model
- Survey of 149 senior purchasing executives in a variety of industries

**Context**

- Relatively high price and heavy advertising can jointly provide an efficient signal of product quality
- Premium received for high quality products gives manufacturer an incentive to maintain quality over time
- Higher price premiums are likely when purchaser is relatively price conscious and when product quality is relatively difficult to evaluate objectively

**Conclusions**

- The differences in goals and risk preferences that occur across salespeople at different stages in their career cycles (Cron and Slocum 1986). For example, as the risk aversion of salespeople increases in the later stages of their career cycles, the theory suggests that the efficiency of salary-based compensation should increase. Indeed, a recent study by Coughlan and Narasimhan (forthcoming) based on survey results from 286 firms in 39 industries found that salesforce compensation is more heavily weighted toward salary in firms whose salespeople’s average years of service is relatively high. However, years of service in a particular firm is not a perfect indicator of a salesperson’s career stage. Also, the career stages model suggests that other psychological changes occur
as people move through their careers (e.g., shifts in goals or valences) that may affect the efficiency of different compensation and reward systems.

The demands imposed by different types of selling jobs (Moncrief 1986). Different types of selling jobs require different amounts of effort on different sets of activities (e.g., servicing current accounts vs. prospecting for new customers). Because those activities may involve different amounts of risk and produce different types of outcomes, a given compensation scheme may be more efficient for some types of sales jobs than others.

Differences in social norms and performance attributions across salespeople (Teas and McElroy 1986). The strength of norms such as "trust" or "organizational commitment" may moderate the use of commission schemes in a firm's total compensation package. Hence, measures of such norms, similar to those recently developed in the TCA literature (e.g., Heide and John 1992), might be incorporated into future agency studies.

Also, additional contractual variables reflecting the wide variety of incentives that firms offer—from bonuses to sliding commissions to job promotions—might be incorporated in future work. For instance:

- One important question concerns the conditions under which pay plans based on relative performance (as is the case in many sales contests) are superior to pay plans based on absolute performance, such as commissions or bonuses (Coughlan and Narasimhan, forthcoming).
- Job promotions have been examined as tournaments that provide incentives for good performance (Ferrall 1991; Green and Stokey 1983; Lazear and Rosen 1981), but the effects of promotion opportunities on performance have received little attention in a sales context.
- Questions about interactions among multiple rewards, and the optimal mix of rewards, also should be explored. As a first step in this direction, Coughlan and Narasimhan (forthcoming) found that the presence of promotion opportunities is related positively to the proportion of salary in salesforces' compensation plans.

Additional insights might also be gained by combining more traditional sales management variables with those of agency theory. For instance, Oliver and Weitz (1991) combined agency constructs with variables from an expectancy model of motivation. One interesting result is the finding that risk-averse salespeople who receive a high proportion of incentive pay actually experience an increase in motivation when they are uncertain about the relationship between effort and sales performance. The authors speculate that salespeople working under incentive plans may feel the need to achieve some minimum level of income, and that they are therefore motivated to work harder when confronted with uncertainty so that they can achieve that target level of income.

The previous work is also largely restricted to analyses of compensation plans for individual agents. Because of the growing use of team selling and the problems firms encounter in motivating and compensating such teams (Murray 1991), future extensions might examine how different compensation and control systems affect the performance of sales teams consisting of multiple agents with heterogeneous characteristics.

Finally, many other sales management issues besides the design of compensation plans might be examined within the agency framework. For instance, several organizational design issues might be addressed, such as:

- Whether to rely on external sales agents (e.g., manufacturers' reps) or to employ company salespeople. Using agency-based arguments, one might hypothesize that manufacturers' reps are preferable when uncertainty is high or when monitoring costs are high.
- The appropriate span of control for sales managers. Conditions favoring behavior-based contracts may also necessitate narrower spans of control.
- The appropriate basis for salesforce specialization (e.g., organization by customer type vs. product line). Such decisions are likely influenced by differences in environmental uncertainty and the ease of monitoring salesperson behavior.

Similarly, the hidden information model might provide insights on personnel issues, such as (1) the most efficient amount of screening for a firm to use when hiring new sales recruits, (2) the kinds of signals that best predict future selling success, and (3) appropriate criteria for selecting salespeople for promotion into management.

**Operationalization and measurement.** Much needs to be done to improve the operationalization and measurement of crucial agency constructs such as environmental uncertainty, reservation utility, and the goals and risk preferences of principals and salespeople. For example, a variety of different operational definitions of the "uncertainty" construct can be found in the literature. John and Weitz (1988) and others measure the construct in terms of the uncertainty of product sales. However, Oliver and Weitz (1991) suggest that a more appropriate definition in a sales context is the perceived uncertainty in the relationship between a salesperson's effort and the sales produced, and they employ multi-item scales to measure the construct.

