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Hidden Costs of Control: Consequences of Over Application of Rigid Control

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Abstract
Control is an integral part of every organization. Without proper application of control an organization can't reach to its goals. But over application of control can cause cost to organization. Impact of rigid control can vary from organization to organization. Excess use of control has adverse effect on customer satisfaction, employee productivity, employee morale & motivation etc. All of these can cause costs to organization; but these costs can't be measured explicitly. In this paper we have tried to describe dysfunctional sides of control. We have presented some empirical evidences against rigid control that may generate hidden costs of control. Based on the findings of this paper we have provided some recommendations which will help people to understand necessity of keeping proper balance regarding application of control.
Keywords: Integral, dysfunctional, hidden costs of control, empirical, explicit

1. Introduction

Control means better utilization of resources. In general, control is system and subsystem involving inflow and outflow of money. The study of organization and the study of control are interrelated. An organization must have control to see whether resources are properly utilized as planned. But this control can be dysfunctional.

Hidden costs occur due to rigid control of the organization. Sometimes organizations lower their control to reduce hidden costs. The effect of hidden costs in some situation may be large like existence of hidden costs due to agency problems. But there are ways too to remove such costs.

Realizing its importance many authors are now working on it. By understanding hidden costs of control organizations may be able to reduce or remove such costs. This paper is also a trial of contributing something regarding hidden costs of control.

The paper has been organized as follows. The Section 2 introduces the hidden costs of control. Next, Section 3 provides the objectives of the study. Section 4 provides the literature review of the study. Section 5 explains the methodology of preparing the paper and Section 6 provides the scope of the study. Section 7 shows the findings of the study which has been divided into two parts: Section 7.1 describes some probable ways to occur hidden costs of control and the resulting consequences and then Section 7.2 provides empirical examples of hidden costs of control and the resulting consequences. Section 8 tries to find out whether hidden costs of control are measurable or not. Then Section 9 shows the relation between hidden costs of control and agency problem. Section 10 tries to provide some ways to remove or at least reduce hidden costs of control which can also be considered as recommendations. And finally Section 11 provides concluding remarks.

2. Hidden Cost of Control

The term control is used at a wide range of levels. At one extreme it means effects to achieve organizational goals and objectives; at another extreme the concern of control is to see if there are two approved signatures on a disbursement check and in between there are all sorts of resources and operational activities, which must be dealt with. Control can pertain to any operational activity, be it financial, administrative, or broader managerial operations (Chowdhury, 2012).

In order to bring discipline control is must. Every organization has some sort of control. An organization always tries to achieve its goals and for this control mechanisms must be properly planned and selected. For proper implementation of control organizations spend much in terms of:-

- Monitoring;
- Checking;
- Training;
- Security systems;
- Technological equipments; and so on.

But the return of such investments may not be always positive. This means that it is not always true that control will provide expected return. It may create costs also.

Many managers are averse to being controlled. Many people want to do their work by their own will and not by any threat. Some agents may perceive control as a signal of distrust in their intrinsic motivation. Firms having more control and less or no access make less profit than firms having free access and less control. Because rigid control gives negative message to the employees and lowers productivity resulting lower profit and increased cost of the lost production.

3. Objective of the Study

The study is conducted to obtain following objectives:-

- To give an idea of dysfunctional sides of control;
- To inform about hidden costs of control;
- To identify effect of over application of control;
- To measure costs associated with rigid control;
- To provide practical examples showing dysfunctional sides of control; and
- To give ways of removing/reducing hidden cost of control.

4. Literature Review

Very few authors have worked on hidden costs of control. It is quite a new concept in the business world. Armin falk and Michael Kosfeld's work entitled "The Hidden Costs of Control" which was published in 2006 is considered as the best work on hidden costs of control where they showed that control entails hidden costs since most agents reduce their performance as a response to the principal's controlling decisions (Falk and Kosfeld, 2006). They dictate that a principal's distrust in the voluntary performance of an agent has a negative impact on the agents motivation to perform well (Falk and Kosfeld, 2006; Falk and Kosfeld, 2004).

