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CORE ASSUMPTIONS IN BUSINESS THEORY

A WEDGE BETWEEN
PERFORMANCE & PROGRESS

EDITED BY SUBRAMANIAN RANGAN

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Subramanian Rangan

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To Jim March

Foreword

Amartya Sen

The great usefulness of well-chosen assumptions and the bad effects of ill-selected ones can both be, sometimes, hard to judge. But the basic issue is simple enough. We do need assumptions of a general kind in order to get started in an economic, social or political analysis, as well as in ethics. They tell us in which lines we might, at least initially, think of proceeding. The important priority is to avoid being locked in misdirecting presumptions, which can be a good way of muffing our attempted analyses altogether.

If the assumptions are intelligently chosen, with good reasoning and an open-minded scrutiny of their empirical foundations, they can be of real use. We should not be deterred from making use of them on the ground that assumptions can also be misleading—and ultimately wrong. We have every reason to pay very serious attention to the fact that some commonly used assumptions, in, say, economics, have proved to be both factually mistaken and significantly misleading. For example, the widely used presumption in standard economic analysis that all people are motivated by self-interest—and *only* by self-interest—has been shown to be both incorrect and delusional. This is a big subject on which several members of this group have written powerfully to denounce the use of the distortion of economic, political and social analyses brought about by such misdirecting but common assumptions.

However, that cannot be a ground for being hostile to the use of assumptions altogether. Indeed, in a great many cases the chosen assumptions are accurate and sometimes useful even without being exactly accurate. The idea that a strict security system can eliminate—or at least reduce—airplanes being sabotaged seems useful enough. More specifically, it seems to make air travel safer if it can be ensured that passengers travel with their checked baggage, which is based on the assumption that people would not like to blow themselves up. However, it is important to recognize that this cannot be a full guarantee of ensuring security, since there are suicide maniacs as well as terrorists who are ready to seek martyrdom through killing themselves along with hundreds of other passengers. It is also important to recognize that while this way of trying to make air journeys more secure began at a time when suicide bombing was uncommon, with the progress of religious politics, that has ceased to be so. So, both the contingency of the circumstances and changing empirical reality have to be brought into the exercise of assessing assumptions.

The assumption of self-interest pursuit also plays an instrumental role in our understanding of a number of other important concepts. For example, the importance we attach to freedom may, in many cases, be linked with the presumption that a good way of ensuring that a person's interests are taken into account is to give the persons the freedom to make the critical choices themselves. Freedom has many virtues, and some of them may have no immediate link with the promotion of self-interest at all, but surely the help that the freedom to choose can provide in promoting people's personal interests must fit somewhere in the picture.

Similarly, the importance that is attached to “accountability”—a widely used idea—is at least partly based on the presumption that an agent, for example a civil servant, can be deflected from doing the right thing because of the pursuit of self-interest that can be, at least to some extent, prevented through making the selfish decisions of public employees identifiable—and potentially punishable—through being easily known by the population at large.

That is argument enough in many contexts, and yet accountability alone may not be adequate for making a public servant appropriately motivated. There are many decisions that a civil servant takes that may not violate established rules of proper behavior, and yet may not be adequately responsive. For example, the National Health Service, as in the UK or France, operates not only on the doctors and other medical personnel being honest and rule-following, but going often enough well beyond what rules demand. To consider an example, when a patient calls a doctor to get some information from the medical records in the hospital or clinic, the doctor may well stay on long beyond the regulated hours (as they often do) to check what records exist. That could be immensely helpful for the patient, and yet leaving the clinic at the regular end of working hours would not have been seen as a failure of specified duties of employment, or be captured through the discipline of accountability. In fact, no health service can run appropriately on the basis of accountability alone, and it needs a broader concept of responsibility that requires a fuller analysis of behavioral motivations and the relevant normative concerns. If the National Health Service has been a success in Europe, it has drawn on much more than accountability.

The assessment of assumptions does call for examination of empirical understandings and social reasoning, and also for the understanding of many concerns that go beyond both the pursuit of self-interest and adherence to simple social rules of an other-regarding nature. Public discussion is not only a good way of pursuing democratic values (as has been widely discussed) but it also has an extensive and systemic role in making us understand what we owe to each other. In assessing assumptions—their prevalence, their plausibility, their usefulness—we have to go beyond rules and easily aired principles. We have to scrutinize their extensive social roles and functionality. We should not have expected less.

