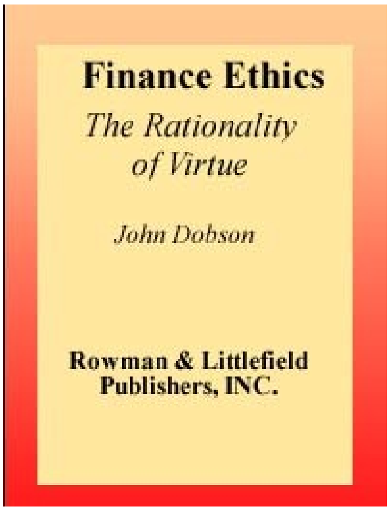

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Finance Ethics

The Rationality of Virtue

John Dobson

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To Sharon

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PREFACE

The theory of the firm, as it has evolved in financial-economic theory, is premised on a single narrow concept of rationality. Within this 'finance paradigm', a rational agent is simply one who pursues personal material advantage *ad infinitum*. In essence, to be rational in finance is to be individualistic, materialistic, and competitive. Business is a game played by individuals, as with all games the object is to win, and winning is measured in terms solely of material wealth. Within the discipline this rationality concept is never questioned, and has indeed become the theory-of-the-firm's *sine qua non*.

Beyond the monastic cloisters of financial economics, however, it is generally recognized that there is no single 'right' concept of rationality. Within the human milieu there are rationalities rather than rationality. This book proposes an alternative rationality premise for financial economics, a premise that is broader and more morally inclusive than the existing 'wealth-maximization' paradigm.

If this book were merely a moral critique of the finance paradigm, it would provide nothing particularly new. The business ethics literature is now replete with such critiques, and the moral shortcomings of the financial-economic concept of rationality are well known. What distinguishes this book, however, is the nature of the critique. Previous criticisms have invariably been by moral philosophers or business ethicists; in other words, by people from the outside looking in. Consequently their critiques are invariably based on some moral perspective that highlights the moral shortcomings of finance.

The distinguishing characteristic of this book is that I critique the finance paradigm from *within* the paradigm. Unlike other authors in this area, my professional background is financial economics. Thus, I view the finance paradigm from the inside, looking out. In part I, I begin with a critique of the paradigm on its own terms, from *within*. I show that even in economic terms, the paradigm has a serious flaw. It views the firm, and financial markets in general, as a contractual nexus, yet it fails to supply any adequate mechanism for the enforcement of these contractual relations.

This lack of an efficient contractual enforcement mechanism in financial markets provides an economic justification for the introduction of some form of ethic. In short, participants in financial markets need to be able to trust one another if these markets are to function efficiently. In part II, a challenge to the existing paradigm, I review the implications of this need for trust, and evaluate some of the conventional ways of imbuing the finance paradigm with some ethic.

These conventional ways have generally taken the form of adding ethics as some form of constraint on the individual's wealth-maximization objective. An obvious practical example would be a corporate credo that lists a set of dos and don'ts. Alternatively, business ethicists have attempted to 'sell' ethics as good for business: ethics is viewed as a means to strategic advantage.

I conclude that these attempts have failed, particularly in the context of international finance. In the final part of the text, therefore, I move beyond the finance paradigm by suggesting a new approach to modeling rational behavior in finance. This approach does not attempt to add on ethics as some form of appendage or constraint to the existing theory; rather it goes right to the heart of the theory: to the finance paradigm's very notion of rationality. I draw on the moral philosophy of virtue ethics to provide an alternative rationality premise for financial economics. This alternative premise brings notions of ethical behavior within the rationality rubric. Thus, such actions as 'honoring trust' become rational in and of themselves, and do not have to be justified in material terms.

The book's central argument is therefore taken full circle. In addition to its moral appeal, this new finance paradigm also enables trust to become a rational contractual enforcement mechanism. So, whether viewed from the perspective of ethics or economics, the new virtue-based paradigm dominates the old.

