Anti-bribery control and incentives as agency theory approaches

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Abstract

This article takes an agency theory approach towards bribery in multinational corporations. In particular, it is advocated that incentives could help to align the interests of principals and agents and reduce information asymmetries. This could help to increase anti-bribery compliance and hence support the fight against corruption in Eastern Europe.

Keywords: Bribery, Corruption, Agency Theory, Compliance.

Introduction

Agency theory is theoretical approach that assumes that humans are self-interested, and that "principals" and "agents" have differing interests (Eisenhardt, 1989a: 59). It is a suitable theoretical approach for this study as it takes both information asymmetry and incentives into account. When it comes to bribery, employees' actions are often unobservable to multinational corporations' shareholders (Wang, 1997: 72). It is assumed that the shareholder (principal) and the employees (agents) have conflicting interests and that their relationship is governed by a contract (Eisenhardt, 1989a: 58 f.). In this context, agency theory is often used to reduce uncertainty (Nilakant & Rao, 1994: 667).

Agency theory's key initiative is to improve the efficient organization of information and to reduce risk-bearing costs. The unit of analysis is usually considered to be a contract between principals and agents (Eisenhardt, 1989a: 59). For the purpose of this study, employment contracts, which typically also include compensation schemes, are considered the unit of analysis. This is because most incentive schemes in multinational corporations are integrated into individual employee contracts.

In agency theory-based approaches, it is generally presumed that humans are self-interested, risk averse, and characterized by bounded rationality (Eisenhardt, 1989a: 58). Agents are thought to care more about their own interests than about the ones of their principals, and may have a different level of risk awareness. While a principal may be against paying bribes, agents might be willing to do so if it benefits them. This is particularly true if an agent's expected utility is high enough and the principal is forced to carry the risk of the agent's misbehavior.

Furthermore, according to this viewpoint, relationships are generally marked by moral hazard, adverse selection, and risk sharing (Ross, 1973: 134). Anti-bribery incentive systems are concerned with all three of these aspects. They most probably force the agent to act in the principal's best interest. Additionally, agents inclined to pay bribes are presumably not going to select a position in which a significant portion of their salaries is going to be based on their compliance with anti-bribery rules. Finally, agents also start to share their principal's risk; if their principal faces difficulties because the agent paid a bribe, the agent's salary is going to be negatively affected too.

This theoretical approach is suitable for the purpose of the present study as managers and shareholders (principals) presumably do not want their employees (agents) to pay bribes, not least as doing so could expose a multinational corporation and its principals to existential risks. Agents, at the same time, are potentially interested in paying bribes since it can help them increase their performance and hence receive desirable benefits, such as job promotions and bonus payments. Consequently, it is clear that there is a conflict of interests between the agents' and the principals' goals. For the principal, it is often difficult to verify whether a bribe has been paid. After all, agents often conduct their business without the presence of their principals. In addition, agents will not want their principals to find out about the payment of bribes and will therefore make an effort to hide any such illegal actions from their superiors. However, it has been suggested that agency problems could be mitigated through suitable management and corporate structures (Dharwadkar et al., 2000: 665). To try to solve agency conflicts in firms, multiple mechanisms, such as a competent board of directors, can be employed (Bathala & Rao, 1995: 60). Furthermore, note that the analytical tools provided by agency theory—namely, information asymmetry and control mechanisms, as well as goal alignment—are also very suitable for the requirements of this study (Gomez-Mejia & Balkin, 1992: 951). Specifically, one of the major issues within corporate corruption is a lack of transparency: it is often impossible to know whether a bribe has been paid. This article explores the impact of various incentives on anti-bribery agency problems.

Prior research in the field suggests that compensation schemes can partly help to redress agency problems (Fama, 1980: 306). For example, it has been found that the perceived effectiveness of subsidiaries tends to go up if the compensation mix takes agency problems into account (Roth & O'Donnell, 1996: 697). In fact, it has been suggested that agency theory provides a particularly useful theoretical framework for the examination of the relationship between monetary compensation and performance in areas with significant discretionary judgment, such as middle management and sales. This is because agency theory provides a broad set of analytical tools, such as different perspectives, that can be adjusted to a large variety of situations (Gomez-Mejia & Balkin, 1992: 951).

