

Self-Interest: The Economist's Straitjacket

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*Comments and Suggestions Appreciated**

This paper examines contemporary economic theories that focus on the design and management of business organizations. In the first part of the paper, a taxonomy is presented that describes the different types of economists interested in this subject—market economists, regulatory economists, and enlightened economists—and illustrates the extent to which each tribe has been captured by the concept of self-interest. After arguing that this fixation has caused—and is likely to continue to cause—significant harm to our economy, the paper then presents an alternative approach based on a theory of business and discusses the implications for research and teaching.

Keywords: self-interest, economists, moral philosophers, agency theory, regulation, capture, organization design, economic theory, organization theory, management theory, business education, competition, customers, commitment, controls, boundaries.

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"I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders."

Alan Greenspan, Chairman of the Federal Reserve¹

In this paper, I critique the economic theories that are used to describe—and prescribe—principles of business organization. Specifically, I focus on the theories that are taught in business schools and animate public policy debates about how firms should be designed and managed. My goal is to cast a critical eye on existing practice and, more importantly, suggest an alternative formulation that may better reflect business realities. In doing so, I hope to generate interest—and spark debate—among scholars who develop and teach theories about how businesses should be organized, managed, and controlled.

It will come as no surprise that the views of economists carry great weight when discussing business organization and design (Ferraro, Pfeffer, and Sutton, 2005). Their ideas underpin many of the policies that facilitate the functioning of markets and, within businesses, the economist's influence is felt in everything from governance processes and executive pay to choices of decentralization and accounting policies.

For example, a recent analysis of mentions of the term "economist" in *The New York Times* ("How Economists Came to Dominate the Conversation") shows that one in every hundred articles on all topics refers to the views of an economist, dwarfing the influence of other academic disciplines. Similarly, an analysis of mentions in the Congressional Record shows that economists dominate other academic disciplines by a wide margin.²

As a result of this high level of influence, economists—and the assumptions on which their prescriptions are based—attract much of the credit (and some of the blame) for the overall health of business and the economy (see, for example, Litan, 2014).

Of course, such preeminence is not without risks. Some scholars worry, for example, that academic economists may be susceptible to conflicts of interest in their policy prescriptions. In voicing such a concern, Zingales (2013) builds on the literature of regulatory capture to argue that economists risk being captured by the very businesses and regulators they collect data from and study. This possibility is probably remote, however, since academics don't typically have the same incentives or revolving doors that are common among regulators where the concept of capture originated (Stigler, 1971).

¹ Testimony before House of Representatives Committee on Oversight and Government Reform, October 23, 2008.

² Justin Wolfers, "How Economists Came to Dominate the Conversation," *The New York Times*, January 23, 2015.

In this paper, I focus on a different kind of capture: the unquestioning and universal acceptance by economists of self-interest—of shareholders, managers, and employees—as the conceptual foundation for business design and management.

This focus on self-interest as the key building block for organization theory is relatively new. Up through the 1970s, economists modelled the firm and its managers as an equilibrium-seeking black box that could be represented by marginal revenue and marginal cost curves. Gibbons (2000) recaps the state of affairs at that time,

For two hundred years, the basic economic model of a firm was a black box: labor and physical inputs went in one end; output came out the other, at minimum cost and maximum profit. Most economists paid little attention to the internal structure and functioning of firms or other organizations. During the 1980s, however, the black box began to open: economists (especially those in business schools) began to study incentives in organizations, often concluding that rational, self-interested organization members might well produce inefficient, informal, and institutionalized organizational behaviors.

This breakthrough—the insight that rational self-interest (coupled with utility maximization, opportunism, and effort aversion) could serve as a theoretical and mathematical foundation for modelling and prescribing individual behavior in organizations—served as a powerful rallying call for economists. Adopting a stripped-down, stylized view of organization functioning, Jensen & Meckling (1976) set the stage by asserting that “most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals” (p. 310). Using this simplifying assumption as a backdrop, they go on to describe the contracts, incentives, monitoring devices, and bonding mechanisms that define a prototypical agency relationship.

Building on this contracting-between-individuals concept of organizations, economists have, for the past forty years, been fixated with the roles and rights of senior executives and shareholders—all working from the fundamental assumption of self-interest, opportunism, and effort aversion.

To explore the implications of this defining assumption, I divide the paper into two parts. In the first part, I present a model of capitalist economies and link this model to the theories developed and taught by economists. Using this taxonomy, I argue that different tribes of economists promote very different ideas about how to design and manage a business. But, regardless of tribe—with their inherently different policy prescriptions—all economists have been captured in one way or another by the concept of self-interest. This “conceptual straitjacket,” I argue, has had profound (and sometimes harmful) effects on the functioning of business organizations, government policies, and the overall health of the economy.

In the second part of the paper, I offer an alternative framework for business design and functioning. In place of self-interest as the dominant organizing principle, I argue that successful

managers focus on the four C's: competition, customers, commitment, and controls. This alternative approach, I argue, is much closer to the way that effective business leaders actually manage and, if modelled in economic theory, will allow a return to policies and techniques that will stimulate increased competitiveness, growth, and value creation.

I. The Fundamentals of Capitalism

1.1 A Schematic Model of Capitalism

To ground my analysis, it is necessary to revisit the first principles of economics to map the underlying structure of the market-based capitalist system. Therefore, as a starting point, I offer (as a hypothesis) that the essence of the capitalist system—and its ability to create unparalleled wealth—can be modeled schematically as follows:

$$\begin{array}{ccccccc}
 \text{Self Interest} + \text{Freedom} & \rightarrow & \left[\begin{array}{c} \text{Individual Effort} \\ + \\ \text{Entrepreneurship} \\ + \\ \text{Innovation} \end{array} \right] & \rightarrow & \text{Growth in Wealth} + \text{Inequality of Outcomes} \\
 (1) & & (2) & & \text{Business Activity} & & (3) & & (4)
 \end{array}$$

The two terms on left-hand side of the model represent the essence of capitalism as described by Adam Smith. The self-interest of atomistic actors coupled with freedom of opportunity results in the unleashing of individual effort, entrepreneurial activity, and innovation. Fueled by self-interest, each individual can create his or her own opportunities. In the capitalist system, every individual enjoys the freedom to work as hard as he or she wants and to enjoy the fruits of their labor. Thus, the capitalist system is often called the ‘free enterprise system.’

Business activity—fueled by individual effort, entrepreneurship, and innovation in a multitude of forms ranging from sole proprietorships to global enterprises—leads to the two outcomes depicted in the right side of the model. The first outcome is growth in wealth in the overall economy: history suggests that no other economic system possesses the equivalent power to unleash effort, entrepreneurship, and innovation to create wealth. Rajan and Zingales (2003), for example, call free market capitalism “perhaps the most beneficial economic institution known to humankind” (p. 293). Even Malthus came to doubt his famous theory—that population growth would inevitably outstrip the increase in food supply—acknowledging later in his life

that he had failed to consider the innovative capacity of industrial economies. (Mayhew, 2013, chapter 5).

The second output variable—term 4 in the model—is a direct consequence of the payoff to initiative, entrepreneurship, and hard work: inequality in outcomes. Those who innovate, work hard, and invest in themselves through education and saving receive relatively more rewards than those who make different choices (I take no position here as to the role of initial endowments: for example, whether these choices are individually determined or a product of the environment in which an individual is born and raised).

Winston Churchill recognized this inequality of outcomes when, during a speech in the British House of Commons, he compared the merits of capitalism and socialism: “The inherent vice of capitalism is the unequal sharing of blessings,” he stated, “and the inherent virtue of socialism is the equal sharing of miseries.”³

1.2 Economists as Tribes

The capitalist model presented above has captured the interest of a variety of economists and moral philosophers. Building on theories of supply and demand, economists seek to understand the power and limits of the left side of the model—self-interest and freedom—as drivers of effort, entrepreneurship, innovation. The objective function of their work is to be found in the third term of the model—wealth creation.

Moral philosophers, in contrast, focus on the rightmost term of the model: inequality of outcomes. More specifically, moral philosophers use theories of justice to question the legitimacy of a system that leaves large segments of the populace at an economic disadvantage.

Using this schematic model as a guide, we can subdivide economists into four tribes: market economists, regulatory economists, macro economists, and enlightened economists. Each “tribe” is interested in different variables in the capitalist model and, as a result, comes to very different policy descriptions.⁴

I should note at the outset that it is beyond the scope of this paper to explain why members of each tribe are drawn to different variables in the capitalist model. One possibility—advanced by Haidt (2012, chapters 7 and 8)—is that different individuals are innately drawn to different conceptions of morality. Such a perspective is reflected in the different moral compasses of our two American political parties: those on the political right put freedom and opportunity foremost in the societal attributes they value while those on the political left place relatively more weight on fairness and equality.

³ October 22, 1945.

⁴ Others have proposed different taxonomies of economist tribes. For example, Leijonhufvud (1973) identifies macro and micro tribes. Millmow and Courvisanos (2007) split economists into financial market economists and academic economists.

Market Economists: ‘Leverage Self-Interest’

Market economists—building on the work of preeminent scholars such as Milton Friedman, Gary Becker, Eugene Fama, and Richard Posner—take the freedom of the market (term 2 of the capitalist model) as given and focus their attention on how to maximize value creation by leveraging the power, and limiting the perils, of self-interest (term 1).

Self-interest, according to the theories of market economists, creates a fundamental divergence of goals between capital owners and individuals at different levels in business organizations. Specifically, those at the top of the hierarchy have different interests than the individuals hired to work for them. Thus, the principal-agent models that are the stock-and-trade of market economists focus on the “agency conflicts” created by the moral hazard and adverse selection that are fueled by self-interest (Jensen and Meckling, 1976).

Principals want their agents to work as hard as possible; agents, responding to their own self-interest, want to work as little as possible. Principals want their agents to be good stewards of the resources that are entrusted to them; agents want to divert those resources for their own personal use and enjoyment. Principals want to hire people who have the requisite skills, aptitude, and training; agents want to exaggerate their talents to get jobs for which they may not be qualified. To compound this basic agency problem of divergent goals, the information available to principals is generally insufficient to provide complete knowledge about the agent’s true level of skills, potential, and effort (Shapiro, 2005).

Left to their own devices, then, self-interested employees can be expected to act in ways that harm the capital owners who form the foundation of the capitalist system. To remedy this potentially catastrophic situation, market economists attempt to channel errant behaviors by using stimulus-response theory (Skinner, 1938) to design rewards and punishments that align the interests of agents with their employers. With incentives properly designed and aligned and effective monitoring mechanisms in place, market economists believe that resources can be allocated to optimize market efficiency and maximize the growth in overall wealth.