Kessler and Laider told that hidden cost of control arises when a principal receives less effort from an agent, and therefore earns less profit, when she controls the agent by taking away his most opportunistic actions(Kessler and laider, 2012). They found that principals and firms should be most concerned about a hidden cost of control when they have established a strong norm with the agent (e.g. via an informal agreement or corporate culture), when their monitoring and control technology is weak, and when their relationship with the agent is highly asymmetric (e.g. in an employment context, or a supply chain setting with a dominant party). Costs of control may be less problematic when both parties are on a more even footing (e.g. a joint venture). Firms may be able to diminish the hidden cost if they can also credibly restrict their own bad actions or if they can allow agents to consent to the control (Kessler and laider, 2012).

One of the main problems of creating hidden costs of control is agency problem. "Principal-agent relations are typically characterized by a conflict of interest. Therefore, principals often use control and incentive devices to eliminate agents' most opportunistic actions. Explicit incentives backfire and performance is lower if the principal controls compared to if he trusts." (Falk and Kosfeld, 2004) "Principals who trust induce, on average, a higher performance and hence earn higher payoffs than principals who control" (Falk and Kosfeld, 2004).

Contracts have also impact on creating hidden cost of control. "The hidden costs of control offer a psychological rationale for the incompleteness of many real-life economic contracts" (Falk and Kosfeld, 2004). "A striking fact is that many contracts are much simpler (and more incomplete) than standard theory would predict" (Kessler and laider, 2012). "Incomplete contracts may actually be superior to more complete contracts" (Falk and Kosfeld, 2004).

"While there is no additional monetary incentive to induce workers from exerting more effort, intrinsic motivation drive worker to provide more than minimum effort in several ways" (Jitsophon and Mori, 2013). Jitsophon and Mori found that production targeting can influence individuals` production decision (Jitsophon and Mori, 2013). Jitsophon and Mori showed that the implementation of both binding and non-binding production target on workers lead to a drastic fall in their productivity after they have achieved their production target (Jitsophon and Mori, 2013).

"Control and explicit incentives entail hidden costs, which should be taken seriously. The message is *not*, however, that it is always better for principals to trust than to control" (Falk and Kosfeld, 2004). "When facing rather opportunistic agents with a low intrinsic motivation to perform in the interest of the principal, controlling generates only minor costs and trusting is likely to be suboptimal"(Falk & Kosfeld, 2004). Falk and Kosfeld found that low wages pay for the principal to control. For higher wages, however, control may no longer be optimal (Falk and Kosfeld, 2004).

Entry barriers can also create hidden costs of control. "Countries differ significantly in the way in which they regulate the entry of new businesses" (Djankov et al., 2002). "Heavy regulation in some countries is a reflection of both significant market failures and the unavailability of alternative mechanisms of addressing them, such as good courts or free press" (Djankov et al., 2002).

Falk and kosfeld pointed: "Control has an adverse effect on many agents' performance. The controlling decision really matters. Agents seem to believe that principals who control expect to get less than those who don't, and their beliefs positively correlate with their behavior. When asked for their emotional perception of control, most agents who react negatively say that they perceive the controlling decision as a signal of distrust or a limitation of their choice autonomy" (Falk and Kosfeld, 2004).

Therefore, hidden costs of control really exist in every business organization. Companies should consider it properly so that they can remove or at least reduce these costs.

5. Methodology

The study is descriptive in nature. Qualitative research approach has been used throughout the study. Here findings & empirical evidences are based on observations, case studies of different authors & conversation. In case of data collection we have used both primary & secondary data.

Primary data collection: Primary data are collected through conversation with different governing bodies & employees of different organizations.

Secondary data Collection: Secondary data are selected from following sources:-

- ✓ Different articles;
- ✓ Journal and relevant books;
- ✓ Website information; and
- ✓ Research documents on hidden costs of control.

6. Scope of the Study

Evaluating effects of rigid control over every organization is a board task. This study tries to cover empirical as well as probable circumstances of creating hidden costs of control in different private & public companies, financial institutions, educational institutions, as well as commercial shops etc.