Within multinational corporations, agents often act as representatives for their principal and are granted decision-making power. Moreover, this set of circumstances is inevitable for many positions vulnerable to bribery, such as sales departments. Although delegation is generally considered to be necessary, it also creates considerable uncertainty (Worsham et al., 1997: 422), which is made worse by the preconception of agents as opportunists who might abuse any power given to them by the principal (Abrahamson & Park, 1994: 1304). One of the key problems identified by agency theory is that an agent might engage in short-run actions that will ultimately harm a corporation's value (Donaldson & Davis, 1991: 50)—ultimately, agents are presumed to be self-interested individuals (Wright et al., 2001: 414). Principal–agent relationships are often deemed problematic in this sense since the former bears responsibility for the outcome of a task that has been delegated to the latter (Ross, 1973: 134). This is particularly true if the agent is unsupervised (Wright et al., 2001: 426), as, for example, they might shirk or use the corporation's resources for their own benefit (Gomez-Mejia & Balkin, 1992: 923). Often, the principal and the agent will have different goals or attitudes toward risk, and it is difficult for the principal to verify the agent's behavior (Hill & Jones, 1992: 131 f.; Eisenhardt, 1989a: 58). Accordingly, it is important to implement appropriate control mechanisms. However, since a principal cannot supervise all agents at all times, it is also important to align the agents' interests with those of their principal. In particular, it needs to be ensured that an agent has the right incentives and that these make him or her act in their principal's best interest.

Congruently, many agents will also want to be compensated for acting in accordance with their principal's best interests (McColgan, 2001: 6). This study focuses on incentivizing employees to act in their principal's best interest specifically with regard to anti-bribery compliance. It has been established that incentives can help to ensure that the agent maximizes their own utility without compromising their principal's needs (Jensen & Meckling, 1994: 41). Additionally, incentive systems seem to be particularly valuable if an agent's actions are unobservable and marked by moral hazard (Reichelstein, 1992: 727). Linking an anti-corruption program to an incentive system can prevent employees from simply reducing their risk and forcing the owners to bear a bigger share of it (Tosi & Gomez-Mejia, 1989: 169).

If suitable utility function and payoff schemes are chosen, the impetus to increase agents' motivation should not necessarily conflict with the attainment of "Pareto efficiency" with respect to an optimal allocation of resources (Ross, 1973: 138). Therefore, the argument that paying for compliance is per se inefficient and not affordable should not be accepted without hesitation. The individual costs depend on an organization's current circumstances, though, and determining such ideal utility functions and payoff schemes can be rather challenging in practice.

Moreover, aligning agents' interests with those of their principals is only feasible up to a certain extent. Therefore, internal audits and control mechanisms are also often used to address agency problems (Adams, 1994: 12), but further analysis is required regarding whether these control mechanisms can be improved. From an agency theory perspective, information is considered a purchasable commodity, and, as such, could help to decrease any information asymmetry between principal and agent (Ross, 1973: 134). In this context, peer-to-peer monitoring should not be underestimated (Shapiro, 2005: 270), whereby a principal could purchase information about certain agents from other agents.

In addition, the present study proposes to differentiate between first-order and second-order incentives. First-order incentives are intended to increase an employee's own compliance; a bonus for complying with anti-bribery training would fall into this category, for example. Second-order incentives go one step further: they should incentivize employees to not only comply with all rules and regulations but also to ensure that everyone else is also acting in a fully compliant way.

While most agency problem theorists regard shareholders as principals and boards of directors as first-order agents, this study will consider both as principals (Lan & Heracleous, 2010: 302), as the analysis needs to extend beyond the simple relationship between shareholders and managers and to take all employees into account (Arthur et al., 1993: 95). Furthermore, not differentiating between a board of directors, which is responsible for ensuring that adequate compliance procedures are implemented, and employees, who are supposed to follow these compliance procedures, would be too superficial and hence detrimental for the purposes of this study. In addition, a board of director's interest in meeting all legal regulations is even higher than shareholders' interest in compliance. This is because, while shareholders will suffer financial threats if their company is sanctioned for illegal actions, the board of directors will suffer both financial and legal consequences—members of the board of directors could even have to serve a jail sentence if they fail to implement adequate compliance procedures.

