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For M.com sem II students

Behavioural Theory of Firm: Cyert and March

Behavioural theory is a more realistic approach of business analysis as it is based on the actual behavior and decision making by the firms. The firms according to this approach do not aim at maximization of either profit, sales and even utility. Instead firms aim at **satisficing**,i.e., having satisfactory performance with respect to profit, market share, sales and so on. **Cyert and March(C&M)** in their work, óA Behavioural Theory of Firmô, published in 1963 have presented a systematic theory about the behaviour of large corporations under uncertainity in an imperfect market. Ownership is divorced from management and decision making is not by a single entity (owner-entrepreneur), but a complex group comprising various members of the multi-goal, multi decision organizational coalition. There might be conflict in goals as individually the interests of the parties in the group may differ. This group may include managers, stock holders, workers, suppliers, vendors etc., labeled by them as **organizational coalition.** C&M reject the assumption of certainty which was a basic assumption in the neo-classical thought. Increased degree of uncertainity and complexity result in limited foresight regarding both internal and external developments.

Conflicting Goals

C&M have emphasized that firms have conflicting multiple goals to pursue, depending on the demands of the members of the coalition. The demands of these members are dependent upon a number of factors, like, aspirations of the members, past achievements, future expectations and so on. These demands of members keep on changing overtime, making this a dynamic theory. The goals of the firm are set by the management. C&M categorize these goals into five:

i) **Production Goal-** is related to output decision making. It incorporates demand of coalition members connected with output ,i.e., workers. It incorporates demands for stable employment, cost, performance and growth.

ii) **Inventory Goal-** it is concerned with the demands of coalition members who are concerned with the inventory of the finished goods,i.e., salesman and customers. It is concerned with the decisions in output and sales areas.

iii) **Sales Goal-** is concerned with the demand of those members who are directly related to sales, i.e., salesman and those who regard sales as necessary condition for sustained growth of the organization. The sales strategy is generally set in the sales department.

iv) **Market share Goal-** relative market share measures the dominance of a firm, thereby being a measure of its comparative success and growth. Those members of the coalition such as top level managers and those concerned with sales management are mainly interested in this goal.

v) **Profit Goal-** is important goal for the organization, meeting the demands of shareholders for distribution as dividends; and management as bonus and perks and also as accumulated resources for other purposes. Monetary profits are generally taken as target achievement. The profit goal may be set in terms of profit share or return on investment. It is related to pricing and resource allocation decisions.

These goals are empirically proven, and according to C&M guide a firm in decision making with regard to price, output and sales strategy. According to them all goals need to be satisfied, but there is latent order of priority in their satisfaction, depending upon the respective bargaining power of the members of the coalition.

Satisficing Behaviour

Following Simon[1], C&M argue that a firm instead of maximizing profit aims at **satisficing,** i.e., achievement of satisfactory performance with respect to the aspiration levels[2] of goals set by it. According to them satisficing behavior is rational. Goals are set by the top management and ratified by the board of directors. These goals take the form of aspiration levels, attainment of which is an indicator of the satisfactory performance of the firm. In words of Koutsoyiannis[3] the Behavioural models, ćredefine rationality. Traditional theory defined the rational firm as the firm that maximizes profit. The behaviourist school is the only theory that postulates a satisficing behavior of the firm, which is rational given the limited information and limited computational abilities of the managers[4].ô

Resolving the conflicting goals

As the coalition is made up of diverse members, their demand and demands for allocation of limited resources give rise to conflicting goals. However according to C&M these do not give rise to any chaos and instability. The decision making and goal setting is based on past performance. Besides, decentralization and delegation of functioning limits the role of individual members, thereby reducing channels of conflicts. Apart from these, top managers use a number of measures for the resolution of conflict, taking the form of money payments, side payments, slack payments, catering to the demands sequentially and decentralized decision making. The money payment is the actual payments made to factors of production, in the traditional theory since there was no conflict of interest, there was no need for additional payments. Side payments come in terms of policy commitments which are made by the firm by earmarking additional funds for the projects of the members. These do not go directly to them as salary but are in form of side payments to them.

Organizational Slack

Organizational slack or slack payments are those payments which are made to the members over and above required for the efficient working of the firm. Although in other managerial theories only management slack is recognized, C&M emphasize that slack payment of other members can also be non-zero. In traditional theory of firm slack is zero.

Some members, particularly the members who are full time employees usually get more slack payments than the others. Organizational slack according to C&M plays both a stabilizing and adaptive role. It serves as a shock absorbing cushion during difficult times. During flourishing times more slack payments are made and vice-versa. The pool of resources for this purpose helps the business to face any adversity, as payment of less slack makes possible for the firm to use the resources for emergency purposes.