It is important to understand that the principal-agent models of market economists are both descriptive and prescriptive theories. Self-interest is used to *describe* individual behavior, but then market economists also argue that managers *should* leverage self-interest as a solution to agency conflicts. Thus, they have elevated self-interest to a normative ideal, becoming proponents of mechanisms such as highly-leveraged stock options and equity-based contracts to ensure that executive incentives are aligned with the interests of shareholders (Mintzberg, Simons, and Basu, 2002). These prescriptive theories have provided guidance (or, more cynically, justification) for skyrocketing CEO compensation that has fueled perceptions of

inequality (Dobbin and Jung, 2010). In 1980, for example, the average ratio of CEO compensation to front-line worker compensation was 25 to 1. Today, it is more than 300 to 1.⁵

As predicted by the capitalist model presented at the beginning of this paper, such highly-leveraged incentives—designed to channel self-interest—coupled with freedom of action, have created unparalleled entrepreneurship and innovation. Economy-wide value and wealth creation have been spectacularly evident, for example, in the growth of the internet and related technology-based businesses and in the development of new shale gas and oil extraction techniques, to name just two of the recent breakthroughs driven by capitalist economies.

But the focus on self-interest also has a dark side. Innovation and entrepreneurship fueled by unlimited wealth creation also resulted in the financial engineering and excessive risk-taking that was a hallmark of the late 1990s and early 2000s. Thus, following the well-publicized failures of companies such as Enron and WorldCom in the early 2000s, the ideals of market economists came under attack in the popular press with articles such as, “The Greed Cycle: How the Financial System Encouraged Corporations to Go Crazy” and “Have They No Shame.”⁶

More recently, the 2007/8 financial crisis—which many blame on a business culture awash in lavish executive rewards prescribed by agency theory—has left many workers unemployed or underemployed and magnified inequity significantly. For example, a 2010 article in *The Economist* stated, “The financial meltdown has certainly undermined two of the big ideas inspired by [agency theory]: that senior managers’ pay should be closely linked to their firm’s share price, and that private equity, backed by mountains of debt, would do a better job of getting managers to maximize value than public equity markets. The bubbles during the past decade in both stock markets, and later, the market for corporate debt highlighted serious flaws in both of these ideas ...”⁷

And, of course, the popular press has picked up this drum beat. In a September 2008 cover story, “The Price of Greed,” *Time* pointed an accusing finger at market-driven self-interest as the cause of the financial crisis (September 29, 2008). More recently, books such as *Age of Greed: The Triumph of Finance and the Decline of America* (Madrack, 2011) chronicle a “deeply disturbing tale of hypocrisy, corruption, and insatiable greed”⁸—all driven by the self-interest prescribed by market economists.

⁵ Lawrence Mishel and Alyssa Davis, “Top CEOs Make 300 Times More than Typical Workers,” Economic Policy Institute, June 21, 2015: <http://www.epi.org/publication/top-ceos-make-300-times-more-than-workers-pay-growth-surpasses-market-gains-and-the-rest-of-the-0-1-percent/>. Accessed October 12, 2015.

⁶ J. Cassidy, “The Greed Cycle: How the Financial System Encouraged Corporations to Go Crazy,” *New Yorker*, September 23, 2002; J. Useem, “Have They No Shame,” *Fortune*, April 14, 2003.

⁷ “Shareholders v stakeholders: A New Idolatry,” *The Economist*, April 28, 2010.

⁸ Paul Krugman and Robin Wells, “The Busts Keep Getting Bigger: Why?” *The New York Review of Books*, July 14, 2011. (A review of Jeff Madrick, *Age of Greed*, Knopf, 2011.)

Regulatory Economists: ‘Constrain Freedom’

While market economists have focused on how to improve the efficiency of organizations by leveraging self-interest, a second group of economists—regulatory economists—are interested in the second term of the capitalist model: freedom. These economists also recognize the power and danger of self-interest. But their approach—instead of attempting to steer self-interest in desired directions—is to impose limits on freedom to ensure that self-interested individuals and the companies they work for are constrained in their ability to inflict harm on society (Ogus, 1994; Breyer, 1982; Braithwaite and Drahos, 2000).

Hägg (1997), for example, defines regulation as follows: “By ‘regulation’ economists have in general aimed at restraints on market actors’ behavior that have originated in law, or alternatively have *ex post* been codified in law, and then are elaborated by administrative agencies and courts respectively.”

The views of regulatory economists are prominent in economics departments at American universities such as Berkeley’s Center for Regulatory Policy and in many European universities. For example, Jean Tirole of the Toulouse School of Economics won the 2014 Nobel Prize for his work on the economics of regulation. In announcing his 2014 Nobel Prize, the selection committee stated that Mr. Tirole’s work clarified, “what sort of regulations . . . we want to put in place so large and mighty firms will act in society’s interest.”⁹ Tirole’s work, not surprisingly, uses an agency theory framework based on self-interest to model the choices that regulators can use to force recalcitrant businesses to reveal their true ability to lower costs.

Because of the potential to influence public policy, many (if not most) regulatory economists—after receiving their graduate degrees in economics—choose to work for government agencies where they can implement the theories that they have been taught by their academic mentors.

The prescriptions of regulatory economists often go beyond ensuring that adequate rules exist to protect property rights, safety, health, and the environment. In the view of regulatory economists, omnipresent business greed fueled by self-interest must be policed by government agencies. Thus, the solution of regulatory economists is to impose rules on business to regulate inputs (licensing requirements), processes (Dodd-Frank Act), and outcomes (limits on executive pay). Wherever self-interest is present, they argue, government bureaucrats must be employed to decide how resources will be allocated and to design reporting mechanisms that enforce compliance.

In following the prescriptions of regulatory economists, government regulators are hired in droves to produce detailed rules to constrain behavior. But regulation is a blunt instrument where cause and effect linkages are often not well understood and unintended consequences are

⁹ “Jean Tirole Wins Nobel in Economics for Work on Regulation,” *The New York Times*, October 13, 2014.

common. As a result, regulation is generally regarded as an inefficient mechanism that can too easily become an impediment to economic growth and wealth creation.

As an example, consider recent rules passed by the French government—an avid producer of regulations to improve market functioning. When legislators became concerned that French food was deteriorating due to the appeal of cheaper but lower quality foreign food, they passed a new law (public decree No. 2014-797) requiring that restaurants display a “saucepan-with-a-roof” symbol to denote locally-made food. Government bureaucrats were then required to define what constitutes home-made food. Illogical inconsistencies abound: frozen *pommes frites* are certified as house-made as long as they are baked in an oven at the restaurant. Similarly, frozen vegetables can be labelled as home-made as long as a local sauce is added. Certain types of industrially prepared pastry can be labelled as house-made while others cannot.¹⁰

As this (seemingly trivial) example illustrates, large bureaucracies must be created to write the detailed rules that anticipate every eventuality and to create elaborate monitoring mechanisms. However, bureaucrats, by skill and self-selection, tend to be less entrepreneurial than the market-based participants they shadow—the business men and women who are constantly trying to find new ways to create value for demanding customers in competitive markets.

As a result, regulators are perpetually playing catch-up in dynamic markets, especially those driven by changes in technology. This viewpoint is evident in the comments of Travis Kalanick, the founder of Uber, the mobile app that has disrupted the U.S. taxi industry, as he describes his approach to entering new foreign cities:

We don't have to beg for forgiveness because we are legal," he said. "But there's been so much corruption and so much cronyism in the taxi industry and so much regulatory capture that if you ask permission upfront for something that's already legal, you'll never get it. There's no upside to them."¹¹

As Uber has encroached on their territory, entrenched interests have staged strikes and demonstrations, causing regulators to rethink their approach to regulation. In discussing how to respond to Uber, Neelie Kroes, a vice president of the European Commission stated that,

The old way of creating services and regulations around producers doesn't work anymore. If you design systems around producers it means more rules and laws (that people say they don't want) and those become quickly out of date, and privilege the groups that were the best political lobbyists when the laws were written.

¹⁰ Tim Harford, “When Regulators Are All Out to Déjeuner,” *Financial Times*, September 26, 2014.

¹¹ “Uber Shocks the Regulators,” *Wall Street Journal*, June 16, 2014.

She urged her fellow Europeans to embrace entrepreneurs: "Otherwise we will be outpaced to our East and our West. We'll be known as the place that used to be the future, but instead has become the world's tourism playground and nursing home."¹²

Unfortunately, few listen to such appeals. Instead, the regulators' solutions to such problems are predictable: to implement more detailed rules to monitor, limit, and check processes. Too often, however, these bureaucratic approaches fail to consider intangible costs and benefits. Consider the recent regulations imposed by the U.S. Federal Health Insurance Portability and Accountability Act which now forbids doctors from displaying baby photographs in their offices. One physician, a clinical professor at the Yale School of Medicine who treats breast cancer and hematologic disorders, described his frustration,

I have accumulated hundreds of pictures, mostly of babies born after recovery from cancer ... Some of my patients send me yearly pictures, usually around Christmas, extending through the graduation and marriages of their children. I have often shared these pictures, which I keep in several albums, with patients confronting new and frightening diagnoses so that they might understand that there is a possibility of a normal life in the future. It reassures them and makes them feel good. I have never had a patient object to my use of these pictures.

The Health Insurance Portability and Accountability Act passed by politicians and administered by bureaucrats who have no idea what we do, has created a nightmare of meaningless paperwork, oversight and requirements that have further eroded what little humanity is left in American medicine.¹³

Few would deny that the power (and cost) of regulation is considerable. A recent report by the National Association of Manufacturers estimated that the aggregate cost of federal regulations in 2012 was \$2.03 trillion (for comparison, the entire federal budget is approximately \$4 trillion). All of these regulations are enforced by what Friedman (1970) calls the "iron fist of Government bureaucrats" who control many of the institutions that create the economic rules of the game (North, 1990, chapter 6).

As a result of bureaucratic rule-making, well-meaning government initiatives are too often high-jacked by excessive regulation imposed by government functionaries. Consider the recently-announced Early Head Start Child Care Partnership and the Preschool Development Grants that will allocate over \$750 million to infant and preschool care with special emphasis on children in disadvantaged communities. The increased regulatory requirements imposed on applicants are onerous: applicants will be required to comply with 2,400 "performance standards" that stipulate everything from staff qualifications (all of the nation's 300,000

¹² Ibid.

