In Search of a Moral Foundation for Capitalism and the Firm

Summary of Presentation:

1. Why is this topic important? Three personal stories
2. Who took morality out of the equation? The influence of the Chicago school
3. What have been the implications for Public Policy?
4. What have been the implications for business education in the US?
5. What the Chicago School got wrong about Adam Smith
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Why is this topic important? Three personal stories:

Story #1: Koch Industries Inc. Market-Based Management Conference in Wichita (July 28, 2010)

Koch Industries invited business faculty from across the country to their world headquarters to promote an innovative management system developed by CEO Charles Koch and described in his best-selling book: “The Science of Success: How Market-Based Management Built the World’s Largest Private Company” (Koch 2007). Koch used neoclassical economic theory from the Chicago school to promote the use of market-based controls and financial incentives. His emphasis on values and integrity, however, lacked theoretical support.
Why is this topic important? Three personal stories:

Story #2: The BB&T Initiative to Find a Moral Foundation for Capitalism at FSU (2008-2013)

While at Florida State University, I participated in a funding initiative by BB&T Bank to explore and teach moral foundations of capitalism. While BB&T encouraged multiple perspectives, they promoted Ayn Rand’s novel *Atlas Shrugged*. BB&T funded similar programs at over 60 colleges and universities including Chapman, Charleston, Duke, George Mason, NC Chapel Hill, Virginia, and Wake Forest. Similar to FSU, many of these colleges and universities found Rand’s glorification of narrow self-interest to be an insufficient moral foundation for capitalism.
Why is this topic important? Three personal stories:

Story #3: The Business Roundtable’s New Statement on the Purpose the Corporation (August 19, 2019)

The BRT recently issued a new Statement on the Purpose of a Corporation signed by 181 CEOs. The new Statement represented a significant departure from previous statements issued by the BRT narrowing the responsibility of the corporation to shareholder profits. The new Statement challenged business leaders to ensure “that the benefits of capitalism flow to every American.” In particular, it extended corporate responsibility beyond the interests of shareholders to other stakeholders of the firm including customers, employees, suppliers, and communities. Although well overdue, this statement was attacked as a veiled move toward socialism.
Why is this topic important? Three personal stories:

These three stories help explain why I believe the topic of this session is so important. In particular, they help explain why I have joined the search for a moral foundation for capitalism and the firm. This search has been joined by many researchers and practitioners who, like myself, feel a large void between the growing demands of our capitalistic system and the economic theory commonly taught in business schools today. Given current events unfolding in the United States and around the world, I believe that this search may be the critical challenge of our age.

**POLLING QUESTION #1**

Were you aware of the new “Statement on the Purpose of a Corporation” issued by the BRT in 2019? Do you agree that business leaders need to do more to ensure that the benefits of capitalism flow to every American?
Who took morality out of the equation?
The influence of the Chicago school

Milton Friedman wrote an essay in 1953 called “The Methodology of Positive Economics” that shaped economists’ conceptions of what constituted good theory and good empirical evidence. After his essay, research in economics became “more mathematical, more analytical, less historical, less institutional, more standardized, and more narrow regarding admissible priors” (Hands 2009). To utilize the new mathematical tools, economists came to rely increasingly on simplified behavioral assumptions that left out morality and values.
Who took morality out of the equation? The influence of the Chicago school

Inspired by Friedman’s positive theory of economics, the Chicago school developed a rigorous theory that characterizes the firm as made up of principal-agent relationships. This theory of the firm, called Agency Theory, includes the following behavioral assumptions:

- **Preferences only for Wealth and Leisure**: In their work for the principal, agents are motivated to maximize their pay and minimize their effort.
- **Risk Preferences**: Agents are risk-averse whereas principals are risk-neutral.
- **Opportunistic Self-Interest**: Agents are not motivated by the welfare of others or any other concern other than maximizing their pay and minimizing their effort.
Who took morality out of the equation? The influence of the Chicago school

One behavioral assumption is especially important to the theory of the firm:

- **Rational Expectations or “Rationality”**: Agents are assumed to be fully-rational in maximizing their pay and minimizing their effort.

In summary, the theory of the firm out of the Chicago school characterizes individuals as fully-rational utility maximizers (fully rational, greedy and lazy). Given the behavioral assumptions above, the theory relies on financial incentives and contracting to control opportunistic behavior on the part of the agent. While it has proven particularly useful in accounting and finance, the theory provides little support for informal, non-financial controls based on morality and professional norms.
What have been the implications for public policy?

The implications of the narrow view of capitalism and the firm out of the Chicago school can be seen in the policy statements of its leading advocates:

- **Milton Friedman:** As Friedman made clear in a 1970 article published in the New York Times, the economic theory out of Chicago left the corporation with no social responsibility other than to increase profits for its shareholders. Friedman went even further to say that promoting any other social responsibility—such as providing employment, eliminating discrimination, or avoiding pollution—is “preaching pure and unadulterated socialism.”
What have been the implications for public policy?

