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THE BEHAVIORAL THEORY OF THE FIRM: FOUNDATIONS, TENETS AND RELEVANCE

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Abstract
The Behavioral Theory of the Firm has for over fifty years shaped a section of economic thought on the nature and functioning of the firm. In this paper, this theory is reviewed with a focus on its foundations, tenets and relevance. The paper posits that the Behavioral Theory of the Firm set out to distinguish from previously known analytical models of the firm. It drew in an interdisciplinary model and explored the firm in more diverse ways than before. The foundations of the theory, its tenets and relevance are discussed. Often traced to Richard Cyert and James March, whose A Behavioral Theory of the Firm (1963) text seemed to commence this theory, the evidence shows that their seminal work was one of several other contributions to its development. What is not in dispute is that the seeds for a Behavioral Theory of the Firm were sown at the Carnegie Mellon University in or around the mid-20th century. Broadly the Behavioral Theory of the Firm conceives the firm as a unit of production with goals, and a dominant coalition that harmonizes different interests of its stakeholders into those goals.

Keywords: *behavior; stakeholders; production.*

JEL Classification: D10

Introduction

Firms are essential components of modern economies. Since the transition from subsistence and retail economies, firms have played a central role in

institutionalizing economic activities. Attempts to define the firm have gained ground but remain a work in progress. However, a firm can be conceived as a business unit that owns assets and is in the business of using inputs to produce outputs that are sold to the market (Carrizosa, 2007). Its boundaries are before it sends goods into a market.

It is widely acknowledged that firms are production units that are independent from their proprietorship, which is represented by a manager. The workings of independent firms may provide insight into the functioning of an industry, which is a combination of different firms (Hart, 2011). Ultimately a theory of the firm will review its internal structure, organization and boundaries. It will also examine the behavior and strategies firms adopt in the particularities of market contexts and dynamics (Dietrich & Krafft, 2012).

Studies on the firm include attempts to define its nature, scope and boundaries. There are several theories of the firm that cover these issues. This paper briefly looks at competing theories but focuses mainly on the behavioral theory of the firm. It posits that the behavioral theory of the firm offers more analytical fronts to explain the firm and its behavior. Thus, the paper analyzes the historical foundations, tenets and relevance of the behavioral theory of the firm. The objectives are to present the foundations of the theory and how it can be applied to studies that intend to explain the day-to-day orientations of firm behavior.

Theory is a fundamental aspect of the production of knowledge as affirmed by Kawulich (2009). Theories tend to explain a phenomenon and predict future occurrences and observations. A theory organizes ideas into an explanatory form, providing guidance to researchers making observations about reality (Collins & Stockton, 2018). Without theory, a research project may be incomplete.

The paper is structured into three respective sections: the foundations of the Behavioral Theory of the Firm; the tenets of the theory, and the relevance of the theory. It is envisaged that the behavioral theory of the firm improves on previous theories of the firm that sought to explore its operational contingencies.

Foundations of Behavioral Theory of the Firm

The Behavioral Theory of the Firm was advanced by, among others, Richard Cyert and James March (1963) then of Carnegie Mellon University in the United States of America. Cyert's preference for interdisciplinary models of social analysis, and March's sociological background could account for their determination to integrate behavioral science with economics in a new approach to studying the firm.

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The Behavioral Theory of the Firm seeks to explain how and why firms make decisions related to their goals, perceptions of uncertainty, and the environment. It takes its inspiration from behavioral economics, psychology, and organizational approaches. It is particularly relevant when addressing questions about firms' response to environmental changes (Cerrato, Alessandri, & Depperu, 2015).

The Behavioral Theory of the Firm has its roots in the Carnegie School of Fresh Water Economics, whose genesis is from the 1940s on to the 1960s. The Carnegie School was a group of scholars based at Carnegie Mellon University United States of America in this period. Cyert, March and Herbert Simon led the school. The focus of the Carnegie School was on how organizations behave in terms of decision making. In their analysis, they explore the relationship between decision making in firms and the objectives, goals, and expectations of firms.