7. Findings

7.1. Probable Circumstances for Creating Hidden Costs of Control and the Resulting Consequences

- ❖ **Distrust**: Putting more control mechanisms sometimes perceived as symbol of distrust not only from employees but also from customers viewpoint. Control system disrupts in creative workings of employees & buying decision of customers. The resulting effect is that lower profit and existence of hidden costs.
- ❖ **Undermining motivation**: Exerting control is sometimes being subject of torture rather than discipline, which has negative effect on employee's intrinsic motivation. When employees lose their motivation for work they become irregular at their work, which is harmful for organization's productivity. To fill up this productivity gap organizations also incur cost on hiring temporary worker. Further, employees who want to do job at their own discretion sometimes find excess surveillance putting restrictions on their freedom of choice. This has negative impact on their job satisfaction which is related with job performance as the lower the job satisfaction the lower the job performance.
- ❖ **Mismatches between values of employee & organization:** Employers basically put control systems to prevent employees' opportunistic behavior which hurt ego of the employees who work by abiding ethical values. And often being pressurized by increased surveillance employees quit from their jobs & switch to other organizations. Due to this reason sometimes organization loses talented employees resulting poor performance of the organization which clearly gives indication of the existence of hidden costs.
- ❖ **Health consequences**: Employee monitoring is associated with a host of mental problems, including high level of tension, severe anxiety & depression. Employees also experience physical disorders like carpal tunnel syndrome, when they perceive their organization's surveillance system as encroaching on their privacy (Cialdini et al., 2004).
- ❖ **Backlash to perceived restrictions of control**: People who feel that their sense of freedom is being threatened will often try to reassert some control over their environment. In the workplace, employees might attempt to empower themselves through both corrective & retributive means; that is, by trying to regain the control that way previously taken away and by committing deliberately hostile actions to retaliate. Consequently in an organization with excessive control system, some employees might be more motivated to steal from company providing a bad signal to the company's monitoring and control system (Cialdini et al., 2004).

7.2. Empirical Examples of the Existence of Hidden Costs of Control and the Resulting Consequences

Rigid access to organization information: In Bangladesh, banks, financial institutions do not want to provide information to the external users especially researchers. It makes bad impact on research work as much important information is not known to the researchers. On the other hand, in most of the developed countries there are separate information desk so that users can get information what they want.

Rigid access to sites: In Bangladesh, students most of the times do not get access to different sites in the internet due to not having account or not knowing password. Sometimes the process of opening an account is very much complicated. Further, some sites ask for debit card or credit card which many times are not available to all students. But in developed countries students get access to any sites for information purpose. This makes a bad impact to the students of our country.

Controlling employees' movements: In Bangladesh, in most of the business organizations employees are strictly controlled by their employers in case of getting access to organization related information. It may help employees not feel himself as a part of the company. In that case, they will work only for their remuneration and they will not try even thinking about contributing more for further progress of the company.

Garment factory: In Bangladesh, in most of the garment factories the gates remain locked at the working time so that no worker can go outside during working hour. And these gates do not make open sometimes if any worker faces any emergency. Additionally, most of the female workers do not get maternal leave duly during their pregnancy time. Moreover, the workers do not enjoy public holidays sometimes due to the pressure of works. All these in aggregate make a seriously negative impact in the minds of the workers which discourage and motivate less them to work more. And most of the time these workers do not feel to contribute something for the company as well as for the economy as a whole.

Shopkeepers' behavior: Some sellers do not behave well with the customers and even sometimes try to control the movement of the customers. These most often make a negative impact on those customers' minds. And many of them do not come to make shopping in the same shop again in future.

Libraries: In Bangladesh, students have limited access to bookshelves whereas in developed countries, the access to books and other reading materials is unlimited. This limited access seriously affects their studies, research, and knowledge (Chowdhury, 2012).

Professor Mohammed Yunus: Recently there has been a debate on chief executive position of Grameen Bank. Professor Yunus, the Nobel Laureate, and the managing director is seventy year old. The government, one of the owners of the bank, has asked Yunus to retire because the retirement age for chief executive of a bank is sixty years. Many people at home and abroad believe that the time limit of sixty years should not be rigidly applicable for the Nobel Laureate who showed charisma and extraordinary leadership in micro credit around the world. They think it would be costly for Grameen Bank and the country if Yunus is separated from the bank at this stage (Chowdhury, 2012).

Business Regulation: Countries with better regulations grow faster. A major determinant of growth is regulations that is governing business entity. The business regulations and growth are consistently and positively correlated. Countries with less burdensome business regulations grow faster (Djankov et al., 2006). The impact of improving business regulations is large. By improving business regulations, average annual growth also increases. The effect of other commonly used growth determinants like improvements in primary school enrollment, secondary education, inflation, and government consumption are significantly lower than the effect of business regulations (Djankov et al., 2006). Thus, countries should put priority on reforming their business regulations when designing growth policies.

