

THE THEORY OF DISCRETIONARY BEHAVIOR: IMPLICATION FOR BUSINESS AND EDUCATIONAL ADMINISTRATION

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Drawing on insights from organizational economics, this paper attempts to explain certain bureaucratic phenomena that have long been outside the purview of economics. It shows that "rational" behavior on the part of the various groups in economic organizations such as business firms and educational institutions preclude the attainment of the traditional goal of profit maximization. The inescapable conclusion is that the analysis of organizational behavior and, indeed, the very notion of optimality of the firm, requires more complex objective functions than what we have long been accustomed to.

Introduction

Bureaucratic behavior has long been the traditional preserve of political science, sociology, social psychology and administrative science. Of late, however, economists have shown increasing interest in bureaucratic phenomena.

This paper highlights the main strands of the economist's perspective of organizational life. Its purpose is to convey the message that this theoretical thrust provides added insights into what continues to be a contentious area of study. Its special relevance to business and educational organizations will be underscored.

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A major criticism of the economic theory of the firm is its simplifying assumption that managerial decisions are made with the single-minded pursuit of profits as the only goal. Economists themselves have long accepted that this assumption is unrealistic.¹ While this assumption might be acceptable as a first approximation for business firms owned and managed by a single person or group of persons, it is patently unrealistic for large corporate entities and other formal organizations that are made up of several groups with divergent — and often conflicting — interests. In most formal organizations, these are: the owners (or the public, in the case of government bureaus and organizations), the professional staff, the support staff, rank-and-file employees, as well as certain elements of the community with interests in the organization.

Recent years have seen the emergence of a number of economic theories that attempt to explain conflicting behavior of groups in organizations.

Theories that Stress Incompatible Behavior of Groups

A number of these theories focus on incompatible behavior among the major groups that comprise the organization. To simplify exposition, we limit ourselves to two contending groups, the owners and the professional managers. Among business firms and privately-owned educational institutions, these are the stockholders or the owning families on the one hand, and the administrators on the other. In publicly-owned schools and businesses, and those run by charitable or religious institutions, the "equity holders" are either the

¹ Tibor Scitovsky (1946) has shown that the assumption of profit maximization implies that owner-managers of business firms have an infinite marginal rate of substitution between profits and the other elements of their utility functions. See his "A Note on Profit Maximization and its Implications," *Rev. of Econ. Studies* XI (1946), 57-60.

public at large or the owning entities. In any case, it is possible to identify the separate goals of the owners and the managers, which, according to this view, are almost certain to be incompatible.

According to Hoenack (1983), owners of organizations typically give discretion to hired managers in the use of resources, not out of trust or magnanimity but in the realization that the managers have knowledge and informational advantages over them. In using these resources, however, employees tend to pursue their own goals along with those of their employers. For example, in a university, it is not unusual for deans and directors and lesser administrators to use university-owned resources (including their own time) for their own personal purposes. The usual practice of overcharging to representation expenses among business executives is another case in point. While employers do attempt to control these resource diversions, they can do so only up to a limited extent due largely to the cost of monitoring.

In using organizational resources for their own use, managers in effect generate demand for both organizational inputs and outputs, thus creating an internal economy where employees and employers interact.

Let us look closely at the rationale for resource diversion by employees.

Suppose the employer requires output q_1 which is produced from inputs a and b . In Figure 1, isoquant I_1 represents this level of output, and the budget line MN is the employer's estimate of his/her minimum cost of producing q_1 . This cost estimate reflects the alternative means available to the employers to produce the desired level of output, and to continue to employ the workers under their strict control. Isoquant I_2 shows the combination of a and b required by the employees to produce q_1 , and the budget line $M'N'$ represents the minimum cost to them of producing that level of output. Now, the budget line $M''N''$ shows the maximum amount that employers are willing to

