

# Role of Psychological Factors in Determining Principal-Agent Relationship: Empirical Evidence from the Insurance Industry of Pakistan

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## Abstract

*This paper aims to determine the influence of the psychological factors of an individual such as the lower order needs, need for extrinsic motivation, organizational identification and organizational commitment on the principal-agent relationship in the workplace. This study follows a cross-sectional and quantitative approach. Self-administered questionnaires are used as an instrument to collect the responses from respondents working in the insurance industry. Kendall tau-b rank correlation coefficient, linear regression and one-way ANOVA are employed for testing conceptual model and hypotheses. The results of the analyses show that each of the independent variable i.e. lower order needs, extrinsic motivation, organizational identification and organizational commitment, significantly influences the dependent variable i.e. principal-agent relationship.*

## Keywords

Agency theory, lower order needs, extrinsic motivation, organizational identification, organizational commitment, principal-agent relationship.

## 1. Introduction

The theory of agency is a pioneering theory in the field of corporate governance. It has its roots in Adam Smith's much celebrated book 'The Wealth

of Nations', first published in 1776. According to Letza et al. (2004), Adam Smith well identified the problems in agency relationship when he emphasized that the directors of a company do not handle the money of others with as much care as they handle their own. According to this theory, not all managers (agents) are innately motivated to work in the best interest of the owners (principals). This is due to the fact that agents often have an informational edge over the principal as well as that the agents try to satisfy their own interests instead of the principals' (Rogerson, 1985).

Agency theory is not only confined to conflicting interests between agents and principals, instead its scope goes far beyond this. On one hand the prevalence of principal-agent relationship shapes an organization's values, culture, structure and design, HR policies and practices, power and politics, management and leadership style, and the overall organizational behavior. On the other hand agency theory also shapes an individual employee's behavior, personality, values, attitudes, perception and aptitude (Gomez-Mejia & Balkin, 1992).

The goal of this of this study is to find out whether or not the psychological factors of an individual such as the lower order needs, need for extrinsic motivation, organizational identification and organizational commitment facilitate the

reinforcement of principal-agent relationship in the workplace.

### 1.1 Research Objectives

This study has four broad objectives: (1) to enhance the understanding of the agency theory by analyzing its constructs, insights, strengths, weaknesses and validity; (2) to determine the significance of an individual's lower order needs and extrinsic motivation needs and their relationship with agent-oriented behavior; (3) to develop understanding of the concepts of organizational identification and organizational commitment and their role in the principal-agent relationship in the workplace; and (4) to provide implications to the management for fostering a climate in the workplace which favors principal-agent relationship.

### 1.2 Literature Review

#### 1.2.1 Agency Theory

The foremost intellectuals who explicitly proposed and created the principal-agent theory are Barry Mitnick and Stephen Ross. Both these scholars put forward the agency theory independently and in tandem with each other. Ross (1973) is accountable for foundation of the economic perspective of agency theory and Mitnick (1980) is responsible for the institutional perspective; however the fundamental theories underlying both these perspectives are similar.

Armstrong (2003) speaks that in the purest form, agency theory acknowledges that in majority of the contemporary corporations the owners (principals) and the managers (agents) are substantially separated from each other due to which the owners (principals) might not have absolute command over the managers (agents). This situation motivates the agents to act in manners that are not entirely exposed to the principals and that might not be in harmony with the requirements of the principals. This causes

what economists label as agency cost; the costs which appear as a result of the difference between what the principals might have earned if they were the managers and the earnings attained when actual managers (agents) worked on their behalf (Grossman & Hart, 1983).

Crowther and Capaldi (2008) express that rather than focusing on the firm specifically, the agency theory highlights the contracts that describe each firm. The agency theory is largely apprehensive about the contractual relationships between owners (principals) and the managers (agents) under circumstances of information asymmetry. Lambert (2001) provides four reasons due to which the agency theory measures the influence of the conflicting interest between the agents and principals, and those reasons are: (1) dodging and fudging by agents; (2) the illicit diversion of principal's resources by the agents for their personal consumption; (3) the disparity in the time horizon of agents and principals; and lastly (4) the degree of difference in the risk aversion between agents and principals.

