

## CHAPTER - 2

## ORGANISATIONAL SLACK : THE CONCEPT AND ITS EVOLUTION

2.1.0 Advertising :- It was Baumol (1957) who first implicitly introduced advertising expenditure as an organisational slack in his revenue maximising model of the firm. His firms maximise sales revenue subject to a minimum required profits constraint. In his model, advertising expenditure functions to equalise the reported profits with the minimum required profits i.e., it stabilises the reported profits by absorbing a portion of sales revenue via an increase in costs. The advertising slack influences the product price positively whereas profits tax and lump sum tax influence the slack inversely. But 'demand shift parameter' (environment influences organisational slack positively.

2.2.0 Utility enhancing expenses :- Alchian and Kessal (1962) envisage the firm as first making all the usual choices necessary to maximise profits and then internally allocating the resulting profits between reported profits and utility enhancing

expenses. They identified excess staff expenditures and managerial emoluments as organisational slacks.

2.3.0 Organisational slacks :- Cyert and March (1963) were the first to give a distinct name to all 'these variables' as organisational slacks, OS. They used the OS concept to explain the overall organisational phenomena. They considered the firm as a coalition of members. Whosoever has got some stake in the firm is a member of the coalition. The function of the management is to ensure the viability of the coalition (thus the firm). The viability of the coalition will be maintained only if the demands of the coalition members are met. Only in the long-run "there is a tendency for payments and demands to be equal."<sup>1</sup> However in the short-run there are "frictions in the mutual adjustment of payments and demands. There is ordinarily a disparity between the resources' available to the organisation and the payments required to maintain the coalition. This difference between total resources and total necessary payments is what....(they).....have called organisational slack. Slack consists in the payments to members of the coalition in excess of what is required to maintain the organisation. Many

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interesting phenomena occur because slack is typically not zero."<sup>2</sup> This is a deviation from the marginal approach of neo-classical theory where the slack is zero at the equilibrium of the firm.

Organisational slack in their model functions both to stabilise and adopt the firm to the shocks in the economic environment by absorbing a significant portion of the potential variation in income during good times and releasing a pool of emergency resources during bad times to retard frequent upward and downward revision of aspiration levels respectively. Thus the firm smoothens the fluctuations in the income streams.<sup>3</sup> They have identified dividends, sub-optimal pricing of products, wages, managerial perquisites, growth of the firm and public services as organisational slacks. They have argued that, "this 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 making 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 rationali-

2.4.0 Management slacks :- Williamson (1964) suggested that the managers maximise their own utility,  $U$ , which is a function of output, management slack absorbed as staff,  $S$ , management slack absorbed as costs,  $M$ , and discretionary investment subject to a minimum required profits constraint. He has identified the following as organisational slacks ( he called them as management slacks ) : salaries of managers, other forms of monetary compensation such as bonuses, stock options, the number and quality of staff personnel who report to the managers, discretionary investment and the type and amount of managerial perquisites such as expense accounts, lavishly furnished offices, chauffeur-driven limousines etc.<sup>5</sup> Environment influences  $S$  and  $M$  positively;  $S$  and  $M$  influence  $U$  positively ; whereas lump sum tax, output tax, variable costs, fixed costs, profits tax, excise tax influence both  $S$  and  $M$  inversely;  $S$  influences the price of the products inversely and sales revenue positively but less than one. Williamson believes "contrary to Cyert and March - that managers consciously and intentionally create and bargain for organisational slack. Managers are motivated to achieve two sets of goals - the firm and their personal goals. Personal goals are directly related to income (salary plus bonus ),

size of staff and control over allocation of resources. To maximise personal goals while achieving the goals of the firm requires a slack environment. This suggests that managers intentionally create slack."<sup>6</sup> However he has not suggested any rationale for the deliberate creation of organisational slack except that it gives utility to the managers. The concept of managerial utility is so broad to accomodate every possible explanation.

