Changing Objectives of Firms and Managerial Preferences: A Review of Models in Microeconomics

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Abstract
Theoretically, producer behavior models postulate that firms have had different objectives ranging from profit maximization to setting aspirational levels. The assumption of the objective of profit maximization was shaped based on the rationality principles, which has lost relevance with the coming of the principle of behavioral economics in recent time. The present paper intends to throw some light on changes that have been made in the objective of firms over years and attempts to review some models emphasizing managerial utility as the core objective of firms.
Keywords: Profit maximization, Sales maximization, Managerial utility function, Managerial discretionary powers, Slacks and salaries, Behavioral economics

Literature in microeconomics has a treasure of descriptions regarding the dominant objectives that the firms have had to pursue. In the beginning, it was thought that the firms had been pursuing and had been expected to pursue only one objective, that is, the maximization of profit. This assumption of the objective of profit maximization was shaped based on rationality principles. Based on rationality, it was supposed that economic agents, being rational, have had to pursue either the goal of utility satisfaction (for consumers) and profit maximization (for producers). Following this, in early times, producer behavioral theories and models in economics emphasized profit maximization as the sole objective of firms. Since then, many shifts have been made in the considerations of the objectives of firms, thanks mainly to the changes in the organization of firms. The objectives of sales maximization, revenue maximization, and managerial satisfaction (popularly known as the managerial utility function) are some of such changes or shifts in the objective of the firms. Among these, the most recent and the important one is the principle of the managerial utility function, which postulates that firms attempt to increase managerial satisfaction as a proxy for many of their other important functions, including the objective profit maximization. The tendency of offering high compensation packages for managers by the corporates stands testimony to the increasing attention on the part of the firms to focus much on the managers in an attempt to materialize the corporate objectives. The present paper intends to throw some light on changes that have been made in the objective of firms over years and attempts to review some models emphasizing managerial utility as the core objective of firms.

Profit Maximization - the Early Sole Objective of Firms

Profit maximization has been hypothesized as the rational behavior of a firm. Every firm attempts to maximize profit given the cost and market conditions. The marginalist school in economics gave sufficient theoretical underpinnings to the objective of profit maximization. The economic theory uses two methods to explain the conditionality for the maximization of profit: One is the famous and direct Total Cost-Total Revenue Concept. The other is the Marginal Cost and Marginal Revenue method. Thanks to the popularity that marginalism has assumed in the field of economics it quite natural that the latter method has received wide currency in the realm of economic literature. The elucidation of the firms' behavior in different market models like perfect completion and monopoly centers around the argument that the firms continue to produce when the profit gets maximized, the so-called equilibrium point. All firms, irrespective of market conditions, are supposed to behave rationally, and therefore, each one of them would be endeavoring to attain maximum profit. Although this could be considered as a starting point of the behavior of firms, this could not be regarded as the single objective with which all firms are expected to have been working.

The main lacuna of this argument is that it does not consider the effect of time, specifically the time value of money. Some firms under the real market conditions may act in such a way that they give up profits to withstand in the market, hoping that in the long run, they would be able to reap the profit. The infamous strategy of selling products at a price less than the average cost by firms in an attempt to capture the market goes diametrically opposite to the profit maximization strategy of the firms. In the short turn, firms are seemed to be giving up their profit for a high profit in the long run. This time element in the profit expectation of firms does not find any place in the profit maximization principle based on the rational economic behavior as postulated by the so-called marginalist school in economics. Another point of weakness of this argument lies in the absolute negligence that it shows towards the uncertainty and risks involved in planning the activities of firms.

Nevertheless, in the case of which ownership and control rest on the same hand, profit maximization may continue to be the sole objective. It is not surprising that in small firms and businesses even today, profit is the sole objective. Some economists opine that the objective of profit maximization is just an assumption (Mert, 2018)

Shareholders and Managers

The organizational changes in the structure of companies made a clear-cut divide between the managers and the shareholders or the exact owners of the firms. The corporatization of business entities fuelled this trend and triggered the difference between the objectives of managers and the shareholders. While in the earlier system of owners acting themselves as the managers, the objective of profit maximization had an important place. But in later times, with the coming up market capitalization of business entities, the objective of the ultimate owners or the shareholders of the company became different from that of the managers. Although the shareholders wanted to have reasonably maximum profit from the business, the managers paid much attention to enhancing their salaries, perks, and other career opportunities. Shareholders did not have much information about the business. Therefore, they could not exercise unlimited influence on the managers to pursue them to fall in line with the objective of maximizing profits.