¹³ Arthur Levy, Letters to the Editor, *The New York Times*, August 17, 2014, published in response to "Baby Pictures at Doctor's? Cute, Sure, but Illegal," August 10, 2014.

preschool teachers would henceforth be required to hold at least a bachelor's degree) to how cots are placed in a room and detailed procedures for cleaning potties.¹⁴

To make things worse, such regulations often create barriers to entry that protect incumbents from competition—motivating both firms within the industry and unions to collude—thereby limiting choice and raising prices to buyers (Rajan and Zingales, 2003, 238-9). This cost is evident in the expansion of licensing requirements across the United States. In the 1970s, 10 percent of workers in the U.S. were required to be licensed; today, that number stands at 30 percent. Cosmetologists in Minnesota must today complete more classroom hours than lawyers; manicurists are required to take twice as many hours of instruction as paramedics. In Louisiana, all florists must be licensed. Not unexpectedly, these newly regulated occupations—with their stricter limits on entry—reduce competition and result in significantly higher prices to consumers.¹⁵

In fact, in every industry that has been deregulated in the past thirty years—trucking, airlines, oil and gas, telecommunications, and (arguably) banking—competition and choice have increased while prices have come down (Litan, 2014).

Of course, there is a bright side for some to all these regulations: they produce significant employment opportunities for compliance experts and risk managers. In July 2014, for example, JP Morgan Chase, the country's largest bank, was forced to hire 10,000 compliance officers—at the same time they were laying off 15,000 other workers—to deal with the over 400 new regulations required by the 2,300 page Dodd-Frank act.¹⁶ More broadly, the American Action Forum estimated that Dodd-Frank will cost industry more than \$20 billion in new compliance costs.¹⁷

As a result of this tension, the relationship between regulators and market participants remains uneasy at best. Regulators often look at those they regulate with envy (because of their substantially higher earning potential) or disdain (if they believe that their behavior is injurious to society). To compound the problem, those being regulated in the market often apply considerable resources to attempt to influence regulatory agencies and limit competition.

Because of the inefficiencies of regulation, few are satisfied—not the bureaucrats who make the rules nor the market participants whose actions are restricted by them. And growth in the economy and the creation of wealth is inevitably retarded as the rules and regulations limit innovation and entrepreneurship.

The exception to this unhappy state of affairs is, of course, the reaction of those concerned about inequality. With increased regulation, inequality is reduced as regulators prop up the bottom of the income distribution using redistributive mechanisms such as minimum

¹⁴ Katherine B. Stevens, "Here Come the Child-Care Cops," *The Wall Street Journal*, December 21, 2014.

¹⁵ Morris M. Kleiner, "Why License a Florist?" *The New York Times*, May 29, 2014.

¹⁶ "Barney Frank 'Not Embarrassed' about Toll of Financial Regulations," *The Hill*, 7/23/2014.

<http://thehill.com/regulation/213118-barney-frank-not-embarrassed-about-toll-of-financial-regs>.

¹⁷ "A Nobel Economist's Caution about Government," *The Wall Street Journal*, October 12, 2014.

wage laws and union contracts, or cap the earning potential at the top through limits on executive pay and steeply progressive income taxes.

Macro Economists: ‘Predict and Stimulate Aggregate Demand’

For the sake of completeness, I include a third tribe—macro economists. These economists are interested primarily in the statistical models that capture the third term in the capitalist equation—growth in wealth. Reaching back to the original work of Keynes (1936), macro economists seek to understand the drivers of aggregate supply and demand and the forces that explain economic growth (Solow, 2007).

With advanced degrees in economics, most macro economists work for government departments, ratings agencies, and financial institutions. Their interests focus mainly on statistical techniques to forecast financial flows based on macroeconomic variables such as the money supply, government spending, and balances of trade.

As a rule, the work of macro economists does not focus on individuals or the behavioral traits that drive effort, entrepreneurship, and innovation in business. As such, they have little interest in human psychology or behavior. This tendency is reinforced by politicians who have forbidden macro economists from using behavioral considerations in their modelling. For example, U.S. laws have not allowed the use of “dynamic” budgeting and forecasting when predicting the cost and revenue effects of new legislation. Thus, macro economists in government agencies have not been allowed to consider the increase in personal spending and economic activity that would result as individuals substitute effort for leisure when marginal income tax rates are reduced. (This policy was reversed in January 2015 when a new Republican-controlled Congress passed legislation that requires the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) to adopt “dynamic scoring” when pricing new legislation.)¹⁸

Moral Philosophers: ‘Seek Justice for All’

To the extent that economists focus either on leveraging self-interest, limiting freedom, or modelling growth in the overall economy, moral philosophers seek an understanding of man and his relation to society. As a result, their concern is with the rightmost terms of the capitalist model: inequality of outcomes.

Notwithstanding (or perhaps because of) the power of the economic engine provided by capitalism, moral philosophers are typically outraged by the “excessive” accumulation of wealth by business owners, shareholders, and executives in capitalist economies. But it is hard to find

¹⁸ White House, Office of Management and Budget, <http://www.whitehouse.gov/blog/2015/01/06/dynamic-scoring-not-answer>, accessed January 7, 2015.

sympathetic ears for these concerns when the economy is booming and a rising tide is lifting all boats. Not surprisingly, this reticence to voice outrage receded rapidly when the tide went out during the 2008 financial crisis and left the middle class reeling.

The views of moral philosophers are best captured in Rawls's influential *Theory of Justice* (1971) which focuses on the concept of distributive justice: the fair and equal distribution of wealth across society in a way that would maximize the wellbeing of those lowest on the economic ladder. Justice is equated with fairness and, as a result, moral philosophers argue that upper bounds must be placed on the accumulation of property by individuals and businesses to preserve political liberty and fair equality of opportunity. In this theory, unequal distributions of opportunity, income, and wealth can only be tolerated if they provide advantage to those at the very bottom of the economic distribution.

Moral philosophers take a deterministic view of human initiative, arguing that outcomes such as income and wealth are determined by luck—a random draw of both the endowments granted by nature and the circumstances into which an individual is born. Rawls (1971), for example, states that ability and talent “are decided by the outcome of the natural lottery and this outcome is arbitrary from a moral perspective.” Moreover, he argues that within this random distribution of ability, an individual's willingness to work hard is predetermined by social conditions: “Even the willingness to make an effort, to try, and so to be deserving in the ordinary sense is itself dependent upon happy family and social circumstances.” (p. 74)

This view has been criticized by economists Arrow (1973) and Sen (2009, p. 52-74) who (using self-interest as a foundation) argue, based on Arrow's impossibility theorem, that such justice is impossible to achieve in practice. Heiner (1983) further argues the “fairness” definition of justice adopted by Rawls depends on his unrealistic “veil of ignorance” mechanism— withholding all information on personal circumstances from decision makers—that is used to create pervasive uncertainty.¹⁹

In general, moral philosophers do not approve of the capitalist system, preferring a society that prioritizes fairness and equality over wealth creation. In practice, however, such views have had little impact on policy because of the demonstrated wealth creation and innovation of capitalist economies.

Enlightened Economists: ‘Support the Greater Good’

Notwithstanding the inevitable inequalities generated by the capitalist system, the pervasive growth in wealth through the latter half of the twentieth century (if not more generally since 1800) was generally sufficient to compensate for any real or perceived inequities. Demand rebounded following the shortages of World War II, businesses prospered, labor unions secured

¹⁹ Within a “veil of ignorance,” individuals who must decide how to allocate resources across society are unaware of their own personal circumstances: they do not know, for example, whether they are rich or poor, well-educated or not. As a result, they are unable make choices based on self-interest.

high wages and benefits for their members, and government created new social programs to support those in need. Prosperity was deep and widely shared (Galbraith, 1984).

But in recent years, inequality—along with resistance to free-market capitalism—has been growing (Rajan and Zingales, 2003, p. 16). In accord with the capitalist model presented at the beginning of this paper, economists such as Thomas Piketty of the Paris School of Economics argue that inequality is an inevitable—and unacceptable—outcome of capitalism. Such inequality, Piketty argues, undermines the concept of social justice upon which democracies and free markets ultimately depend (Piketty, 2014, p. 571).²⁰

Those on the political left blame increasing inequality on the policies promoted by market economists: they see a system that is rigged to favor the wealthy through investment credits, tax breaks, and excessive executive compensation. Those on the political right blame the policies of regulatory economists: rules and regulations that dampen animal spirits and depress opportunity for those at the bottom of the income distribution. (Some on the right also blame the Federal Reserve’s quantitative easing program for the flood of easy money that has increased risk-taking, inflated the value of financial and real estate assets owned by the affluent, and eliminated interest payments on popular mass-market savings accounts.)

Because of the potentially injurious outcomes of the policies promoted by market economists (leveraging greed that has increased inequality and fueled the financial crisis) and the drag of the policies of regulatory economists (rules and regulations that have stifled initiative and retard economic growth), a third group of economists is emerging—enlightened economists.

Enlightened economists—like all economists—are trained in market economics and regulatory economics (the mainstay of all economics graduate degree programs), but they are moralists at heart. They are driven by a sense of social justice and seek to redress injustices from causes as varied as executive pay, corruption, global warming, access to health care, poverty, and human rights violations.

However, unlike moral philosophers who typically disdain capitalism, enlightened economists embrace the free enterprise system. Because of their training, they recognize the economic power of the capitalist system—especially as compared to other failed alternatives. They agree with Milton Friedman’s assessment, “... the record of history is absolutely crystal

²⁰ It should be noted, however, that the validity of Piketty’s calculations have been challenged on a variety of grounds. For example, Magness and Murphy (“Challenging the Empirical Contribution of Thomas Piketty’s Capital in the 21st Century,” *Journal of Private Enterprise*, Spring 2015), find “evidence of pervasive errors of historical fact, opaque methodological choices, and the cherry-picking of sources to construct favorable patterns from ambiguous data.” Harvard economist Martin Feldstein argues that Piketty’s calculations ignore both wealth creation over a lifetime and how changes in tax rates create false impressions of rising inequality (“Piketty’s Numbers Don’t Add Up,” *The Wall Street Journal*, May 15, 2014). In addition, Gramm and Solon argue that Piketty excludes from income a variety of noncash compensation such as employer-provided health plans and pension receipts, tax-exempt gains from the sale of homes, social security payments, Medicare, Medicaid, and more than 100 other means-tested government programs. After accounting for these additional sources of income, the inequalities that Piketty identifies disappear or are reversed (“How to Distort Income Equality,” *The Wall Street Journal*, November 12, 2014).

clear. That there is no alternative way, so far discovered, of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system.”²¹ This assertion is empirically supported by macro economists who have linked the relative growth in global wealth to the adoption of capitalist systems of trade and commerce by industrialized nations (Lucas, 2004).