2.5.0 Short-run profits :- Berle (1965) has pointed out indirectly the organisational slacks when he stated that, "at any given moment...(the corporation interested in the long-run position)... will sacrifice a portion of immediate profit,"<sup>7</sup> which may take many forms : addition to capital, allocation of resources for experimental operations (research and development) etc. He further posited that the stock options are "endeavours to soften the impact of income rises or spread out the high pay of productive years to take care of administrator's declining years."<sup>8</sup>

2.6.0 Profits margin :- Peterson (1965) pointed out that "some part of the margin (in price) but a very small part of product value and resource use,

may be thought unnecessary to the health of the firm and thus manipulable in non-profit directions... and...where profits are exceptional managers may indulge in non-profit leadings in greater degree ....(and)...there may be occassional instances of deliberate worsening of the revenue-cost relation .....(for example).....a needy employee is kept who is not worth his pay."<sup>9</sup>

2.7.0 Budgetary slacks :- To Schiff and Lewin (1968) the budget preparation process is a highly participative effort on the part of all managerial levels and since budgets are criterion for measuring performance, by which they will be judged throughout the year and for resource allocation, it clearly serves the interests of the management, and it bargains to incorporate varying degrees of slack in the budget. "It became cumulatively certain...that budgetary slack can be incorporated into both revenue and cost projections and that internal slack may arise through accounting adjustment."<sup>10</sup>

It may be noted that they have contradicted themselves. At one place, they stated, "we believe as does Williamson-Contrary to Cyert and March-that managers consciously and intention-

ally create and bargain for organisational slack,"<sup>11</sup> and at another, they have contradictorily claimed and concluded that, "our results amply support the behavioural implication for the occurrence of the slack as an unintended result of the budget and control system especially where the system is based on the traditional accounting model of the firm.... on the basis of our pilot study how management can and does create slack to achieve attainable budgets and to secure resources for furthering their personal goals and desires."<sup>12</sup> They "concluded that slack may account for as much as 20 to 25 percent of divisional budgeted operating expenses."<sup>13</sup>

2.8.0 Price :- Linter (1970) has identified price of the product as an organisational slack. He deliberately "omits.....any consideration of advertising or other discretionary expenditures (and) his firms use price reduction to reduce the variance of profits."<sup>14</sup>

2.9.0 Advertising :- Schramm and Sherman (1976) have demonstrated a plausible systematic advertising response to variations of demand under conditions of imperfect information which will enable the firm to reduce its profit risk in exchange for some reduction

in its expected profit. Such behaviour can be motivated if managers are averse to profit risk and they indulge in their own preferences.

#### 2.10.0 Managers discretionary expenditures :-

Jensen and Meckling's (1976) manager makes operating decisions which maximise his utility. "These decisions will involve not only the benefit he derives from pecuniary returns but also the utility generated by various non-pecuniary aspects of his entrepreneurial activities such as physical appointments of the office, the attractiveness of the secretarial staff, the level of employee discipline, the kind and amount of charitable contributions, personal relations ("love", "respect" etc) with employees, a larger than optimal computer to play with, purchase of production inputs from friends etc. The optimum mix (in the absence of taxes) of the various pecuniary and non-pecuniary benefits is achieved when the marginal utility derived from an additional dollar of expenditure (measured net of any productive efforts) is equal for each non-pecuniary item and equal to the marginal utility derived from the additional dollars of after tax purchasing power (wealth)."<sup>15</sup> They suggested that the consumption of non-pecuniary benefits (perquisites - an organi-

sational slack) is inversely related to the fraction of ownership held by the managers.

2.11.0 Branching :- Edwards (1977) for the first time has suggested branching as a strategy as an organisational slack to increase utility enhancing expenditures on staff, in a highly regulated industry, Banking. Also he has given "an explanation that has not been advanced, however, is that the management of (monopolistic) banks appropriate part of the profit through expense preference behaviour by paying themselves higher salaries, hiring excessive staff, or being lax in their personnel supervision, all of which may enhance their utility (and increase costs) while lowering reported profitability."<sup>16</sup>

2.12.0 Price stability :- Schramm and Sherman (1977) suggested that by keeping the price of the product stable the firm can reduce the variations in the profits which seem to please the risk-averse managers and in circumstances will also enhance the market value of the firm. For if investors take variations in reported profits as a reflector of risk, controlling those variations can reduce the

apparent risk and thereby enhance the value of the firm for a given average profits. It is to be noted that unlike others they kept the prices constant and thus excluded price from treating it as an organisational slack.