Decision Making Process

The decision making has to be done at the top management as well as lower management level. Depending upon the available resources and goals of the firm, distribution of resources to various departments is done by the top management according to budget. The proportion of budget to various departments depends upon bargaining power and skill of the departmental head. The aim is to secure a large share for various departments but the top management retains some resources to be used at their discretion whenever required.

The top management approves the proposals of the departments on the basis of two criteria: the **budgetary** or the financial criterion which tests whether adequate funds are available for the project; and, the **improvement** criterion which analyses whether the project in question will lead to a betterment of the organization.

For the above decision making process, information flow is required. This is not free as assumed by the traditional theories. Information determines demand of each department which helps top management in goal setting.

At the lower management level, once the departmental budgets are earmarked, decision making is decentralized by the delegation of authority in each department facilitated by the blueprint of rules. The staff at lower level learns from past experience and discards measures which did not work for the organization in the past. So continuous efforts are made to achieve a better state for the organization in the future. According to C&M the firm is an **adaptively rational system**[5]. The budget and balance sheet of every department are the controlling tools in the hands of top management.

Uncertainty and the Firm's Environment

The model talks about two types of uncertainties: market uncertainty and uncertainty regarding competitorŵs reactions. The first one can occur due to a change in consumersô preferences or changes in production technique. This uncertainty cannot be avoided, the theory therefore ignores long run in which these uncertainties occur and considers only the short period time horizon.

The second uncertainty arising out of competitorŵs behavior is completely ignored by assuming that the firms have arrived at a tacit collusion in the oligopolistic set up. The firms are assumed to negotiate with their competitors to avoid the second uncertainty.

Price Behaviour in the Model

C&M developed a simple behavioural model explaining the process of decision making on price, output, cost, profits etc. Goals for the firm are with regard to profits, production and sales. At the beginning of each period aspiration levels are considered and modified on the basis of past experience. On basis of the demand and cost the firm fixes its output. However, when this output does not result in aspired level of profit, then a search is made for means of reducing costs and changing the demand goal. Possibly the profit goal is lowered. For reduction in cost of production, various expenditures including sales promotion expenditures and organizational slack is reduced. This helps in lowering the price of the product and in difficult scenario, the profit goal. In this model a close relationship is found to exist between price, costs and profits on the basis of empirical evidence. In response to the changing business environment the behavioural theory accommodates an adjustment in terms of cost of production and price, which is not found in the traditional theory, in where least cost combination is attained independently to market conditions prevailing with respect to the product.

Criticism

One of the major shifts of thought in the theory of firm, behavioural theory has provided realistic insights into decision making process of the firms. It is able to explain the goal setting process and internal resource allocation of a firm. Further, it also is able to highlight stabilizing role of organizational slack during varying growth phases of the firm, although they deal with only managerial slack. Apart from this, the theory also realistically gave up the maximizing behaviour as the only goal pursued as assumed by the traditional theory of firm. In spite, there have been some points of critique also, given as follows.

i) The theory is based on the simulation approach which is a predictive technique. It simply predicts the firmǿs behaviour, without explaining it.

ii) The behavioural theory is based on empirical evidence of duopoly; does not explain interdependence and interaction of firms. Further to avoid uncertainty a tacit collusion between firms is assumed. The conditions for arriving at stable industry equilibrium are not touched upon.

iii) The conditions of entry and behaviour of existing firms on face of potential entry are not discussed.

iv) It is concerned only with short run, therefore the impact of invention and innovations on firms behaviour cannot be analyzed as these are long run activities.

v) The assessment of satisfactory performance requires ‘constant measuring rod’[6] i.e. well defined set of long run goals.

vi) To avoid market uncertainty, short run planning is assumed. Long term analysis of market is required for realistic decision making.

Notes and References

1. H.A.Simon, ‘A Behavioural Model of Rational Choice’, Quarterly Journal of Economics,1955 and ‘Models of Bounded Rationality,Volume1:Economic Analysis and Public Policy’,1982.
2. Aspiration level theories assume that an agent has an aspiration level, which is either a value on a goal variable(e.g. profit or market share)or, in case of the multiple goals, a vector of goal values that is satisfactory to the agent. Aspiration levels are not fixed and can be dynamically adjusted on basis of internal and external business conditions. Ibid,1982.
3. Koutsoyiannis, Modern Microeconomics, Second Edition,p. 390.
4. Rationality is bounded rationality, i.e., rationality subject to constraint.
5. Individuals and firms learn from experience, see Roger Frantz, The Beginnings of Behavioural Economics: Katona, Simon and Leibenstein’s X-Efficiency Theory, Academic Press, 2020.
6. Op. cit., Koutsoyiannis, second ed.
7. H.L. Ahuja, Advanced Economic Theory, S. Chand & co., 2010.