In a formal educational context, I have found that this book makes an excellent supplementary text in both finance and business ethics courses at the upper-level undergraduate and graduate levels. 1 In the case of finance, because the subject of financial ethics is so new, there is really nothing available in this area and finance texts themselves give ethicsat mosta cursory mention. In the case of business ethics, although there are now several business ethics texts available, these texts cover all areas of business and generally tend to focus on the management function since the authors, if not moral philosophers, tend to be in the management area. In a finance course, therefore, this book is a valuable supplementary text because it covers the financial aspects of business enterprise from the latest theoretical perspective, namely that of agency theory. It also gives a detailed overview of virtue-ethics theory, which is often inadequately addressed in existing business ethics texts.

I am indebted to the work of many authors. I build from a concept of the firm that finds its origin in Adam Smith's The *Wealth of Nations*, published originally in 1776, and more recently in the work of R.H. Coase (1937), "The Nature of the Firm," and in the modern development of agency theory.[2] The critique of economic rationality owes much to many other authors whose work is neatly summarized in Richard Thaler's book *Paradoxes and Anomalies of Economic Life* (1992).[3]

Recent interpretations of Aristotelian moral philosophy are used extensively. 4 In particular the concept of "practical rationality" as elucidated by Alasdair MacIntyre in *After Virtue* (1984) and *Whose Justice? Which Rationality?* (1988). This concept also helps place the finance paradigm in an historical context.5 The synthesis of economic theory and moral philosophy undertaken here reflects, in part, a growing body of literature in the area of business ethics.6 Finally, the underlying structure of the book's normarive thrust is provided by Robert M. Pirsig who, through his evocative "Metaphysics of Quality," provides a pattern by which to weave these heretofore disparate literary threads.

I would also like to acknowledge the help of the editorial staff at Row-man & Littlefield, and the tireless dedication of my student assistant, Erin Yokayama.

INTRODUCTION

The paradigm about self-interest leading to a workable and perhaps even optimal social order without any admixture of "benevolence" has now been around so long that it has become intellectually challenging to rediscover the need for morality. To affirm this need has today almost the same surprise value and air of paradox which the Smithian farewell to benevolence had in its own time. Second, and more important, it has become increasingly clear that, in a number of important areas, the economy is in fact likely to perform poorly without a minimum of "benevolence."
Albert O. Hirschman

Upon listening to the current controversy surrounding the role of ethics in business, financial managers may understandably feel somewhat bemused. On the one hand they will remember their business school training, during which they were continually instructed that the primary objective of the firm is to maximize shareholders' wealth, or as Milton Friedman put it in the title of his oft-quoted *New York Times* article: "The Social Responsibility of Business Is to Increase Its Profits." 1

But these financial managers may also come across statements from leading business ethicists such as the "primary obligation [of business] is to provide meaningful work for . . . employees," or "if in some instance it turns out that what is ethical leads to a company's demise . . . so be it."2 Not to mention such proclamations as "provision to meet need is the highest purpose of business; provision to satisfy unreasonable and socially harmful desire . . . perverts the purpose of business," and "it is usually profitable to be honorable, and virtue is more than its own reward."3

How, if at all, can these views be reconciled? In the context of financial economics, is shareholder-wealth maximization antithetical to honor and virtue? Are agency problems, such as excessive management remuneration or management's delay in releasing negative financial information, also ethical problems? Assuming that it is relevant, is ethics too nebulous a concept for serious consideration within the financial contracting rubric? In practice, on what basis should decisions be made when an apparent conflict exists between profits and ethics? If corporations should temper their pecuniary aspirations with some ethic, then which of the various moral philosophies is most practical in a financial context?

Business ethics and financial economics both analyze business and thus both address aspects of these and many similar questions. Even the most cursory review of their respective literatures, however, will reveal that they tend to do so from distinctly different perspectives. This difference is often explained in terms of a positive (i.e., descriptive) approach versus a normatire (i.e., prescriptive) approach: financial economics attempts to explain what the firm *is*, whereas business ethics attempts to explain what the firm *should be*. But this explanation is lacking. In finance, for example, Merton Miller's invocation of the firm as "an abstract engine that 'uses money today to make money tomorrow'" has both positive and normative elements. 4 It describes what the firm is, but it also describes whatwithin the finance paradigmthe firm should be: the firm *is* a type of financial engine, and the *firm should be* an engine that makes "money tomorrow."

