The theory of firms economics essay

Economics

In economics, many theories of the firm exist to predict various aspects of an organisation or firm, from its nature, structure and behaviour to the relationship it shares with the market. The various theories of the firm are ________________. The theory most suitable to India is the managerial theory of the firm, especially in cases where firms are divided into managers and their owners. Unlike sole proprietorships with a single entrepreneur where the goals of the firm are clearly started and the aim of the organisation is usually solely profit maximization, in most companies where a divide between the owners and managers is seen, the managers running the day-to-day affairs of the company and the owner who's interest lies in profit maximization (and who are not the decisional makers), the managerial theory of the firm is most appropriate. The theory differentiates and contrasts the goals of the managers and the owners, drawing comparisons and proposing compromising techniques and methods that firms could use between the groups by making clear the motivation, choices and interests that each group could face. The three theories of managerialism are Baumol's (1959) Model of Sales Revenue Maximization, Marris's (1964) theory of managerial enterprise and Williamson's (1964) theory of managerial discretion. All the above theories stem from the Berle and Means (1934) theory when they first spoke of separation of ownership and control as two detached entities in an organization. Baumol (1959) spoke of the revenue maximization hypothesis that stated that " after a minimum amount of profits have been reached firms that operate in an oligopolistic market will aim for sales revenue maximization and not profit maximization", implying that firms will naturally lean towards producing their maximum output levels (Crossan, 2009). Through his model it becomes apparent that firms

concentrate on their sales for firstly, decrease in sales usually gives the firm a " negative" impression for potential buyers; and secondly, in some firms executive pay is " linked more closely to sales than profits" (Crossan, 2009). Baumol’s (1959) model claimed that sales maximization was the ultimate objective and did not in any way state that firms may maximise their sales profits only because it can mean increased market share in the long run. He identified managers to be less likely as risk-takers which enables stabilisation of economic performance of the firm or company. The model has some shortcomings. To being with the question of time is not addressed – for how long should sales be maximised? Maximising sales in the short term is a common strategy seen in many firms to order to gain market share only so that they can increase their profits in the long term. Secondly, by not addressing the question of time in relation to sales there is inconsistency in the model as Baumol stated that " sales were the ultimate objective" (Khanna & TR, 2010). Thirdly, he assumes that it is only because the aim of the company is it maximise sales that managers are doing so, they are not maximising sales because of any other ulterior motive. Baumol fails to indentify the aspect of salary and maximising sales that Williamson (1964) does in his model. Is it possible that managers are maximising sales only because their pay will increase and by doing so they can also gain power within the firm itself? Lastly, although Baumol makes a sound argument for advertising and sales revenue maximization he provides no empirical evidence for the same[1]. Unlike Baumol’s (1959) model of sales maximisation, Willaimson (1964) hypothesised that " managers of joint stock firms would have a different set of objectives from that of profit maximizing" (Crossan, 2009). Although he first began by explaining the how price and

output can be determined using the traditional method of profit maximization, he went on the say that " managers will gain utility from discretionary expenditure on perks such as additional staff" and special projects and any other spending that will not directly affect the firm's profits (Crossan, 2009). This means that using their discretion, managers maximise their own utility increases their job security. Regardless of utility, managers tend to ensure minimum profits to entice shareholders through dividends but these profits are always less than what they would be had the firm used a profit maximization approach. Although similar to the classical model in many ways, Willaimson's (1964) model uses mathematics and quantifiable data (discretionary expenditure and staff expenditure) to explain managerial behaviour, justifying the variables as he assumes that they give insights into prestige, job security and power, indirectly indicating the manager's professional achievements. Williamson (1964) model is high on validity when speaking purely of the objectives of managers and businesses but fails if one is to literally identify " how businesses set prices and outputsbased on his model alone (Crossan, 2009). In the same year, Marris (1964) developed a theory on managerial enterprise that differentiated, based on variables of the utility functions of the owners and those of the managers. The utility variables include size of capital and output, market share, profits and the image of the company in the public's eyes. Managers he claimed want to maximise their rate of growth of sales " subject to a share price/capital worth constraint" (Crossan, 2009). Taking this into context, if share prices fall too low in comparison to the worth of the firm (capital worth), it is at a risk of take-over bid. The two most important distinctions it makes between managerially controlled and owner controlled firms are: Managerial

controlled firms chose higher rate of sales growth, which they believe is indicative of growth of firmsOwner controlled firms chose lower rate of sales growth than managerial controlled firmsIn such a situation (point one) the profit rate for the owners and shareholders will also be lowerThe above two phenomenon occur when profits are retained within the firm to fund growth for future projects such as product development and breaking into new markets – new market development. The utilities of the managers and owners do not usually clash because of the underlying, common factor of size of the firm. Similar to Williamson (1964) model, even Mariss's (1964) looks at a " trade off between managers' desire for a high rate of sales growth, that can offer them the opportunity to maximise their own utility and the need to offer dividends to shareholders" (Crossan, 2009). This is also linked to job security as, if dividends are not high enough their (manager's) jobs are at risk. The two limitations of Mariss's (1964) model are firstly, the managerial team constraint and secondly, the job security constraint. The former addresses the issue of hiring new managers in the firm. As management work in some firms requires group work, it takes time for the new manager to get acquainted with the firm and its working environment, affecting the rate of demand and capital. The latter limitation, deals with the problem of managers wanting to gain job security through the two financial ratios – liquidity ratio and equity ratio. Marris (1964) and Williamson (1964) models that explain managerial behaviour move away from the abstract analysis of the neoclassical theory known to us and concentrate on building a more realistic, applicable framework for the analysis of firm behaviour, applicable even in the Indian industry and her firms. They use mathematical equation to explain managerial behaviour and offer deep insights into the

division of ownership that may directly or indirectly affect the workings and objectives of the firm. Despite their easy understanding and applicability across firms, they lack a general rule for a theory of the firm. Nevertheless, Baumol (1959), Marris (1964) and Williamson (1964) offer models that are best applicable to the Indian context and for Joint Stock Companies that have to deal with the problem of separation of ownership of control.