As described above, market economists focus primarily on leveraging self-interest while regulatory economists focus primarily on constraining market freedoms. Enlightened economists are different from these traditional tribes in two respects. First, their focus is on the *interaction* between self-interest and market freedom. Specifically, enlightened economists argue that the self-interest of business executives drives them to influence the rules of the game by lobbying regulators and standard-setters to obtain outcomes that provide their firms with economic advantage. Of course, this idea is not new: there are long and extensive literatures on regulatory capture (for reviews of this literature see Levine and Forrence, 1990 and Dal Bó, 2006) and public choice theory which models the interactions of self-interested voters, politicians, and government bureaucrats (see, for example, Buchanan and Tullock, 1962 and Buchanan, 1975).

The second difference, and what really sets enlightened economists apart from regulatory economists, is their focus on the rightmost variable in the model—inequality of outcomes—as the key objective function. While market economists focus on economic growth and wealth creation as their objective function, and regulatory economists focus on the avoidance of specific ills related to the products and services that firms produce as their objective function, enlightened economists argue that the results of unbridled self-interest and unregulated freedom are failures of governance systems, environmental degradation, climate change, and poverty: all linked directly or indirectly—as cause or effect—to inequality of outcomes.

This view is proving increasingly popular with students, at least those in European economics departments. A September 2014 *Financial Times* article titled, “Economics Faculties Rethink Formulas,” reports: “Since the financial crisis, student groups have attacked economics departments for failing to deal with the world’s most pressing social issues, including inequality and global warming. They have also criticized professors’ reluctance to teach a range of economic theories, with courses instead focusing on neoclassical models which they claim do little to explain the 2008 meltdown.”²²

In response to these sentiments, enlightened economists are seeking radically new solutions to the seemingly intractable problems of our time. They attempt to think outside the box of existing paradigms. But there are limits as to how far outside the box any serious economist can venture. Unlike moral philosophers, no economist who wants to be taken seriously by professional peers can abandon self-interest as a first-principle organizing concept: Miller (1999), for example, claims that self-interest is the “cardinal human motive” in the

²¹ In response to a question on *the Phil Donahue Show* in 1980. As reported by William Ruger, *Milton Friedman*, Bloomsbury Publishing, 2011, 128-129.

²² C. Jones, *Financial Times*, September 23, 2014.

economics literature; Henrich et al (2001) describe self-interest as the “canonical assumption” in economics.²³

Because self-interest is so deeply ingrained in the DNA of economists, enlightened economists have been forced to redefine the concept of self-interest to make it fit with their theories and normative prescriptions. Drawing on the theories of moral philosophers, these economists promote what they call “enlightened self-interest” as the new norm under which business executives should conduct themselves.

In arguing for enlightened self-interest, the intent of enlightened economists is to level the playing field to ensure that inequality and its spawn—social injustice, corruption, pollution, global warming, and human rights violations—are reduced or eliminated. They believe that corporations have too much influence in the political process and use this influence to rig the rules of the game for self-serving outcomes that harm society at large.

To right these wrongs, enlightened economists argue that business executives have a moral responsibility to change their behaviors to support the capitalist system. More specifically, managers must recognize their “agency” responsibilities to the legislative and regulatory rule-making infrastructure that supports the “system” in which their firms are embedded. Gomory and Sylla (2013), for example, state that aligning the actions of corporations with the broader interests of the country is a different, but equally valid, application of the traditional principal-agent problem.

In an article titled, “Why Managers Have a Moral Obligation to Preserve Capitalism,” Henderson and Ramanna (2013) argue that managers should not think of themselves solely as agents for shareholders, but also as agents for the system as a whole. They elaborate these ideas in a 2015 paper where they argue that “since [in thin political markets] advancing the interests of shareholders usually subverts the conditions that enable capitalism to meet its normative goals, ... managers should consider themselves first and foremost agents of society, with the objective to approximate the conditions under which capitalism can flourish—that is, the conditions that underlie free and fair competition.” Pointing to enlightened self-interest, they elaborate that “the firm and its managers, acting as an agent of the state that chartered it, has a duty to advance the interests of the capitalist system as a whole. This duty might at times require subverting the profit interests of the firm itself.”

In their analysis, Henderson and Ramanna pay special attention to “thin political markets” which include various expert-knowledge, state-mandated institutions—such as regulatory agencies, auditors, and accounting standard-setting bodies—that support the functioning of markets.²⁴ Their solution to information asymmetries in these “political markets” is to demand that executive refrain from attempting to influence regulation. Instead, in this

²³ Reported in Ferraro, Pfeffer, and Sutton, 2005.

²⁴ Such markets are split into two types: “thick” markets with many buyers and sellers and “thin” markets where only experts possess the requisite knowledge to engage.

newly-imagined world of enlightened self-interest, executives should proclaim their fealty to the state-mandated institutions that promote the greater good (Ramanna, 2015).

Pies, Hielscher, and Beckman (2009) similarly argue that, “business firms can and—judged by the criterion of prudent self-interest—‘should’ take on an active role in rule-finding discourses and rule-setting processes that aim at ... improving the institutional framework of the economic game.” They argue that firms should make self-binding commitments to work together to create rules and regulations that will serve the public good. In a later paper (2014), they elaborate, “Companies that participate in political processes can do so in a way that is either at the expense of the public interest or in a way that furthers it. With regard to the latter, ... companies can cooperate with state actors and other civil society organizations to organize collective action among diverse industry members and other market players.”

The term “political markets” that enlightened economists adopt is an important choice of wording for two reasons. First, it recognizes that these expert knowledge organizations (e.g., accounting standard-setting bodies and regulatory agencies) are markets in ideas—with technical experts considering competing viewpoints, writing policy papers, issuing proposals, and reviewing comments from those affected by various rulings. Second, the adjective “political” recognizes the political nature of regulation—one that can be linked back to the traditional self-interest that is evident in lobbying and other influence activities.

In the theories of enlightened economists, the redefinition of self-interest as “allegiance to the system” leads inexorably—and importantly—to self-regulation. Such a reorientation, they argue, must become the new norm or paradigm to support the common good. Instead of competing in a traditional free enterprise system, enlightened economists insist that executives should agree to submit to regulation and agree not to compete on issues of regulatory access and design. Moreover, enlightened economists argue that new measures and reporting systems must be developed to police compliance with these new norms.

Invoking a doomsday scenario, these economists argue that if executives do not embrace enlightened self-interest as their new norm and the changes that such a view implies, legitimacy for capitalism itself will inevitably erode, the system will crumble, and business executives will find themselves immeasurably worse off.

However, enlightened economists are realists enough to recognize that such appeals to traditional self-interest (“what goes around, comes around”) may not be enough to convince executives to implement these new ideas. So, if their recommendations are not adopted, enlightened economists are quick to trade the carrot for the stick by issuing threats that focus on the second term of the capitalist model: freedom of action. If managers fail to recognize their new definition of enlightened self-interest, they argue, the rules of the game—specifically the nature of market institutions—must be changed.

In this stage of their arguments, the focus is redirected to the right of corporations to exist. Enlightened economists argue that the notion of a corporation is a socially-constructed

concept that exists only through mutable laws. Therefore, if business executives fail to redirect their self-interest to support the institutions that enlightened economists favor (e.g., regulators and government agencies), new corporate charters should be imposed that will curtail executive freedom and require business leaders to serve all stakeholders equally. These new corporate charters might take the form of mutual corporations, cooperatives, and Benefit (or B) Corporations—an incorporation statute first offered in 2010 and now available in 22 states—that require directors and officers to consider the interests of all stakeholders, not just shareholders. Alternatively—or in addition—enlightened economists favor punitive tax policies to ensure that companies do what governments want them to do (Gomory and Sylla, 2013).

To create legitimacy for this approach, enlightened economists draw on the reasoning of moral philosophers to argue that property rights and contracts are not basic rights, but are instead social constructs. Like Rawls (1971), enlightened economists have great faith in government-mandated institutions as guarantors of justice. Regulators, in their view, must be given more power to reset the rules of the game to ensure that all market participants work for the greater good of society.

On the face of it, the idea that business executives should support the institutions of capitalism seems fair-minded and reasonable (in the same way that sports teams support rules and referees to ensure fair competition). However, there are several potential problems in implementing these ideas. The first is simply the practicality of enforcement. Although Henderson and Ramanna (2015) recommend the creation of new monitoring and enforcement mechanisms to ensure that managers support the public good, no suggestions—except requiring that companies report their expenditures on sustainability and climate change initiatives—are offered on how to do this. Recognizing the difficulty of *ex post* enforcement, Ramanna (2015) suggests, as an alternative, that executives be required to swear under oath that any views they present to regulators and standard-setters will be in the best interests of society. He further argues that any executives found wanting by an independent panel would be subject to prosecution. However, mandating such an oath with enforcement penalties—similar to the swearing-in procedure during court proceedings—may be difficult to apply in practice.

Second, while enlightened economists argue that executives must recognize their moral obligation to support the government-sponsored systems that underpin capitalism, they are silent on how or who should determine which statutory institutions executives must proclaim fealty to. Consider the leaders of two different companies. Executives in Company A believe that new regulations (say a cap-and-trade carbon tax) would reduce global warming and help to sustain capitalism in the long-term. Executives in Company B, in contrast, believe that the very same regulation would misallocate scarce resources and be detrimental to the efficiency of a capitalist economy. What does this imply for the moral duties that enlightened economists would impose on managers of these two companies? Do executives of Company A have a moral duty to support regulators and political parties that attempt to enact cap-and-trade laws? Conversely, do

executives of Company B have a moral duty to support political action committees that are dedicated to blocking the very same legislation?

This brings us full circle to the preferred definition by enlightened economists of regulation and standards as a political process. This, of course, will come as no surprise to students of Milton Friedman (1970) who presciently observed, "... the doctrine of 'social responsibility' involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses."

This leads to the third, and philosophically more difficult, problem with the theories of enlightened economists. At the heart of their argument, enlightened economists insist that business executives must subjugate their self-interest and freedom to benefit the common good. This is old wine in a new bottle. There is a name for such a doctrine: it is called collectivism—a system that advocates that individuals (and businesses) must subordinate themselves to a social collective. In a collectivist philosophy, the good of society takes priority over the welfare of the individual acting individually or on behalf of business organizations.

