Not Principals and Agents, but Beneficiaries and Trustees

WORKING PAPER
(Comments welcomed)

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Abstract

These are notes starting from Rasmusen (1997) to try to take up the idea proposed there. It is barely started. Independent central bankers and judges can both be more usefully viewed as *trustees* than as *agents*. A trust is a legal institution with rules set up by a *settlor*, administered by a *trustee* on behalf of *beneficiaries*. Public trustees often are motivated more by Pride, Policy, Place, and Power than by money, and economists should take this into account.

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> "The lawmakers virtually sit on the board of directors of a $35 billion entity called Pennsylvania," House Democrat Leader H. William DeWeese told the Philadelphia Inquirer.
>
> That's how Rep. DeWeese is defending the recent legislative pay grab in Pennsylvania in which the state's politicians voted themselves salary hikes ranging from 16 to 38 percent, by comparing the Legislature to a corporate board that's running a multibillion-dollar company. ...
>
> For Mr. DeWeese to "virtually sit on the board of directors of a $35 billion entity called Pennsylvania," his new annual paycheck, up nearly 40 percent from last year, is $137,771 – not counting the free car, expense accounts, free prescriptions, staff money, free parking, fully paid health and long-term care insurance, free gas, defined-benefit pension, dental and vision coverage, "walking around money," and the $128 daily reimbursement for every day the Legislature is in session, even if somebody else is picking up the tab for lunch and dinner.[1]

1. Introduction

xxxx Not written yet.

2 A Theory of Trustees

First, I must talk about agents.

Agency is an old concept in Anglo-Saxon law that has been widely used in economics since the 1970's. One party, the principal, hires another, the agent, to act for him. The principal can issue orders of varying specificity and can compensate the agent in various ways. He can fire the agent at any time unless they have a contract that forbids it, and even if the contract requires him to keep paying the agent, he can end the status as "agent" by removing all the authority delegated to the agent. In law, the main questions involving agents concern the effect on third parties of misbehavior such as negligent harm or making unauthorized contracts, something I have written about in Rasmusen (2004). In economics, the main questions involve how the agent's compensation can be designed to make him follow orders properly rather than shirking. All of the problems economists usually study, though, would disappear if the principal had the same information as the agent, knowing the state of the world at every moment and knowing what actions the agent has taken.

Thus, this paradigm does not fit governments and independent central bankers. If the central bank is independent, it is acting on behalf of the government, but not under its orders. The government may very well know that the central bank is keeping interest rates high, but it cannot fire the central bank. Not agency, but a different legal paradigm is appropriate: the trust.

A trust is created when one party, the Settlor, grants some property to be controlled

[1] "Hog Heaven," *The American Spectator*, Ralph R. Reiland, http://www.spectator.org/dsp_article.asp?art_id=8627, (8/23/2005 12:05:58 AM).

by a second party, the Trustee, on behalf of a third party, the Beneficiary. In the law, one person can fill more than one of these roles, and indeed could perhaps fill all three– I would have to do more research to discover that. A father can, for example, put ten thousand dollars in trust for his son's education, with himself as trustee. If he changes his mind later, he cannot take back the money (unless the trust is "revocable"), but as trustee he can control how it is invested.

The purpose of a trust is to make a commitment. Once the trust is set up, the Settlor no longer has control over the assets. Nor does the Beneficiary have control; the Beneficiary may be unhappy about how the trust is managed, but the Trustee is not obliged to obey the Beneficiary's orders, and often a trust is set up precisely because the Beneficiary's desires are to be thwarted. The father in my example could have given the money directly to his son, but he chose to tie it up a trust for a specific purpose instead.

