Modified rationality with a firm as an economic subject

Dyanko Minchev

The article presents critical rethinking of one of the main hypotheses of the basic direction in the economic theory; the one about the rationally acting economic subject*. The neoclassical statement is contradicted by the concept of modified rationality in one of its forms having as an economic subject a firm.*

Key words*: rationality, modified rationality*

Introduction

One of the main principles that the neoclassical theory is based on is the principle of rationality. The actions of "homo economicus" are one of the initial hypotheses of the neoclassical school. This is however unrealistic. With the individual as an economic subject it is more correct to assume the thesis about modified rationality. [5] But this is true not only of the individual but also of the firm, although it is closer to rational behavior than all the other economic subjects.

Background

There are several reasons why the firm as an economic subject is closest to rational behavior.

1) The firm is established to make a profit and (or, but more rarely), for its creator to survive. Therefore a specific goal and task of the entrepreneur (entrepreneurs) is to achieve a final (financial) result, which is bigger than the starting one. With the individual consumer this is more of a theoretical, rather than a practical situation, because the main goal is a better life, which is a result of not one but of many and different goals, deals and activity.

2) The striving towards profit is mainly with the firm and this suggests the invention of a whole mechanism for monitoring the "price of this profit" – how much has been given and how much has been received – a task for the accountancy department.

3) Another reason for this is the competitive pressure[3] and the fact that the firm is most often an organization. And the organization, according to the important ascertainment of Ronald Coase,[4] originates, to reduce "the costs for use of the market", the transaction costs and the uncertainty.

Of all market players we can especially agree that investors come closest to rational behavior.But they also divert from this behavior under the influence of many factors, including institutional ones. Milton Freedman criticizes the behavior of the IMF regarding the Mexican financial crisis of 1994-1995 as well as all other cases of financial support in return for reforms, which enables the governments to show irresponsible behavior, knowing that in the end the MVF will help them, and that is a "moral risk". That is why Freedman and other authors believe that the removal of the moral risk removes the issue with international financial crisis as well. [5]

---

[3]"And that is why, in general, no rationality is needed to trigger competition, and it is competition or traditions, which enable competition, that cause rational behavior" [4]

[4] Oliver Williamson continues this tradition by transferring this onto all institutions of capitalism. "The precise assessment of the economic institutions of capitalism cannot be reached at if the crucial significance of economizing on transactional costs is denied" [6]

[5] Explaining all of this P. Gilpin adds:"Indeed existing evidence leads this author to the conclusion that investors are not always rational and that they are sometimes seized by the so called Minski "euphoria" and that many innocent people are affected when the balloon bursts. This is the reason for the reluctance of most governments to risk financial activities and leave them entirely "at the mercy of the market". [3]

Although we have the highest level of exhibited rationality with the firm, it is a misconception to believe that it is substantively rational. The behavior of the firm as an organization cannot be called fully rational, because of:

1) A limitation of knowledge which often functions in accordance with the “trial and error” method.

Firstly, time is not always sufficient to find the best price of the resources – the minimal for a given amount – and to compare the costs of this search with the expected profit. Secondly, it is not always possible to estimate if it is better to sacrifice profit for the sake of a new market or vice versa. The objection, that exactly this striving towards the most profitable option characterizes them as the most rational player, is not enough. Because my objection is not based on whether the economic subjects want to be rational, but on whether they really are such. They are not. And furthermore, not all firms can calculate the influence of information costs and, in general, the so called transactional costs.

2) Complicated organizational structure, which gives birth to bureaucratic setbacks, as well as to limitations for the management. The firm management itself is based on the thesis about the economic person. In line with the dominating general theory, many managers think that consumers knowingly consider their purchases, the characteristics of the given goods and after that they take a rational decision based on this information.

At the same time, with their actions, other managers show that they do not pay attention to the theory, which postulates the rational actions of the consumers and the evidence for this is advertising and other activities connected to marketing, which are successful in most cases, based not on the rational thinking of the consumers, but on the contrary, based on feelings, emotions and the subconscious. They have not always considered the fact that the consumers act irrationally, but when they have done it, they have demonstrated actual rational behavior from the target’s point of view – realization of the product and hence maximization of the profit. The rational thing is that the irrational action of the consumers is being noted and this action is being studied. But the general theory claims otherwise. Let it claim so, in this case it does not hinder the increase in sales. How does the thesis about the behavior of the viscous oligopoly, which aims to addict the customers to its product, combine with the thesis about the rational behavior of the buyer according to the theory of choice? Which of the two is incorrect?