Classifications of economic thought in the United States of America around water bodies pits Fresh Water Economics, located at institutions near freshwater Great Lakes, and Salt Water Economics based at Salt Water Ocean Bodies. The Great Lakes include Lake Erie, Lake Superior, Lake Michigan, Lake Huron and Lake Ontario. The Salt Water Ocean Bodies in this case comprise the Pacific and Atlantic Oceans respectively.

As such, Fresh Water Economics is linked to institutions such as Carnegie Mellon, Chicago, Minneapolis, and Rochester. Salt Water Economics is emphasized at institutions such as Harvard, Massachusetts Institute of Technology (MIT), and the University of California at Berkeley. The critical distinction between the two economic schools is about what extent governments should intervene in economic activity. Salt Water Economists promote a bigger role for government in economic activity, while Fresh Water Economists advocate for lesser government intervention in economic activity (see Arnold 2011/2014).

Behavioral theorists of the firm posit that the behavior of firms represented by the actions they take, comes from a nexus of relationships between its stakeholders. Stakeholder goals impact how the firms make decisions related to both internal and external conditions. A major work that set the foundations of the theory was Cyert and March's *A Behavioral Theory of the Firm* (1963). It provides a framework for examining economic crises as environmental dynamics that firms encounter and which determine decisions they make to survive.

Competing Theories of the firm

Theories of the firm are those that seek to explain and predict the nature of the firm, including its existence, behavior, structure, and relationship to the market

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(Kantarelis, 2007; Spulber, 2009). A firm can is as an organization that carries out production in an economic system. The economic system and changes therein affect firms and direct their actions as and when they occur. A firm is founded by an authority (an "entrepreneur") who directs resources towards production. A firm consists of a system of relationships that come into existence when the direction of resources is dependent on an entrepreneur (Coase, 1993). Depending on the theory used to explore the firm, the decisions about resource allocation and direction may lie in the hands of the entrepreneur or manager. Nonetheless, other factors eventually determine how those decisions are made and how the firm behaves, as further indicated in this section.

Theories of the firm are concerned about five main areas of studying the firm. First, theories of the firm are concerned about its existence: how and why do firms emerge. Second, the boundaries of the firm are of interest to theories of the firm. They inquire about which transactions are performed internally and which are negotiated externally on the market. Third, theories of the firm are interested in how firms are organized. They are interested in knowing how and why are firms structured in a specific way. For example, they ask whether firms are organized in the forms of hierarchy or decentralization. What is the interplay between formal and informal relationships in the firm? Fourth, heterogeneity of the firm actions and performances is of concern to the theories of the firm. What drives the different actions and performance of firms? Fifth, the theories of the firm are interested in tests of the postulations of different theories of the firm (Hubbard, 2008; Richman and Mache, 2008).

There are four main theories of the firm: transaction cost theory, managerial theory; principal-agent theory; and behavioral theory. The transaction cost theory of the firm emerged in 1937 and was formulated by Ronald Coase. It was a neoclassical theory that considered the processes of profit maximization. Transaction cost theory emphasized analysis of the costs of conducting transactions (buying and selling of goods and services) and the decisions related to that process. The managerial theory, as proposed by William Baumol (1959 and 1969), Robin Marris (1964), and Oliver E. Williamson (1966) emphasize the role of managers in the formation, organization, and performance of the firm. This theory clarified that managers maximize their utility (benefits) and in the process, satisfy the utility of shareholders and entrepreneurs. The principal-agent theory evolved from managerial theories. Principal agent theorists such as Spence and Zeckhauser (1971) and Ross (1973) indicate that managers are more knowledgeable than the

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entrepreneur and so they are vital to the goals of the firm. Because of their expertise, they cannot be directed by the entrepreneur. Behavioral theories of the firm (the 1960s) focused on decision making in the firm and how it shapes how the firm behaves internally and externally.

Tenets of The Behavioral Theory of the Firm

Behavioral theorists slightly differed from the aforementioned competing theories because they give priority to goals as the axis of firm behavior. They propose that goals are the result of multiple stakeholders. A firm's behavior tends to be conditioned by factors that prompt a behavior to arise. These factors are called stimuli (singular stimulus). All responses are made towards a stimulus (Anderson cited in Reese, 1989). The stimulus determines they type of response of behavior that is elicited. Environmental conditions are the stimuli that elicit behavior from firms.