According to Jensen and Meckling (1976), the agency problem is generally the conflicting interests between owners (principals) and their managers (agents). Baums and Scott (2005) argue that the central problem is that the principals hand over some authority to the agents over their assets and investments, which are intended to be employed to enhance the interests of the principals instead for the selfish gains of agents.

#### 1.2.2 Extrinsic Motivation

Deci (1972) define extrinsic motivation as a monetary and oral reinforcement which is intervening from outside of the individual; whereas, the intrinsic motivation comes from within the individual. Extrinsically motivated activities help in the realization of incentives that are outwardly imposed, including the possessions of valuables, remuneration, additional benefits, encouraging feedbacks, popularity, fame,

promotional opportunities etc. (Ryan & Deci, 2000). Hennessey and Amabile (2005) portray that when a person is extrinsically motivated, he/she acts in a certain way to ensure that some specified external goal is achieved or so that some externally inflicted constriction is met.

Amabile (1993) claims that employees are either motivated intrinsically or extrinsically or can be even motivated by both. Amabile describes this in following way: (1) when individuals look for pleasure, curiosity, articulacy, or challenge in the task, they are intrinsically motivated; and (2) when they take on work with an intention of obtaining some benefit that is separate from the task itself, then they are extrinsically motivated.

### 1.2.3 Lower order needs

American clinical psychologist Abraham H. Maslow (1908-1970) proposed Maslow's hierarchy of needs in his prominent paper of 1943, titled '*A Theory of Human Motivation*'. Maslow (1948) assembles the human needs in a pyramid shaped model by placing the basic human physiological needs at the base and self-actualization needs at the peak. The lower order needs are called deficiency needs and the higher order needs are called growth needs. The deficiency needs must be fulfilled in order to ensure an individual's survival, safety and necessity for human interaction. The growth needs are apprehensive about an individual's personal development and meeting one's ultimate potential. Unless the lower order needs are satisfied, the person cannot move towards the activation of higher order needs (Wehrich & Koontz, 2000).

McGregor (1957) define the physiological needs as the fundamental bodily necessities like nourishment, water, protection, reasonable temperature, relaxation, and sleep. Majority of the corporate jobs play a fine role in meeting the physiological needs. Rest and sleep to lessen stress and enhance productivity helps employees

to meet a vital physiological need. A worker whose job is firefighting or coal mining can never fully satisfy their physiological needs (DuBrin, 2011).

Hersey and Blanchard (1969) illustrate that safety needs embrace an individual's desire to be secure from both bodily and emotional harm. Workers who perform risky jobs would be having a strong carving for obtaining safety. DuBrin (2011) provides an example that computer operator suffering from cumulative trauma disorder (CTD) would fancy for job that demands less pressure on his wrists. A highly stressful job often frustrates the human desire for emotional safety (Martin & Loomis, 2006).

Alderfer (1969) states that social needs describe an individual's need for affection, belonging, and association with people. Alderfer believes that management can play an important role in the fulfillment of these employees' requirements by providing them an environment which favors cooperation, collaboration and allows them to chat about their personal and professional lives with each other.

### 1.2.4 Organizational identification

Hall et al. (1970) define organizational identification as the means by which the organizational goals and objectives become increasingly homogenous and in tandem with the individual goals and objectives. Whetten and Godfrey (1998) assert that organization identification is a much researched area in organizational theory, yet this construct is often confused with the concepts of organizational commitment, internalization of organizational beliefs and values, and personal organizational fit. When exploring an organization's behavior, design and effectiveness, organizational identification is an unavoidable construct (Brown, 1969; Patchen, 1970; Lee, 1971; O'Reilly & Chatman, 1986).