The concept of collectivism is a forerunner to social democracy—which aims to reduce the inequities of capitalism through government regulation and redistribution of income—and, eventually, socialism. Of course, collectivism and free-market capitalism are fundamentally at odds. If the policies and precepts of enlightened economists are adopted, we will inevitably transition away from a free-enterprise market economy to a collectivist economy that emphasizes populist outcomes. Such an approach—with more centrally-planned government and regulatory oversight—will undoubtedly minimize inequality, but at what cost? (Remember Winston Churchill's observation quoted earlier).

Echoing the controversial writings of Ayn Rand (whose views were shaped during her childhood years in communist Russia), Friedman notes,

In an ideal free market resting on private property, no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate. There are no values, no "social" responsibilities in any sense other than the shared values and responsibilities of individuals. Society is a collection of individuals and of the various groups they voluntarily form.

He continues that, in a collectivist economy,

... the political mechanism is conformity. The individual must serve a more general social interest—whether that be determined by a church or a dictator or a majority. The individual may have a vote and say in what is to be done, but if he is overruled, he must conform. It is appropriate for some to require others to contribute to a general social purpose whether they wish to or not.

Focusing on corporate social responsibility (which argues that executives should put the common good ahead of corporate interests), he concludes,

... the doctrine of ‘social responsibility’ taken seriously would extend the scope of the political mechanism to every human activity. It does not differ in philosophy from the most explicitly collective doctrine. It differs only by professing to believe that collectivist ends can be attained without collectivist means. That is why, in my book *Capitalism and Freedom*,²⁵ I have called it a “fundamentally subversive doctrine” in a free society, and have said that in such a society, “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open and free competition without deception or fraud.”

There will always be a tradeoff between equity and efficiency (Okun, 1975). However, in pursuing the agenda of enlightened economists, we should be aware that their increased focus on equity—at the inevitable cost of market dynamism—will very likely dampen the innovation, enterprise, and wealth-creation that is the engine of capitalism.

Not surprisingly, enlightened economists studiously avoid any mention of collectivism or socialism, knowing that Americans abhor the threat to liberty and prosperity that such creeds create (it is no accident that Ayn Rand’s “Atlas Shrugged”—a book that celebrates individual freedom and the nobility of meaningful work, and rails against the dangers of collectivism—was voted the second-most influential book in America, second only to the Bible²⁶).

Instead, such economists profess affection for a new type of “enlightened” capitalism.

1.3 The Economist’s Straitjacket

Few would dispute that self-interest is a defining characteristic of human behavior. And, as a result, many academic disciplines—from anthropology to evolutionary psychology—have drawn upon this concept in developing their theories. However, the use of self-interest in economics is unique: instead of treating self-interest as a psychological variable that can be used to explain the nuances of human and group behavior over time, self-interest was introduced to the economics literature as a simplifying assumption to aid in model building (Friedman, 1966). Over time, however, as analytic models have been refined and elaborated, what was once a simplifying assumption has now become the bedrock behavioral foundation of *Homo economicus*.

²⁵ Litan (2014, 17) calls *Capitalism and Freedom* one of the most influential economics books of all time. The only other book he mentions as having equal impact is Keynes’ *General Theory of Employment, Money and Interest*.

²⁶ “Survey of Lifetime Reading Habits” conducted by Book-of-the-Month Club and the Library of Congress in 1991. More recently, Random House’s online poll of the best English-language novels of the 20th century ranked Atlas Shrugged first (www.noblesoul.com/orc/books/rand/atlas/faq.html).

Notwithstanding the strong endorsement by economists of using the self-interest of managers and employees as a foundational principle, concerns have been growing about the peril of this perspective. In a widely-cited article, “Bad Management Theories are Destroying Good Management Practices,” Goshal (2005) argues that an academic ideology rooted in a set of pessimistic assumptions about individual motives and institutional functioning has resulted in research that, on one hand, revels in a false pretense of scientific rigor and, on the other, ignores the multidimensional—especially social—nature of people and organizations.

In questioning why economists should be so fixated on maximizing shareholder value in the name of narrow self-interest, Goshal suggests,

The answer ... is that this assumption helps in structuring and solving nice mathematical models. Casting shareholders in the role of “principals” who are equivalent to owners or proprietors, and managers as “agents” who are self-centered and are only interested in using company resources to their own advantage is justified simply because, with this assumption, the elegant mathematics of principal-agent models can be applied to the enormously complex economic, social, and moral issues related to the governance of giant public corporations that have such enormous influence on the lives of thousands—often millions—of people.

The obsession with self-interest—by economists of all tribes—has created an intellectual straitjacket that has constrained their theories and contributed to practices that have the potential to do significant harm. **Figure 1** summarizes what these ideas—economic theories firmly rooted in self-interest—have wrought.

Insert **Figure 1** Here

Market economists have used their powerful voice and influence to provide the intellectual justification for the governance and executive compensation structures that define today’s modern markets: in essence, their theories have made greed respectable.

However, following the raft of scandals at WorldCom, Global Crossing, Tyco, Enron (and others), authors such as Osterloh and Frey (2004, 2013) have argued that the highly-leveraged rewards prescribed by principal-agent models have resulted in operational and financial risk-taking that effectively created a “governance structure for crooks.” Similarly, Henry Mintzberg and I predicted the problems that were to come as a consequence of the “house that self-interest built” five years before the 2007/8 financial crisis (Mintzberg, Simons, and Basu, 2002).

Regulatory economists, for their part, have provided license to burden the economy with excess regulations that strangle competitiveness and growth. For example, in 2013 the federal government created 3,659 “final rules” that must be newly-obeyed: explicating the

implementation and enforcement of these rules required 26,417 pages in the Federal Register (this was the fourth highest in history, challenging the all-time record set in 2010). In addition, there were 2,594 “new rules” proposed in 2013 that will be recorded in future years when finalized.²⁷

Enlightened economists represent the views of moral philosophers who have never had standing to advise policy makers. Enlightened economists do have standing. Moreover, their appeals—to subjugate free will in the name of the collective good—are increasingly in accord with populist political movements that are emerging in response to the underemployment and wage stagnation that are hallmarks of the current economic malaise. Their proposals—on a path to collectivism—are fundamentally at odds with the principles of free enterprise.

Emerging Perspectives within Economics

Economic theory is, of course, not static: like all academic disciplines, new approaches are constantly evolving that may one day influence the economist’s view of organizations and management. Some of these ideas may loosen the straitjacket of self-interest.

For example, there is a new and growing literature that attempts to move away from the strictures of narrow self-interest by considering when and why individuals take other people’s utility into account when making personal decisions (see, for example, Fehr and Gächter, 2000(a) and (b)). This research, surveyed by Rotemberg (2014), still has self-interest at its core, but it suggests that people care about others to the extent that it affects their own utility or “because they wish to impress others with their social-mindedness.”

The experiments of behavioral economics are also beginning to test the limits of rationality that underlie most economic models. Such studies provide intriguing insights into, for example, how much people will be willing to spend on a product with different pricing schemes, the propensity to save for retirement when savings are automatically deducted from paychecks, deciding when and how much to cheat in different circumstances, and whether to make healthy choices in diet and sex (Ariely, 2009). So far, however, these new approaches remain focused on the decisions of self-interested individuals in the face of different contextual cues; they have not yet been applied to the theories of organization and management.

At the other end of the spectrum, economists who write about organizations have recently begun to recognize the importance of informal relationships in what they call “relational contracts.” Baker, Gibbons, and Murphy (2002), for example, define relational contracts as, “informal agreements and unwritten codes of conduct that powerfully affect the behaviors of individuals within firms.” Based a mathematical model, they conclude that such multi-period relationships matter: “We find it curious that most of the literature on the [economic] theory of the firm makes little reference to (non-owner) managers. By emphasizing the importance of

²⁷ “Regulator Without Peer,” *Wall Street Journal*, April 16, 2014.

relational contracts, our model highlights a role for managers: the development and maintenance of relational contracts, both within and between firms.”

In a related paper, Gibbons and Henderson (2012) argue that relational contracts—“an economist’s term for collaboration sustained by the shadow of the future as opposed to formal contracts enforced by courts”—represent a key organizational capability. To support their case, the authors propose that the production system at Toyota and drug discovery capabilities at Merck cannot be explained by formal contracting alone. Instead, they claim that informal relationships are critical to understanding how these firms operate.

In keeping with contemporary ideological norms, the theory of “relational contracts” is built on the economist’s familiar foundation of self-interest and moral hazard. However, this emerging perspective may, in time, offer the possibility of recognizing a broader sense of commitment and engagement—rooted in values and trust—as additional variables in the economist’s toolkit of organization design and management.

Part Two: An Alternative Approach to Organization Theory Building

2.1 Is Business the Problem ... or the Solution?

There is a strong assumption in much of the current academic literature (especially by regulatory and enlightened economists) that business—driven by self-interest—is the problem (“it is implicated”) and must be brought to heel and reformed. And, not surprisingly, the theories of economics purportedly offer solutions—whether developed by market economists, regulatory economists, or enlightened economists.

But what if the problem statement is reversed? What if it is the theories of economics that have contributed to these problems and it is theories of business that are needed to correct them? What if we took another tack and dropped the obsession with self-interest that defines the DNA of all modern economists in favor of applying business principles to model the way firms operate? Within my area (accounting), even some highly-regarded accounting researchers who have devoted their life to applying the principal-agent model—with its focus on self-interest, effort aversion, and opportunism—are beginning to question whether this is an accurate representation of how executives actually manage their businesses (Ball, 2013).

Of course, we must still acknowledge that self-interest is a powerful *descriptive* theory that can often predict how individuals will act. For example, self-interest is a primary driver of the political process and will generally determine how individuals vote: unemployed people can be expected to vote for parties that campaign to increase unemployment benefits; African Americans will typically vote for those who support affirmative action; the wealthy will vote to oppose income distribution laws; those with high levels of education and achievement potential will oppose race or gender-based hiring quotas; gays and lesbians will vote for those who

champion anti-discrimination laws based on sexual orientation (Weeden and Kurzban, 2014; Haidt, 2012, p. 86).

But these examples focus on individuals in a faceless political system. When economists use the concept of self-interest to develop *prescriptions* about how to design and operate business organizations, they ignore the fact that, when people work side-by-side in organizations to achieve shared goals, they are not functioning as atomistic actors blindly pursuing their own self-interest.