Hence, this study focuses not only on the (top-)management level but also on the lower levels of corporate hierarchy. Accordingly, any employee who could either pay a bribe or witness someone else is paying a bribe is considered to be an agent. Shareholders and members of boards of directors are referred to as principals as it is presumed that they will not have an incentive to engage in illicit behavior.

A review of the above-proposed categorization of principals and agents, however, suggests that it is vulnerable and might not be applicable under certain conditions. For example, a major shareholder with a predisposition for illicit behavior and a significant influence on the board of directors or the senior management team could foster bribery. Also, members of the board of directors could be either unaware of or indifferent toward the risks resulting from bribery and hence tolerate or even stimulate illegal behavior. In both scenarios, the proposed categorization would be inapplicable. However, it should also be noted that both scenarios are rather unlikely. Major shareholders looking for more risk could easily achieve their goal in a legal way by including derivatives in their portfolio; they do not need to engage in illegal behavior in order to increase their potential performance. Moreover, it can reasonably be assumed that the overwhelming majority of boards of directors are aware of the risks resulting from bribery and want to minimize them. In addition, corporate governance mechanisms, such as audit committees, help to ensure that boards of directors fulfill all the applicable legal standards. Hence, it can be concluded that, while there are always going to be black sheep and exceptions to the rule, in most cases, the agency and principal categorization outlined above should be suitable for use in most multinational corporations' cases.

Before proceeding to a more detailed analysis of the first-order and the second-order incentives, it should also be acknowledged that agency theory itself has several important limitations. Firstly, it often fails to take behavioral aspects into account (Kunz & Pfaff, 2002: 292). For instance, interpersonal relationships between principals and agents could significantly influence the latter's behavior: if a sales manager has been in a long-lasting and rewarding friendship characterized by mutual trust with their principal, they might be more willing to accept the principal's new anti-bribery compliance program.

Secondly, not every organizational challenge can be considered an agency problem. For example, principals and agents may have the same goals and thereby avoid any conflict of interests (Gomez-Mejia & Wiseman, 2007: 82), particularly if the agent also aims to reduce bribery. However, since incidents of bribery are still occurring rather frequently, it cannot presumed that all agents are against bribery and act accordingly. Thirdly, it should also be considered that a risk-averse agent might not be optimally incentivized by an accounting-based performance evaluation, as such a system passes the risk to the agent, which they might not consider to be a particularly attractive prospect (Ekanayake, 2004: 52). Moreover, it has been suggested that agency theory's ability to predict behavior in high-risk situations may be rather limited (Stroh et al., 1996: 762). However, the idea of passing risk to the agent could also positively impact the recruitment process, as an agent presumably knows whether they are going to pay bribes and hence can estimate the potential impact of accepting a scheme that passes the risks associated with bribery to them.

A fourth limitation to the theory is that it is difficult to identify agents who cheat if the only observable output is achieved by a team, which can in fact lead to significant free riding (Holmstrom, 1982a: 325). Since many anti-bribery compliance tasks are team based, this limitation needs to be kept in mind when designing performance measurement aspects of incentive systems.

Finally, cultural differences should also be acknowledged, as they can lead to diverse reactions to incentive systems in different cultural settings. For instance, Eastern cultures have been observed to have a stronger preference for behavior-based contracts than Western cultures (Johnson & Droege, 2004: 334 f.). Accordingly, one should be mindful of the possibility that agents with dissimilar cultural backgrounds might act differently. However, agency theory fails to account for behavioral aspects and cultural differences and is thus considered to be a simplified depiction of the reality. Nonetheless, it remains the most suitable approach to use in the present study, as it is the closest theory to practice regarding compliance and non-compliance in multinational corporations. Slight adjustments may need to be made to agency theory, though, in order to optimize its suitability for the purposes of this study.

In fact, some of the above-detailed limitations can partly be addressed through the introduction of changes to the agency theory. For instance, it has been suggested that integrating trust-embedded economic theories might broaden agency theory's scope of application and improve its validity. However, due to legal constraints, such an adaption would not be suitable for use in this study: while trust may play an important role in fostering anti-bribery compliance from a purely organizational perspective, in the case of a violation, there would be considerable legal concerns and risks if the affected multinational corporation had to admit that its anti-bribery policy was in fact based on trust. Furthermore, while uncertainty and the resulting agency problems might also be reduced through social and cultural means, this study is going to focus on contractual instruments (Nilakant & Rao, 1994: 657).