Albert and Whetten (1985) describe organizational identification as how an employee sees himself/herself in relation to the organization. It is an employee's feeling of uniformity or association with a workplace. An employee tends to identify himself/herself with the organization as a result of three factors: (1) feelings of alliance and comradeship with the workplace; (2) support of his/her attitude and behavior by the organization; and (3) the impression of common characteristics between him/her and other members of organization.

Ashforth and Mael (1992) point out two main factors which are a source of organizational identification and they are: organizational factors and individual factors. The organizational factors include organizational uniqueness, reputation and competition; while, the individual factors include an employee's tenure, duration of membership, organizational satisfaction and organizational sentimentality.

### 1.2.5 Organizational commitment

According to Porter et al. (1974) organizational commitment is a measure of how strongly an employee identifies himself/herself with an organization and how much he/she involves himself/herself in an organization. According to them organizational commitment is made up of three factors. Firstly, the employee has a strong faith in the morals and principles of the organization. Secondly, the employee is ready to exert an extra effort in his/her job. Lastly, the employee strongly desires to preserve his/her link with the organization.

Steers (1977) presented a two-tier model which demonstrates the sources and the outcomes of organizational commitment (OC). According to him, there are three main types of sources for OC and they are: individual traits, job characteristics, and work related experiences. Individual traits include a person's age and qualification. Job characteristics comprise of the level of challenge

in a job and the feedback an employee gets. Work related experiences include the employee's attitudes toward the organization and their level of trust and dependability on it.

Meyer and Allen (1991) put forward a three-tier model of organizational commitment which aims to add three concepts in the attitudinal definition of commitment. The first concept is affective commitment which explains an employee's craving for membership in the organization. The second concept is normative commitment which explains an employee's obligation to be a member of the organization. The third concept is continuance commitment which explains an employee's need to be a member of the organization.

### 1.3 Hypotheses

This study attempts to test the following four hypotheses which have been adopted from the work of Davis et al. (1997):

H<sub>1</sub>: People who are motivated by lower order needs are more likely to become agents in a principal-agent relationship.

H<sub>2</sub>: People who are motivated by extrinsic factors are more likely to become agents in a principal-agent relationship.

H<sub>3</sub>: People who have low identification with the organization are more likely to become agents in a principal-agent relationship.

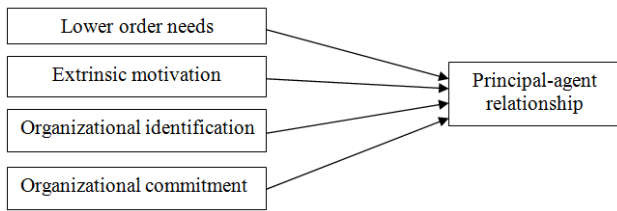
H<sub>4</sub>: People who have low commitment with the organization are more likely to become agents in a principal-agent relationship.

## 2. Methods and Materials

### 2.1 Theoretical Framework

The proposed theoretical model for hypotheses testing is as follows:

**Figure 1: Conceptual Framework**



There are four independent variables in this study namely, (1) lower order needs; (2) extrinsic motivation; (3) organizational identification; and (4) organizational commitment. Each of these variable directly influences the dependent variable i.e. prevalence of principal-agent relationship in the workplace.

### 2.2 Nature of the study

This study aims to enhance the existing body of knowledge in the field of corporate governance; therefore, it is a basic research. This study is a cross-sectional in nature as it is conducted at one specific point of time. This study is quantitative as it is based on a survey which intends to assemble the responses of a large number of people in short time and within a small budget.

### 2.3 Instrument

For the purpose of data gathering a questionnaire is specifically designed which comprises of 37 questions. The questionnaire consists of six parts. The first part's questions are based on nominal and ordinal scale and the questions for the parts two to six are based on a five point Likert scale. The answers of the respondents vary from 1 (strongly agree) to 5 (strongly disagree).