In essence, finance views the objective of the firm solely in terms of economic efficiency (as the quote from Miller indicates), whereas business ethics extends the objectives of the firm to encompass the moral good, but both disciplines address positive and normative issues. For example, in the case of business ethics theory, normative statements such as "provision to meet need is the highest purpose of business" are in sharp contrast to positive observations such as the finding of "a marked negative association between accountants' position or rank [within large accounting rums] and their level of ethical reasoning."5

This positive-normative dichotomy, therefore, does not fully account for the difference between business ethics and financial economics. But there clearly is a difference. Both disciplines are concerned with the same entity, namely the firm, but both disciplines operate in paradigmatically separate universes. Finance essentially takes the values and goals of the agent as given and focuses instead on the contractual structure of the firm. Contrarily, business ethics questions these very values and goals.

But even though the distinction between normative and positive does not adequately account for the difference between business ethics and finance, it can provide some valuable insights. In the context of finance, relatively little distinction is made between normative and positive as regards the concept of the firm itself. The only absolute is the normative dictum that firms should be efficient, but the questions of how firms should be structured in order to maximize efficiency and how they actually *are* structured are recognized as open questions. Michael Jensen and William Meckling, for example, define firms as "legal fictions which serve as a nexus for a set of contracting relations among individuals," but they do not claim that such firms are the normative ideal, nor do they claim that this definition is the definitive positive statement on what the firm actually is.[6] If you compare IBM and Microsoft, for example, both firms fit the above definition of a contractual nexus and both presumably strive for efficiency, but the composition of these firms and the means by which they strive for efficiency are clearly very different. One might convincingly argue that the fact that IBM lost approximately 50 percent of its market value in recent years, and that this market value was temporarily exceeded by that of Microsoft, indicates that the latter is a more efficient contractual nexus than the former. But one could no doubt envisage a still more efficient firm. At the firm level, therefore, finance recognizes the evolutionary nature of both normative and positive concepts.

When one shifts from the structure of the firm to the behavior of individuals within the firm, however, finance's approach becomes considerably more rigid. Here the behavioral prerogatives of the agent are taken as absolute and inviolable. The concept of agents as wealth-maximizing opportunists is finance's *sine qua non*, and any hint of the possibility of other behavioral motivations is summarily dismissed as no more than a "'Nirvana' form of analysis." 7 Thus, when it comes to the behavioral motivations of individuals, finance's conceptual rigidity is absolute.

Turning now to business ethics, the conceptualization is very similar in terms of the firm, but very different in terms of the agent. As regards the firm, business ethicists would generally concur with financial economists that the firm is and should be a contractual nexus, and that the practical specifics of what form this contractual nexus takes, and what form it should take, are indeterminate and evolutionary. Also business ethicists would not necessarily dispute the corporate goal of economic efficiency *per se*: they recognize the firm as an economic mechanism.

Where finance and business ethics diverge, however, is in their respective concepts of the behavior of agents within Furs. Business ethics does not accept finance's conceptual rigidity on the questions of what does motivate the agent and what should motivate the agent. On the positive side, business ethics draws on multidisciplinary evidence that agents' behavioral choices and aspirations are malleable, and that the structure of the firm itself can significantly alter behavior.8 On the normative side, business ethics undertakes the aforementioned "'Nirvana' form of analysis" in earnest. Indeed, the question of what *should motivate* agents provides business ethics' main normative focus.

Finance's conceptual rigidity regarding agents' behavior, therefore, limits its normative focus to the substance-based structure of the firm only, with no consideration given to the value base of the agents. Finance's sole normative quest is to discern the most economically efficient market structure; in the case of the firm, this is the one that will maximize shareholders' material wealth. Contrarily, business ethics spreads its normative net to encompass broader questions regarding the objectives of markets, firms, and individuals. This conceptual difference is reflected in the methodologies of the two disciplines: finance's rigidity regarding behavior has enabled it to achieve a high degree of mathematical rigor in both empirics and theory, whereas the broader normative focus in business ethics has limited mathematical precision to empirical studies only. Indeed, it was this quest for mathematical precision that led the finance paradigm to define rational behavior in such spectacularly narrow terms.