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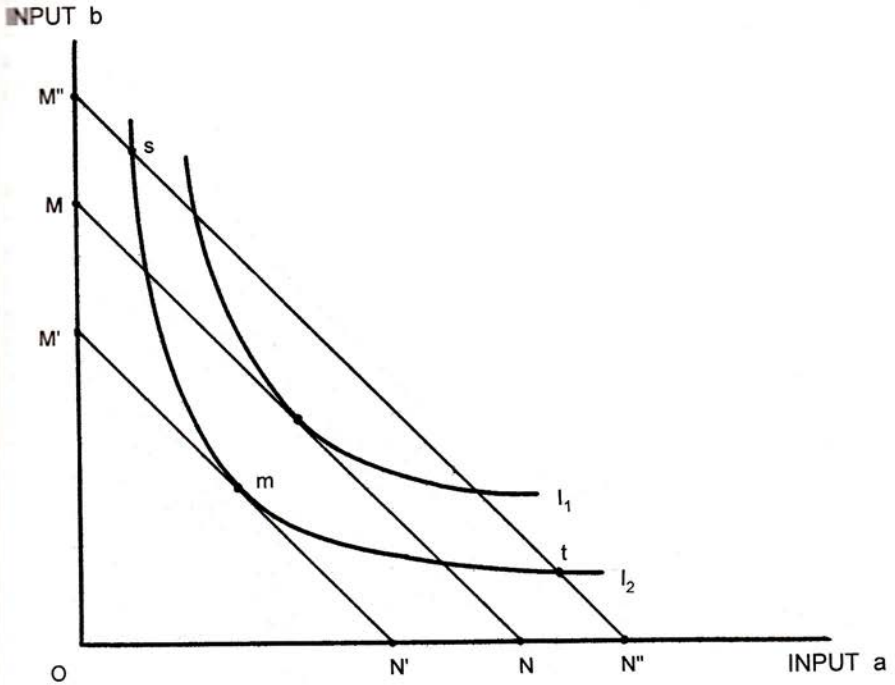


Figure 1 - Resource Diversion in Organizations

(Adapted from Stephen A. Hoeneck, *Economic Behavior Within Organizations* (London: Cambridge Univ. Press, 1983, p. 70), by permission of the publisher.)

incur to acquire q_1 rather than do without it; it reflects the cost of acquiring the product by alternative means or from other sources, including the costs associated with disruptions in production, dismissing current employees, and hiring new ones. *At the limit, employees must produce q_1 at a cost represented by $M''N''$ if they are to avoid being fired or subject to more stringent controls.*

The amount of resources represented by the difference between $M'N'$ and $M''N''$ is a form of *surplus* to be shared between employees and employers, the actual allocation of which depending on the relative power possessed by each (including access to relevant information). This surplus is roughly the flow equivalent of what Herbert Simon (1957) calls *organizational slack*.

Risk-averse employees will be willing to produce q_1 at a lower cost than that represented by $M''N''$ (or produce a higher level of output at that cost level). If they have no use for the product but attach positive MU's to the inputs, they will choose combinations of a and b between s and t along $M''N''$; if they settle at either point, the budget is exhausted and nothing is left for them. The optimum point is m , the point of tangency between I_2 and $M'N'$; here, costs are minimized and the potential gains to both employees and employers are maximized. If the employees derive satisfaction from the output, either for direct consumption or for conversion to cash, they are likely to produce a level of output $q > q_1$.

As a general rule, the faculty and staff of publicly owned schools and universities enjoy tenure and civil service protection, and therefore face much less risk of punitive actions and severe control measures from their employers as compared to their counterparts in privately owned institutions. Moreover, while they have wide-ranging bureaucratic control powers at their disposal, employers tend to be lax in imposing these measures. Consequently, these organizations are expected to operate at cost levels at or approaching the maximum limit, or to perform at less than desirable levels, or both.

On the part of the owners, the optimal point m can be approximated by setting up more elaborate (and expensive) control procedures intended to discourage resource diversion. Additional control costs will be incurred for as long as these are expected to be exceeded by the corresponding benefits. In the following diagram, the curve labelled B represents the perceived benefits arising from control, and $C1$ and $C2$ reflect, respectively, the cost of control in business firms

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and in educational institutions. C^* is the optimum level of control in a typical business firm, and C^{**} is the corresponding optimum level in a comparable educational institution. At these levels, an extra peso spent on control will yield exactly one peso in benefits to the organization.

