

LUIGI DE BERNARDIS

HOW CAN A GOVERNANCE BASED ON MULTIPLE DECISION MAKERS INFLUENCE FIRM'S ABILITY TO ECONOMIZE TRANSACTIONS? *

1. Introduction

Topic

The aim of this paper is to investigate about what happens when decision taking process is not individual but collective. Can the presence of multiple decision makers influence human behaviour?

From research problem to research question.

Are performance of the firm influenced by both internal and external alignments (market structure and strategic priorities; organizational goals and individual behaviour)?

The answer to this question requires a correct definition of the two constructs of “alignment” and “performance”.

A lot of studies analyze relations between structure of the market and performance of the firm. This relation is the same of Bain's framework “structure of the market - conduct of the firm – performance” (Bain, 1959).

Bain gave a less consideration to “conduct of the firm” and, even if other authors (Scherer, 1980) modified his framework giving more emphasis to “conduct”, two strong assumptions are still in their framework:

1. The first assumption is the fact that organizations are “individual entities”: this assumption is very often used to simplify reality. Even if the assumption that rational behaviour has been replaced by bounded rationality, considering organizations as individuals is a too strong simplification. On the contrary, the alignment among strategy and people's behaviour is one of the most important problem within the companies life.
2. The second assumption is that the market is an entity with clear characteristics and boundaries. Actually, the market is a competitive interaction among firms and/or can be considered interaction among customers with several priorities. Several studies research

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correlations between market's characteristics (concentration, uncertainty, life cycle step/maturity, ...) and performance (stock value, profitability, ...).

The aim of this study is verify consequences on performance of these two assumptions removal introducing "plurality" of market and of decision makers.

The assumptions are always introduced with the goal to simplify reality "paying" a price in terms of coherence with real situations.

Remove the assumptions above can help managers to recognize their specific situation and use the results of research that fit better to their own context.

This study requires a multilevel analysis (organizations, groups, individuals). More exactly, relations among different levels is the aim of this study.

People who work in companies have every day problems in terms of knowledge, disagreement and implementation like, for instance, the following:

- management control systems often measure only financial performances and customers have no possibilities to communicate their satisfaction;
- managers spend little time in discussing corporate strategies;
- strategies aren't communicated to people;
- incentive systems are often based on expected behaviours that are often opposite to strategies expectations;
- belonging to a team change people behaviour;
- decision making is very often un-rational and different in collective situation.

Evidence of these statements were found by Norton in a survey. His findings were the following (Kaplan and Norton, 2006):

- in 60% of organization there is no connection between strategy and budget;
- in 70% of organization there is no connection between middle management incentive and strategy;
- 85% of executive board spend less than an hour per month discussing strategy;
- 95% of people don't understand company strategy;
- 90% of organization fail in translating strategy into actions.

Understanding effect of multiple decision makers on performance could be very interesting for managers in order to design appropriate organizational microstructures or procedures and tools.

The problem of "internal" alignment is less interesting when the dimension of companies is smaller: in this case shareholders and managers could be the same people and relations among management and workers use the form of coordination that Mintzberg classify as "direct supervision" (Mintzberg, 1971).



How it is possible to classify different symptoms of dis-alignment into categories that could help operationalization of the concepts?

Alignment requires - for both internal and external - at least:

- Knowledge of organizational and individual priorities;
- Sharing priorities (sense making, values, ...);
- Translation in action and concrete behaviour.

External alignment requires that:

1. people know customers' key performance expectations;
2. people want to change their priorities following customers' expectations;
3. people are able to innovate processes according to new priorities.

Internal alignment requires that:

1. people know corporate strategy;
2. people believe in company's values;
3. people are able to realize initiatives scheduled in strategy.

The most specific management approach dealing alignment problem seems to be SFO (Strategy Focused Organization) developed by Kaplan and Norton as consequence of prior studies about balanced scorecard (Kaplan and Norton, 2006).

Anyway, finding answers to specific research questions about alignment and performance could help organizational choice of top management.