Färe and Primont (1994/2003) link behavioral theories of the firm to behavioral economics. They propose that in determining which theories to use to study the firm, one must form assumptions. The choice of an economic model of the firm depends, in part, on what assumptions one is willing to make about the economic behavior of the firm. Behavioral theories of the firm are linked to a broader paradigm of behavioral economics that challenges neoclassical versions of economic behavior. Hayes (2018) argues that investors generally do not behave as predicted by traditional financial theory. Traditional financial theory assumes that each individual behaves rationally to maximize utility. Rather, Hayes contends, people often behave irrationally and can be driven by their emotions, particularly when the economy is in turbulence. Behavioral finance theory, an emerging field, focuses on describing how people behave than how they should behave as prescribed by financial theory.

The neoclassical theory of the firm examines the behavior of firms concerning the inputs they buy. It also analyzes the production techniques they adopt. Neoclassical theory is further interested in the quantity at which firms produce, and the price at which they sell their output. It is assumed that the producers, whether they are monopolists or perfect competitors, aim at maximizing profit. It is assumed that firms produce to the point where marginal cost equals marginal revenue. Firms spend on inputs to the point where marginal revenue is equal to the marginal cost of the inputs (Xiao, 2004). The objective of profit maximization governs decision making in a variety of areas, including resource allocation,

production technique, pricing adjustments, and quantity produced (Chen & Murphy, 2018).

The neoclassical theory has some very clear shortcomings. It overlooks the organization of production in a firm. It downplays the conflicts in the varying interests in a firm's key constituencies. These constituencies comprise workers, managers, owners, and consumers. The neoclassical theory does not seek to understand how these conflicts are resolved. Nor is it concerned about the way the firms achieve their goal of profit-maximization.

One of the main shortcomings of neoclassical theory is its inadequacy in determining the size of the firm and its boundaries. It gives limited attention to the firm's size or extent. The neoclassical theory would not be concerned about how firms merge or disintegrate and the effects or consequences of this kind of firm behavior. The neoclassical theory explains how firms function but does not give a lot of attention to the structure of the firm (Hart, 1989).

The behavioral theory of the firm was founded in response to the inadequacies of neoclassical theories of the firm. It suggests that the firm does not only exist to maximize profit, but there are other goals associated with its formation, operations, and existence. These goals are derived from a variety of stakeholders who coalesce to structure its behavior. Firm goals provide the context of the firm's behavior.

The Behavioral Theory of the Firm is a recent theory. It is recent in the sense that it emerged less than one hundred years ago. Some studies name Herbert Simon as the founding father of Behavioral Theory of the Firm. Simon, a member of the Carnegie School, wrote 'A Behavioral Model of Rational Choice,' which is viewed as the genesis of the theory.

According to Dutt (2010), Simon called for a new direction away from the neoclassical rationality. He preferred a new direction that took examined the costs and limitations that shape firm behavior. Simon was emphatic on behavioralists examining the actual process by which people (and firms) made decisions. His model paved the way for behavioral approaches to the study of the firm.

Nelson and Winter (1982) explain further the role of Simon in advancing behavioral theory. They argue that this concept of bounded rationality [or rationality with limitations] meant rationality was not a given among firms. Real-life decision problems were too complex to comprehend, and therefore firms cannot maximize over the set of all conceivable alternatives. This bounded reality gives the varying contexts of firm behavior.

Pervan and Višić (2012), on the other hand, attribute the rise of the behavioral theory of the firm to Richard Cyert, James March and Herbert Simon of the

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Carnegie School (see also Zbaracki and Bergen, 2015). Cyert and March contested neoclassical assumptions of economic behavior and proposed that firm behavior can be analyzed through exploring the nature of the firm and decision making in the firm. They suggest that firm behavior is influenced by organizational expectations, organizational choice, and organizational goals. Behavior is also determined by its environment and perception of uncertainty (Soni 2014; Dasgupta, 2003). Rulz (2010) has furthered the debate by identifying the complex process of goal formation and decision making in the firm.