The implications of the narrow economic theory out of the Chicago school can be seen in the policy statements of its leading advocates:

- **George Stigler**: Applying Friedman’s methodology of positive economics to public policy, Stigler (1971) developed a theory of economic regulation that reduced such regulation to narrow self-interest on the part of regulators and their constituents. In their application of Friedman’s methodology to accounting, which they called *positive accounting theory*, Watts and Zimmerman (1978) characterized the standard-setting process in accounting as a conflict between self-interested parties including accounting firms and regulators.
What have been the implications for public policy?

The implications of the narrow economic theory out of the Chicago school can be seen in the policy statements of its leading advocates:

• **Michael Jensen**: Jensen used agency theory to encourage some forms of organizational control and discourage others. For example, Jensen helped legitimize the takeover movement in the 1980s by presenting it as an important aspect of corporate governance. Jensen discouraged the use of participative budgeting because “it encourages managers to lie and cheat” (Jensen 2001, *Harvard Business Review*) and discouraged the use of the balanced scorecard because “maximizing the total market value of the firm” is the only objective function needed by management to efficiently run an organization (Jensen 2002, *Business Ethics Quarterly*).
What have been the implications for business education in the US?

The rigorous neoclassical theory out of the Chicago school has significantly influenced business education in the US (Khurana 2007):

1) *Early Phase from the founding of Wharton through the 1940s:* Business management was viewed as a profession with a moral dimension that valued professional norms. This professionalism project was driven primarily by *institutional economists* who were becoming increasingly marginalized in economics by *neoclassical economists*.

2) *Second Phase in the 1950s:* Business management was viewed primarily as “scientific” with an emphasis on technical training. This view was supported by two foundation reports in 1959 that were highly critical of the university-based business school and promoted basic research.

3) *Third Phase in the 1960s and beyond:* Business management was viewed primarily as the maximization of stock price. This view represented a revitalized neoclassical theory and an abandonment of the professionalism project initiated by institutional economists.
What have been the implications for business education in the US?

The institutional economists who founded the university-based business school were vitally concerned with transmitting professional norms of business conduct from one generation to the next. These professional norms included the following:

- **Integrity**
- **Transparency and Accountability**
- **Responsibility and Trustworthiness**
- **Competence and Disinterestedness**
- **Duties of Care and Loyalty**
What have been the implications for business education in the US?

After the 1960s, the university-based business school became increasingly influenced by neoclassical economic theory and the Chicago school. Neoclassical economists had a more narrow view of managers and the obligations of the firm than institutional economists:

- **Institutional Economists** emphasized the role of power, values, belief systems, and historical contingency on economic behavior. This supported a broad view of managers and the obligations of the firm.

- **Neoclassical Economics** emphasized the role of markets, contracts, trade, and property rights on economic behavior. This supported a narrow view of managers and the obligations of the firm.
What have been the implications for business education in the US?

In the hands of neoclassical economists associated with the Chicago school, the theory of the firm used in accounting and finance took on a decidedly analytical focus that deemphasized the legitimacy of management and public policy.

- **The Role of Managers**: The new theory reduced the role of managers to maximizing share price in a highly efficient capital market.

- **The Role of Financial Regulation**: The new theory reduced financial regulation to opportunistic behavior between self-interested regulators and their constituents.

- **The Role of Professional Norms**: The new theory left no role for morality or professional norms in accounting and finance.
What have been the implications for business education in the US?

The new theory of the firm out of Chicago had a significant influence on the way accounting and finance was taught in university-based business schools. In particular, the theory caused faculty to frame managerial, organizational, and even social issues of the day in terms of *narrow self interest* (Stevens 2019). Michael Jensen has proudly stated that his MBA students at Rochester and Harvard found that his courses challenged “some of their deeply held beliefs” (Khurana 2007). Similarly, I found the narrow view of capitalism and the firm inconsistent with many of my beliefs.

**POLLING QUESTION #2**

Were you taught the economic theory of the firm in your accounting education? What was your initial response to the theory? Did it challenge any of your deeply held beliefs?
What the Chicago school got wrong about Adam Smith

The Chicago school attributed their narrow view of capitalism to Adam Smith and his classic work of political economy. George Stigler (1971, 265) wrote, “The Wealth of Nations is a stupendous palace erected upon the granite of self interest.” This view can be attributed to the following:

• **Clumsy attempts to reconcile Smith’s two major works.** A simplistic and misguided interpretation of Smith’s two major works fueled a major debate in Germany in the 1870s called “Das Adam Smith Problem.”