Compared with, say, manufacturing firms, the performance of educational institutions, especially its quality dimension, is extremely difficult to measure. Thus, controls are largely intended to measure behavior rather than performance

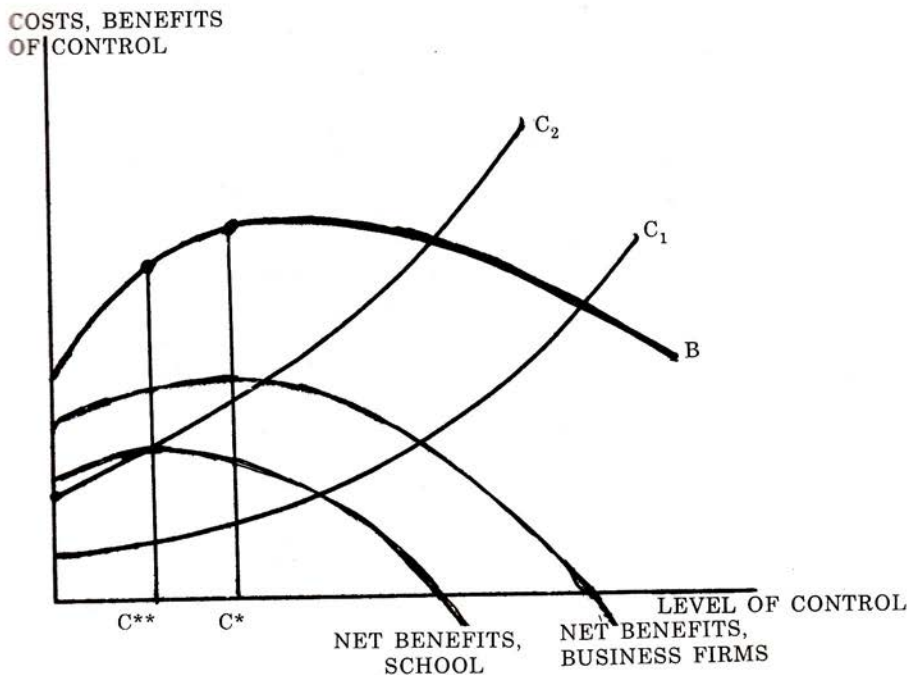


Figure 2 - Optimal Levels of Control in Schools and in Business Organizations

(Ouchi and Maguire, 1975) and therefore tend to be more costly. While the optimal level of control tends to be smaller in schools than in business organizations, so, however, is the comparable level of performance.

Supply of, and Demand for Informal Services

An alternative framework is developed by Brenton and Wintrobe (1982), who liken the workings of bureaucracies to those of market competition and exchange. Their model applies to the interaction between top managers ("superiors") and those below them ("subordinates"). In their analysis, the implicit assumption is made that the personal goals of superiors coincide with those of the owners (that is, there is a high degree of *goal congruence* between these two groups).

A fundamental premise of this model is that *trust*, rather than property rights, is the basis of economic exchange between superiors and subordinates. This means to say that superiors expect subordinates to comply with their commitments, and vice versa. Such trust obviates the cost of control and monitoring on the part of either party to the transactions.

Another basic element of the model is *selective behavior*. Subordinates are assumed neither to be super-efficient bureaucrats ala Weber, nor incompetent bunglers ala Parkinson. Neither are they motivated solely by personal gain. Rather, *they can be all these, depending on their assessment of costs and benefits*. Whether subordinates choose to be "efficient" (i.e., perform at higher than the formally required level), or "inefficient" (below) *depends on the bargaining process*, the "trade" between superiors and subordinates.

The actual (or *equilibrium*) amount of efficient or inefficient services rendered by subordinates is determined by supply and demand. In Figure 3, *S* is the supply of "informal services," those rendered over and above what is formally required by the organization. These services are either efficient or inefficient depending on the demand for such services by superiors. An example of an efficient service in

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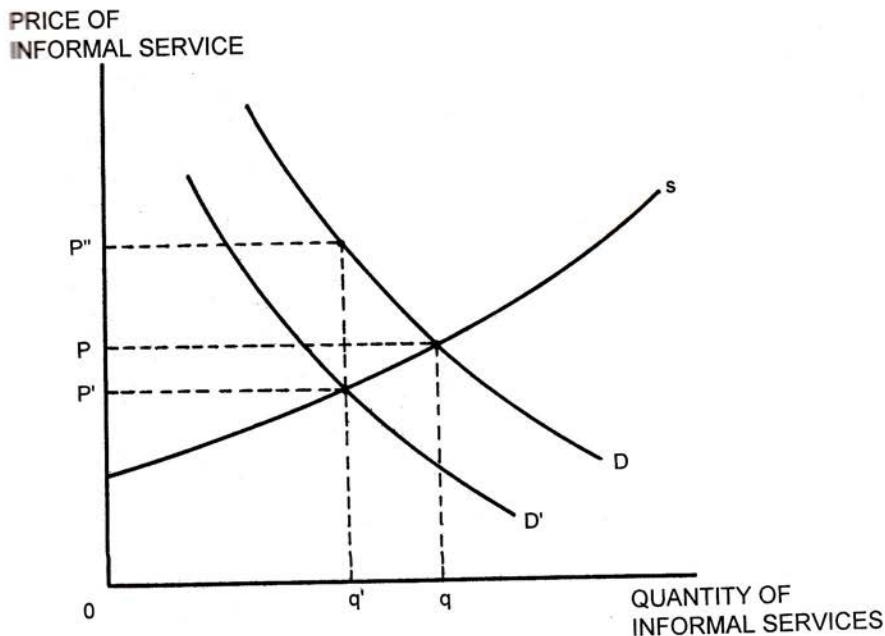