Attempting to transform self-interest from a descriptive theory of behavior into prescriptions for organization design—as economists do—creates what I call the paradox of central tendency: managers cannot do their jobs effectively unless they understand central tendencies, but central tendencies should not serve as a blueprint for action. Why? Because central tendencies attach too much importance to the undifferentiated average traits of groups. Effective managers do not strive to achieve average outcomes: instead, they work to move employees into the upper tail of the distribution (Simons, 1995, 23-25).

This is not to say that we can ever ignore the importance of incentives and monitoring within organizations: as long as people value extrinsic rewards, they will always be important. In fact, in a limited number of instances, formal incentives can be sufficient to motivate success (for example, when customers are in liquid markets with low switching costs such as auction markets: in these settings, employees can be paid entirely by commission based on their individual contribution). But in the vast majority of business settings, incentives and monitoring—designed to leverage narrow self-interest—are insufficient descriptors of how businesses work and how managers attempt to achieve their objectives.

2.2 A “Business” Perspective on Organizational Functioning

Business managers clearly understand the importance of self-interest and freedom as prerequisites of the capitalist model: as a result, they are often outspoken advocates and defenders of these basic rights. But their day-to-day attention is devoted elsewhere: managing the business activities that leverage effort, entrepreneurship, and innovation to create growth and profit.

To business executives, organizations are not merely “legal fictions” that represent contracting relationships among self-interested individuals who dislike effort, want to divert resources for their own benefit, and are likely to harm the firm’s constituents. Instead, business executives see organizations as goal-seeking and purpose-driven vehicles to create value in highly competitive markets (Bartlett and Ghoshal, 1994).

Therefore, notwithstanding economists’ obsession with self-interest as the theoretical foundation of organization design, successful managers focus on what I will call (with the aid of alliteration) the four Cs: Competition, Customers, Commitment, and Controls. I will argue that,

collectively, these are the critically-important concepts that need to be reintroduced into the economic theories and models that are used to describe and prescribe organizational functioning.

Competition: ‘Only the Paranoid Survive’

Throughout the history of modern economic thought, competition has been the driving force of a firm’s existence. Adam Smith was the first to articulate the economic benefits of open markets comprised of atomistic, self-interested individuals transacting with profit-seeking companies able to take advantage of labor specialization. But we should remember that the power of free markets as conceptualized by Smith was their ability to put economic decisions in the hands of customers who were then free to decide where to spend their scarce resources based on the relative merits of different product and service offerings (Levin, 2010).

The general-equilibrium theories developed in the 1950s reflected this perspective: businesses earned the right to exist by supplying goods and services at prices, quantities, and quality levels that would meet, if not beat, those of competitors (Arrow and Debreu, 1954; McKenzie, 1959; Black, 1995)

Business managers have never had the luxury of ignoring this competitive reality. They know from personal experience that the power of capitalism’s wealth-creation engine is fueled by creative destruction (Schumpeter, 1947: 81-86). As a result, the capacity to innovate—the drive to create something better—is the only guarantee of long-term sustainability.

Recognizing the critical role of competition for business success, some economists have followed Porter (1980, 1985) to develop theories that describe the power of differentiated business strategies in gaining competitive advantage. But such work focuses on only one side of the coin: strategy formulation. It offers little insight into how to implement those strategies inside complex organizations. Moreover, with the introduction of principal-agent models in the late 1970s, much of the economics profession—at least those interested in the design and management of business organizations—moved away from market competition as the driving force of theory-building to adopt the mantle of self-interest as the new foundation of organization theory.

In developing their theories, economists invariably look inside organizations to construct models that leverage and control the demands of self-interested individuals. Business leaders have a different perspective: they look outward for guidance as to how to build organizations capable of satisfying the unyielding demands of customers. They understand that to create sustainable economic value they must create a value proposition that will attract customers—fully aware that skilled and aggressive competitors are simultaneously trying to beat them at the same game.

Andy Grove, CEO of Intel, pointed to this competitive reality in the title of his 1996 book, *Only the Paranoid Survive*. He elaborates, “I worry about competitors. I worry about other

people figuring out how to do what we do better or cheaper, and displacing us with our customers. . . . The prime responsibility of a manager is to guard constantly against other people's attacks and inculcate this guardian attitude in the people under his or her management." (p. 3)

Customers: 'The Purpose of Business is to Create a Customer'²⁸

The preeminent importance of customers as the foundation of any business is second-nature to business executives who operate in competitive markets. As General Electric's CEO Jack Welch stated repeatedly: it is not companies that guarantee jobs, but satisfied customers.²⁹ Welch famously went on to state, "On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy . . . Your main constituencies are your employees, your customers and your products."³⁰ Similarly, Paul Polman, CEO of consumer-giant Unilever, stated, "I do not work for the shareholder, to be honest; I work for the consumer, the customer . . ."³¹

The point here is not to argue that economists should become experts in consumer marketing. Instead, economists—at least those who are interested in business design and management—need to recognize that the most important task for business leaders is to look outward to markets to understand customer needs and then deploy internal company resources in specific, differentiated ways to meet those needs. As managers at GE have stated, "Customers are seen for what they are—the lifeblood of a company. Customers' vision of their needs and the company's view become identical, and every effort of every man and woman in the company is focused on satisfying those needs."³²

The key question, then, that all business executives must address is, "Who is our primary customer and what do they value?" (Simons, 2010, chapter 1). Different firms within the same industry will frequently have different answers. Some firms may choose retailers as their primary customer while others in the same industry may choose wholesalers or consumers. These customers will in turn make their own choices—driven by their preference functions—to transact with those firms that best meet their needs.

Some customers look for the lowest price, others for the best technology or brand; some seek local value creation, others a dedicated service relationship. To win in competitive markets, each of these different customer types requires a substantially different allocation of resources and a fundamentally different organization design. Thus, understanding customer needs is the essential prerequisite for managers (and theorists) who want to understand how to allocate resources—and accountability—within any businesses organization.

²⁸ Alan Kantrow, "Why Read Peter Drucker?" *Harvard Business Review*, 87: 11, 2009, 72-82.

²⁹ "Jack Welch Class Day Interview," *Harvard Business School Working Knowledge*, June 11, 2001.

³⁰ Francesco Guerrera, "Welch Condemns Share Price Focus," *The Financial Times*, March 12, 2009.

³¹ "Shareholder v Stakeholders: A New Idolatry," *The Economist*, April 28, 2010.

³² GE Annual Report 1990, 2.

As an example, **Figure 2** illustrates five organization design prototypes determined by the differing needs of different customer types.

Insert **Figure 2** Here

Given the unerring focus on customers by business executives, it is somewhat surprising that economists who proffer theories and prescriptions on business management and organization design do not share this interest. Market economists are animated by opportunism and modelling the principal-agent roles of stockholders and CEOs; regulatory and enlightened economists focus on the interests of a broad range of stakeholders that might be harmed by errant corporate behavior.

The inefficiencies of regulation can be traced directly to the inherent lack of customer focus by government functionaries. Without any market pressure to respond to customer needs or to allocate resources efficiently, regulators too often act with impunity (or incompetence) knowing that such behavior has little personal consequence. As one commenter cheekily observed, “Working for the government means never having to say you’re sorry.” (Tamny, 2015, 104)

It is not an exaggeration to state that the concept of customer is virtually absent in the mainstream economics literature. If you searched articles in the five top-ranked economics journals—*Journal of Political Economy*, *The Quarterly Journal of Economics*, *Econometrica*, *The Review of Economic Studies*, and *The American Economic Review*—you would discover that only five of the 2,256 articles published in the last five years (January 2010 – December 2014) contain the word “customer” in their titles.³³

Of course, the absence of customers in the economics literature might be explained by the fact that only a small percentage of published papers focus on organizations and internal business functioning. So, you might turn, as I did, to the recently-published *Handbook of Organizational Economics* (Gibbons and Roberts, 2013). This 1,200 page compendium (weighing almost 5 lbs.) presents 28 papers by 45 of the world’s leading economic scholars who specialize in organization management and design. According to the editors, the purpose of organizational economics is to “use ... economic logic and methods to understand the existence, nature, design, and performance of organizations, especially managed ones.” (p. 1). As would be expected in such a volume, a wide variety of topics is covered with titles such as: “Decisions in Organizations,” “Hierarchy and the Division of Labor,” “Strategy and Organization,” and “What Do Managers Do?”

³³ The five top journals were chosen based on analysis in K. M. Engemann and H. J. Wall, “A Journal Ranking for the Ambitious Economist”, *Federal Reserve Bank of St. Louis Review*, May/ June 2009, 127-139, and K. Ritzberger, “A Ranking of Journals in Economics and Related Fields,” *German Economic Review*, 9 (4), 2008: 402-430.

The book concludes with a detailed 30-page index with over 2,000 subject entries. The word “customer” appears only once in the index: under the subheading, “Opportunism, of customers.”

Commitment: ‘Living the Business Twenty-Four Hours a Day’³⁴

Once a primary customer is identified and resources are allocated through tailored organization designs, the next priority for business executives is to motivate everyone in the organization to work diligently to serve those customers’ needs.

Economists, of course, are also interested in theories that show how to motivate employee effort to create value for the firm. Not surprisingly, therefore, as a prelude to presenting their models and policy prescriptions, economists often discuss a “first-best” solution to the agency problem: principals and agents would mutually agree upon and align their goals, both would eschew self-interest in favor of cooperation, and agents would report their performance completely and truthfully to their superiors (Lambert, 2001). This first-best solution, however, is usually offered merely as a rhetorical device to set up the traditional analysis that follows: a second-best, carrot-and-stick approach that assumes divergent goals, opportunism, and the distortion of performance measures for personal gain—all driven by rational self-interest (whether for money, leisure, or other valued attributes).

Business executives are not bound by the same conceptual straitjacket as economists. While they recognize self-interest as part of human nature, business managers understand that the way to motivate exceptional performance and win in highly competitive markets is to capture the heart and minds of employees. As highlighted in the schematic model of capitalism presented at the beginning of this paper, managers must spur individual effort, entrepreneurship, and innovation in their firms. All of this requires cooperation that can only be achieved with an engaged and committed workforce. Incentives and performance measures are part of the answer, but typically a relatively small part of the success equation (Pfeffer, 1998).³⁵

High commitment—bringing with it the willingness to cooperate and help others—emanates from shared purpose, group identity, trust, and a sense of fairness (Simons, 2005, 169-170). And it is to these ends that effective leaders devote their energy.