A related problem is the measurement of risk preferences. Such preferences can be difficult to pin down in a survey setting. Researchers have tended to use a lottery technique in which subjects are asked to choose between risky alternatives and their certainty equivalents (e.g., Oliver and Weitz 1991), but such measures can have validity and reliability problems (Hauser and Urban 1979). One alternative for research purposes might be to manipulate such preferences experimentally. For example, Berg et al. (1986) induced different risk preferences (i.e., risk aversion and risk loving) in a laboratory setting by employing different
transformation functions. In a field setting, some analysts (e.g., Coughlan and Sen 1989) suggest that a firm might offer salespeople a menu of contracts with the same expected value and infer risk aversion from their choice of contract, thereby offering an opportunity for self-selection by salespeople. Indeed, Lal and Staelin (1986, p. 180) report that IBM and St. Regis Paper have offered such a menu of contracts to their salespeople and allowed them to select different compensation plans by prespecifying their expected sales volume for the next period. Finally, a more perplexing measurement issue involves finding ways to separate the effects of risk from other factors in a salesperson’s decision process (Dyer and Sarin 1982).

Measuring reservation utility, which corresponds to the “most desirable alternate employment” (Basu et al. 1985, p. 274) available to the salesperson, is also problematic. It often is estimated by examining wage rates for alternative jobs inside the firm or in other, similar firms (e.g., John and Weitz 1988) or for salespeople with similar seniority and education levels within the same industry (Coughlan and Narasimhan, forthcoming). However, monetary wages are conceptually very different from the utility an agent with specific characteristics and preferences might gain from an alternative job. One possible solution may be to develop multi-item measures of the perceived availability and relative attractiveness of alternative employment opportunities.

Another research problem is inconsistent levels of analysis between hypothesized relationships and the data used to test them. Though agency theory is basically concerned with relationships between individuals, much of the empirical work focuses on firm- or business-level variables, such as differences in the proportion of salary across firms’ compensation plans.

Some researchers have examined agency propositions at an individual level of analysis, but they have tended to rely on cross-sectional surveys (e.g., Oliver and Weitz 1991), some conducted within a single firm (Lal, Outland, and Staelin 1990). Those researchers admit that a more appropriate dataset for conducting such research “... would be longitudinal and include measures of the personal, environmental, and organizational factors postulated to affect the form of the compensation for each person” (Lal, Outland, and Staelin 1990, p. 9). In contrast, some researchers argue that the business level is a more realistic, and therefore appropriate, level of analysis to employ when studying variations in sales compensation plans even though it is inconsistent with the individual-level focus of agency theory. Their rationale is that person-specific compensation plans tend to be found only at top management levels and that most firms currently employ a single, homogeneous compensation plan for everyone in the salesforce (John and Weitz 1988). In any case, it is clear that researchers need to devote more thought to the problems involved in matching the conceptual focus of agency theory with the constraints of “mundane realism” (Berkowitz and Donnerstein 1982). Such problems may help explain why some agency theoretical propositions have received less than perfect empirical support.

Channel Coordination and Control

A distribution channel constitutes a set of agency relationships. The manufacturer depends on resellers to perform a variety of functions on its behalf, including the provision of shelf space, local advertising, point-of-purchase promotion, and implementation of an effective pricing strategy. However, differences in goals and preferences between a manufacturer and a reseller can lead to conflicts over how channel revenues and costs should be allocated among the participants and can produce incentive problems within the channel. If a powerful manufacturer attempts to increase profits by offering relatively low margins to a reseller, for instance, that reseller may not have adequate incentives to promote or price the product very aggressively. In turn, the reseller’s tendency to shirk by underpromoting or overpricing the product under such circumstances may lower sales volume and lead to a less than optimal amount of profit for the manufacturer.

A manufacturer might attempt to control the actions of the members of its distribution channel in several ways by making it incentive compatible for them to engage in actions consistent with the firm’s objectives. Such controls include pricing mechanisms, constraints on channel members’ freedom of action (e.g., promotional allowances), and franchising arrangements.

Pricing mechanisms. Current models suggest that incentive problems can sometimes be overcome through various types of pricing mechanisms. One is for the manufacturer to offer the reseller quantity discounts in order to increase marginal profit from selling additional volume and thus give the reseller more incentive to expend the effort needed to do so. A second approach for aligning the reseller’s incentives with the manufacturer’s objectives is for the manufacturer to set a “two-part tariff” consisting of both a wholesale price and a franchise fee. The wholesale price should

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9For a more detailed discussion of alternative measures of risk and risk preference, see MacCrimmon and Wehrung (1985).

10Likewise, retailers and wholesalers also depend on their suppliers to perform certain functions, but most of the literature to date has not examined issues from their perspective.

11For a more extensive survey of the economic research on channel relationships, see Rey and Tirole (1986b), Tirole (1989, ch. 4), and Katz (1988).
reflect only the true marginal cost of the product, whereas the franchise fee should constitute the man-
ufacturer’s share of the resulting profits. Because the franchise fee is fixed, the retailer is better off selling a larger volume of the product and is thus motivated to do so (Moorthy 1987).