Regulation of Entry: Public interest theory assumes that if the regulation of entry serves public interest it should be associated with higher quality of goods, fewer damaging externalities, and greater competition. The public interest model predicts that governments whose interests are aligned with those of consumers, which we think of as the more representative and more limited governments, should ceteris paribus regulate entry more strictly. On the other hand, **public choice theory** predicts that stricter regulation is most closely associated with less competition and higher corruption. This model assumes that the governments least subject to popular oversight should pursue the strictest regulations, to benefit themselves and possibly the incumbent firms (Djankov et al., 2002; Djankov at al., 2006).

Countries with heavier regulation of entry have higher corruption and larger unofficial economies, but not better quality of public or private goods. Countries with more democratic and limited governments have lighter regulation of entry. Sometimes entry regulation benefits politicians and bureaucrats (Djankov et al., 2002). Countries with more open access to political power, greater constraints on the executive, and greater political rights have less burdensome regulation of entry – even controlling for per capita income – than do the countries with less representative, less limited, and less free governments (Djankov et al., 2002).

8. Measurement of Hidden Costs of Control

Hidden costs are not explicit. They are implicit and not easily visible like other costs. Thus it can be called intangible costs or opportunity costs. Moreover, hidden costs are difficult to measure qualitatively as there is no model to estimate hidden costs of control yet. But hidden costs can be measured qualitatively. We may assume that the hidden cost may be that amount which is occurring due to rigid control or the amount of profit losing due to this control.

Some probable ways of measurement are given below:-

For shop: If a shopkeeper loses 5 customers due to his rigid control he can estimate the hidden costs by estimating the amount of profits if those customers purchased from his shop. And this cost can be shown as a non-operating item in the income statement.

For bank: if we want to find out the hidden costs of a bank who is not giving access to the users especially researchers to get information, it would be difficult to measure quantitatively but not impossible. We may estimate it by assuming that if the researcher got information from the bank, he would have a positive thinking about the bank. And he may include the name of the bank in his writings particularly in the reference. And the readers will come to know about the bank. Moreover in future that bank may get new customers who have become interested about the bank due to its providing information to that researcher. The hidden costs of that bank may be the amount of profit not making due to not getting a certain amount of customers as a result of not providing information to the researcher.

Thus, we may estimate or measure hidden costs in approximate by making logical judgments about particular situations and circumstances. And we may record it as a non-operating item in the income statement.

9. Hidden Costs of Control and Agency Problem

Agency theory is concerned with contractual relationships between two or more persons. Under these contractual relationships, one or more persons, called the principal(s), engage another person or persons, called the agent(s), to perform some service on their behalf (Chowdhury, 2012).

Agency problem arises mainly due to the following reasons:-

- A rational individual is usually assumed to try to maximize his or her utility;
- The principal does not directly take part in management;
- There is asymmetry of information between the agent and the principal; and
- The agent is generally assumed to be the risk-averter and the principal to be the risk-seeker.

Agency problem may contribute to increase organization's hidden costs of control drastically. If the agents are strictly regulated and controlled by their principals they reduce their performance as they take their principals' control as a symbol of distrust and a limitation of their choice of economy (Falk & Kosfeld, 2006). This is because for many individuals, intrinsic motivation and/or social norms can lead to costly pro-social behavior in the absence of explicit incentives, and that perversely interventions such as increased monitoring and/or fines can destroy intrinsic motivation and lead to worse behavior (Kessler and Leider, 2012). Pro-social behavior; i.e., voluntary behavior intended to benefit another is a social behavior that benefit(s) other people or society as a whole, such as helping, sharing, donating, co-operating, and volunteering. These actions may be motivated by empathy and by concern about welfare and rights of others, as well as for egoistic or practical concerns. In case of a business organization the pro-social behavior of an agent is monitored and controlled by the principal strategically and indirectly so that the agent's performance does not get hindrance.

Hidden costs exist even after employees are given incentives if employees do not want to be controlled by principals and also if agents by themselves feel to perform better. Workplace environment that limits freedom of choice and signals low expectations, such as high levels of monitoring and surveillance create hidden costs of control.