Rather than reifying self-interest as a normative ideal, managers work to create shared purpose through a collective focus on doing what is best for your primary customer (discussed above) and clarity concerning core values—specifically about whose interests should come first when faced with tough decisions (Simons, 2010, 41-55). Instead of viewing employees as interchangeable free agents, executives strive to create a sense of group identity and cohesiveness by careful employee selection, training, and indoctrination in group norms. Rather

³⁴ Harold Geneen, 1984, 118.

³⁵ In principle, the intrinsic drivers of motivation can be incorporated in the utility function of individuals. In practice, such intrinsic drivers are rarely consequential in the models of organization developed by economists.

than assuming that all employees will act opportunistically with guile, managers seek to create an environment of trust—which must be earned over time—as a bulwark against self-interest (Hosking, 2014). And, finally, instead of relying on tournaments and winner-take-all incentives, managers work to create a sense of fairness—in both intrinsic and extrinsic rewards—to inoculate the organization against resentment which is corrosive to shared commitment.

Economists' models invariably assume that shareholder interests dominate other constituents. And in some cases, this is indeed the choice that executives make. But it is difficult to generate commitment and inspire people when the overarching goal is to enrich shareholders. Accordingly, if the goal of business executives is to maximize shareholders wealth (which it sometimes is), they have no choice but to use—as economists' models duly predict— equity-based compensation to motivate employee effort.

However, there are alternatives which often offer a superior path to long-term success. The core values of some companies (e.g., Merck) instruct employees to put customers first when faced with tough decisions that might favor one constituent over another. Alternatively, the core values of other companies (e.g., Southwest Airlines) put employees first. There is no right or wrong. What is critical is choosing and communicating that choice consistently over time to employees. (It should be noted, however, that commitment and engagement are likely to be much stronger when employees are asked to put customers first or employees first; it is much harder to inspire people to work hard to make shareholders rich.)

Controls: 'The Power of Negative Thinking'

There is no doubt that business firms, and the people who work in them, sometimes engage in behaviors that can harm others. This is an inevitable consequence of the self-interest and freedom that underpin capitalism.

The roots of such problems are found in a fundamental tension of human nature: pressure combined with opportunity creates temptation (**Figure 3**). This is an inescapable part of the human condition. In a business setting, pressure might take the form of expectations to deliver difficult growth targets, fear of failure, a desire for bonuses or promotion, or the need for extra money to support an extravagant life style, to name just a few. The opportunity to engage in questionable behavior without detection or immediate consequence is often present in businesses as resources are delegated and individuals are given the freedom to work without direct oversight. When such pressures and opportunities are combined, the result is temptation: one might, for example, be tempted to cut corners on quality to hit shipment numbers, to record revenue that is not yet earned to meet analysts' expectations, or to loosen loan requirements to attract customers. The permutations and combinations are limited only by human imagination.

Insert **Figure 3** Here

It is not surprising, therefore, that controls figure prominently in the toolkit of economists. Market economists argue that *ex post* monitoring is necessary to ensure that self-serving subordinates do not shirk. Regulatory economists favor the creation of detailed *ex ante* rules and operating procedures to limit the discretion that business provides. Enlightened economists champion new types of reporting systems to track executive allegiance to the government institutions and agencies that, in their view, support the common good.

Economists are correct in paying attention to controls and monitoring. But they often fail to appreciate what business managers know from years of experience: there are two ways to control behavior—telling people what to do or telling them what *not* to do. As discussed in the previous section, regulators invariably choose the first option resulting in long lists of detailed rules as bureaucrats attempt to predict each and every possible contingency and stipulate the required response. While this approach may be appropriate for safety or quality concerns, the creation of a plethora of rules invariably crushes innovation.

If the goal is to foster creativity and entrepreneurial activity, the pressure and opportunity that collectively form the basis of capitalism are necessary prerequisites. Together, they create the breeding ground for innovation and extraordinary effort. Yet, these same conditions—pressure and opportunity—also create temptation and the possibility of wrongdoing.

The solution to this dilemma is to recognize that people do not typically act on the temptations that surround them unless one additional ingredient is also present: the ability to rationalize their behavior (**Figure 3**). Rationalizations might include, “I’ll never get caught; everybody does it; nobody will be hurt; I’m doing it for the good of the company; I will return the missing funds next month . . .” Again, the ability to rationalize is limited only by human imagination.

Recognizing both the universality of temptation and peoples’ creative ability to rationalize, effective managers declare in clear and unambiguous terms what people must *never* do—thereby creating limits on the domain of acceptable behavior. These boundaries specify what activities—both ethical and strategic—are off-limits (Simons, 1995, chapter 3; Widener, 2007).

Removing the ability to rationalize—as a technique to control temptation—is as old as the Bible: the Ten Commandments are stated (with one or two exceptions) in the negative (thou shall not . . .). Like the Ten Commandments, the boundaries established by effective business leaders—and communicated throughout their organizations—are fueled by sanctions and punishment rather than rewards.

At the most basic level, managers often adopt their own versions of the physician’s Hippocratic Oath: “Do No Harm.” But boundaries will often also encompass industry-specific risks (e.g., avoiding short-cuts that could compromise safety in automotive or medical device

businesses) and strategic initiatives (e.g., specifying the markets and customers that a business will not serve).

Of course, such boundaries—always stated in the negative—should never stand alone. Like the Ten Commandments, they should co-exist with positive, aspirational values (thou shalt love thy neighbor as thyself) that are an essential ingredient in creating the commitment discussed above.

The power of such “negative thinking”—in contrast to the 3,659 rules issued by Federal regulators—is that, like the Ten Commandments, the list of behaviors declared off-limits can be short (if not sweet). And, by deduction, anything not explicitly forbidden is permitted—providing a broad and fertile domain for innovation and experimentation. The exception to this principle, of course, is where safety and quality concerns trump innovation and growth. In such cases—food safety or the operation of a nuclear power plant, for example—the risks of a compliance failure are so severe that detailed internal controls and standard operating procedures become essential and mandatory.

2.3 Implications for Business Schools

The economic theories used to describe business practices—whether promulgated by market economists, regulatory economists, or enlightened economists—have had, and will continue to have, enormous impact. Moreover, the power of these ideas is often magnified as predicted effects become self-fulfilling prophecies. As Ferraro, Pfeffer, and Sutton (2005) remind us, “Theories become self-fulfilling when the language and assumptions they promulgate affect how individuals see and understand themselves and the world.”

For example, when managers and regulators design incentive and control systems by following the economist’s advice that people will act only in their narrow self-interest, the systems themselves are likely to induce the gaming and opportunistic behavior that these economic models predict (Ferraro, Pfeffer, and Sutton, 2005; Goshal, 2005). Eccles and Nohria (1992) reached a similar conclusion: “The way people talk about the world has everything to do with the way the world is ultimately understood and acted in.” (p. 29)

In previous work, I have argued that business schools may be abrogating their duty to teach future business leaders how to compete successfully in increasingly competitive global markets. Theory creep, mission creep, doing well by doing good, and the quest for enlightenment are increasingly occupying the agendas of business schools, crowding out scarce attention that could be devoted to teaching students how to win against increasingly agile, global competitors (Simons, 2013).

Because of these increasingly influential social agendas, there is less and less room in business school curriculums for teaching theories and best-practices that focus on how to compete successfully. Within this limited space, the theories of economists are foundationally

important in educating students about the power of competitive markets. If we, as educators, succeed in our mission—setting students on a path that they will pursue throughout their business careers—are we doing them a disservice, and setting up self-fulfilling prophecies, by teaching them to design and manage businesses according to principles of self-interest?

We should be asking whether students would be better served if economists become interested in the same variables that animate business leaders. How, for example, would the models and prescriptions taught in business schools change if economists' theories recognized the critically-important task of competing for customers: identifying a primary customer and devoting the resources of the entire organization to meeting that customer's needs? What would economists say to students if building commitment to a shared mission—on a foundation of trust rather than self-interest—was the overriding objective of business managers?

Of course, we must still recognize legitimate concerns voiced by both regulatory and enlightened economists: the temptations created by competition and capitalism can undoubtedly lead to bad outcomes (cheating, bribery, child labor, pollution ...). To overcome these very real risks, some have argued that the answer is to eschew competition altogether in favor of cooperation (Heffernan, 2014). However, the benefits of capitalism—individual effort, entrepreneurship, and innovation leading to unmatched wealth creation—are so overwhelming that such calls will inevitably go unheeded in any society that has tasted the benefits of market economies.

The solution to this dilemma is the introduction of appropriate controls, but of a distinct type. Rather than the plethora of rules and regulations advocated by regulatory economists or the highly-leveraged CEO rewards favored by market economists, economists might become interested in understanding the nature of the boundary systems that managers (and boards of directors) use to declare certain behaviors and initiatives off-limits, thereby staking out the domain for creative innovation and risk-taking and, at the same time, inoculating the business from wrongdoing.

Turning to the work of enlightened economists, it is beyond the scope of this paper to attempt a solution to society's ills. However, it is worth noting that society's concern with inequality—as evidenced in political discourse and the popular press—is inversely correlated with economic growth: in an improving economy, new jobs are created, wages increase, and people sense they are moving up the opportunity ladder. Individuals at all levels of society perceive increasing prosperity: as a result, there is greater emphasis on freedom and less on constraints (Sen, 1999). We should ask, therefore, whether solutions to problems of inequality are not to be found in policies that encourage businesses to grow—coupled always with appropriate boundary controls—and to be leery of additional rules and constraints that stifle opportunity-seeking, innovation, and economic growth.

On a final note, it is impossible to say whether the economist's fixation on narrow self-interest—a self-imposed conceptual straitjacket—is due to the constraints of mathematical modelling or to a fascination with the more ignoble human traits. But there is little doubt that the

modern theories of economists—all predicated on self-interest—have influenced the world in which we live. And, as John Maynard Keynes reminded us 80 years ago, “the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. . . . I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. . . . It is ideas, not vested interests, which are dangerous for good and evil.” (1936: 383-384).

I realize that the ideas advanced in this paper advocate turning an entire academic discipline on its ear. And, I also recognize that the existing paradigm based on the iron-clad principle of self-interest will be exceedingly hard to alter when a generation of economists has staked its research and reputation on this perspective (Kuhn, 1962).