Vertical restraints. It is often in a manufacturer’s interest for its retailers to engage in local advertising and promotion efforts aimed at stimulating demand for its brand. Retailers may be reluctant to undertake such efforts, however, particularly when a brand is distributed through several competing retailers and where promotional “spillovers” occur. It may not be incentive compatible for a retailer to promote a product aggressively in such circumstances because he or she is unable to capture the full benefits of such efforts. Some of the resulting sales will accrue to competing retailers. Worse, such situations provide a retailer with a motivation to “free ride,” to forgo promotional expenses while reaping the benefits of other retailers’ efforts.

One way a manufacturer might prevent its retailers from engaging in opportunistic actions in such situations is by imposing constraints on their behavior. Such constraints might (conceptually, at least) take the form of exclusive territory assignments or resale price maintenance. Such restrictions reduce the ability of a free-riding retailer to entice customers away from other retailers. Also, by limiting the competitive erosion of retail margins, they help ensure appropriate incentives to overcome spillover effects.

Work by Mathewson and Winter (1984, 1986) indicates that resale price maintenance—and sometimes exclusive territories—can work in conjunction with a two-part tariff to improve the efficiency of channels involving competing retailers and promotional spillovers, but no environmental uncertainty. However, other work indicates that the usefulness of vertical restraints is moderated by the level of environmental uncertainty, retailers’ risk preferences, and their governance properties. For instance, Rey and Tirole (1986) explore the impact of differing risk preferences on channel outcomes when there are no promotional spillovers among retailers, but when the environment is uncertain and there is information asymmetry (i.e., retailers have more information about local demand and retail costs than the manufacturer). Their findings indicate that when retailers are very risk averse, a manufacturer’s profits are greater when it allows unrestricted competition among those retailers than when it imposes either resale price maintenance or exclusive territories. Further, Dutta, Bergen, and John (1991) show that, from a manufacturer’s perspective, the governance properties (i.e., enforceability) of exclusive territories have a substantial impact on a channel’s profitability. They suggest that exclusive territories are more desirable when the dealers perceive a “longer shadow of the future” with respect to the manufacturer.

Functional incentives. Instead of trying to impose restrictions on its resellers, a manufacturer might resolve incentive compatibility problems in a channel by offering positive inducements in the form of functional incentives. Such incentives involve additional payments to the agent if he or she engages in a specific activity in the manufacturer’s interest. Examples include co-op advertising and promotional allowances. For instance, Bergen and John (1991) show that when there are promotional spillovers between retailers but no environmental uncertainty, promotional allowances can work in conjunction with a two-part tariff to improve channel efficiency.

Franchising agreements. Agency theory can also help identify conditions in which franchising leads to greater channel efficiency than do other alternatives, such as vertical integration. For instance, Brickley and Dark (1987) suggest that franchising is more efficient than using company-owned outlets when there is environmental uncertainty and when it is difficult for the manufacturer to monitor the behavior of individual outlets. Though company-owned outlets do not necessitate sharing profits with an intermediary, such profit sharing provides strong incentives for franchisees to operate efficiently. Hence, unless the company is able to monitor the behavior of local managers effectively, the increase in margin gained by direct ownership is not sufficient to offset the greater efficiency of franchisees. Brickley and Dark found empirical support for their propositions from a survey of 36 franchise organizations with 10,524 retail units where the geographic proximity of retail outlets to the manufacturer’s headquarters was used as a proxy for the ease of monitoring an outlet’s behavior.

In a supporting study, Norton (1988) used industry labor-output ratios and the proportion of a state’s population living in rural areas as proxies for a franchisor’s monitoring costs. His rationale was that monitoring costs should increase as a greater amount of labor is involved in an outlet’s operations and as greater geographic dispersion is necessary to cover a substantially rural population. As hypothesized, both surrogates for monitoring cost were related negatively to the incidence of franchising when examined across industries with aggregate data drawn from the U.S. Censuses of Retail Trade and Service Industries.

Agency research has also demonstrated that the incidence of franchising in a distribution channel is related positively to the expected value of the franchise to potential franchisees. Banerji and Simon (1991), in a study of 34 franchisors in the fast food industry,
found the proportion of franchised outlets in their channels to be linked positively to the value of the franchisor’s trademark, as measured by Tobin’s Q-ratio. They argue that the incentives for franchisors and franchisees are more closely aligned in channels where the value of the franchisor’s trademark is high because of the size of the future income stream the franchisee would lose should his or her contract be terminated for cheating.

Another franchising question that has been addressed involves the most appropriate terms of the franchise contract under various conditions. For instance, Mathewson and Winter (1985) and Lal (1990) demonstrate that incorporating royalty payments in a franchise contract is most desirable when actions taken by both the manufacturer and the franchisee have significant positive effects on retail demand. When a manufacturer’s actions have little effect on demand, it is better off offering a contract that incorporates a fixed initial franchise fee, quoting a wholesale price, and then monitoring franchisees’ actions.