Because of its recognition of cognitive processes, the Behavioral Theory of the Firm is described as a psychological approach. Detzer and Herr (2014) trace the origin of the theory to psychologists who, in the 1960s and 1970s, began to examine economic decision-making processes. They detailed heuristics and biases of humans that make their decisions under uncertainty. Biases meant that their decision tended to be irrational.

Prior research has shown that behavioral responses can be assessed as follows: (1) well-defined endpoints that are practical to measure, (2) well understood relative to environmental factors that cause variation in the response, (3) sensitive to a range of stimulants (which elicit the response) and adaptable to different entities, and (4) ecologically relevant (Rand cited in Little and Brewer, 2001).

A Behavioral Theory of the Firm: 1. focuses on a small number of key economic decisions made by the firm. These decisions include price and output decisions and internal allocation, and market strategy decisions. 2. Develop process-oriented models of the firm which view decisions of the firm as the result of a well-defined sequence of behaviors in that firm; and study the decisions by studying the process. 3. Link models of the firm to empirical observations of both the decision output and the process structure of actual business organizations. The models are based on observations and empirical tests of firms concerning the actual behavior of identifiable firms. 4. Develops a theory which can generalize beyond the specific firms studied. This generalization involves summarizing concepts and relations that enhance scientific understanding of the behavior of a variety of organizations in a variety of decision situations (Cyert & March cited in Argote & Greve, 2007).

Behavioral theories of the firm make some assumptions about the nature and behavior of firms that differ from neoclassical suppositions of the firm. According to March (2008), firms are characterized by 1) imperfect environmental matching (firms do not perfectly fit with their environmental circumstances) 2) Bounded

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rationality (limitations to make rational decisions), and 3) Unresolved conflicts which lead them to keep shifting goals and changing behavior.

Behavioral theorists of the firm also define and examine the firm as an organization (Becerra, 2009; Tommaso and Dubbini, 2000). Accordingly, the modern “representative firm” is a large, complex organization (Cyert & March, cited in Schrader, 1993) with goals. Mindful of the diversity in and of firms, behavioral theorists have also considered the firm as heterogeneous units with different characteristics (Tecce, Pisano and Shuen, 2008).

The goals of the firm are those objectives that an organization is ostensibly designed to achieve (Mansfield, 2013). Moreover, firm behavior is influenced by the goals and expectations of firms and their coalition of stakeholders (Soni, 2014; Dasgupta, 2003). There are five main goals pursued by firms: (a) production goal (b) inventory goal (c) sales goal (d) share of the market goal and (e) profit goal (Kumar, 2017).

Rulz (2010) has studied goal formation in firms and describes it as a complex process because of the different interests and constituencies that firms have to cater. In firms, there are multiple stakeholders with multiple expectations, which result in ever-changing goals (Ledenyov & Ledenyov, 2018). As such, goals set by firms tend to be flexible and revisable from time to time depending on past attainments, conditions prevailing in the economy, and changes in the aspirations of the various groups within the firm (Kumar, 2017). The interactions between the various groups are not always smooth. Lindblom (cited in Tsoukas and Knudsen, 2006) suggests that the firm is often viewed as a ‘political coalition’ between different interest groups for which a truce should be constantly found.

The goals of the firm are normally the underlying motivations for decisions made within and by the firm. This has led behavioral theorists of the firm to study the firm as a decision-making unit with greater emphasis on its decision-making processes (Brannon, Thommesen, & Marshall, 2003; Simon cited in Dutt, 2010). They focus on how decisions, judgments, or responses related to the situation of the firm are reached. Dosi and Marengo (2007) propose that firm behavior is problem-solving activities that are a product of physical and cognitive acts within a procedure, leading to the achievement of a specific outcome.

In making decisions, behavioral theorists argue, those decision-makers in the firms are affected by bounded rationality. In other words, the rationality of individuals who make decisions is limited by the amount of information in their possession. They are also constrained by the cognitive limitations of their minds

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and the finite or limited time frame the managers have to decide (Simon, 1957). According to Azid, Asutay, & Burki (2007) firms do not function rationally. There are other reasons why firms could act in different ways.