The first part is made up of four questions namely, age, gender, education and tenure. This parts aims get a hold of the background information of a respondent. The second part asks six questions to respondents regarding their understanding with the basic assumptions of agency theory. The third part comprises of six questions about the lower-order needs of an

employee. The fourth part comprises of six questions about how extrinsically motivated an employee is. The fifth part encompasses seven questions about an employee's level of organizational identification. Lastly, the sixth part of the questionnaire includes seven questions about the extent of commitment to the organization.

### 2.4 Participants

First the top three insurance companies of Pakistan are identified and then their head offices in Rawalpindi and Islamabad are targeted. The selected insurance companies are State Life Insurance, Adamjee Insurance and New Jubilee Insurance. From each of these three companies, 100 employees were selected through convenience sampling. This makes a total sample size of 300 respondents.

The male representation in sample is 63.7%; whereas, female representation is only 36.3%. The mean age of the sample was 33.84 years (SD=7.299). With 64.3% Masters is the most common degree held by the respondents leaving behind Bachelors with 34.7%. The mean tenure of the sample was 7.73 years (SD=4.144).

### 2.5 Reliability test

Cronbach's Alpha is employed to measure the consistency of the diverse variables that constitute a particular construct (Santos, 1999). The table presented below shows the Cronbach's alpha for each of the construct in the questionnaire.

**Table 1: Scale Reliability Analysis**

Construct	Cronbach's Alpha	Guttman Split-Half Coefficient
AT	0.857	0.826
LON	0.881	0.846
EM	0.890	0.866
OI	0.819	0.754

OC	0.870	0.798
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### 3 Results and Discussion

In order to explore the data collected and to test the hypotheses of this study, IBM Statistical Package for the Social Sciences (SPSS) is used. The SPSS employs Kendall tau-b rank correlation coefficient, linear regression and one-way ANOVA for testing the hypotheses. In this section the results each of the four hypotheses will be separately analyzed.

**Table 2: Results of Demographic Questions**

	Age	Gender	Education	Tenure
Mean	33.8	.36	3.66	7.73
Median	33.0	0.00	4.00	7.00
Mode	30	0	4	7
Std. D.	7.29	.482	.494	4.144
Variance	53.2	.232	.244	17.176
Skew.	.438	.571	-.442	.123
Kurtosis	-.474	-1.685	-1.187	-1.057

**Table 3: Correlation Analysis**

	Agency Theory
Lower Order Needs	0.531**
Extrinsic Motivation	0.642**
Organizational Identification	0.743**
Organizational Commitment	0.522**

Note: \*\* Significant at 0.01 level

**Table 4: Regression Analysis**

	R <sup>2</sup>	β	t	Sig.	F
LON	0.733	0.059	0.33	0.00	820.33
EM	0.833	-0.136	-2.03	0.00	1495.28
OI	0.808	-0.392	-10.51	0.00	1256.56
OC	0.663	-0.311	-4.53	0.00	588.39

#### 3.1 Hypothesis 1

The first hypothesis investigates if there is a relationship between the employees' lower order needs and principal-agent relationship. The Kendall tau-b correlation coefficient is 0.531 with  $p < 0.01$ . This shows that there is a moderate positive association between the two variables. Thus, this hypothesis is accepted and null hypothesis is rejected. The linear regression shows that 73.4% of variation in the principal-agent relationship is due to the independent variable lower order needs (adjusted  $R^2 = 0.733$ ). One-way ANOVA shows that the F value is 820.334 and  $p < 0.01$  which concludes that the regression is statistically significant.

#### 3.2 Hypothesis 2

The first hypothesis investigates if there is a relationship between the employees' extrinsic motivation needs and principal-agent relationship. The Kendall tau-b correlation coefficient is 0.642 with  $p < 0.01$ . This shows that there is a moderate positive relationship between the two variables. Thus, the null hypothesis of no relation is rejected and alternate is accepted. The linear regression shows that 83.4% of variation in the principal-agent relationship is due to the extrinsic motivation needs (adjusted  $R^2 = 0.833$ ). One-way ANOVA shows that the F value is 1495.283 and  $p < 0.01$  which concludes that the regression is statistically significant.