Potential extensions. Though constructs from agency and related theories have been applied to a wide variety of channel issues, many research opportunities remain because most of the propositions that have been developed have gone largely untested. In addition, future research should attempt to incorporate a more detailed and comprehensive set of the variables that affect channel relationships. For example:

• Because most previous research is static, examinations of how solutions to agency problems in channels may vary over time are needed. Some analysts have begun to develop propositions about shifts in channel members’ behavior, and the appropriate incentives to direct that behavior, over time (e.g., Lambert 1983; Radner 1981, 1985), but those propositions have yet to be examined with longitudinal data. One approach for incorporating time into channel analysis is to examine whether price premiums offered by a manufacturer create incentives for its retailers to provide appropriate levels of service over time (Klein and Leffler 1981). Indeed, assigning exclusive territories may be one way to ensure such price premiums (Klein and Murphy 1988).

• Though many real-world channels involve resellers who handle products from multiple manufacturers, most agency models assume a single principal. Some analysts have begun to tackle the competitive issues that emerge when multiple principals deal with the same agent (e.g., Bernheim and Whinston 1985). For instance, there is some evidence that a manufacturer is more likely to distribute its product through retailers who carry competing brands than to integrate vertically when substitutability across brands is high because the retailer helps deflect competition among the manufacturers (Coughlan 1985; McGuire and Staelin 1983). Some analysts have also examined problems that emerge when multiple principals deal with multiple agents (Bergen 1990; Rey and Stiglitz 1988), but many such issues have yet to be examined.

• In most agency-based analyses, resellers are assumed to have little or no power in their dealings with the manufacturer. In these days of scanner data, mergers, and increased concentration among resellers, many channels are characterized by relative power distributions that are either balanced or skewed in favor of large resellers such as Walmart, Jewel, and Sears. Yet, most published work has not yet grappled with the complications that emerge when the agent is assumed to have power in relation to the principal. One possible step in this direction is suggested by the work of Jeuland and Shugan (1983, 1988), who treat channel members as symmetric partners, each making independent decisions and sharing the ensuing profits. Their findings suggest that quantity discount schedules can be an effective coordination device in such balanced power relationships. Future work might address reseller power by incorporating bargaining processes into the framework of the hidden action model (Dwyer and Walker 1981; Zussman and Elgar 1981) and by allowing for offers by agents as well as principals.

• Differences in social norms and performance attributions across channels may also affect the efficiency of various control mechanisms and incentives. Researchers have only recently begun to examine the effects of social norms such as “trust” and “commitment” within a channels context (Heide and John 1992). Such norms are likely to moderate the need for restrictive contractual arrangements, such as exclusive territories, and for complex incentive schemes like two-part tariffs.

Operationalization and measurement. As with the agency-based research on salesforce compensation, the research on channel relationships has shortcomings in the operationalization and measurement of common agency constructs, such as environmental uncertainty, reservation utility, and the goals and risk preferences of principals and agents. In addition, the proxy variables used to measure channel-specific constructs, such as monitoring costs, the value of the principal’s trademark, and promotional spillovers, have also been suspect.

For example, Brickley and Dark’s (1987) reliance on geographic proximity and Norton’s (1988) use of labor intensity and population dispersion as indicators of a manufacturer’s ability to observe the behavior of retail outlets all seem questionable in the presence of scanners and computerized inventory control systems. Similarly, Banerji and Simon’s (1991) use of Tobin’s Q-ratio as an indicator of the value of a manufacturer’s trademark can be questioned because it is influenced by several other factors not controlled in their study. Yet another measurement problem is illustrated by the work on promotional spillovers. For instance, Bergen and John (1991) assume that industrial products have fewer spillovers than consumer products because intermediaries are less likely to promote such products through mass media. Though their assumption may be valid, it yields a rather gross and uncalibrated measure of the construct.

Agency research on channel relationships also has some of the same level-of-analysis problems encountered in other subject areas. Agency theory is concerned with relationships between individual firms,
but at least some of the empirical research has attempted to test agency propositions with aggregate data on differences in channel structures across entire industries (e.g., Norton 1988).

Many of the operationalization and measurement problems arise from the fact that much of the research in the channels area has relied on secondary data to test agency-based propositions. Hence, more field surveys and the use of more specific measures developed by sound psychometric techniques should help resolve some of these problems. Laboratory studies would allow direct manipulation of agency constructs that are difficult to measure or control in field settings, such as risk preferences, reservation utilities, and relative power. Because marketing has a history of laboratory studies of channel issues (e.g., Dwyer and Walker 1981; Eliashberg et al. 1986), established techniques can be melded with related work in experimental economics (e.g., Berg et al. 1986) to develop more useful methods for studying agency-based propositions in a channels context.