The research problem of verifying if performance is correlated with internal and external alignment is very interesting for managers but, at the same time, it is too "wide".

A selection among interesting research questions could suggest to analyze how correlation between performance (measured through firm's ability to economize transactions) and external alignment (measured through human behaviour) changes in presence of multiple decision makers.

Thus, research question can be formulated as follows:

How can a governance based on multiple decision makers influence firm's ability to economize transactions?

Theories that pertain

In this paper the research question is analyzed matching assumption and findings of transaction cost theory and theory of decision.

Transaction Cost theory suggests that the choice between market and hierarchy (hybrid form are also considered) should be a process to individuate the most efficient wideness of the firm.

This theory is based on two main assumptions about human behaviour (opportunism and bounded rationality): how would change the result of these studies when we introduce multiple not-aligned decision makers?

Theory of decision describes decision process from four perspectives:

- rational process
- process based on rules
- administrative process
- cultural process.

How can we match these new assumptions in transaction cost theory? In the following section I analyze literature that contribute to this goal.

2. Literature review

The relation between transaction cost and human behaviour is analyzed by Nickerson. He argues (Nickerson, 2003) that transaction cost hypothesis is that organizational actors try to economize on transaction costs by "assigning transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way" (Williamson, 1985). The behavioural assumptions of bounded rationality and opportunism in transaction cost give a "pessimistic" view of human behaviour.

Linderberg's view of human behaviour is different. He proposes the concept of "Social Rationality model" (Linderberg, 2001). Linderberg tries to overcome some Simon's approach limitations in bounded rationality.

According to Simon, bounded rationality refers to decision process that "takes into account the cognitive limitations of the decision maker" (Simon, 1972).

According to Williamson the opportunistic behaviour of the agent has two limitations (Williamson, 1985):

- Neurophysiological limitations (that limit the possibility to perceive, accumulate and process information without error);
- Language limitations (limit in elaborate and communicate knowledge).

So, while Williamson use bounded rationality to reduce inclusion of cognitive processes, Simon use it to include cognitive processes in a positive organizational identification.

Linderberg argues that people behave on the basis of mental models in order to be coherent with their relationships. This model is based on:

- a goal;

- a frame.

The frame is a selective process that helps agent (who doesn't have attention for all aspects) to concentrate himself on aspects more connected to a salient goal.

With the social rationality model Linderberg provides a formulation of human behaviour named RREEMM.

The meaning of this acronyms is:

- R as Resourceful in their goal;
- R as Restricted in their resources;
- E as Expecting (they create expectations about past, present and future);
- E as Evaluating;
- M as Motivated to get better conditions;
- M as Meaning (they give sense to situations in order to achieve a specific goal).

Provenzano, starting from Linderberg analysis, uses the concept of "Absorptive Rationality", defined as the ability to identify, assimilate and exploit knowledge from the environment, to argues that managers should design their decision-making process and choose different form of control. (Provenzano, 2007).

Williamson (Williamson, 1991) finds that the two following dimensions are different in market, hierarchy and hybrid form:

- contract law;
- adaptation.

About contract law, he proposes three regulation form:

1. Classical: is a legal view where actors are autonomous and their identities are not relevant.
2. Neoclassical: contractors are autonomous but become inter-connected. This helps the continuity and it is a typical form of Hybrid governance. Two examples are regulated markets and franchising.
3. Forbearance: In Hierarchy the form of organization is more elastic and adaptive. Even relationship between employee and employer is a contract. A bilateral adaptation effected through fiat is typical of internal organization and origins from employment contract.

Transaction cost approach is alternative to the classical one.

About adaptation (the second dimension) Williamson finds three forms:

1. "A" typology: price is the only effective tool
2. "C" typology: cooperation is needed (cooperation has a cost)
3. differential incentive intensity

Even if in the “A” adaptation price is sufficient to regulate relationships. Actually, it is simplistic think that the parts always react in the same way to environmental signal (non convergent expectation): these differences generate coordination costs.

So, while hybrid form maintains contractors autonomy, an advantage of hierarchy is that contracts can be less complete.