3) The difficulties caused by the relations “principal-agent”, mostly with top level firms such as joint-stock companies. Starting with absenteeism and other types of opportunism, “agent costs”, all other problems, originating from the separation of property from management, and up to the combining of the interests of owners and managers through the purchasing and cession of shares – a decision based on the neoclassical methodological individualism.

4) In the organizations (including companies) people do not act only as agents pursuing their own selfish interests. Their actions cannot be described as optimizing the final result compared with resources used. On joining the firm they “become” rational to some extent [6]. What is more, the cultural environment can cause irrational behavior

[6] „Organizations are based on norms and other irrational sources of behavior which has serious behavioral consequences. The circumstance connected with limited rationality in organizational context is linked to the fact that the members of the organizations perceive the world and calculate future results through a social filter formed by their colleagues. (this shows the influence of the team on individual decisions – D.M.). *They substitute individual decisions with institutional judgment. They pursue satisfaction from the situation they are in rather than trying to optimize it because their decision- making scope is determined by their social role or function. They are strongly motivated not only by their narrow economical egoistic interest, but also by norms of loyalty, reciprocity, professional pride or by the will to keep the tradition going. Markets rarely form a feeling of own identity in the individual, but organizations do it.*” [2] The thesis about the limited rationality in the organization was first preconceived by Chester Bernard in 1938 and developed further to different extents by a number of authors such as H. Simon, Philip Selznik, Richard Sayart, James March, Michael

through the company management such as copying an organizational structure for the sake of image and legitimacy in business[7].

5) And probably the most important argument – the company consists of individuals and the relations between them, and they cannot be rational, despite the fact that they may be striving to achieve rationality.[8]

Conclusion

All things considered, it can be concluded that companies (as well as individual market players and even more the state) can only aim at adopting rational behavior depending on their capabilities, but as a rule they are insufficiently rational. The more they approach ideal rationality the more they gain, and the more they distance themselves from rationality, the more they lose. It is due to the fact that the created goods (and value) have to be redistributed between the participants in the process. The one who has created more and used less will benefit from this, if the relations are not immoral, but they often are. The subjects are irrational and provided they can correct this flaw, they will win more. But the adjusting is due to both economic as well as non-economic factors such as the individual character, company organization and socio-cultural characteristics of the individual state. It is here that we can see the role of well-structured institutions and the relationships between them.

References:

[1] DiMaggio, P. Cultural aspects of economic action. In: Anthology of Economics and Sociology: American economic sociology after 1970. Sofia. Lik. 1999., p. 274

[2] Fukuyama, F. State building. S. Obsidian. 2004., p.110.

[3] Gilpin, R. Global Political Economy. Sofia. Damian Yakov. 2003, p.336

[4] Hayek, F. Law, legislation, freedom. Sofia. University Publishing House St Kliment Ohridski. Volume 3, 1998., p. 99

[5] Minchev, D. Modified Reality as an Alternative to the Neoclassical Assumption about the “homo economicus”.// Economic Alternatives. 2012, №2.

[6] Williamson, O. Economics of Transactional Expenses. In Anthology of Economics and Sociology: American economic sociology after 1970. Sofia. Lik. 1999., p. 144

За контакти: Assoc. Prof. Dr. Dyanko Minchev, Department of Economics, Business and Management Faculty, University of Ruse, E-mail: **dminchev@uni-ruse.bg**

Докладът е рецензиран.

Cohen, Edgar Shine, James Wilson who in fact formed the sociological branch, unlike neoclassical institutionalism favored by Oliver Williamson. [6, p.111]

[7] …”a considerable part of the company behavior is irrational because it reacts not to market incentives but to managers’ whims or corporate fashion. …up to an extent to which organizations need to be legitimate in order to survive, and the cultural prescriptions for the bureaucracy are obligatory guarantees for legitimacy, acceptance of the unproductive but conventional structures may be fully rational even if it is technically ineffective.”[1]

[8] See [5]