

M.Com(semester-II) Applied Economics

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Williamson's Model of Managerial Discretion

O.E. Williamson presented his model in the article, 'Managerial Discretion and Business Behaviour' published in American Economic Review (1963). According to him managers have the discretion of following policies which further their utility maximization objective, rather than that of owners. But discretion of managers is limited by the desire of owners to earn a minimum level of profits. This acts as a constraint on the profit maximizing behaviour of the managers.

Managers utility function comprises the variables as salary, job security, power, status, position etc. The profits that satisfy the owners have been conceptualized as follows:

(a) Actual profit :

Actual profit is sales revenue less total costs including staff expenditure

$$= R - C - S$$

(b) Reported Profit R :

This actual profit is reported to the tax authority after deducting managerial emoluments. In other words it is the difference between actual profit and management slack (nonessential managerial expenditure)

$$R = R - M = R - C - S - M$$

(c) Minimum Profit P_0 :

This is indeed the minimum amount of profit (after tax) needed to pay satisfactory dividends to the shareholders, without which the 'job security' of the manager may be at stake. This is because if shareholders do not get reasonable dividends then either there will be a possibility of takeover or the top management may be dismissed.

$$R \geq P_0 + T$$

Thus reported profits should be sufficient enough cover minimum profit plus the taxation.

(d) Discretionary profit D :

This is also a residue, i.e., the amount of profit left after subtracting the minimum profits and the tax

$$D = R - C_0 - T$$

(e) Discretionary investment, I_D :

This is a residue of the amount left from the reported profit after setting aside minimum profit and meeting the tax obligations. Thus

$$I_D = R - C_0 - T$$

The difference between discretionary profits and investment arises due to M (management slack) which is incorporated in the former but not in the latter. Thus

$$D = I_D + M$$

if $M=0$; then $D = I_D$ as $R =$

The model

According to Williamson, managers are concerned with the goodwill of the firm only to the extent that it favours their own personal motives and ambitions. He argues that the most important motive of managers are desires for salary, security, dominance and professional excellence

These can be gained by incurring additional expenditure on staff, managerial emoluments and discretionary investment. Williamson argues that managers have discretion in pursuing policies which maximize their own utility rather than seeking the maximization of profits which maximize the utility of most shareholders (i.e., the owners of the company). The function can be written as

$$U_m = f(S, M, I_D)$$

where U_m = managerial utility, S = monetary expenditure on staff including managerial salary, M = Managerial slack, absorbed as a cost, and I_D = amount of discretionary investment. Apart from salary directly, managerial power and status in the firm also depend on number of staff working under him. This being directly related to salary is clubbed with it in the U_m function. Management slack concerns non essential expenditure on lavishly furnished offices, luxurious company car and the like. Discretionary investment is the amount of funds the managers can use according to their will. Maximization of the above utility function is subject to minimum profit constant.

Price in the model is $P = f(X, S, e)$

That is, P is a function of output, staff expenditure and a demand shift parameter showing autonomous change in demand. Cost is assumed to be an increasing function of output.

Confining only to a simplified model where M is taken as nil, the mathematical and diagrammatic illustration has been given in the succeeding paragraphs. Thus