Trusts are better for commitment than either contracts or promises. Promises, as opposed to contracts, generally cannot be enforced in Anglo-Saxon law, and when they can be enforced, it is often on the logic that the promise has implicitly set up a trust for the one to whom the promise was made. Contracts are enforceable, of course, but not if both parties decide to waive enforcement (see Section IIIe of Rasmusen & Stake (1997) for references). A Trustee is bound to carry out the terms of the trust, however, even if the Beneficiary objects.[2]

Let us now return to government institutions. These are often usefully viewed as trusts. Consider elected officials. Generally they are completely free of the control of the citizens between elections, though they can be sued for malfeasance in the courts. Thus, they are not agents, but trustees. As Rousseau said in *The Social Contract*, Book III, Chapter 15, "The English people believes itself to be free; it is gravely mistaken; it is free only during the election of Members of Parliament; as soon as the Members are elected, the people is enslaved." Only if elected officials can be recalled– as they can in certain American jurisdictions– are they properly agents rather than trustees with limited terms. In fact, the American system was set up to have federal officials with diverse degrees of independence. "Representatives" were elected every two years by popular vote, but "Senators" were deliberately chosen only every six years, and then by the state assemblies rather than by the voters. (This was later replaced by direct election by the voters, but still only every six years.) The purpose of the six-year term is explicitly so that the senators will be unresponsive to the popular will.

Federal judges are the extreme. They are appointed for life, and can be removed only by special impeachment proceedings of Congress. There is a literature that looks at the

[2]Note, however, that if the Settlors and Beneficiaries unanimously agree, then the Trust can generally be dissolved, even against the will of the Trustee, and probably against the explicit terms of the Trust. See the Restatement, Second, of Trusts, Section 337, the Reporter's Notes to which say that in England the Beneficiaries can terminate the trust even if that defeats the Settlor's purpose, citing *Saunders v. Vautier*, 4 Beav. 115 (1841), though in America this is not allowed.

advantages and disadvantages of this independence.[3] The seminal article is Landes & Posner (1975), which notes that independent judges help solve a commitment problem. If judges were agents of Congress, then Congress could pass laws repudiating its previous agreements. Consequently, nobody would make agreements with the government. By delegating the power to enforce agreements to independent courts as trustees, Congress induces others to trust its agreements.

Many such cases exist, in which a Settlor government gives some of its powers to a Trustee institution because the government knows it would be tempted to abuse those powers otherwise. A more specific example is the way in which the U.S. Congress votes to give "fast track authority" to the President to make trade agreements. Under fast track authority, Congress agrees not to amend any agreements the President makes with foreign countries, but only to vote the agreement up or down. Congress delegates this power because it knows that otherwise it will be irresistably tempted to amend the agreement, and this will make foreign negotiations futile.

Independent central banks are also Trustees, with the elected government as Settlor and the citizenry as Beneficiaries. The property in trust is the power to inflate the currency, a power with which the elected government does not trust itself. Central banks that are not independent, on the other hand, are Agents, carrying out the orders of the Principal, the elected government, whether that be to inflate the currency or not. This is the well- known idea of Barro & Gordon (1983) and Rogoff (1985) rephrased.[4] The fundamental problem is the government's desire to inflate the currency. This has three advantages for the elected officials. First, it generates short-term macroeconomic gains by reducing interest rates and stimulating investment. Second, it earns seigneurage which can replace tax revenue. Third, it reduces the value of the national debt, reducing the government's liabilities. None of these mechanisms, however, have desirable long-term effects, and the inflation that results is costly in itself. Thus, it may be desirable to give this power to a Trustee.

Not all central banks are Trusts, of course, only independent ones. The central banks of the United States and Germany have a high degree of independence, and can viewed as Trusts. The central bank of Turkey and many other countries are better viewed as Agencies. The effects of each organizatonal form are what the vigorous discussion in academia is all about.[5]

The biggest problem that arises with Trustees, a problem for both judges and central

[3]See Cooter (1983) and Posner (1994) on judicial objectives, Ramseyer (1994) on the Japanese judiciary, Spiller & Gely (1995) on the interaction between Congress and the U.S. Supreme Court, Rasmusen (1994) on precedent as a control, and Ramseyer & Rasmusen (1997) on political influence on judges in Japan.

[4]See also Miller (1997), which, like this paper, analogizes central bankers to judges, and follows the paradigm of Landes & Posner's 1975 article on judges to argue that the purpose of an independent central bank is to enforce contracts made by the government.

[5]Institutional details clearly matter tremendously in this discussion. See Goodhart (1995) for a book-length treatment of these.

banks, is that the Trustee might not act on behalf of the Beneficiary or according to the terms of the Trust. If the Trustee is independent, how will he decide how to use his power? Driffill (1997) and Miller (1997) survey the large literature that has developed to look at that question in macroeconomics and political science, a literature that includes much discussion of how to design optimal incentives for central bankers. Before we can reach the question of optimal contracts, though, we must address the question of what bankers care about, what they would maximize in the absence of external constraints.