Figure 3 - Supply and Demand for Informal Services

(Adapted from Albert Brenton and Ronald Wintrobe, *The Logic of Bureaucratic Conduct* (London: Cambridge Univ. Press, 1982, p. 49), by permission of the publisher.)

a business firm is a painstakingly prepared sales report that exceeds in quality the usual expectations of top managers. In schools, a good example would be the extra hours spent by teachers on slow-learning pupils to enhance their performance.

Suppose superiors demand efficient services (perhaps because this is viewed as contributing to their own personal goals). If D is the demand for superior services, equilibrium will settle at q , which will be traded at price p .

In reality, however, trust is never perfect, and costs are incurred to implement the contract between superiors and subordinates. With monitoring costs considered, the effective demand is D' , and the equilibrium values of price and quantity will be p'' (plotted along D), and q' , respectively.

In applying this model to say, a college of a large university, the dean may be treated as the superior and the teaching staff as the subordinates. The amount of informal services rendered (in terms of, say, high quality research output or teaching performance) and the price (in terms of faculty privileges, expected recommendations for promotions, etc.) will depend in large measure on the amount of trust between the dean and the staff. In situations where the dean is regarded with low esteem, the level of efficient services will be expected to be low, and whatever amount is rendered will require a higher-than-usual price. In cases where morale is high due to mutual respect between the parties, high performance may be expected without the need for substantial material inducements.

Agency Theory: Behavior of Non-Owner Managers

In most situations, the owners of business and other types of organizations, realizing their inadequacy in effectively running their business affairs, hire professional managers to do the job for them. Agency relationships are the results of this separation of ownership and management control. In these relationships, agency costs are incurred by the *principals* to insure that their *agents* are doing what they have contracted to do, and are not engaging in activities that are prejudicial to the interests of the organization (Jensen and Meckling, 1976).

Managers who own less than 100 percent of equity have the incentive to undertake activities that are inimical to the interest

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of stockholders. They will attempt to enhance their welfare by appropriating organizational resources for their own use. By so doing, they reap all the benefits, *but bear only part or none of the cost*. Of course, the owners employ a variety of monitoring strategies intended to limit resource diversion, but invariably stop short of complete control. Among these strategies are the use and strict enforcement of contracts and the effective use of the board of directors as a monitoring body.

In Figure 4, OB is the market value of non-monetary benefits enjoyed by agents. This is equal to OA , the market

