MANAGERIAL THEORIES OF FIRM

AGE 525

(MICROECONOMICS IN AGRICULTURE)
Introduction

• Managerial theories conceive the firm as a ‘coalition’ (of managers, workers, stockholders, suppliers, customers, tax collectors) whose members have conflicting goals that must be reconciled if the firm is to survive.

• Clearly the most important member of the ‘coalition’ is top management, because of its power in decision-making (goal-setting, basic decisions on investment and expansion, promotions and appointments of ‘key’ personnel) and access to information.

• The basic characteristics of the ‘managerial business’ is the divorce of ownership from management. The owners are the shareholders, whose power lies in appointing the board of directors, which in turn appoints the top management.

![Diagram showing the relationship between Owners, Shareholders, Board of directors, and Top management]
• The shareholders have in fact less power than the above scheme may suggest, because shares are in the hands of a large number of persons or institutions (mainly insurance companies, pension funds, finance companies).
• Small shareholders rarely attend general meetings. Instead the election of the board of directors is arranged by the existing board, assisted by the appointment of proxies (representatives of shareholders).
• The system of voting by proxies is well manipulated by the top management, which is often directly represented in the board of directors and can thus influence decisions on further appointments of top managers.
• Thus the top management tends to be self-perpetuating, provided that the level of profits is ‘acceptable’ to the body of shareholders, the rate of growth of the firm is ‘reasonable’ relative to the growth of other firms, and the dividends paid out to shareholders are sufficient to keep them happy and prevent a fall in the prices of shares, which would make the firm attractive to take-over raids.
• Thus the basic features of all managerial theories is that the managers maximise their own utility, subject to a minimum profit constraint (which is set at a level adequate to satisfy the above conditions) necessary for the job security of the top managers.
Managerial Models

Three models of managerialism will be discussed.

(1) Baumol’s model of ‘sales revenue maximisation’;
(2) Marris’s model of ‘managerial enterprise’;
(3) Williamson’s model of ‘managerial discretion’.

• These models have the same basic assumption, the maximization of the utility of the managers subject to a minimum profit constraint.

• They differ:
  
  (a) In the factors which enter into the managerial utility function,

  (b) In the key policy variables (instruments) which the managers will use in attaining their goals,

  (c) In their predictions of the consequences of changes of various parameters of the model.
Baumol’s Theory of Sales Revenue Maximisation

W. J. Baumol suggested sales revenue maximization as an alternative goal to profit maximization. He presented two basic models:

(a) static single-period model

(b) multi-period dynamic model of growth of sales revenue maximization.

Each model has two versions, one without and one with advertising activities.

Baumol offers several justifications of sales maximisation as a goal of the firm.

The separation of ownership from management, characteristic of the modern firm, gives discretion to the managers to pursue goals which maximise their own utility and deviate from profit maximisation, which is the desirable goal of owners.
Baumol’s Theory of Sales Revenue Maximisation

Several reasons seem to explain this attitude of the top management

• Firstly, there is evidence that salaries and other (slack) earnings of top managers are correlated more closely with sales than with profits.

• Secondly, the banks and other financial institutions keep a close eye on the sales of firms and are more willing to finance firms with large and growing sales.

• Thirdly, personnel problems are handled more satisfactorily when sales are growing. The employees at all levels can be given higher earnings and better terms of work in general. Declining sales, on the other hand, will make necessary the reduction of salaries and other payments and perhaps the lay-off of some employees. Such measures create dissatisfaction and uncertainty among personnel at all levels.
Baumol’s Theory of Sales Revenue Maximisation

- Fourthly, large sales, growing over time, give prestige to managers, while large profits go into the pockets of shareholders.
- Fifthly, managers prefer a steady performance with ‘satisfactory’ profits to spectacular profit maximisation projects. If they realise maximum high profits in one period, they might find themselves in trouble in other periods when profits are less than maximum.
- Sixthly, large, growing sales strengthen the power to adopt competitive tactics, while a low or declining share of the market weakens the competitive position of the firm and its bargaining power vis-à-vis its rivals.
- The desire for a steady performance with satisfactory profits, coupled with the separation of ownership and management, tend to make the managers reluctant to adopt promising projects which are risky.
- The top managers become to a certain extent risk-avoiders, and this attitude may act as a curb on economic growth. However, the desire for steady performance has a stabilising effect on economic activity.
- In general, large firms have research units which develop new ideas of products or techniques of production. Baumol seems to imply that the risk-avoidance and the desire for steady growth of the large corporations secure ‘orderly markets’, in the sense that they have stabilising effects on the economy.
Baumol’s Static Models

The basic assumptions of the static models

(1) The time-horizon of a firm is a single period
(2) During this period the firm attempts to maximize its total sales revenue (not physical volume of output) subject to a profit constraint. The firm in these models does not consider what will happen in subsequent periods as a result of the decisions taken in the current period.
(3) The minimum profit constraint is exogenously determined by the demands and expectations of the shareholders, the banks and other financial institutions. The firm must realise a minimum level of profits to keep shareholders happy and avoid a fall of the prices of shares on the stock exchange. If profits are below this exogenously determined minimum acceptable level the managers run the risk of being dismissed, since shareholders may sell their shares and take-over raiders may be attracted by a fall of the prices of shares.
(4) ‘Conventional’ cost and revenue functions are assumed. That is, Baumol accepts that cost curves are U-shaped and the demand curve of the firm is downward-sloping.
Baumol’s Dynamic Models

The static single-period model developed above is only an introduction to the more ambitious multi-period analysis attempted by Baumol. The most serious weakness of the static model is the short time-horizon of the firm and the treatment of the profit constraint as an exogenously determined magnitude. In the dynamic model the time-horizon is extended and the profit constraint is endogenously determined.