2.13.0 Discretionary expenditures :- Christofides and Tapon (1979) incorporated discretionary expenditures as organisational slacks, uncertainty and risk aversion explicitly and developed a model of the firm wherein the manager maximises the utility of expected profits. The firm uses price,  $P$ , and per unit discretionary expenditures,  $S$ , as decision variables and are "adjusted in order to maximise the certainty equivalent profit  $\hat{\pi}$  (expected profits)... the firm will periodically adjust  $P$  and  $S$  optimally."<sup>17</sup> They have also explained that "in the context of imperfectly competitive markets price adjustments are relatively infrequent...the firm will..... consider price as given and attempt to attain a better mean-profit variance of profit position (a higher expected utility) by adjusting per unit discretionary expenditures."<sup>18</sup> They define "discretionary expenditures to refer to every type of expenditure that the firms adjust so as to reduce profit risk. These expenditures may include advertising,

selling and administrative costs and R & D."<sup>19</sup>  
 Optimal level of  $S$  is decided at  $\hat{\pi}_s = 0$ ,<sup>20</sup> which  
 will be greater under uncertainty than under perfect  
 certainty. "Both in the Behavioural theory and our  
 own theory slack or per unit discretionary expen-  
 ditures act as a built-in-stabiliser for the firm's  
 activities. One major difference between our theory  
 and Cyert and March's is that in their theory slack  
 plays the role of a stabiliser automatically.....  
 In our theory, on the other hand, per unit discretion-  
 ary expenditures are deliberately adjusted to achieve  
 the desired stability in the profit rates."<sup>21</sup> Relevant  
 comparative static properties are  $q_s > 0$  ;  $q_{ss} < 0$  ;  
 $S_u > 0$  ; where  $u$  refers to uncertainty.

2.14.0 Income smoothing :- Mosen and Downs (1965)  
 were the first to find that the income streams in  
 management controlled firms, MCs, will be less variable  
 than those in owner controlled firms, OC. This implies  
 that MCs smooth their income streams.<sup>22</sup> There  
 has been several studies which empirically verified  
 and supported this behaviour since then ( Mosen et al  
 (1968), Kamerschen (1968), Radice (1971), Boudreaux  
 (1973) and Holl (1975)).

Lev and Kunitzky (1974) observed that the degree of smoothness of accounting return of both MCs and OCs to be strongly related with the systematic risk of the firm. They also found that sales, production, capital expenditures, dividends and earning streams were smoothed and were also found to be significantly correlated with the overall and systematic common risk measures. Kamin and Ronen (1978) have stated that "smoothing can be effected through accounting techniques, without changing the underlying earnings generating process ; it could also be 'real' in the sense actual operating decisions are made to smooth the firm's input and output series which in turn, affects reported income."<sup>23</sup> They found that under high barriers to entry (BTE) in the industry the MCs smoothed more extensively than the OCs. Whereas OCs smoothed more extensively than MCs under low BTE. "Under higher BTE (Barriers to Entry), both the MCs and OCs have greater discretion over discretionary expenses since they generate more than normal competitive profits that allow them to create slack within which they can maneuver more flexibly and extensively."<sup>24</sup>

Ronen and Sadan (1981) have reported that "an inference that reported income series has been 'smoothed' over time could be consistent with

two major types of smoothing : (1) accounting smoothing which does not result from changing the operating decisions and their timing, but which affects income through accounting dimensions, notably the accounting recognition of economic events and the accounting allocation over fiscal years and / or classification of the event's effects; and (2) 'real' smoothing, that is, actual smoothing of the firm's input and output series through the making and timing of operating decisions."<sup>25</sup> However Brooks and Buckmaster (1976) have observed that "greater smoothness of series containing a material deviation from previous levels may be management induced or inherent in the income determination process....(They) do not maintain that management does smooth income."<sup>26</sup> Also they have suggested that "management may engage in income manipulation behaviour other than smoothing."<sup>27</sup>

#### 2.15.0 Size and market power of the firm :-

Galbraith (1967) presented the idea that " a significant portion of the potential profits latent in (the) position of market power (held by large firms) is taken in the form of avoiding uncertainty."<sup>28</sup> Thus he indirectly pointed out that potential profits are diffused to stabilise the profit stream by the

'technocrats'. Later studies by Caves and Yamey (1971), Palmer (1973) and Ranjit Sau (1984) also conclude and support the same. For example Ranjit Sau observes from his study on Indian industries that "the profit rate varies directly with the size of the company ; what is more, the degree of fluctuation over time (as measured by the standard deviation) varies inversely with the size of the company. To put it differently, large companies succeeded not only in getting a higher rate of profit, but also in keeping it comparatively stable over time."<sup>29</sup>