So what do Trustees care about? The usual arguments of a utility function in principal-agent models are effort and money. Those are important for many Trustees, too. When a bank acts as a Trustee for a spendthrift trust created to give an income to an heir, for example, the bank values the fees it collects and will minimize its effort subject to the constraint of its legal duties, its reputation in the market for becoming a trustee, and, one hopes, a sense of moral duty. The problem of trustee misbehavior, whether in collecting overgenerous fees, exerting too little effort, or stealing from the trust are well worth studying.

Here, however, we will concentrate on more metaphorical trustees– judges, politicians, and central bankers. The proper way to model their utility functions is different. Effort and money are minor concerns. It is rare for abuse of power by these trustees to take the form of low effort. Nor can varying their compensation be expected to make much difference.[6] I have suggested elsewhere that politicians should be paid generously because their salaries are trivial compared with the amount of wealth that their decisions affect, and we would like to reduce their marginal utility of income to reduce the temptation to steal (Rasmusen [1992]). But all three of these occupations select for people who care less for money than for other things. Most politicians could increase their income by quitting politics for the private sector, and this is true of the vast majority of judges (above the local level) and central bankers in most countries. This is no less true because of the fact that their high alternative income often arises from their having held those positions– once they hold the positions, if they value money much, they will resign quickly.[7]

The Chairman of the Untied States Board of Governors of the Federal Reserve, for example, earned a salary of \$133,600 in 1995, while the lowest- paid president of the twelve Federal Reserve District Banks earned \$177,550, and even the head of the Research and Statistics department at the Board of Governors earned more than Chairman Greenspan.[8] Compare this with \$2,989, 832, the 1995 annual salary plus bonus

[6]Hence, the literature represented by Walsh (1995) and Goodhart & Huang (1995), in which central bankers' compensation is linked to inflation and unemployment rates, is misguided. I have not yet seen a copy of Bruno Frey's new book, *Not Just for the Money: An Economic Theory of Personal Motivation*, but it would seem useful for this kind of task.

[7]On the other hand, trustees can make large amounts of money by stealing. I should discuss this. It is not something the contract can deal with, but laws against trustee theft are very important, and some trustees take the job to get the opportunity to steal.

[8]See Thomas (1997) at 299 and Cassidy (1996) at 41. Also, it seems that in 1996 the head of custodial

of the CEO of the Bank of Boston Corp. , or the \$494, 615 for the fifth-highest-paid officer of that bank.[9] When Board members leave office, their salaries rise. This was true even of Board member Alan Blinder, a professor of economics, who increased his salary when he returned to academia in 1994, and who must have increased his earnings far more with the consulting activities Princeton allows him (Cassidy (1996), at 46).

The position of federal judges in the United States is similar: virtually all of them could earn more if they lost their jobs. Elsewhere in the world this is also true; this is why in our forthcoming paper on the Japanese judiciary, Mark Ramseyer and I felt comfortable in proceeding without salary data to look at judicial rewards in terms of location and court hierarchy.

So what do trustees want? I suggest a "Four P's" approach, hijacking a slogan from marketing. The "Four P's of Marketing" are Price, Product, Promotion, and Place. My "Four P's of Trustees" are Policy, Pride, Place, and Power.

POLICY refers to the trustee's desire to see particular policies in place, usually because of his political or moral principles. A central banker has a personal preference for the inflation rate. A judge has a personal preference for whether abortion is legal or not. A politician has a personal preference for the rate of income tax. A good way to model this is to label the trustee's policy choice x, his personal preference x_i, and the settlor's preference x^*, where all these variables lie in the interval $[0, 1]$. The Trustee wants the policy to be as close to his desired policy as possible, so let us have $\frac{1}{(x-x_i)^2}$ enter his utility function.

PRIDE refers to the trustee's reputation for competence. A central banker wants to be known as someone who understands the economy and the effects of the instruments at his disposal. A judge wants to be known to the legal profession as someone who can argue cogently for his positions and who knows the law. A politician wants to be known as someone who can get things done. Let us denote Pride by the variable y_i for Trustee i's perceived ability, a variable lying on the $[0, \infty]$ continuum.