• **Misinterpretations of passages within TWN.** Certain passages of Smith’s 2nd major work, when taken out of context, could be taken to support a narrow view of capitalism and the firm.
What the Chicago school got wrong about Adam Smith

A deeper analysis of Smith’s life and writings reflects a fuller view of capitalism with an emphasis on culture, institutions, and social norms.

• Adam Smith was born in 1723 in Kirkcaldy, Scotland. He attended Glasgow University from 1737-1740 and Oxford from 1740-1746.

• Smith was appointed Professor of Logic at the University of Glasgow in 1751 and Professor of Moral Philosophy from 1752-1764.

• Smith published the 1st edition of The Theory of Moral Sentiments in 1759, which gained him widespread recognition as a leading moral philosopher.

• Smith published the 1st edition of The Wealth of Nations in 1776 after returning from a trip through Europe with the future Duke of Buccleuch.

• Smith continuously revised his two major works up to his death in 1790, but he considered The Theory of Moral Sentiments a superior work.
What the Chicago school got wrong about Adam Smith

Researchers have recently (re)discovered the importance of morality and social norms in *The Wealth of Nations*. This includes new evidence that:

- Smith viewed *TWN* as part of a comprehensive system that had *TMS* as its foundation, and included content from both major works in early lectures.
- *TWN* presents a theory of political economy that incorporates institutions and social norms and claims to better the lot of ordinary people.
- *TWN* grants commerce, religion, education, and government important roles in maintaining high moral character.
- *TWN* grants business professionals both a financial and nonfinancial incentive to be honorable and prove themselves trustworthy.
- Rather than promote narrow self-interest, therefore, *TWN* promotes the proper structuring of social institutions to establish and maintain proper virtues and norms.
What the Chicago school got wrong about Adam Smith

The 6th edition of *The Theory of Moral Sentiments* (1790) contains Smith’s final version of his moral theory based on social norms:

- Smith begins *TMS* by refuting narrow self-interest. He does this by condemning Mandeville’s view of virtue and by distinguishing between good self-interest (prudence) and bad self-interest (selfishness).
- Smith grants mankind the ability to empathize with others, which he calls *sympathy*, and makes it *the* major force behind moral judgment and behavior.
- Smith uses the concept of an *impartial spectator* to explain the moral conscience. Individuals observe what constitutes praiseworthy behavior over time and internalize these behavioral norms.
- Smith adds a new section on moral virtue to emphasize that individuals are driven by both the desire for *praise* and the desire to be *praiseworthy*.
Neoclassical economists have recently changed their minds about morality


The book includes a forward written by Michael Jensen, who argues that economics “has far too long ignored the normative world,” or the world of values and norms that specify desirable conduct (page ix). He concludes: “I look forward to seeing the creation of an entirely new field of inquiry in economics, and in its sister social sciences, focused deeply on the positive analysis of the role of values...” (page x).

More recently, Jensen and his colleagues have pivoted from brashly banning any discussion of morality and values to promoting a new positive theory of “integrity” that encourages managers and students to practice their personal values on the job with “authenticity” (Erhard et al. 2013).
Neoclassical economists have recently changed their minds about morality

The neoclassical theory of the firm that emanated from the Chicago school emphasized the use of financial incentives to control opportunistic behavior within the firm. Recent empirical findings, however, suggest the following:

- **Optimal Incentive Contracts not Optimal**: Rather than being “optimal,” incentive contracts are often inefficient and unrelated to performance.

- **Enrichment of Top Executives**: Consistent with the “Berle-Means thesis,” corporate boards use incentive contracts largely to enrich top executives.

- **Crowding Out Behavior**: Incentive contracting has been found to diminish intrinsic motivations consistent with values and norms.

- **Excessive Risk-Taking Behavior**: Incentive contracting has been found to cause excessive risk-taking behavior, putting firms and economies at risk.
Neoclassical economists have recently changed their minds about morality

Based on these empirical findings, agency researchers have begun to emphasize the importance of informal, non-financial controls such as corporate culture and social norms (Sunder 2016), and have encouraged archival researchers to test the effectiveness of such controls (Larcker and Tayan 2013). The latest archival research has documented the following:

- **Differential Social Norm Sensitivity**: Top managers exhibit idiosyncratic differences in corporate reporting, with some reflecting greater transparency, honesty, and integrity (Bamber, Jiang, and Wang 2010).

- **General Religious Culture**: Firms located in counties with high religious adherence are associated with a lower likelihood of financial misreporting (Dyreng, Mayew, and Williams 2012; McGuire, Omer, and Sharp 2012).