Sales Maximization, not Profit Maximization

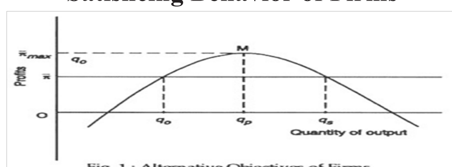
Managers appear to be more concerned with increasing the company's sales to keep the company as a market leader. The prestige of the manager does not depend on maximizing the profit but on the size of the market and the volume of business that they command. Taking this into account Prof. Baumol, opined that firms' main objective is not to raise the level of profit but to raise the sales of the company after having attained a certain desirable limit of profit. In the view of Baumol, after an acceptable level of profit is reached, the emphasis of the firm will be shifted from profit maximization to sales maximization. Baumol argues that given the separation of ownership from management and changing the organizational structure of firms, the

shift to the objective of sales maximization has been quite evident. Since managers' salaries and slacks (slacks are what managers receive over and above what is required to maintain them in the company. It is similar to 'economic rent' in traditional theory (Koutsoyiannis, 1979)) is more aligned with the volume of sales, not with the profit of the firms, it quite natural that managers would be focusing more on sales maximization rather than the profit maximization (Baumol, 1959).

Satisficing Behavior of Firms

In firms with dichotomization of the ownership and control of the entity, profit satisficing has been considered to be an important objective. Here, managers of the firms are expected to profit from the business, making shareholders or the owners of firms happy. After making that satisficing profit, another objective that meets the aspirations of the managers would be followed. The difference between the production behavior aiming for profit maximization and profit satisficing can be understood from the following figure. The X-axis measures the quantity of output and Y-axis profits. Two profit levels are shown viz.' π_{max},' maximum profit level and 'π,' satisfying profit. A profit-maximizing firm would choose to produce 'q_p' quantity of output while a profit satisficing might produce any quantity between 'q_o' and 'q_s' (https://www.economicsdiscussion.net/firm, 2021). The principle-agent problem would occur in these cases. Managers being the agents, possess all information about the firms. Therefore, they attempt to capitalize on the information asymmetry and try to pursue their own goals instead of focusing on enhancing the level of profit after a certain limit.

Figure 1: Alternative Objectives of Firms: Profit Satisficing Behavior of Firms



Source: https://www.economicsdiscussion.net/firm

Marris's Managerial Utility Function

In Marris's model of Managerial Enterprise, Marris stresses the importance of managerial utility function in accomplishing the goal of a firm, the maximization of the balanced rate growth of the firm (Marris R., 1963). In pursuing this goal, the firm has two main constraints: the availability of managerial team and skill and a financial constraint (Marris R., 1964). The utility function of the managers may be written as:

$$U_M = f\,(\text{salaries, power, status, job security})$$

In the utility function of the managers, as outlined above, salaries occupy an important place along with other elements like power, status, and job security. Putting it differently, the managerial utility function is nothing but a function of the compensation to managers plus some other quality variables like job security and status. In pursuance of this, firms have been offering high salaries and job security to top-level managers to prompt promising managers to continue in the job and concentrate on furthering the designed objectives of firms, including maximization of revenue, sales, and profits.

Williamson's Model of Managerial Discretion

It is well known that in the emerging business environment and the changing organizational structure of enterprises, managers enjoy certain discretionary powers in running the business not only in the interest of owners or shareholders but also, more importantly, in the interest of the managers themselves. These discretionary powers have been modeled first by O. Williamson in 1963 (Williamson, 1963). It is argued that managers have full discretion in pursuing their own goals and not the owners' objective of maximizing the profit. Making or maximizing profit is regarded as something which acts as a hindrance to the behavior of the managers. But, they need to take care of the profit in the absence of which their job security would be endangered. As in Marris's model here also the managerial utility function encompasses variables like salary, security, power, status, prestige, professional excellence, and the like. It is obvious that of these variables, only the first one can be made amenable to measurement. The others variable are together labeled as expense preference, 'which is defined as the satisfaction which managers derive from certain types of expenditures' (Koutsoyiannis, 1979).

Concluding Observations

Thus, it is quite evident that the tendency of offering high compensation packages for managers by the corporates stands testimony to the increasing attention on the part of the firms to focus much on the managers in an attempt to materialize the corporate objectives. This paper has thrown some light on changes that have been made in the objective of firms over years and attempts to review some models emphasizing managerial utility as the core objective of firms. As evident from the review of models, one can comprehend the importance attached to the maximization of the managerial utility function these days as the prominent objective of firms.

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