However, it is equally important to recognize that the economic theories developed in business schools have had—and will continue to have—a consequential impact on business practices and public policies. Moreover, it is worth remembering the founding mission of Harvard Business School (America’s first graduate school of business administration) as articulated by Dean Edwin Gay in 1908: to train people to make a decent profit decently.³⁶

Accordingly, for all of us who are interested in developing theories of organization and management, it may be time to ask economists who share this interest to broaden their perspective beyond narrow self-interest and reflect in their theories what Abraham Lincoln called “the better angels of our nature.”³⁷

³⁶ F. Warren McFarlan, “HBS Past and Present,” The Centennial Global Business Summit, Harvard Business School, October 12, 2008.

³⁷ President Lincoln's Inaugural Address, March 4, 1861.

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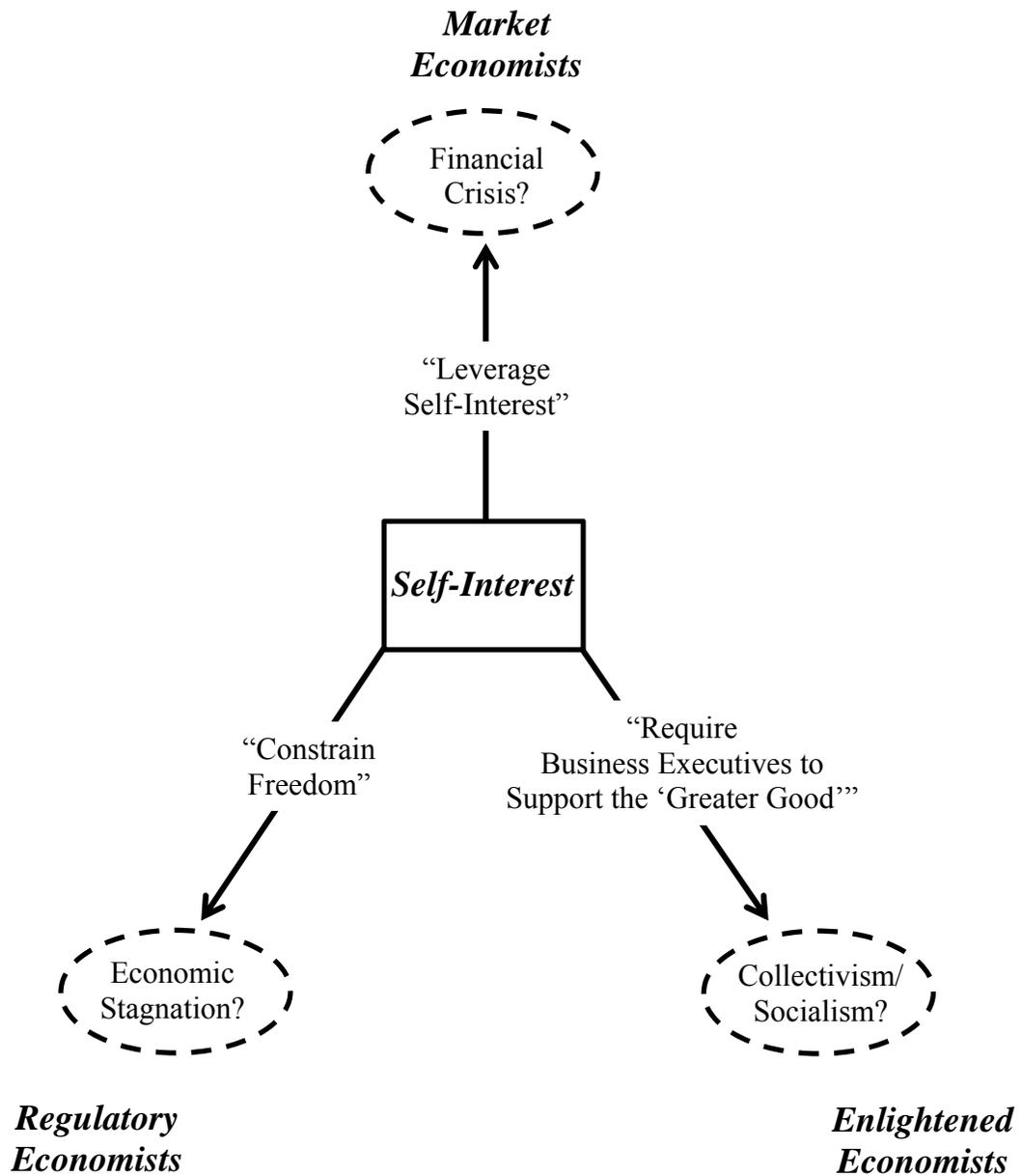
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Figure 1

Economists' Theories of Business Built on a Foundation of Self-Interest:
Prescriptions and Potential Consequences by Tribe



Different Customer Types Require Different Organization Designs
 (Size of boxes represents relative amount of resources allocated to specific units)

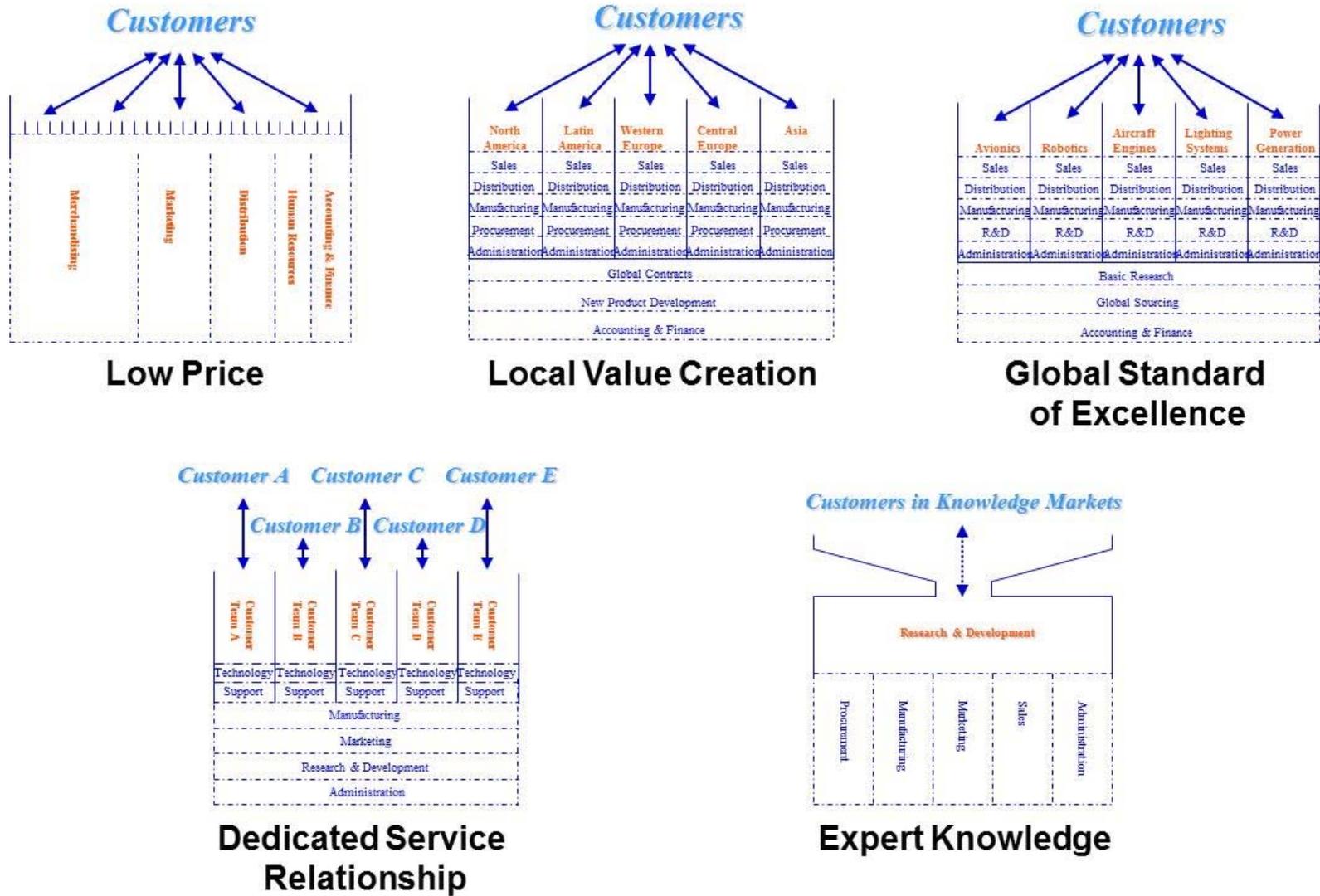
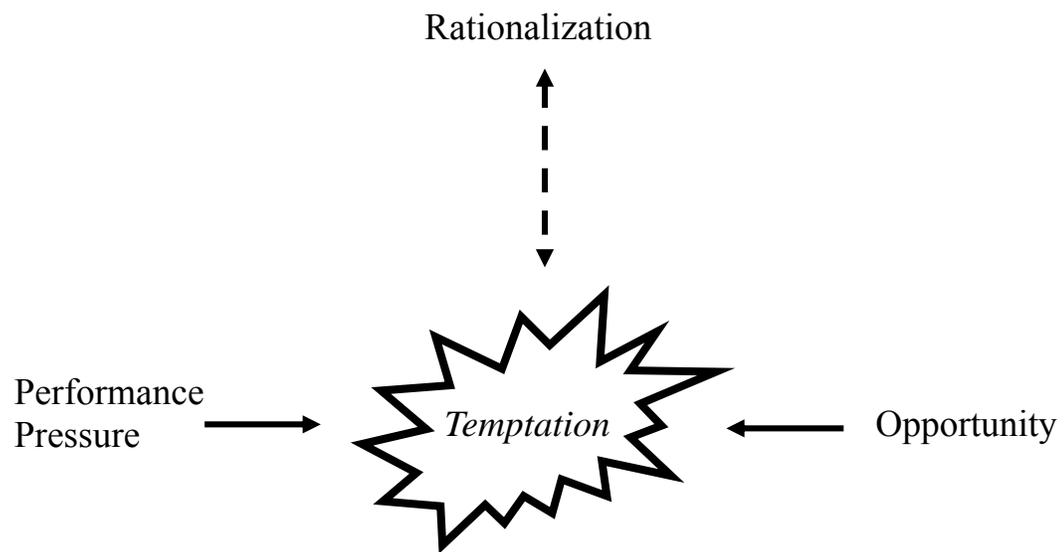


Figure 3
The Dangerous Triad



Source: Simons, 2000, p.270.