**Consumer Promotion and Competitive Signals**

When customers make purchase decisions, they search for information about alternative brands. This search may include personal and noncommercial sources of information, but it is also likely to incorporate information from the manufacturers, distributors, or retailers who are competing for the customer’s business. After all, the producer of a high quality brand has information about the product that customers might find useful and that would be in the producer’s self-interest to share with potential buyers. Unfortunately, producers of inferior brands might be motivated to mislead customers into believing that their products are better than they actually are by heavily promoting their brands or engaging in puffery. The crucial question for a manufacturer, then, is whether the costs and revenues associated with a particular promotional activity make it a valid and efficient signaling mechanism for helping potential customers differentiate between high quality brands and their inferior competitors. This question can be analyzed as a hidden information problem in which the customer is viewed as a principal who must choose among several alternative agents (manufacturers).

In general, agency models suggest that the size of promotional expenditures can serve as an efficient signal of product quality. Nelson (1974) was one of the first to suggest that the volume of advertising could provide such a signal. More recent models show that promotional investments can work in conjunction with high prices (Milgrom and Roberts 1982) and investments in expanded production capacity (Devinney 1988) to efficiently signal high product quality. Indeed, price alone can serve as a signal of product quality, as Davis (1991) shows in a world with both hidden information and hidden action problems.

Though a high price can signal high quality, it can also provide an incentive for the manufacturer to maintain the quality of its product over time. Klein and Leffler (1981) used a repeated hidden action model to examine the price premium that high quality manufacturers must receive to make it incentive compatible for them to continue producing a high quality product rather than maximizing profits in the current period by skimping on quality while charging a high price. Consumers may stop buying a manufacturer’s goods if they discover that it has begun to lower quality. Thus, if the quality premium is high enough, the expected future revenue loss due to skimping on quality will exceed the additional profits to be gained in the current period.

Recently, a few tests of agency-based propositions about signals of product quality have begun to appear. For instance, Rao and Monroe (1991) recently developed several propositions about the conditions under which suppliers are most likely to use price premiums to signal product quality. For example, they suggest that such premiums are likely to be used when

- the product’s quality is relatively difficult to evaluate objectively prior to purchase,
- prospective purchasers are relatively quality conscious, and
- the seller does not have a well-established reputation for quality.

In a subsequent attempt to test those hypotheses, Rao and Bergen (1991) collected perceptual data from 149 senior purchasing executives in a variety of industries. Their evidence provides support for most of the propositions.

**Potential extensions.** Though several different potential signals of quality have been examined, the work to date has only scratched the surface of the wide range of promotional tools—and combinations of tools—available to marketers. Moreover, those alternative tools may vary both in their value as signals and in the agency costs to the manufacturers who use them. For example:

- Some evidence suggests that an extensive warranty can serve as a signal of a product’s quality (Wiener 1985). From the manufacturer’s perspective, however, such warranties can pose a potential hidden action problem because they make it more vulnerable to possible abuses by buyers. Customers may be less likely to treat the product with proper care and may rely on the extensive warranty to compensate for any resulting product failure, thus increasing the manufacturer’s warranty costs. Cooper and Ross (1985), among others, employed a combination hidden information and hidden action model to explore efficient ways to balance the signaling value of warranties against the potential costs of customers’ hidden actions.
• Similar cost-benefit tradeoffs might arise with a variety of other potential signals of product quality, such as various types of consumer promotions and joint branding (i.e., the promotion of brand-name component parts or ingredients, as in Diet Coke with NutraSweet).

Though most signaling models are static, the impact of a given signal of product quality may change over time as potential buyers gain access to additional kinds and amounts of information. Hence, an obvious extension is to examine changes in the efficiency of a given signal over time. As a first step in this direction, Bagwell and Riordan (1991, p. 224) used a variety of hidden information models to examine the fact that "the rank-order correlation between price and quality is declining over time . . . [that] firms signal high-quality new products with prices that are above full-information, profit-maximizing prices . . . [and that] . . . over time, as information about the product diffuses, this price distortion lessens or vanishes entirely." Thus, future research might examine how price-quality relationships change as the amount of various types of information available to customers changes over time (e.g., the publication of a Consumer Reports evaluation, the cumulative effects of advertising, etc.).

Though most of the work on signaling concerns manufacturers' efforts to influence the current behavior of potential customers toward current product offerings, signals also can be aimed at shaping future behavior of potential customers as well as other audiences. Agency theory provides a framework for improving our understanding of the circumstances in which such signals are most likely to be employed and their impact on the behavior of various groups. For instance:

- A manufacturer might preannounce the future introduction of a new product in an attempt to persuade potential buyers to postpone purchase decisions until it is available or to increase their predisposition to buy it. However, such action risks retaliation by competitors. A recent study by Eliashberg and Robertson (1988) found managers are most likely to preannounce new products when they perceive (1) their firms to be small and without market dominance in the product category, (2) the competitive situation to be relatively noncombative, and (3) the new product to involve substantial switching costs, and therefore an extensive decision process, for potential customers. To date, however, little is known about the impact of such preannouncements on customers' subsequent purchase decisions (Farquhar and Pratkanis 1986), firms' sales performance, or the reactions of their competitors.
- Similar questions might be examined for preannouncement signals of other marketing actions, such as forthcoming price or distribution changes.
- Signals of a firm's planned future actions may be aimed at influencing the behavior of other audiences in addition to customers and competitors, such as members of the salesforce or the distribution channel. Therefore, future research might focus on the audience-specific rationale and impact of such signals.