About this aspect Anderlini and Felli (Anderlini and Felli, 2004) analyze the link between bounded rational behaviour and incomplete contracts. They start with a definition of contract incompleteness. The aim of their paper is to show that the algorithmic nature of contracts is not enough to generate incomplete contracts.

Anderlini and Felli consider contractual situations in which the complexity costs of a contract are explicit and consider a class of complexity measures.

In this way they show that incomplete contracts obtain in equilibrium.

In the quantitative model used by Williamson (Williamson, 1991) the base-unit is transaction. Each transaction is characterized by:

1. frequency;
2. uncertainty;
3. asset specificity.

Asset specificity depends on: site specificity, physical asset specificity, human specificity that arise in learning by doing, brand name capital, dedicated asset (on customer), temporal specificity.

Williamson in his paper (Williamson, 1991) assume a simplification reducing specificity causes only to site and physical asset.

Correlation between asset specificity and governance could be a “measure” of alignment that represents the research problem of this paper.

About the specific research question (multiple decision makers impact) it is interesting analyze how decision theory’s way to distinguish identities and preferences of decision makers could have effect on human asset specificity.

March (March, 1994) has explained how decision process change when there are multiple decision makers who have:

- different preferences;
- different identities;
- ambiguity in their own identity;
- limitation in time and resources.

Some authors use a simplification to solve the problem of multiple decision makers: they suppose that all decision makers have the same preferences and identity.

When all decision makers have the same preferences and identity they are defined as a “team”.

According to March (March, 1994) a team can be used as a:

- Proxi;
- Simplification (differences among individual are ignored to emphasize differences among groups);
- Contract (non-coherence are negotiated using contracts).

In real organizations people have non-coherent preferences and identity. Two Egyptian researchers (O.A. El Sawy, H. El Sherif, 1988) analyzed the decision process in order to design a decision support system for Egyptian Cabinet: the result was an ambiguous decision process characterized by negotiations, different values and interests, casual information and time problems.

The assumption of multiple decision makers theory are the followings:

1. each participant has coherent identity and preferences;
2. each participant has different identity and preferences;
3. different identities and preferences cannot be realized at the same time.

An implicit assumption is that each participant knows others' preferences and identity and assumes that others use them in a coherent way.

Disagreement is important in multiple decision makers process and has the following cognitive bases:

- wrong interpretation of identity and preferences;
- hierarchy has effects on identity and preferences;
- people support often disagreement (not agreement).

Cooperation has often advantages for partners but they have constrains about identities and incentives to defeat.

Game theory gives clear example of these constrains. Augier and Swedberg argue about need to have a “sociological version of game theory” (Augier and Swedberg, 2003).

Remove disagreement requires:

- alignment of incentive in rational perspective (contracts that provides anticipatory consequences);
- alignment of identities in rule perspective (partners selection, socialization, role interpretation).

Provenzano, as mentioned above, argues that managers can help cooperation if design their decision-making process and choose different form of control: informal control. Transaction Cost approach is based on formal control: hypothesis are traditional self-interest motivations and utilization of formal rules to reward desirable performance. (Provenzano, 2007).

3. Summary

Isolating the gaps in literature

Several studies analyzes effect of bounded rationality on human behaviour. A lot of them not only confirm:

- clear evidence in reality;
- difficulties in generalizations and measurements;

but also find evidence of:

- ambiguity of identities;
- limitation in attention.

Some authors investigate on effects of introducing bounded rationality modifying in transaction cost approach the assumptions about human behaviour.

We find in literature analysis of effects of specific hypothesis (contracts' incompleteness, form of control, ...).

Nevertheless, an integrated view of modifications needed by transaction cost theory when there are multiple decision makers could be very interesting.

Research opportunities

The literature review suggests to design a research with the following goals:

- integrate in the TCE framework the different contributions that we find in literature;
- make a deeper effort about impact of multiple decision makers on adaptation form;
- make a deeper effort about impact of multiple decision makers on asset specificity;
- test experimentally the model that will come from this theoretical activities.

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