Theory Of The Firm-Are Firms Just In Business To Make Profits Essay, Research Paper

Firms are in business for a simple reason: To make money. Traditional economic theory suggests that firms make their decisions on supply and output on the basis of profit maximisation.

However many Economists and managerial Scientists in our days question that the sole aim of a firm is the maximisation of profits.

The most serious critique on the theory of the firm comes from those who question whether firms even make an effort to maximise their profits. A firm (especially a large corporation) is not a single decision-maker

, but a collection of people within it. This implies that in order to understand the decision-making process within firms, we have to analyse who controls the firm and what their interests are.

The fact that most large companies are not run by the their owners is often brought forward to support this claim. A large corporation typically is owned by thousands of shareholders, most of whom have nothing to do with the business decisions. Those decisions are made by a professional management team, appointed by a salaried board of directors.

In most cases these managers will not own stock in the company which may lead to strongly differing goals of owners and managers. Since ownership gives a person a claim on the profit of the firm, the greater the firm’s profit, the higher the owners income. Hence the owners goal will be profit maximisation.

When managers salary stays unaffected by higher profits they may pursue other goals to raise their personal utility.

This behaviour strikes the critical observer regularly when for example reading or watching the financial media. Managers there often rather mention the rises in sales or the growth of their company rather then the profits. Some economists like Begg (1996) argued that managers have an incentive to promote growth as managers of larger companies usually get higher salaries. Others like Williamson (1964) suggested that managers derive further utility from perquisites such as big offices, many subordinate workers, company cars etc. Fanning (1990) gives a rather bizarre example: When WPP Group PLC took over the J. Walter Thompson Company, they found that the firm was spending $80,000 p.a. to have a butler deliver a peeled orange every morning to one of their executives. An unnecessary cost clearly from the perspective of the company owners. But often it becomes difficult to identify and separate this amenity maximisation from profit maximisation. A corporate jet for example could be either justified as a profit maximising response to the high opportunity cost of a top executive or an expensive and costly executive status symbol.

Baumol (1967) hypothesised that managers often attach their personal prestige to the company s revenue or sales. A prestige maximising manager therefore would rather attempt to maximise the firms total revenue then their profits.

Figure 1 illustrates how the output choices of revenue- and profit maximising managers differ.

The figure plots the marginal revenue and marginal cost curves. Total Revenue peaks at x r , which is the quantity at which the marginal revenue curve crosses the horizontal axis. Any quantity below x r , marginal revenue will be positive and the total revenue curve will rise as output goes up. Hence a revenue-maximising manager would continue to produce additional output regardless of its effects on cost.

Given this information one might ask why the owners don t intervene when their appointed managers don t direct their actions in the interest of the owners, by maximising profits.

First of all, the owners will not have the same access to information as the managers do. Where Information relates to professional skills of Business administration as well as those of the firms inner structure and its market enviroment.

Furthermore, when confronted with the owners demands for profit maximising policies, a clever manager can always argue that her engagement in activities, like a damaging price war or an expensive advertising campaign serve the long-run prospect of high profits. This excuse is very difficult to challenge until it is too late.

Another aspect is that managers aiming to maximise growth of their company (expecting higher salaries, power, prestige, etc.) often operate with a profit constraint.

A profit constraint is the minimum level of profit needed to keep the shareholders happy. The effects of such a profit constraint are illustrated in Figure2.

Figure2 shows a total profit curve (T∏). T∏ is derived from the difference between TR and TC at each output level. If the minimum acceptable level of profit is ∏, any output greater then Q3 will result in a profit below ∏. Thus a sales-maximising manager will opt for Q3 which gives the highest level of sales at the minimum possible profit. This however would not be the profit maximising option. In order to maximise profits the manager would have to chose an output level that creates Q2, where profits are highest but sales lower then in Q3.

So given this conflict of interests between the owners and the managers of a firm? What are the possible solutions available to the owners, to make their agents work in their interest?

It is often suggested that an effective way to control the managers behaviour and bring it in line with the owners interests, is to make the managers owners themselves by giving them a share in the company. However, research by De Meza & Lockwood (1998) suggests that even with the managers owning assets, their performance does not necessarily become more profit raising. Rajan & Zingales (1998) assessed the impact of power and access to it on the behaviour and performance of managers. Their findings suggest that the power gained by access to critical resources is more contingent than ownership on managers or agents to make the right investment and decisions then ownership. They also report adverse effects of ownership on the incentive to specialise.

Other ways to control managers include performance based pay, which can prove to be effective in the short-run but again, the long-run perspective of the firm may suffer, when managers neglect crucial

Long-run investments into Research and Development, restructuring, equipment or advertising to raise short-run profits and hence their own salaries.

In conclusion it is important to note that profit maximisation fails to demonstrate a general validity when applied as a theory of firm-behaviour. The real world businesses often operate on a multi-dimensional basis with many confronting interests and aims. As well as differing short-run and long run aims. Therefore profit-maximisation should be regarded as one possible goal of a firm but not necessarily its sole one. There is also a difference to be noted between the size of firms. A small family-run business for instance can easily adopt a pure profit-maximising approach, since the utility of its owners equals that of the labour-force and the management. In this setting, the income will equal profit.

Therefore it is imperative to assess and develop a theory of firm behaviour on the different classes of firms with a perspective to their individual differences in management, ownership and market enviroment.

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