Similarly, real-life decisions are too complex to comprehend, and therefore, firms cannot maximize the set of all conceivable alternatives. This bounded reality gives the varying contexts of firm behavior (Nelson & Winter, 1982). This contrasted with the neoclassical view that firms have perfect, logical, and deductive rationality.

Besides the bounded rationality of its decision-makers, firm behavior is also induced by environmental incentives and constraints (Luthans, Avey, & Luthans, 2008). For example, firms tend to solve their pressing problems rather than develop long-run strategies that could be standard practice across a wider sector or industry (Tecce, Pisano & Shuen, 2008). Wolff and Resnick (2012) have attributed the unpredictability of firm behavior to natural, cultural, political, and economic processes. As such, to analyze firm behavior, each firm should, therefore, be studied for its unique contexts.

According to behavioral theory of the firm, three sets of conditions also shape firm behavior: (1) conditions inside the firm, (2) conditions in the industry and, in particular, in rival firms; and (3) conditions in the economy as a whole (Cyert & De Groot, 1987). Of importance is who the firm interacts with. More specifically, Jirasek (2016) states, the interaction of a firm with both its customers and competitors leads to certain behavioral patterns that could be followed to understand the motives behind particular actions of the firm. The behavior of firms in the market place has become a central point of inquiry for behavioral theorists of the firm (Todeva, 2007; Stremţan, et al., 2009).

Besides externally produced factors, firm behavior may also be determined by its internal dynamics (Huff, Huff, & Bar, 2000). This accounts for the different ways firms react to changing environmental (competitive) conditions from ways that are known of their competitors. After studying firm behavior over some period of time, Liberman and Asaba (2006) and Cyert and March (cited in Tsoukas & Knudsen, 2006) suggest that firms may either imitate other firms or adapt to their environments. They are influenced by the behavior of their rivals, who they think may obtain a competitive edge through the actions that they take. Several studies have explored adaptation as one of the main forms of firm behavior (Abatecola, 2012; Tsoukas & Knudsen, 2006; Gibbons, 2005; Teece, 2007; Tsoukas & Knudsen, 2006; Williams, 2007; Sternard, 2012). They view the firm as an

adaptive institution whose short-term behavior is determined by its 'standard operating procedures.

According to Wong and Candolin (2015), behavioral adjustments represent the first response to altered conditions. This adjustment to conditions is referred to as adaptation. Firms adapt to survive. Behavioral theory or its institutional theoretical strand, explains how the firm adapts to a symbolic environment of cognitions and expectations and a regulatory environment of rules and sanctions.

The theory assumes bounded rationality; additional key borrowings from the behavioral theory of the firm are uncertainty avoidance (Argote & Greve, 2007). A summary of the core premises of behavioral theories of the firm as given by Argote and Greve are: bounded rationality, problemistic search, the dominant coalition, standard operating procedures, and slack search. These premises and concepts serve to explain how decision making and firms generally function.

Bounded rationality identifies the limitations of a decision-maker at a cognitive level and at a contextual level, which shapes the decision-making process (Simon, 1990). The decisions made with inadequate knowledge are rationalized by the lack of knowledge. Accordingly, the principle of bounded rationality is that perfect decisions are never possible, because of either the limitations of knowledge or the inability of the decision maker to behave rationally (Ballester & Rojas, 2012). Different contexts influence the decisions make, rendering some of them to be non-rational (Hernandez & Ortega, 2019).

Problemistic search is a concept used to describe how in terms of behavior, firms search for solutions to problems after receiving feedback about performance. When the firm's performance falls below expectation, it initiates a search for solutions. This may result into performance to the aspired level (Posen, Keil, Kim and Meissner, 2018). Sometimes firms use benchmarking to determine what they should achieve, and undergo problemistic search to attain those levels of performance. There two types of performance aspirational levels: historical aspiration and social aspiration. Historical aspirational level is about the firm's past performance in relation to the present while social aspirational level is the firm's current performance in relation to its competitors in the market (Kim, Finkelstein, & Haleblian, 2015).

