CHAPTER - 1

INTRODUCTION AND STATEMENT OF THE PROBLEM

1.0.0 RISK AND UNCERTAINTY IN ECONOMIC MODELS OF THE FIRMS :

Risk and uncer tainty are inseparable ingrediants of business activity. This phenomenon did not find a place in Classical and Neo-Classical models of the firm as they assumed conditions of perfect competition. Under perfect competition, it is assumed that all the firms have perfect knowledge and that they know the business environment with certainty. Recent developments in the literature are predominantly featured by theories that reject the Classical model of the firm and introduce risk and uncertainty of external environment in their models. But they too assume Classical forms of maximising behaviour like 'maximising' shareholder utility, 'maximising' managerial utility etc. For example, Managerial[1], Organisational[2] and Behavioural[3] theories of the firm first recognise the separation of ownership and control ; and then based on this, develop models to explain the business behaviour. However these models, unlike the Classical model, recognise the presence of risk and uncertainty in the business environment and take these factors into account while explaining the business behaviour.

In the Classical model of the firm, the sole-owner-manager of the firm bears the entire risk, if at all there is any, since ownership and control of the firm lie in the same hands i.e., there is no divorce between the ownership of the firm from its control. The problem arises once the control is separated from the owners of the firm. Managerial and Behavioural models of the firm basically deal with this very phenomenon.

Economic, Managerial and Financial theories of the firm[4] state that the firms make decisions according to a set of predetermined rules aimed at either maximising or minimising one thing or the other. The common characteristic of all these firms is that they have a single goal.

1.1.0 BEHAVIOURAL THEORY OF THE FIRM :

An important deviation from this tradition is the Behavioural Theory of the Firm propounded by Professors R.M.Cyert and J.G.March. Unlike in other theories, they treat the firm (i) as a coalition of members of conflicting interests ; (ii) it has five goals viz.inventory goal,production goal,sales goal,market share goal and a profit goal ; (iii) with no predetermined mathematical models or equations to make decisions ; (iv) they lay emphasis on the internal decision making process like how decisions are made and how the decisions change over time. They argue that any conflict among coalition members is resolved by paying organisational slack. The coalition is feasible one only if their demands are met. The demands of the coalition members and the actual payments are equal only in the long-run. They focus on the short-run relationship between the demands and the actual payments and on the imperfections in the factor market which dominate the firm behaviour. In the short-run there are frictions in the mutual adjustment of payments and demands. There is a disparity between the payments needed to maintain the coalition and the resources available to the organisation. This "difference between total resources and total necessary payment"[5] is termed as organisational slack,also called as side payments."Slack consists ~~in~~ of payments to member of the coalition in excess of what is required to maintain the organisation

1.2.0 ORGANISATIONAL SLACK :

Cyert and March suggested that "many forms of slack typically exist : stockholders are paid dividends in excess of those required to keep shareholders (or banks) within the organisation; prices are set lower than necessary to maintain adequate income from buyers; wages in excess of those required to maintain labour are paid;executives are provided with services and personal luxuries in excess of those required to keep them; the sub-units are permitted to grow without real concern for the relation between additional payments and additional revenue; public services are provided in excess of those required."[7] Thus they identified dividends, prices,wages,managerial perquisites,growth and public services as organisational slack variables. "In conventional economic theory slack is zero (at least at equilibrium)....attention is ordinarily focused on only one part of slack-payments to owners-and it is assumed that other slacks are maintained at zero."[8]

1.3.0 ORGANISATIONAL SLACK IS NOT DELIBERATELY CREATED ?

But they argue that organisational slack is not deliberately created. It arises automatically from the bargaining and decision process without any conscious intent on the part of the coalition members. To quote :

"Slack operates to stabilise the system in two ways : (1) by absorbing excess resources it retards upward adjustment of aspirations during relatively good times ;(2) by providing a pool of emergency resources it permits aspirations to be maintained (and achieved) during relatively bad times...This is not to argue that slack is deliberately created for such a stabilising purpose ; in fact,it is not. Slack arises from the bargaining and decision process .....without conscious intent on the part of the coalition members to provide stability to the organisation. In a sense,the process is reinforced because it 'works' and it 'works' partly because it generates slack,but we have seen no significant evidence for the conscious reationalisation of slack in business firms." [9]

1.4.0 STATEMENT OF THE PROBLEM :

This is the arguement that provides a base for the present work. We express our doubt as to the validity of their statement and hypothesise that slacks are deliberately created with all the conscious intent on the part of the management (both the top and the below the top management)[10] one of the members of the coalition. The present work attempts to test this hypothesis with an evidence for the same from the Indian industry.

1.5.0 ECONOMIC LEVERAGE :

The concept of organisational slack, OS,is found to be too narrow to encompass all the variables identified from various studies as slacks and to deal with the phenomenon of firm's adaptability to environmental changes to protect its fluctuating fortunes. Moreover,there are a number of inconsistencies in the concept of organisational slack. As such we have introduced a better and broader concept 'Economic Leverage',EL, to include all such possible variables. Positive evidence of conscious rationalisation of deliberate creation of EL will confirm the deliberate creation of OS as the later is a part of the former.

1.6.0 OBJECTIVE OF THE STUDY :

The basic objective of the study is to give a conscious rationalisation for the deliberate creation and management of Economic Leverage. While doing so,it attempts :

(i) to critically evaluate the concept of organisational slack with regard to its explanatory power and logical consistency for analysing firms' behaviour especially its adaptability to environmental changes,

(ii) to identify Economic Leverage variables, estimate their relationship with 'performance' variables and assess their role in the firm's smoothing behaviour,

(iii) to propose an alternative criterion to classify firms into Traditional and the Non-Traditional ones to facilitate a better logical analysis of firms' behaviour,

(iv) to test the smoothing behaviour with the available appropriate statistical techniques,

(v) to find the best exponential smoothing order and the best smoothing constant and

(vi) to propose an algorithm for estimating the amount of Economic Leverage approximately.

The present work is planned in such a way that Section - I comprising of the first two Chapters, deals with the statement of the problem, observations of various studies dealing with organisational slack, its meaning, evolution and use in the context of maintaining the coalition of the stakeholders of the firm. Section - II comprises of Chapters

3,4 and 5 provide a theoretical analysis of the problem. Chapter - 3 critically examines the concept of organisational slack,its role in decision making processess,logical inconsistencies observed in the concept and the output decision process. Chapter-4 concentrates on the concept of Economic Leverage,identifies the Economic Leverage variables,presents the smoothing process,proposes a method for estimating the amount of Economic Leverage approximately,Chapter - 5 proposes an alternative criterion,on the basis of the presence of smoothing behaviour,to classify firms. Section-III consists of Chapters-6,7 and 8,deals with empirical testing of the hypothesis. Chapter-6 provides the methodology explaining sampling of the firms,hypothesis,test designs,statistical design,classification and definition of the variables used in the study. Chapter-7 tests the major hypothesis and gives the results of the analysis based on the quantitative data from the sample firms. Whereas Chapter-8 tests the hypothesis on the basis of the qualitative data,from the sample firms,recieved from the senior executives through personal interviews. Chapter - 9 pin-points the contributions of the present study, summarises major findings and throws light upon the scope for further research in the area.