#### 3.3 Hypothesis 3

The first hypothesis investigates if there is a relationship between the employees' organizational identification and principal-agent relationship. The Kendall tau-b correlation coefficient is 0.743 with  $p < 0.01$ . This shows that there is a strong positive association between the two variables. Thus, this hypothesis is accepted and null hypothesis is rejected. The linear regression shows that 80.8% of variation in the principal-agent relationship is due to the

organizational identification of employees (adjusted  $R^2=0.808$ ). One-way ANOVA shows that the F value is 1256.565 and  $p<0.01$  which concludes that the regression is statistically significant.

### 3.4 Hypothesis 4

The first hypothesis investigates if there is a relationship between the employees' organizational commitment and principal-agent relationship. The Kendall tau-b correlation coefficient is 0.522 with  $p<0.01$ . This shows that there is a moderate positive association between the two variables. Thus, this hypothesis is accepted and null hypothesis is rejected. The linear regression shows that 66.4% of variation in the principal-agent relationship is due to the independent variable of organizational commitment (adjusted  $R^2=0.663$ ). One-way ANOVA shows that the F value is 588.391 and  $p<0.01$  which concludes that the regression is statistically significant.

## 4 Conclusion

This study attempts to explore the effect of psychological factors of employees (such as lower order needs, extrinsic motivation, organizational identification and organizational commitment) on the pervasiveness of principal-agent relationship in the workplace. All the four hypotheses have been accepted after applying some statistical tests on them. This study shows that employees for whom the basic human needs like food, clothes, shelter, safety, love and affection are important are likely to portray an agent-oriented behavior. Similarly those employees who have a need for power, fame, professional growth and monetary rewards are also likely to show agent-oriented behavior. The employees who identify themselves strongly with their organization and those who feel that it is their obligation to remain with their organization are expected to act agents in a principal-agent relationship in the workplace.

This study will help them management in comprehending the relationship between the basic HR concepts and agency theory. The study will help the principals and agents in making sense of the various organizational behaviors, practices and functions with respect to agency theory. This study will create some harmony between the principals and agents by presenting them an opportunity to better understand each other. This study will help the practitioners in viewing the agency theory from different perspectives. And it will also motivate the followers of other theories in corporate governance to challenge this study and come up with new and different results.

## 5 Recommendations

The management of the corporations needs to become conscious of the probable impacts that the concepts of motivation, organizational identification and commitment have on the principal-agent relationship in the workplace. If the management wishes to have a principal-agent relationship in the workplace it should design the policies and practices keeping in mind the needs, wants, goals and aspirations of the individual employees. Also the management should try to align the organizational interests, goals, objectives and values with that of the employees. The entire organization should be regarded as a family where everyone is respected and accepted for what they are. This will help in increasing the organizational commitment and identification of the employees.

There are certain considerations for future research in this area such as: (1) there is a need for longitudinal research which could probe into the agency-oriented behavioral changes in employees over time; (2) the sample size should be enlarged and probability sampling techniques should be employed when drawing the sample so that every member has a fair chance of being selected; (3) more businesses from different sectors should be included in research; and lastly (4) instead of relying on a survey based

quantitative research, other methods of research should be used such a triangulation technique.

## 6 Limitations

This study is subject to few limitations such as: (1) due to the time and budget restrictions this study is kept cross-sectional; (2) the sample of this study is restricted only to Pakistan therefore comparing results across different nations is not

possible; (3) owing to the small sample size this study is low on precision and validity and the results may lack generalizability; (4) to draw the sample, convenience sampling technique is used which does not gives the population elements an equal chance of selection; (5) this is an entirely survey based research and questionnaire is the only instrument for collecting the data; and lastly (6) the respondents might not fully understand the questions or the misinterpret them or they may not take them seriously.

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