**The assumptions of the dynamic model**

- The firm attempts to maximise the rate of growth of sales over its lifetime.
- Profit is the main means of financing growth of sales, and as such is an instrumental variable whose value is endogenously determined.
- Demand and costs have the traditional shape; demand is downward-falling and costs are U-shaped.

Profit is not a constraint (as in the static model) but an instrumental variable, a means whereby the top management will achieve its goal of a maximum rate of growth of sales.

Growth may be financed by internal and external sources. However, there are limits to the external sources of finance. Thus profits will be the main source for financing the rate of growth of sales revenue. For simplicity we may actually assume that growth will be entirely financed by profit.
Marris’s Model of Managerial Enterprise

The goals of the firm in Marri’s model is the maximization of the balanced rate of growth of the firm, that is, the maximization of the rate of growth of demand for the products of the firm, and of the growth of its capital supply. In pursuing this maximum balanced growth rate, the firm has two constraints.

• Firstly, a constraint set by the available managerial team and its skills.
• Secondly, a financial constraint set by the desire of managers to achieve maximum job security.

The rationality of this goal is that by jointly maximizing the rate of growth of demand and capital the managers achieve maximization of their own utility as well as of the utility of the owners-shareholders.

It is usually argued by managerial theorists that the division of ownership and management allows the managers to set goals which do not necessarily coincide with those of owners.

The utility function of managers include variables such as salaries, status, power and job security, while the utility function of owners includes variables such as profits, size of output, size of capital, share of the market and public image. Thus the managers want to maximize their own utility while the owners seek the maximization of their utility.
Marris’s Model of Managerial Enterprise

• Marris argues that the difference between the goals of managers and the goals of the owners is not so wide as other managerial theories claim, because most of the variables appearing in both functions are strongly correlated with single variable: the size of the firm.
• There are various measures (indicators) of size: capital, output, revenue, market share, and there is no consensus about which of these measures is the best.
• Furthermore, Marris argues that the managers do not maximize the absolute size of the firm, but the rate of growth (= change of the size) of the firm.
• The size and the rate of growth are not necessarily equivalent from the point of view of managerial utility.
Williamson’s Model of Managerial Discretion

- Williamson argues that managers have discretion in pursuing policies which maximise their own utility rather than attempting the maximisation of profits which maximises the utility of owner-shareholders.

- Profit acts as a constraint to this managerial behaviour, in that the financial market and the shareholders require a minimum profit to be paid out in the form of dividends, otherwise the job security of managers is endangered.

- The managerial utility function includes such variables as salary, security, power, status, prestige, professional excellence. Of these variables only the first (salary) is measurable. The others are non-pecuniary and if they are to be operational they must be expressed in terms of other variables with which they are connected and which are measurable.

- This is attained by the concept of expense preference, which is defined as the satisfaction which managers derive from certain types of expenditures. In particular, staff expenditures on emoluments (slack payments), and funds available for discretionary investment give to managers a positive satisfaction (utility), because these expenditures are a source of security and reflect the power, status, prestige and professional achievement of managers.

- Staff increases are to a certain extent equivalent to promotion, since they increase the range of activity and control of managers over resources. Being the head of a large staff is a symbol of power, status and prestige, as well as a measure of professional success, because progressive and increasing staffs implies successful expansion of a particular activity for which a manager is responsible within a firm.
Behavioural Theory of the Firm

- Behavioural theory of the firm (BTF) is a composition of a number of theories that have emerged within economics, sociology, business and management studies – to deal with the issues of how firms behave in a market place and what determines the inter-firm relationships.

- The economic theory of the firm looks at the firm as a black box, as a unit processing inputs into outputs.

- The behavioural theory of the firm (BTF) attempt to compensate for this narrow view, and looks at what happens inside the firm, how the throughput takes place as economic activity, and how decisions are made regarding production, scheduling, and inventory.

- The BTF is known also as a decision theory, as it explains the circumstances of operational decisions, and the outcomes that contribute to value added. Decisions are interpreted as a sequential process which includes both rational and non-rational aspects, and are affected by ownership rights, liabilities, control over resources, and power.
Other core concepts related to the BTF are the notion of firm’s competences and capabilities, organisational learning, accumulation of knowledge, cognition and motivation, or how firms learn about their internal and external environment.

The BTF advocates for the endogeneity of preferences and expectation as the main source of bounded rationality, or the ‘irrational’ choices made by firm’s managers in situations of uncertainty and complexity.

The BTF is a complex agglomeration of business and management theories that contribute to our understanding of the firm.

Since its inception, the BTF is dealing with the question of firm boundaries and the related questions of incentives within and outside these boundaries, or opportunities in the environment to capture value and to generate profits and rents.

Ultimately the BTF explains strategic decision making beyond environmental incentives. It is also related to the foundations of the institutional and evolutionary theory of the firm and to various learning and innovation theories.