EQUITIES

Testing Agency Theory With Entrepreneur Effort and Wealth

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We apply agency theory to an entrepreneurial setting by augmenting the standard principal-agent framework. We then test the model's implications using unique data on entrepreneurial effort and wealth in privately held firms.

In the model, a risk-averse entrepreneur seeking financing wishes to sell part of his equity stake to outside investors concerned with moral hazard. The ownership structure, entrepreneurial effort, and size of the firm are determined endogenously. The model confirms that the standard predictions of agency theory apply in an entrepreneurial setting and in the presence of endogenously chosen firm size. A few novel testable implications are generated as well.

Employing a structural model augmented to fit the entrepreneurial labor market and using two samples of private firms, we test the implications of agency theory in three stages: (1) What determines the entrepreneur's compensation contract (equity share)? (2) How does the entrepreneur respond to the incentives provided by the contract? (3) How is firm performance related to the response of the entrepreneur?

Overall, we find fairly strong evidence supporting agency theory's predictions across two data sets, using several sets of instrumental variables, and across a variety of specifications and subsamples. We present direct evidence of the effect of entrepreneur wealth on the contract, of the response of entrepreneur actions, measured by hours worked, to the contract, and of the impact of those actions on firm output.

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