Thus, despite these limitations, agency theory still seems to be the most suitable theoretical approach for use in this study. Although stewardship theory, which argues that employees' objectives are aligned with those of their principals, is often more applicable for analyzing managerial behavior than agency theory, for this study, a control-based approach seems to be more appropriate than a collaborative one (Davis et al., 1997: 21; Fox & Hamilton, 1994: 78). Stewards commonly expect service and advice instead of control and discipline from their board (Sundaramurthy & Lewis, 2003: 398), and such a lack of control could be disastrous for compliance systems and lead to substantial legal issues. Nevertheless, it is acknowledged that, for increasing agents' motivation for other tasks, such as increasing returns on equity, stewardship theory might lead to better results than agency theory (Donaldson & Davis, 1991: 62). This seems to be particularly true in relation to managers. However, since this study focuses on a broader group of employees and, due to legal constraints, it has to take control mechanisms into account, agency theory appears to be more appropriate.

Institutional theory was also discounted as being less appropriate than agency theory for use in the study. In contrast to the agency theory, which presumes that employees are self-interested and rational human beings, institutional theory suggests that members of a corporation seek legitimacy and thereby want to engage in behavior that is generally accepted by the organization. Hence, institutional theory is often used to ensure that agents' and principals' interests do not diverge (Davis et al., 1997: 20 f.). However, since institutions are influenced by separate rules, such as societal values, and their members often try to conform to such external norms, it is important to ensure, through sufficient governance mechanisms, that an "anything goes" culture cannot be developed (Eisenhardt, 1988: 491; Kulik, 2005: 349). After all, corruption might be accepted by wider society in certain parts of the world but multinational corporations still cannot allow it. Herein, institutional theory highlights the role of normative influences in decision making in multinational corporations (Tolbert & Zucker, 1999: 186). For instance, if social norms suggest that corruption is tolerated, employees might rather live up to these social norms than to compliance policies that have been drafted at the company headquarters at the other end of the world. Ultimately, while corporations can often benefit from a combination of both agency and institutional theory, concerning compliance tasks, agency theory seems to be more appropriate (Eisenhardt, 1988: 488 f.).

There are many ways of deciding on a suitable theoretical foundation for a research project, ranging from inductively analyzing case studies to drawing upon the existing literature (Eisenhardt, 1989b: 546). This study draws on prior research while also adapting existing agency theory approaches. Moreover, even though agency theory only receives support under certain conditions, multinational corporations are dynamic organizations and so the suitability of a particular theoretical approach might change over time. For instance, agents could become stewards and vice versa (Parks & Conlon, 1995: 832; Albanese et al., 1997: 611).

Thus, agency theory is based on the core assumption that principals and agents have differing goals (Davis & Schoorman, 1997: 612); if this assumption were not upheld, the theory would be obsolete and stewardship or institutional theory would offer more suitable methodologies toward addressing the bribery problem. However, it simply cannot be argued that it is in shareholders' or boards of directors' best interest to engage in bribery. Equally, if multinational corporations' employees still pay bribes, they are acting against their principals' best interests, and, hence, agency theory is applicable.

Agency Theory-Based Incentives

As previously noted, agency theory centers on two main issues: first, principals' goals might be different from agents' ones; second, it is often difficult for the principal to verify an agent's actions (Eisenhardt, 1989a: 58). In the context of the present study, first-order incentives should prompt employees to increase their own compliance with anti-bribery rules and regulations by helping to align principals' and agents' goals. The goal would be to determine the optimal contract in order to ensure that the agent acts in the principal's very best interest (Eisenhardt, 1985: 136). Hence, such incentives are targeted toward solving the problems arising from differing interests by aligning the agents' goals with those of their principals. While is difficult to eliminate self-interest, aligning agents' interests with those of their principals seems a feasible solution.

Furthermore, a multidimensional approach toward incentives is appropriate, as several elements of agency theory need to be taken into account. Agency theory is based on behavior measurement, risk sharing, and outcome measurement (Eisenhardt, 1985: 137), and so both measurable behaviors and outcomes that are going to be monitored and rewarded need to be defined. In addition, risks need to be shared in a way that creates an incentive for agents to act in the principal's best interest.