PLACE is the Trustee's job. He likes being a trustee, and does not like being fired, quite apart from the losses in the other variables. Central bankers, judges, and elected officials all are granted deference and perks based solely on their positions, and instantly lose most of this when they leave their positions. Let us denote Place by Z_i, which take the value 0 if the Trustee loses his job and 1 if he keeps it.

POWER is a different dimension than Place. A trustee can keep his position but have no discretion to do anything. Or, the trust could separate out position and power; the emperor is worshipped as a god, but the shogun makes all the decisions. Power is here

services was earning \$163, 800 per year (Ralph Vartabedian, "Tightfisted Fed Generous to Own Staff, Panel Reports, " *Los Angeles Times* , September 12, 1996, p. D1).

[9]Salaries from p. 19 of www.sec.gov/Archives/edgar/data/36672/0000950135-97-001232.txt, on November 7, 1997.

considered as a good in itself, not as a means to influence Policy. A simple way to model Power is as the number of decisions the Trustee is free to make. Here, let us denote it by D, an integer from 0 to M. In the modelling of Policy above, the Trustee was limited to one decision variable, x. We can easily make this a vector with $N \geq M$ elements, where N could be larger than M because it may be useful to model the Trustee as having preferences over some policy variables that he cannot possibly affect by his actions. Also, note that we can keep the model simple by continuing to model Policy as unidimensional; this implies that the Trustee likes having more decisions to make because of Power, but he only cares about the outcome of one of them for Policy.

We can thus write the Trustee's utility function as

$$U_i = U(\frac{1}{(x - x_i)^2}, y_i, Z_i, D), \tag{1}$$

with U increasing in all its arguments.

Let me now return to Pride. How does a Trustee improve his reputation for competence? That depends on the setting. Let us consider a central banker. One possibility is that he is rated on his ability to achieve his Policy, Place, and Power objectives. If that is so, then Pride will have little independent effect, perhaps even having no effect on his decisions. A second possibility is that Pride depends only on how well he achieves one of the other objectives– on his Power, for example, but not on his Policy. In that case, the effect of Pride is just to magnify the effect of Power relative to Policy and Place, increasing the importance of Power as an incentive tool.

A third possibility is the most interesting. Suppose the central banker's competence is rated on how close he comes to achieving the beneficiary's desired Policy. This can be modelled as

$$y_i = \frac{1}{(x - x^*)^2}$$

In the example of a central banker, the story would be that if the banker's personal preference is for 0 percent inflation, but the electorate's ex ante, informed preference is for 10 percent, then the banker will not choose 0 percent, but rather something in between. If he chooses 0 percent inflation, people perceive his ability to be low– they think that he tried for higher inflation, but couldn't manage to get what he wanted. The belief is self-confirming.

Pride is interesting because there are multiple equilibria in it. It all depends on what people think is the signal of ability. If the Settlor of the trust can set up expectations a certain way, he can use this tool to move the Trustee to the Settlor's preferred Policy and away from the Trustee's.

The Four P's Theory also allows us to explain certain other aspects of central banking. One question is why a central bank should have authority over banking regulation as well as over interest rates. It is certainly desirable to have an independent Trustee supervising banking regulation, given the experience of the United States (and no doubt other countries) with elected officials pressuring regulators to go easy on troubled and criminal banks. But why not set up a separate Trustee? The answer may be in the central bank's love of Power. In the United States, the Federal Reserve has resisted attempts to take away the control it has over certain bank regulations and rationalize regulation within a single agency. An obvious explanation is the utility of Power.

We can also explain the low salaries of Federal Reserve governors. The salaries of Board members are set by Congress, and it may be advantageous to set them low. This reduces the value of Place, and Board members commonly leave before their 14-year terms are up. They clearly have independence from Congressional bribery, and they do not care about reappointment simply because the law forbids them to be reappointed– an interesting aid to independence. Moreover, there is a beneficial selection effect. Paying public servants a low salary to attract only those with particular utility functions– who wish to serve the public rather than earn money– is an old idea, though usually applied to elected officials. We have deliberately selected for Trustees who are unusually unresponsive to monetary incentives.