The dominant coalition is the group that institutes and modifies the general management logic of the organization (Leone, 2016). It is assumed by Bowen (2005) that all firms have some kind of dominant coalition that makes decisions from within. The coalition tends to play a leading role in the organization and

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shape the general direction it takes. It influences the missions and goals of the coalition and the implementation of these missions and goals. This is in spite of the various interests' different stakeholders within and outside the organization may have.

Standard Operating Procedures (SOPs) are instructional mantles that tells employees of firm how to do what they do. The document defines expected practices and sets quality standards (Gough & Hamrell, 2009). According to De Treville, Antonakis and Edelson (2005), the use of Standard Operating Procedures (SOPs) that guides employees, generally improves the outcomes of production at firms. The SOPs are relevant to different firms and contribute to the effective management of the system. They promote transparency and can assist in building transparent systems with components to prevent error and mechanisms for correction (Amare, 2012).

Slack refers to the resources and inputs that an organization may have and which may not have been used to advance the goals of the firm (Daniel, et al., 2004). They are reserve resources that can be deployed if need be to realize objectives of the firm. Slack search involves the process of the organization developing such resources and inputs even when they might not be using them to solve any immediate problems (Argote & Greve, 2007).These concepts are important ideas that can be used when applying the theory to studies of the firm.

Relevance and Limitations of Behavioral Theory of the Firm

The influence of the Behavioral Theory of the Firm has been widely emphasized (Gavetti, Greve & Levinthal, 2012) because it set the agenda for studying the behavior of firms at an organizational and strategic level. Unlike previously existing economic theories of the firm that in a limited way viewed the firm as a black box, churning inputs into outputs, in other words, its typical production function, the behavioral theory of the firm broadens the scope of analyzing the firm into a variety of possibilities. It examines the internal and external dynamics of the firm, it focuses on decision making related to production, scheduling, and inventory, and identifies the circumstances that surround decisions, and outcomes from a rational and non-rational perspective (Todeva, 2007). The behavioral theory of the firm also promoted an interdisciplinary model for studying the firm. This ideally synthesizes many disciplines and enriches the scope of ideas that can be developed about the firm (Jones, 2009). While this may prove problematic in agreeing on the methodological focus of studies on the firm, it

provides a platform for digging into crates of methods that can create new knowledge about firms.

One of the limitations of the Behavioral Theory of the Firm is that the behavior of the firm is taken as highly variable. It is very difficult to define a firm using the behavioral theory of the firm. The theory also assumes that the behavior of the firm can be as diverse as the heterogeneity of its decision-makers, and environment. The use of interdisciplinary frameworks to examine firms makes it a very broad terrain of analysis, that could retreat from the core operational tendencies of firms, which are largely economic organizations.

Conclusions

This paper concludes that theories of the firm explain the nature and operations of the firm. The behavioral theory of the firm which is the main focus of discussion emerged as a response to the analytical inadequacies of the neoclassical theory of the firm. Its founders, based at Carnegie Mellon University sought interdisciplinary methods to conceptualize and predict firm behavior. Behavioral science was central to the construction of this theory.

Because of the numerous contributors to the theory and the strands and tributaries that evolved out of it, it is concluded that the nomenclature of the behavioral theory of the firm is in actual sense behavioral theories of the firm. This plurality of thought may equate behavioral theory of the firm to an entire field of analysis of firm behavior, that a mere set of ideas that define and explore the firm.

Central to its perspective is the fact that the behavior of the firm is generated by relationships between its stakeholders, which account for its decisions. The goals of the firm, which unify the vast interests of its stakeholders are the primary hinges of decision making in the firm.

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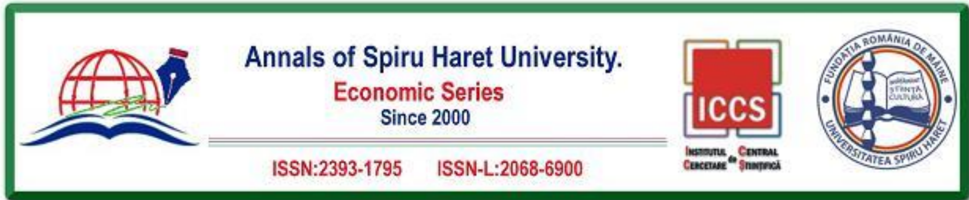

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