An apologist for the finance paradigm might defend its conceptual rigidity as follows. Although there are undoubtedly motivations other than wealth maximization that influence, and should influence, behavior, the assumptions of the finance paradigm provide a reasonable approximation of agents' behavior over a broad spectrum of business environments. The firm is an economic mechanism and agents act within the firm for fundamentally economic reasons. In addition, the construction of mathematically robust models requires simplifying assumptions. Like perfect-and-frictionless capital markets, wealth maximization is one such simplifying assumption. All disciplines have their conceptual boundaries, and any value-based normative consideration of human behavior simply lies beyond finance's conceptual boundary. Indeed, if finance were to stretch this boundary in an attempt to encompass such questions, mathematical rigor would be lost. Finance would be set adrift in the scientifically unnavigable sea of moral philosophy. Wealth maximization provides a secure anchorage from which a rigorous theory of financial-market behavior can be built. Says Norman Bowie, "Like perfect information and zero transaction costs, psychological egoism [i.e., wealth maximization] is one of the simplifying assumptions needed for the mathematics of equilibrium analysis." 9

But this defense of the finance paradigm's notion of rationality may be countered as follows. A close scrutiny of the wealth-maximization assumption as invoked in the finance paradigm reveals that its mathematical rigor is in fact a chimera. Consider, for example, the concept of utility-of-wealth that is used frequently in financial contracting models.10 We may say that this utility increases with increasing wealth, and decreases with increasing risk and effort, but even though the functional relationship may be approximated by a lognormal or similar utility function, this function can never be measured with precision for any one individual or individuals in aggregate.11 Even wealth maximization, therefore, accommodates a margin of judgment concerning an agent's behavioral prerogatives, which broaches the question of whether other behavioral assumptions might not provide an equally secure conceptual anchorage. Also, the recent history of financial economics has essentially been one of weighing conceptual anchors. Indeed, finance's newer and most informative theories, namely agency, signaling, and reputation theories, arose from the weighing of the perfect-and-frictionless-capital-markets anchor: these theories are built on the recognition of market inefficiencies and have been instrumental in the evolution of the contemporary theory of the firm. Weighing the wealth-maximization anchor, therefore, may simply be the next logical step in the evolution of a theory of what the firm is, and of what the farm should be. Indeed, agency and signaling theory reveal clearly the normative undesirability of wealth maximization. These models inevitably engender equilibria that are inefficient in that wealth is not maximized either for the agents involved or for the economy in aggregate, hence the "finance paradox" in which a strategy of wealth maximization does not maximize wealth. But more on this in chapter 1.

Furthermore, there is increasing evidence that human behavior, even in a financial context, is far more complex and multifaceted than financial theorists have recognized. The behavioral assumptions that form the foundation of the finance paradigm have been criticized on two broad fronts. First, from a descriptive perspective, the empirical validity of finance's simple personal-wealth-maximization assumption has been questioned. Second, arguments have been made to the effect that the descriptive accuracy of economic rationality is inseparable from its prescriptive desirability. Agents change their behavior when confronted with role models or assumptions about how other agents behave. In other words, 'is' inevitably implies 'ought.' A recognition that the descriptive and prescriptive aspects of human rationality are inseparable draws finance inevitably into the domain of moral philosophy: these fascinating questions of how agents *do* behave, and how agents *should* behave, and the extent to which do and should are connected extend our enquiry beyond the boundaries of what has traditionally been regarded as the "finance paradigm." *Financial ethics* is born.

But in general discourse, the term 'financial ethics' often evokes wry smiles and chuckles. "Isn't that an oxymoron?" will often be the sardonic retort. Such cynicism is perhaps not surprising in light of the continual scandals that have rocked both domestic and overseas financial markets in recent years, not to mention the questionable practices of many business organizations and the (handsomely remunerated) executives therein. Indeed, from a pedagogical perspectivewith ethics having permeated the disciplines of accounting, marketing, and managementfinance survives as the last bastion of a value-free business discipline. Finance has traditionally been regarded as value free because it was seen as dealing with the purely technical aspects of business enterprise: such issues as the optimal mix of debt and equity financing, dividend policy, and the evaluation of alternative investment projects, and more recently the valuation of options, futures, swaps, and other derivative securities. Such questions are essentially technical in nature and would appear to render little scope for ethical evaluation.

But beneath this technical facade financial economics remains, at heart, *a social* science. With the advent of agency theory, the purview of this