The theory has implications for the dimensionality of central bank objectives. A Trustee whose Trust has many objectives has much greater discretion, since he can choose which objectives to favor. This allows great scope for satisfying his personal Policy preferences (as we see with independent American federal judges, whose objectives have very high dimensionality, besides being quite vague). If, on the other hand, the central bank is given one objective– low inflation, for example– it is much easier to monitor how it is doing, and much easier to use Pride by showing that the bank has failed to meet its formal objective.

It is equally important to give the Trustee only objectives which are under his control. Ordering a central bank to deliver "a healthy economy" is futile. Moreover, if some objectives are out of the bank's control, the banker already loses some utility from Pride, or gains some from successes not really due to his own effort, making it harder to use that instrument to control his behavior in more relevant areas. Combining the ideas of these last two paragraphs: if the central banker has 10 targets, of which only inflation is truly under his control, then inflation will be so small a part of his reputation that he will use it to satisfiy his personal Policy preferences instead of to gratify his Pride by improving his reputation for effectiveness.

I hope that these thoughts may be useful in organizing our thinking about government institutions. The Four P's Theory hardly deserves the name of theory, since it has been largely taxonomic. I have, in fact, committed a sin of which I frequently accuse graduate students: constructing a model without coming to any propositions. I hope this taxonomy, though, will be useful to shift from thinking of agents to thinking of trustees. The shift of emphasis has quite different implications for how to structure their incentives.

Postscript

To the other four P's, I must add a fifth, Principle. This is not quite the same as Policy, the P to which it is closest. By "Principle" I mean a desire to take a stand, regardless of whether taking a stand helps to achieve the desired end or not. Suppose, for example, that a politician desires a 30 percent tax cut. He could satisfy Principle, by holding out for 30 percent, knowing that the result will be no tax cut at all, or satisfy Policy, by compromising on a 10 percent tax cut. These are distinct goals. In modelling terms, the Trustee obtains a Principle payoff from taking a particular action; he obtains a Policy payoff from a particular event happening, whether or not it happens because of his action. The Policy goal is advanced, of course, by the Trustee's actions, but he will be just as happy if the event happens without his intervention.

Principle is very important for judges. A judge who tries to interpret the law according to original intent or plain meaning is motivated by Principle, and will often obtain Policies that he dislikes. Other judges are motivated by Policy, and their decisions are "result-oriented", independent of the laws they are supposedly interpreting.

Central banking has less opportunity for divergence between Policy and Principle, but it still can arise. A central banker, might, for example, find that he could achieve more stable economic growth by doing favors for elected officials. This would go against Principle, but aid Policy. Corporate officers and literal trustees of charitable or other trusts could find themselves having to make similar tradeoffs with respect to bribes that would help their beneficiaries.

Compare independent contractors to agents and trustees.

Discuss motives and examples from corporate boards, politicians, charitably foundation boards, judges, parents. This could be the bulk of the paper.

What kind of contracts would one design for trustees? Maybe none at all. That is why the institutions are set up with trustees instead of agents. A contract could not cover the important stuff,and would fall into the multitasking fallacy of Holmstrom & Milgrom (1991)– of giving high-powered incentives for the unimportant tasks,leading to neglect of the important ones.

Or maybe set up a contract based on the 5 P's and information release– shaming poor performers. This would probably be an implicit contract, but it would be important for the trustee to know the implicit rules.

Trustees are typically highly subject to peer pressure. CEO's and ex-CEO's and judges, at least, think of themselves as a small, elite group, better than other people. That means they care less about opinion generally, but more about the opinion of their peers.

It may look like the law heavily constrains true trustees and corporate directors, since it has detailed rules for what happens in case of misbehavior. But this is misleading. Actually, the law only comes into play in extreme cases, and is not felt as a binding constraint in most cases, no more than laws against theft are the main thing that stop agents from stealing, or that impeachment is the main constraint on a president or governor.

What authority is given to individual trustees? Typically they have overseers. A corporation has a board of more than one director. A judge sits on a panel, or is a trial judge who can be overruled by a higher court. A legislator is one of many legislators. A president or governor can be checked by the legislature or judiciary. Agents are more often left on their own.

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