$$U_m = f(S, I_D)$$

Where $M=0$, and therefore as $R =$

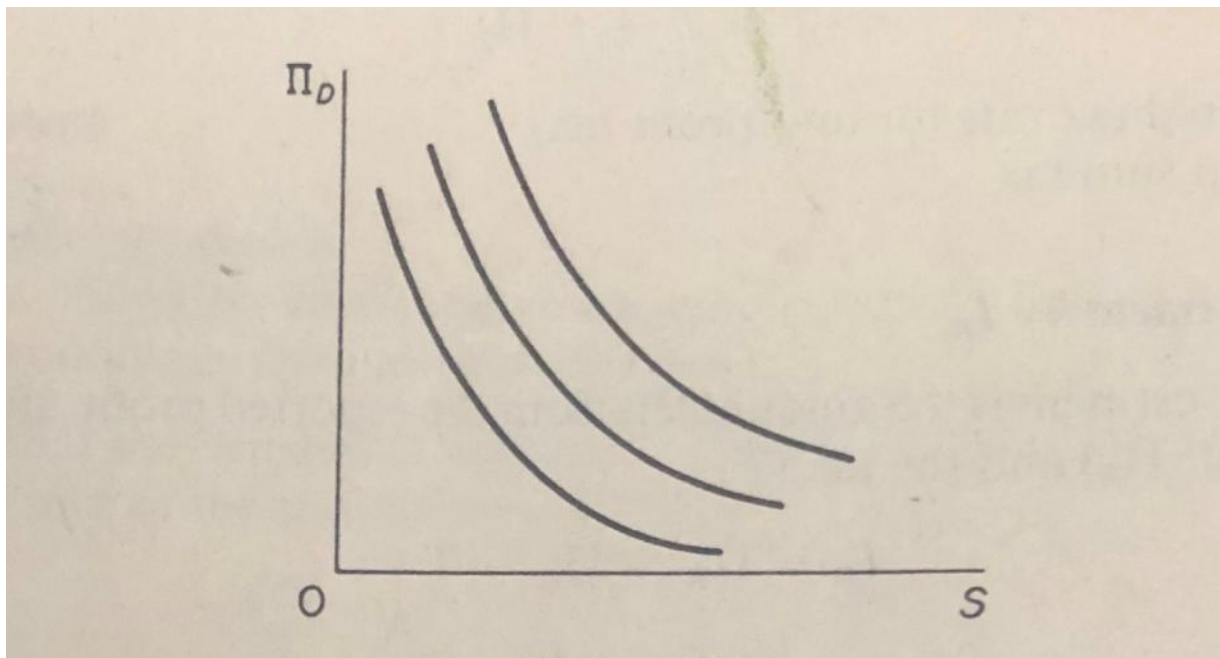
$$I_D = \dots - 0 - T$$

Or,

$$\text{Maximise: } U_m = f[S, (\dots - 0 - T)]$$

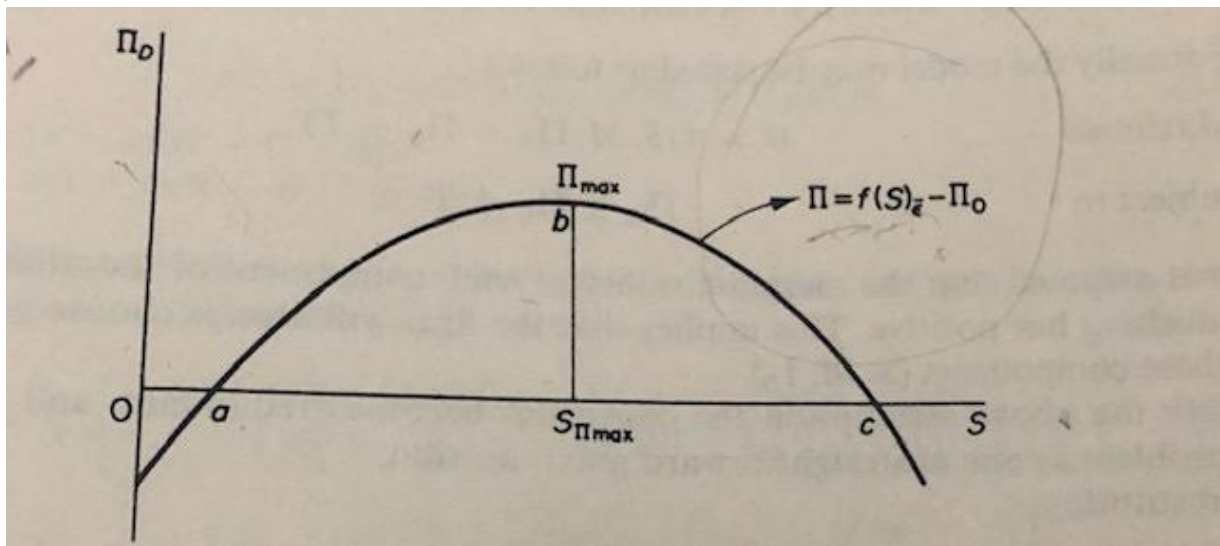
$$\text{Subject to: } R \dots 0 + T$$

Diagrammatically equilibrium of the firm in Williamson's model can be shown by first drawing indifference map for managers based on their utility function. These ICs show the indifference of managers between staff expenditure and discretionary profit ($I_D = I_D$). These curves have the usual properties.



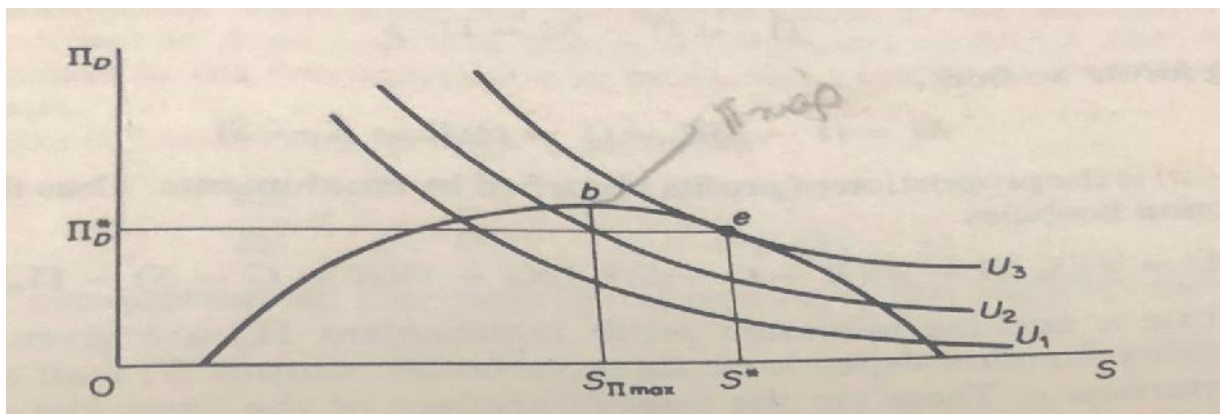
Source: A. Koutsoyiannis, Macmillan

The relationship between discretionary profit and staff expenditure is determined by the profit function.



Source:A. Koutsoyiannis, Macmillan

With the increase in staff expenditure there is an increase in output and discretionary profits up to the point of maximum profits, beyond which discretionary profits tend to decline. Increase in staff expenditure beyond c results in discretionary profits turning negative.



Source:A. Koutsoyiannis, Macmillan

To find the equilibrium, manager's indifference map and discretionary profit curve is brought together. The point of tangency of profit-staff curve with the highest possible managerial indifference curve at point e shows the equilibrium of the firm. Since ICs have a negative slope, the equilibrium point will be at the falling part of profit curve. Thus according to Williamson, there is a greater preference for staff expenditure by the managers. The staff expenditure here will be greater than that of a profit maximiser. This model implies higher output, lower price and lower level of profit than the profit maximization model.

References

1. A. Koutsoyiannis, Macmillan
 2. H.L. Ahuja, Advanced Economic Theory
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