Principals sometimes fix targets of production and provide incentives to the agent who satisfies the target level and give punishment who fails to meet the target. This most often transfer a negative feedback to the agents. And most of the time they either only produce up to the target level or produce less. And they never try to improve their performance. Therefore, it would be better to not to fix target level for example fixing to produce 100 to 150 units of product per working day and give freedom to the agents. If principals voluntarily refrain from using the punishment threat when it is available, agents exhibit significantly more trustworthiness than if the punishment threat is not available. Thus, if agents face no punishment threat, the mere fact that the principal could have used the punishment option affects the agent's trustworthiness in a positive manner (Fehr and List, 2004).

10. Ways to Remove/Reduce Hidden Costs of Control

Information availability: Control comes from distrust and distrust is the result of information asymmetry. So to reduce the hidden costs of control it is necessary to make information available to related parties.

Freedom of choice: To flourish creativity and new ideas universities, educational institutions, research and development teams should have flexibilities and freedom of choice in their work because control can hinder creativity (Chowdhury, 2012).

Less regulation: Countries with lower regulation of entry like number of procedures, official time and costs have lower corruption (Djankovet 2002). So it is better to have less rules and regulation.

Lower power distance: People in high power distance countries tend to believe that power and authority are facts of life. Both consciously and unconsciously, these cultures teach their members that people are not equal in this world and that everybody has a rightful place, which is clearly marked by countless vertical arrangements.

Social hierarchy is prevalent and institutionalizes that inequality. In this controlled environment it is difficult to create something new or break the tradition. On the other hand, in lower power distance countries there is a preference for consultation and subordinates will quite readily approach and contradict their bosses. The parties will openly work towards resolving any dispute by stating their own points of view. If they cannot come to a satisfactory conclusion, they may choose to involve a mediator. Leaders actually encourage independent thought and contributions to problem solving and expect (within reason) to be challenged (Hofstede, 1984). Lower power distance means less control and more flexibility.

Strategic Control: Corporate governance relies on distrust in so far as the board is not to trust the reports it receives from management, but is empowered to investigate them, challenge them, and otherwise act on behalf of shareholders versus managers. So they try to control management and agents reduce their performances in reaction to the controlling environment. To reduce this problem control should not be direct and rigid it should be strategic.

Workplace flexibility: Flexibility is better than control for organization. A 2003 study where professional and technical workers were surveyed in seven biopharmaceutical firms in one state found that the mere presence of formal or informal flexibility policies was "significantly associated with higher productivity." Not surprisingly, the study noted that businesses are most advantaged by such workplace flexibility policies when employees actually "perceive" that they can utilize them (Focus on workplace flexibility, 2014).

Flexible corporate culture: Organization which can change consistently according to their customers and environment and learn from their mistake tends to do better than the organization with rigid or structured corporate culture.

11. Conclusion

From the above study it is almost clear that hidden costs of control exist more or less in all organizations. So it is important to identify such costs and take necessary steps to reduce or remove such costs. For this it is important to know about hidden costs of control clearly. Hidden costs of control may arise due to various reasons like distrust, undermining motivation, mismatches between values of employee and organization, health consequences, and so on.

Countries having rigid regulation of entry cannot do well in doing business. But countries having limited governments, free of access, easy start-up procedures, as well as flexible regulation progress in business field indirectly helping to improve the economy of the country.

It is not easy to measure hidden costs of control especially quantitatively due to not having any model to measure it. But we may qualitatively measure hidden costs of control. And we may assume such costs as an intangible cost or opportunity cost. Hidden costs of control may occur due to agency problems. Employees may produce less, remain absent, and even leave the job due to rigid control. Further hidden costs of control exist due to exercise of excess power. In some cases the amount or effect of hidden costs of control may be large. So it would be better to reduce or remove such costs. We may do this in different ways like information availability, freedom of choice, less regulation, lower power distance, strategic control, and so on.

Therefore, hidden costs of control may be identified to increase the productivity as well as reducing costs and to increase profit not only short-term but also long-term. Further, organizations should always scrutinize whether there exists any such costs or not. Additionally, for the betterment of organization it is necessary to practice strategic control rather than applying it directly.

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