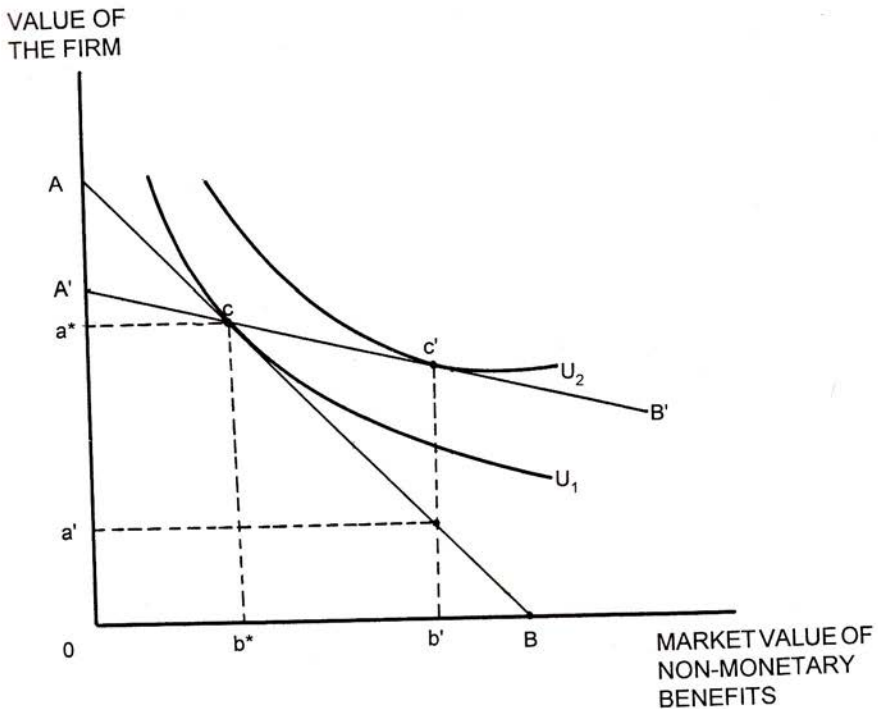


Figure 4 - Determination of Managers' Expenditure on Non-Monetary Benefits from the Firm

(Adapted from Michael Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Jour. of Financial Econ.*, 3 (1976), p. 225), by permission of the publisher.)

value of the firm were there no such perks and other resource diversions. Thus, AB is the firm's "budget line;" it shows the different combinations of value of the firm and market value of non-monetary benefits to managers. Given his/her utility function in terms of these two variables, (as reflected in the indifference curve U_1), the owner-manager will be at optimum at point c , and he/she will choose a combination of Oa^* of value of the firm and Ob^* of non-monetary benefits.

By contrast, *the same manager* who owns only 10 percent of the firm's equity faces the *apparent* budget line $A'B'$ (with a slope of -0.10) and will opt for combination c' , which represents a much larger amount of non-monetary benefits. At the limit, a manager who owns no stock will prefer to be at point B .

Of course, managers can be brought to line with the use of appropriate monitoring and control procedures. (Jensen and Meckling show that the costs of such control procedures are ultimately borne by the managers, and not by the owners!)

As a general rule, stock options are not available to managers of educational organizations, certainly not in publicly owned ones. Thus, we will expect a substantial amount of personal use of organizational resources in schools. Of course, the owners (including the public, as in the case of U.P.) will tend to put in place elaborate control procedures to restrict the behavior of university administrators, staff, and personnel. At the University of the Philippines, for example, the Board of Regents exercises substantial control over the decision-making processes at the University and College — and even lower — levels of administration. Ironically, while these controls are intended to enhance the performance of the staff, they also tend to be ultimately dysfunctional because they limit the flexibility of the university's professional staff in dealing with an increasingly complex and dynamic environment. Moreover, there is the nagging question as to whether the Board or any other such entity is truly competent to provide the appropriate decisional premises for the rest of the organization.

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Theories that Stress Mutually Beneficial Activities of Owners and Managers

Models developed by Williamson (1964) and Marris (1965) posit a high degree of *goal congruency* among owners and managers. Specifically, they assume that profit explicitly enters the manager's utility function as a proxy for benefits associated with it, such as bonuses, promotions and the like. Thus, the economic fortunes of owners and managers are closely linked, and managers are expected to work for the enhancement of the firm's profits.

Here's the rub, however: while profit is indeed an essential element of the manager's utility function, at any particular curve in his/her indifference map, it is *negatively* related to all other variables in the function. Moreover, given the amount of resources available to the firm, beyond a certain level of output, more profits can be realized only at the expense of those other variables,² and *vice versa*. As we shall demonstrate shortly, this leads to an optimum in which profits are less than maximized.

The production tradeoff between profits and all the other variables is described by curve *AB* in Figure 5, which, in conjunction with the manager's indifference curve *I*, shows an optimum point *b*. At his/her most desired position, the manager generates OP^* of profits and enjoys OS^* of non-pecuniary benefits. Only on the untenable assumption that the typical owner-manager has zero marginal utility for staff and emoluments (and therefore has a perfectly horizontal indifference curve between profits and those variables) is optimum achieved where profits are maximized (point *a* on the diagram). In a similar vein, Marris argues that managers tend to set corporate growth at levels higher than that at which profits are maximized.

² These other elements in the manager's utility function include administrative expenses, or what Williamson calls "staff," discretionary perks ("emoluments"), along with corporate growth, which Marris notes leads to higher scales of operation and hence higher pay.