2.16.0 Accounting smoothing :- Gordon et al (1966) explicitly suggested that the top management behaved as if it were 'smoothing' reported income and showed that "reported income of the U.S. Steel Corporation appeared to be smoothed through judicious application of accounting methods."<sup>30</sup> Schiff (1966) also "noted that management appears to have deliberately evened out reported income by decisions to expend or deferring advertising costs of new products. This was apparently motivated by the management's desire to protect an image of company growth."<sup>31</sup> Lewin and Seidler reported that, "'income management' - the discretionary use of accounting methods - seem-

ingly painless to apply and is, therefore, preferred by top management,"<sup>32</sup> to smooth the income series of the firm," to the difficult alternative of correcting internal problems that can be rationalised as temporary."<sup>33</sup> Caves (1970) "also reviews a variety of policies available to the managers of firms possessing market power who wish to avoid uncertainty and argues that large firms are more frequent users of these policies than small firms with less market power. As a consequence.....expect large firm's profits to be more stable over time and their mean profits to be lower than they otherwise might have been."<sup>34</sup> Ball and Watts (1972) reported that the firms smooth their income streams through sub-martingale process.<sup>35</sup> Schramm and Sherman (1974) have suggested that the management of the firm tends to use its discretion in the timing of the operating decisions to affect the variations in the profits stream. "Expenditures for advertising and research actually can be used by the firm to reduce the standard deviation of these reported earnings."<sup>36</sup> Amihud and Lev (1981) found managers engaging in conglomerate mergers to decrease their largely undiversifiable 'employment risk'. "Such risk-reduction activities are considered here as managerial perquisites in the context of

the agency cost model."<sup>37</sup> Amihud et al (1983) showed that income smoothing was prevalent in MCs as well as OCs. However in the former, the extent of smoothing was more and the firm's unique risk and systematic risk were less than the later. Their rationale for smoothing income series is that the risk averse manager "blocked from diversification of his job income in outside markets, would be expected to attempt to diversify his 'employment risk' internally by project selection or by 'income smoothing', intended to stabilise the firm's income streams and thus, in turn, his employment income."<sup>38</sup>

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NOTES

1. Cyert and March.op.cit.,p.36.
2. Ibid.,
3. Thus the concept of income smoothing behaviour implies the manipulation of organisational slacks to stabilise the organisation. Thus the studies dealing with the smoothing behaviour have also been reviewed.
4. Cyert and March.op.cit.,p.38.

5. Cohen and Cyert (1976),p.425.
6. Schiff and Lewin (1968),p.51.
7. Berle (1963),p.34.
8. Ibid.,p.31.
9. Peterson (1965),pp.9-16.
10. Schiff and Lewin.op.cit.,pp.56-62.
11. Ibid., p-56.
12. Ibid.,p.62.
13. Ibid.,
14. Christofides and Tapon (1979),p.307.
15. Jensen and Meckling (1976),p.312.
16. Edwards (1977),p.148.
17. Christofides and Tapon,op.cit.,p.307.
18. Ibid.,p.308.
19. Ibid.,p.317.
20.  $\hat{\Pi}_s$  means the first derivative of  $\hat{\Pi}$  with respect to S. In this context the subscripts would refer to derivatives.
21. Ibid.,p.311.
22. The relation between income smoothing and organisational slacks was pointed out already. Organisational slacks are manipulated to affect (smooth) income series. Hence income smoothing may imply manipulation of organisational slack.
23. Kamin and Ronen (1978),p.192.
24. Ibid.,pp.185-186.

25. Amihud et al (1983),p.192.
26. Brooks and Buckmaster (1976),p.1371.
27. Ibid.,p.1362.
28. Galbraith (1967),p.284.
29. Ranjit Sau (1984),p.M-143.
30. Schiff and Lewin,op.cit.,p.51.
31. Ibid.,
32. Ibid.,
33. Ibid.,
34. Christofides and Tapon,op.cit.p304.
35. Sub-martingale means the best predictor of income of period  $t$  is the the income of period  $t-1$ .
36. Schramm and Sherman (1974),p.356.
37. Amihud and Lev (1981),p.605.
38. Amihud et al (1983),p.191.