Agency theory provides a useful framework for examining the efficiency of various market signals, but it is somewhat constrained by its economic foundations and its implicit assumptions about the "economic rationality" of customers and other audiences. For instance, the theory assumes that the essential value of advertising is in providing functional information to the customer and largely ignores other psychological outcomes, such as perceptions of a brand's image and positioning. One contribution marketers might make, then, is to incorporate social and psychological factors that influence the interpretation of and behavioral responses to different signals by customers, competitors, and other audiences. For instance:

- Heil (1988) offers some evidence that a receiver's evaluation and interpretation of a given signal is influenced by such factors as (1) the signal's clarity, (2) its compatibility with related signals, (3) the credibility of the sender, and (4) the perceived commitment behind it (e.g., building a new plant in support of a new product preannouncement). However, other factors affecting the encoding of different types of signals, the attention paid to them, and the responses they provoke among different audiences have received little attention.
- More specifically, though agency theory suggests that investments for large-scale production are a signal of high product quality, such investments might also reduce consumers' perceptions of the product's uniqueness and social prestige, particularly if the product is an expensive durable good (Jacobson and Aaker 1987).

Operations and measurement. Researchers working on signals in a marketing context will have to wrestle with many of the same problems in operationalizing and measuring underlying constructs that researchers face in studying salesforces and channel relationships. An additional problem arises in this area, however, because of the fact that "objective" measures of such factors as product quality and price premiums are needed as benchmarks for evaluating the validity and efficiency of various signals. For example, though Wiener (1985) and others have used ratings from Consumer Reports as an objective measure of quality, considerable debate continues about the definition and measurement of the construct (e.g., Holbrook and Corfman 1985).

In view of such measurement difficulties inherent in studying signaling phenomena with secondary data or field surveys, laboratory experimentation may provide a useful alternative. Such research could build on the methods and measures developed within the marketing literature on the price-quality relationship (e.g., Rao and Monroe 1988, 1989) and in relevant research in experimental economics (e.g., Lynch et al. 1986; Palfrey and Romer 1986).
Unexplored Agency Applications in Marketing

In addition to the many opportunities to extend and empirically test agency applications in topic areas that have already been addressed, entire topics within marketing are amenable to agency analysis but have received little or no attention. Promising areas for future applications include aspects of international marketing, industrial buying behavior, and issues involving advertising agencies.\(^{13}\)

**International Marketing**

Because cross-cultural differences magnify the problems of uncertainty, asymmetric information, and monitoring, efficient agency relationships can be even more difficult to achieve in multinational markets than in domestic markets. To date, however, agency-based research has examined the relative efficiency of only two of the many organizational mechanisms firms might employ for entering foreign markets—licensing and direct investment (Horstmann and Markusen 1987; Senbet and Taylor 1986).

Licensing enables the manufacturer to share the risk inherent in an unfamiliar foreign environment and to take advantage of the licensee’s greater information about local conditions. However, the information asymmetries inherent in licensing arrangements and difficulties in monitoring a licensee’s behavior may enable a licensee to free ride on the licensor’s reputation by letting product quality slip and thereby lowering costs and increasing profits. Under such conditions, a manufacturer may need to offer additional incentives to the licensee, or engage in extensive monitoring activities, to maintain the quality of the licensed brand.

In contrast, though direct investment involves greater upfront costs and exposes the manufacturer to greater risk, it also provides greater control over the quality of output. In addition, it can help increase local customers’ information about the firm’s product and provide them assurances of product quality (Senbet and Taylor 1986).

Given that only two foreign market entry modes have been examined within an agency framework, an obvious direction for future development is to investigate a broader range of entry options—such as the use of independent export or import agents—and the conditions and contractual variables that affect their relative efficiency. Analyses of other forms of “strategic alliances” between multinational firms, such as joint R&D and product development agreements, are also needed.

**Industrial Buying Behavior—Reciprocity**

Industrial purchasing often involves obtaining large quantities of technically complex products from a small number of alternative suppliers. These task characteristics increase the uncertainty and risk for the buyer and enhance the potential for hidden information and hidden action problems in relationships with suppliers. Hence, industrial buyer behavior is a fertile field for analysis from an agency theory perspective.

One example of a behavior pattern seen in industrial purchasing that might be examined with agency theory is reciprocity, whereby a firm gives preference to a supplier who is also a customer for the firm’s products. Marketers offer several explanations for this phenomenon (e.g., Moriarty 1983), but reciprocity might be seen simply as an attempt to attenuate potential agency problems. It may be difficult for a buyer to determine whether a supplier is expending a proper amount of effort to control and maintain the quality of the products and services. The establishment of trade relations with a supplier helps align the interests of the two parties because the supplier then becomes a customer for the purchaser’s output. This approach may be an efficient organizational response if it reduces the purchaser’s screening and monitoring costs.