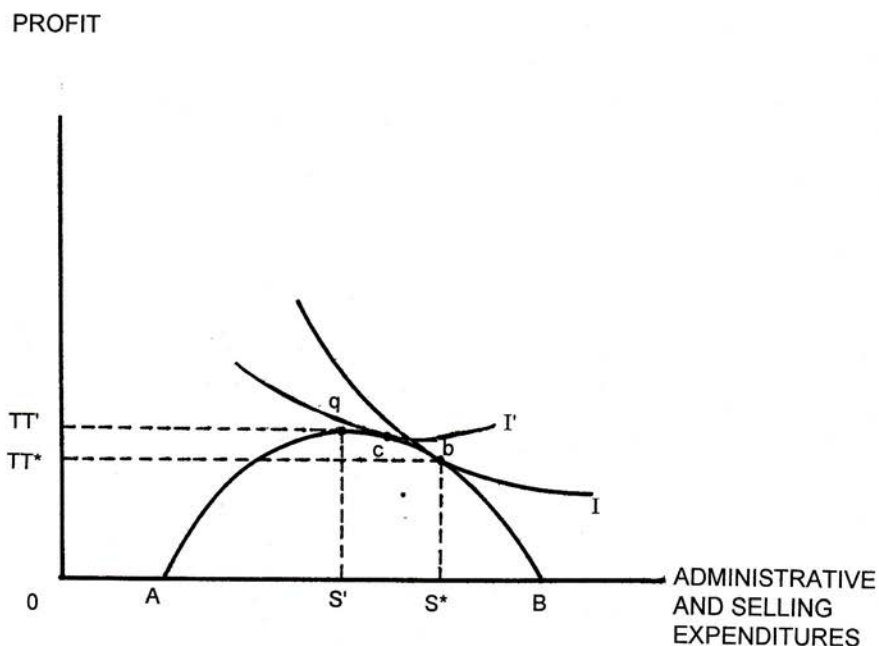


Figure 5 - Optimal Level of Administrative and Selling Expenditure

(Adapted from Oliver E. Williamson, *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm* (Englewood Cliffs, N.J.: Prentice-Hall, 1964, p. 43), by permission of the publisher.)

In professional organizations such as schools, universities and other knowledge-based organizations, the assumption of goal congruence between “owners” and “employees” is even more compelling. In such organizations, there tends to be a strong commitment among the staff to professional excellence. However, as in the case of business managers, employees of

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educational institutions do have certain interests of their own that are in conflict with organizational objectives. Thus, university professors and administrators are not beyond bringing home office supplies for family use, or, more seriously, spending more time in private consulting than on their official responsibilities. There are other, more subtle ways of diverting resources in colleges and universities. For example, watered-down curricula may be purposely put in place by the teaching staff in order to spread the substantive coverage of degree courses among a larger number of three-unit subjects, each covering a very small area. In this way, the total number of courses required for each degree course and offered per semester is increased, thus allowing more opportunities for the teaching staff to collect honoraria for teaching overloads. In business organizations, jobs may be so designed as to require more time and resources than what is necessary, with the equity holders not being the wiser.

While stricter enforcement of control procedures tends to limit such resource diversions, these tend to be both expensive and dysfunctional. Moreover, strict bureaucratic controls are anathema to the culture of professionalism that is expected of educational organizations, especially institutions of higher learning. The model suggests that the more appropriate approach is to *enhance goal congruence* in knowledge-based organizations such as colleges and universities by (1) tying rewards more closely to performance; and (2) increasing rewards, both monetary and non-monetary, to reduce the perceived relative attractiveness of resource-diverting activities, such as academic moonlighting.³ These strategies increase the professional staff's relative valuation of organizational goals and reshape their utility functions in such a way as to flatten out their indifference curves between profits (or its equivalent in educational institutions) and the other variables in their utility functions, leading to an optimum point c in Figure 5.

³ This doesn't mean upgrading salary scales of university professors all the way to levels enjoyed by their professional counterparts in private industry because of the premium the former place on academic work.

Conclusion

Drawing on the organizational economics literature, this paper discussed the implications of certain models of discretionary behavior on the reward structure and certain aspects of inter-group relations in business and educational organizations. Regardless of whether the interests of certain groups, in particular, those of the owners and of the professional managers, are assumed to be coincident or in conflict, we noted that control serves as an important intervening factor. However, because of the costs associated with control, and the fact that the control function, as with most other organizational processes, is subject to diminishing returns, we found that organizational equilibrium invariably settles at a level where performance is less than maximized. This conclusion suggests the need to reconceptualize the notion of rationality in organizational choice.

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