Agency theory suggests that agents are more likely to act in their principal's interest if their contracts are outcome based (Eisenhardt, 1989a: 60). First-order incentives are intended to create a motivation for the agent to act in the principal's best interest without having to give up his or her self-interested goals. For example, if a principal offers an agent a bonus for attaining excellent scores on an e-learning anti-bribery compliance exam, the agent is likely to make an effort toward achieving a high score in order to receive the bonus.

Alternatively, it has also been observed that behavior-based contracts tend to be more effective than outcome-based ones in influencing the performance of private firms (Dharwadkar et al., 2000: 663). Certainly, the empirical evidence regarding solving agency conflicts through behavior- or outcome-based contracts remains unclear. However, the present study proposes to address this significant research gap in the context of anti-bribery compliance in multinational corporations.

The second problem addressed by agency theory—information asymmetry—is going to be resolved by so-called second-order incentives that will encourage employees to supervise their peers, superiors, and subordinates in order to ensure their compliance with anti-bribery rules and regulations (Eisenhardt, 1989a: 58). This is particularly important as officers and directors have been known to attempt to conceal negative organizational outcomes (Abrahamson & Park, 1994: 1302).

Perhaps most significantly for the present study, agency theory considers information to be a purchasable good. Hence, it is a particularly suitable approach with respect to whistleblowing (Eisenhardt, 1989a: 59), with peer-to-peer supervision offering two key advantages. First, violations of an anti-bribery policy are ideally discovered internally, before they are subject to an external organization. This allows multinational corporations to self-report incidents of bribery to the authorities, which in turn often leads to less substantial sanctions. Second, employees who violate their company's compliance policy can be detected and removed from the organization, thereby preventing future incidences of bribery.

Furthermore, agency theory suggests that agents are more likely to act in their principal's interest if the principal has access to information to verify their agents' behavior (Eisenhardt, 1989a: 60). Herein, there is an interplay between the first- and second-order incentives. Increasing a principal's access to information by introducing peer-to-peer monitoring in the form of whistleblowing mechanisms could help to solve agency problems, while employees will presumably fear detection and abstain from violating the compliance policy if their risk of being detected is increased through a whistleblowing scheme.

Overall, agency theory is a highly suitable theoretical framework for the purposes of this study. On the one hand, first-order incentives can help to align the agents' interests with those of their principals. On the other hand, second-order incentives allow the principal to purchase information that allows him or her to discover violations of the anti-bribery policy while also implementing a preventive mechanism. As specified, agents who become aware of a peer-monitoring mechanism are also less likely to engage in bribery due to the increased risk of detection.

However, as has also already been mentioned, both first- and second-order incentives have significant limitations. In particular, first-order incentives are not very useful if the principal and the agent do not have diverging interests. In a worst-case scenario, agents whose goals are already in line with those of their principals would be provided with purposeless incentives; for instance, they could be paid a bonus for not bribing anyone, even though they were already compliant before the introduction of the anti-bribery incentives review. Second-order incentives could foster denunciation and hence negatively impact a multinational corporation's culture. This issue is not sufficiently taken into account in agency theory; in fact, the theory does not account for behavioral or cultural aspects.

Lastly, it should be emphasized that not all agents are selfish human beings who try to take advantage of information asymmetries in order to exploit their principals. There are indeed many kind and intrinsically motivated agents who endeavor to do their very best for their principals and do not need to be subject to strict control mechanisms or rewarding incentive schemes. Countless people believe in higher goals and so will confront potentially damaging actions or behaviors such as bribery. However, it must also be acknowledged that some other people are indeed selfish and able to cause enormous damage to both their principals and society as a whole.

Compliance systems, unfortunately, have to account for all kinds of human behavior as well as cultural, ethical, and moral norms. Moreover, legal requirements oblige multinational corporations to implement adequate control mechanisms in order to ensure that their employees are compliant with all applicable rules and regulations. Hence, this study focuses on worst-case scenarios and therefore assumes that all agents are indeed self-interested (Teichmann, 2017: 1 pp).[1]

[1] Article taken from Teichmann, F. (2017). Anti-Bribery Compliance Incentives. Kassel: Kassel University Press.

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