**Advertising Agency–Client Relationships**

Relationships between firms and their advertising agencies face a variety of agency problems. Concerns cited in the literature include excessive agency turnover (Hagopian 1985), disagreements over objectives, the development of conflicting accounts by agencies (Wackman, Salmon, and Salmon 1987), and inefficient incentive and control systems (Calantone and Drury 1979).

The agency turnover problem is one good example of an issue that might be usefully addressed with agency concepts. At least a part of this problem can be traced to inadequate screening and selection procedures, which lead clients to select agencies that later turn out to be unsatisfactory. It also raises a closely related question about the efficacy of various signals of agency quality.

The agency compensation problem is another issue that is ripe for agency analysis. Difficulty in objectively measuring the outcomes of advertising campaigns has forced clients to rely heavily on behavior-based methods for controlling their agencies. The traditional advertising commission structure, for instance, ties agency compensation largely to media purchases. However, this system does little to control

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\(^{13}\)Agency theory might be applied to many other more narrowly focused marketing issues. For instance, the hidden information model could help answer questions about how industrial purchasers choose suppliers, how not-for-profit organizations can efficiently signal potential donors about the quality of their programs during fund-raising efforts, and how donors might efficiently screen the many organizations seeking support. Unfortunately, space limitations preclude a discussion of such issues.
the creative quality of the ads placed in the media and it exacerbates goal conflicts by making it in the agency's self-interest to argue for larger advertising budgets, even when such budgets might not be strategically justified.

Consequently, firms have recently adopted a variety of monitoring schemes for better evaluation of their agencies' actions and they have sought new compensation methods to align agency incentives better with their own objectives (Calantone and Drury 1979). For example, DDB Needham has announced an outcome-based commission plan that "asks clients to re-ward the agency with payments equalling as much as a 20 percent commission when sales exceed preset goals, and to penalize it with sharply reduced compensa-tion—or none at all—if goals aren't met" (Levin and Lafayette 1990). Such a compensation plan would shift some risk from the client to the agency, but the fact that sales volume is affected by many other variables besides advertising makes it difficult to measure objectively the outcomes of an agency's performance. Thus, the proposed plan might be an inappropriate type of control mechanism—a concern expressed by several of Needham's competitors.

In any case, the efficiency of Needham's proposal, and of most other attempts to resolve the many ongoing problems involved in advertising agency-client relationships, has yet to be examined. The issues in this area afford many opportunities to apply agency theory.

**Conclusions and Implications**

Our review of agency applications suggests that agency theory can contribute much to our understanding of a wide range of marketing issues. Throughout our article, we suggest specific areas in which the theory might profitably be applied or extended. However, one general principle seems to underlie all of those suggestions: agency theory is likely to prove most useful for examining situations characterized by factors unique to the theory—factors that make contracting with and controlling the performance of agents especially difficult. Hence, the theory might be used most productively to examine situations involving (1) substantial goal conflict between a principal and its agents, (2) sufficient environmental uncertainty to trigger the risk-sharing implications of the theory, (3) substantial information asymmetries, and/or (4) difficulty in evaluating performance (e.g., creative, team-oriented, or long-term marketing activities).

**The Theory's Limitations**

Our review also suggests that agency theory has some limitations as a vehicle for improving our understanding of marketing phenomena. Some of those limitations are inherent in the scope and structure of the theory itself, whereas others may be more a reflection of the early stage of its application within the marketing discipline.

Agency theory's origin in economics is a source of conceptual strength as well as a cause of some of its inherent limitations. As Hirsch, Michaels, and Friedman (1987) argue, economic theories have the advantage of carefully developed assumptions and logical, internally consistent propositions. In addition, they incorporate variables and concepts that have been given relatively little attention in other behavioral sciences, such as the notions of risk preferences, the behavioral consequences of risk sharing, and information asymmetries found in agency theory.

On the other side, however, Hirsch and his colleagues argue that economics is dominated by a single paradigm, price theory, and a single view of human nature, self-interest. This narrowness of focus aids the internal consistency of economic theories, but it also limits their usefulness for fully understanding many marketing phenomena, phenomena that are often affected by a variety of human motives and complex webs of contingency variables. Because agency theory's narrow focus and rigorous structure make it difficult to analyze such complexity, "pure" applications of the theory in marketing have had to center on only the simplest cases or to assume away many of the variables that complicate the decisions faced by marketing managers. Consequently, it is not surprising that many potential extensions and new applications of agency theory in marketing call for examinations of more complex situations and the incorporation of a broader range of variables.

Another shortcoming of past agency theory applications is the paucity of rigorous testing. Though the evidence is encouraging, it is insufficient to resolve questions about the theory's external validity or the generalizability of its propositions. Also, some results must be viewed with caution because of problems in the operationalization and measurement of key constructs. Those problems are exacerbated in some studies because they examine agency propositions at inappropriate levels, testing individual-level models with corporate- or industry-level variables. Some of the more common measurement and analysis problems identified throughout our review are summarized in Table 3, together with some suggestions for alternative approaches that might be used in future agency research.