- **Professional Culture**: Corporate Social Responsibility (CSR) activities reflect managers’ motivation to be honest, trustworthy, and ethical (Kim, Park, and Wier 2012; Gao, Lisic, and Zhang 2014; Christensen 2016).
Neoclassical economists have recently changed their minds about morality

As researchers in economics developed experimental methods and utilized them in their research, the narrow assumptions of neoclassical economic theory were submitted to rigorous testing. The results of these experimental tests pose the greatest challenge to the culture-free, norm-free theory of the firm. In violation of narrow self-interest, they reflect norm-based behavior:

- **Dictator Game**: A game in which one player proposes the split of an amount with another player. Despite the dominant prediction of an offer of zero, proposers commonly offer positive amounts.

- **Ultimatum Game**: Differs from the dictator game in that the receiving player can reject the split. Despite the dominant prediction of a minimal amount offered, proposers commonly offer between 40% and 50%.

Neoclassical economist Vernon Smith (2008) has coined the term “ecological rationality” to explain norm-based behavior emerging in the lab.
Neoclassical economists have recently changed their minds about morality

The largest experimental literature in managerial accounting examines budgetary slack creation in participative budgeting settings. A slack-inducing pay scheme is commonly used where the principal pays the agent a bonus for performance relative to the budget.

• Despite the dominant prediction of 100% budgetary slack, agents commonly present budgets that reflect expected performance.

• Researchers have used this setting to test social norm behavior such as honesty, fairness, reciprocity, and responsibility.

• Researchers have demonstrated that cues in the participative budgeting setting can activate such norms in the agent.

• Finally, researchers have demonstrated that agents have differential norm sensitivity that affects their response to these situational cues.
Neoclassical economists have recently changed their minds about morality

When leading researchers in a given field change their mind, we call that a *paradigm shift* (Kuhn 1962). The economic theory that developed out of the Chicago school in the 1960s represented a paradigm shift in accounting.

- **Dominant Research Paradigm in the 1960s**: Most accounting research was “*a priori*” in nature and dealt with normative debates related to the value of current financial reporting methods to investors.

- **Dominant Research Paradigm after the 1960s**: Accounting research became increasingly empirical in nature due to advances in positive economic theory, market data availability, and econometric tools. This emphasis on “positive theory” pushed out issues of morality and values.

- **Dominant Research Paradigm after the 2020s???:** I believe that we are on the verge of another paradigm shift in accounting that incorporates the positive (descriptive) effect of morality in capitalism and the firm.
Moral foundations for capitalism and the firm

Researchers have applied various foundations in their search for a moral foundation for capitalism and the firm. While these foundations have generated valuable insights, they have proven insufficient to initiate a paradigm shift in the theory of the firm:

- **Religion**: Religion is a powerful source of norm-based behavior, but it requires unqualified assent in which rational people can disagree.

- **Moral Psychology**: Psychology is fully able to incorporate non-financial effects, but it treats norm-based behavior as irrational.

- **Moral Philosophy**: Philosophy has a long history of addressing moral issues, but it treats behavioral norms as a low form of moral reasoning.

- **Narrow Self-Interest**: Many neoclassical theorists have used the traditional assumption of narrow self-interest to incorporate morality into economic theory. This approach, however, also treats norm-based behavior as irrational and frequently disparages religion (Ayn Rand).
Moral foundations for capitalism and the firm

At the School of Accountancy at GSU, we have found Adam Smith’s writings to provide a strong moral foundation for capitalism and the firm.

- **Moral Theory:** Adam Smith’s writings provide a powerful moral theory based on culture and social norms. His moral theory is particularly useful because it describes how real people behave in the real world.

- **Economic Theory:** Adam Smith’s writings also provide the foundation for the economic theory of the firm, so they provide an opportunity to teach both economic and moral foundations of capitalism and the firm.

- **Application by other Leading Economists:** Leading neoclassical economists such as Vernon Smith have already applied Adam Smith’s writings to incorporate morality into traditional economic theory.

- **Potential to Lead a Paradigm Shift:** Adam Smith’s moral foundation addresses the weaknesses found in other moral foundations and thereby has the greatest potential of leading a paradigm shift in accounting.
Moral foundations for capitalism and the firm

We teach the importance of morality and professional norms in accounting in our undergraduate capstone course for seniors (ACCT 4750), in our graduate managerial accounting course (ACCT 8310), and in a Ph.D. seminar covering the theory of the firm in accounting research (BA 9330). For this purpose, we use my book at Cambridge University Press entitled, “Social Norms and the Theory of the Firm: A Foundational Approach” (Stevens 2019).

To clarify, we do not disparage the rigorous theory of the firm that evolved out of the Chicago school in the 1960s and came to dominate accounting research and education. Our goal is to demonstrate how the theory can be enhanced by incorporating culture and social norms as a moral foundation.

**POLLING QUESTION #3**

How could incorporating culture and social norms enhance accounting theory and practice? How could it support the use of current organizational controls? How could it support the use of new organizational controls?