**Marketing Implications**

Though agency theory's shortcomings present problems, they can also be viewed as attractive opportunities for marketing researchers. Not only are there many ways in which marketers might contribute to the further development of the theory, but the actions that
TABLE 3
Selected Measurement and Analysis Problems in Agency Research

<table>
<thead>
<tr>
<th>Problem</th>
<th>Possible Alternative Approaches</th>
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<tr>
<td><strong>Level of Analysis</strong></td>
<td>Some argue that business-level data are most &quot;realistic&quot; because most businesses employ a single compensation program for all salespeople (e.g., John and Weitz 1988).</td>
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<tr>
<td>Use of corporate- or SBU-level data to test individual-level models of salesperson behavior (e.g., Eisenhardt 1985; John and Weitz 1988)</td>
<td>Examination of individual differences in preferences for and responses to different compensation plans is more consistent with conceptual focus of agency theory:</td>
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<td></td>
<td>• Evaluate alternative plans offered with a single company (e.g., Lal, Outland, and Staelin 1990).</td>
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<td>• Use choice of employer and employer's current plan as proxy for employee's preferences.</td>
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<td></td>
<td>• Explicitly measure individual's preferences for alternative plans, satisfaction with current plan, current motivation level, etc. (e.g., Oliver and Weitz 1991).</td>
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<tr>
<td>Use of industry-level data to test company-level hypotheses (e.g., Norton 1988)</td>
<td>Relate differences in channel structures and/or control mechanisms to differences across firms in a single industry (e.g., Banerji and Simon 1991).</td>
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<td></td>
<td>Examine the impact of a broader range of environmental contingency variables by examining differences in channels or contracts employed by individual firms operating in a variety of different industries and/or product categories (e.g., Bergen and John 1991).</td>
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<td>Develop multi-item or rating scales of perceived product quality, supplier reputation, price premium, etc. (e.g., Rao and Bergen 1991).</td>
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<td><strong>Time Frame</strong></td>
<td>Develop hypotheses based on dynamic agency relationships (e.g., Klein and Leffler 1981; Klein and Murphy 1988; Rao and Monroe 1991).</td>
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<td>Reliance on static models and cross-sectional studies to examine agency relationships that likely change over time because of changing situational factors and incomplete contracting</td>
<td>Evaluate changes in channel structures or relationships over two or more discrete time periods (e.g., Banerji and Simon 1991).</td>
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<td></td>
<td>Longitudinal examinations of interactions between incentives offered by principals and behavioral responses of agents would be the ideal, though perhaps not always practical, design for field studies of agency problems.</td>
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<td></td>
<td>Laboratory experiments with multiple trials can be used to stimulate dynamic agency relationships within controlled settings.</td>
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<tr>
<td><strong>Operationalization and Measurement of Key Constructs</strong></td>
<td>Subjective measures of the uncertainty perceived by individual agents, such as the perceived uncertainty in the linkage between individual effort and job performance, might be used in conjunction with more objective financial measures (e.g., Oliver and Weitz 1991).</td>
</tr>
<tr>
<td>Aggregate economic measures of environmental uncertainty, such as historical variance in a firm's financial performance, may not adequately capture the psychological dimensions of the construct from an individual agent's perspective</td>
<td>Risk preferences might be inferred by allowing agents to self-select from a menu of alternative contracts within a single environmental setting (i.e., level of environmental uncertainty; e.g., Coughlan and Sen 1989).</td>
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<tr>
<td>Lottery techniques for measuring agents' risk preferences, where respondents are asked to choose between risky alternatives and their certainty equivalents (e.g., Oliver and Weitz 1991), can have low reliability and validity</td>
<td>Variations in risk preferences might be manipulated in laboratory settings by employing different transformation functions (e.g., Berg et al. 1986).</td>
</tr>
</tbody>
</table>
Most need to be taken also happen to fit well with marketers' distinctive competencies. Thus, a marriage between agency theory and marketing offers some promise for wedded bliss—or at least for a mutually beneficial union.

The marketing discipline has a long and productive tradition of creatively borrowing, adapting, and synthesizing constructs from a variety of social sciences to obtain multiple perspectives and richer frameworks for understanding complex marketing phenomena. Given that agency theory provides only a partial view of the world, there are many opportunities to meld agency constructs with those adapted from other theories—and from our own empirically acquired wisdom—to achieve a more thorough understanding of complicated marketing relationships.

Such synthesis is likely to necessitate sacrificing some of agency theory's internal consistency and rigor, but improvements in external validity and explanatory completeness should make such sacrifices worthwhile.

Similarly, marketers have much experience in coping with the complexities of doing research with real-world consumers and organizations. Given the nature of many of the shortcomings of current agency-based research and the strong traditions within the marketing discipline for careful measurement, survey research, and experimentation, our greatest contribution to the further development of agency theory may involve finding more appropriate ways to test current propositions within meaningful marketing settings.

REFERENCES


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