Acknowledgments

This unlikely project commenced in 2018 as an intuition. The intuition was that core assumptions in business theory might be a little-noticed but critical contributor to failings that seem concerningly routine and evident in the modern economic system. If core assumptions were flawed or had fading validity, then impairments could be propagated to the real world via business education and practice. Indeed, errant assumptions could act as a “wedge” cleaving apart performance and progress. In an applied field such as business, where theory tends to be normative, the consequences could be grave.

Exciting as intuitions can be, they are also tenuous at inception. I recall timidly sharing the intuition with a couple of colleagues at INSEAD. They were intrigued and expressed a “why not?” reaction. Heartened, I conferred with a couple of senior scholars (a social scientist and a philosopher) at the Society for Progress. I do not rule out that I subconsciously approached the ones whom I felt might react favorably but react favorably they did. In particular, Jim March, to whom we dedicate this volume, was enthusiastic and strongly urged me to pursue the intuition. Emboldened, I widened the inquiry and received more nods. On the back of this wider encouragement, I approached Adam Swallow at Oxford University Press. Adam heard me out and was also inclined positively. His interest and backing gave me the confidence to develop the intuition into a project and organize the collective effort whose fruits we finally present here. I am grateful to these “first responders” who nurtured the seeds of the intuition that eventually grew into this elaborate work and volume. I thank Oxford University Press and, in particular, Adam Swallow for safely guiding this ship to shore, and Rajeswari Azayecoche and Kayley Gilbert for helping dispatch its contents.

It is atypical in a business school that faculty pursue abstract or fundamental research. I feel fortunate and grateful that my school INSEAD enables such freedom. My chair in “societal progress,” envisioned with and endowed by the Abu Dhabi Crown Prince Court, has not only provided time and funding but has also shaped my purpose and identity as a scholar. Beyond this, in my three decades at the school, I have had incredibly caring mentors, supportive and generous colleagues, and engaged students. They have shown interest, taken time, shared feedback, and above all encouraged my rather abstract inquiry on the evolution of the economic system. In terms of governance, too, our school is blessed with a board and alumni that wish the school to be relevant and well reputed when it comes to research. I thank them all and wish to mention in particular my three formative mentors in the strategy department: Gareth Dyas, Dominique Héau, and Heinz Thanheiser.

Among other colleagues at the school, a few followed the project closely and have been invaluable sounding boards. They include Antonio Fatas, Tim Van Zandt, Urs Peyer, Alexandra Roulet, and, especially, Michael Brimm. I am indebted to them for their generosity and willingness to engage in numerous and wide-ranging discussions on the sense and specifics of the issues addressed in this volume. Other individuals that I wish to thank include Philippe Aghion, Chris Avery, Laurence Capron, Javier Gimeno, Ilze Kivleniece, Donald MacKenzie, Felipe Monteiro, Tomasz Obloj, Metin Sengul, Phebo Wibbens, and Peter Zemsky.

Outside the school, my greatest debt of gratitude goes to the fellows of the Society for Progress—the primary contributors to this project. For the social scientists among the

fellows, it was, I suspect, a bit of a self-conscious task to reflect on and articulate core assumptions in their own fields. For philosophers, it was arguably a more challenging task to read and react to the presentations of the social scientists. I am not entirely certain that this design works in all cases, and I am hence doubly grateful to all the contributors for going along with it.

I wish to register a special and deep appreciation for the sincere engagement of Itzhak Gilboa, Edward Kaplan, Philip Kotler, Ellen Quigley, Raghu Rajan, Marti Subrahmanyam, and Jean Tirole. These scholars, though not affiliated as fellows of the Society for Progress, made nonetheless the effort to understand the project and dedicate time to develop and share their reflections with the SFP community.

I express my heartfelt appreciation to the generous and engaged individuals whose financial support of the Society for Progress made it possible for us to organize and host in-person assemblies that were indispensable in the preparation of this volume. They include Rolf and Anna Abdon, Oleg and Alina Bagrin, Frank and Susan Brown, Steve and Roberta Denning, Fadi Ghandour, Guilherme Leal, Sunil Munjal, Babu Padmanabhan, Pedro Passos, Luiz Seabra, Shibu and Kumari Shibulal, and Ruben Vardanyan.

I wish to underline the influence and impact on me of three “gentle giants” who are no longer with us. Ken Arrow was a founding member of the Society for Progress. His wisdom and generosity are legend and have been crucial in my development as a scholar and human being. Jim March, also a founding member of the Society, was equally precious as a mentor and exemplar. His convictions about the endogeneity of much that we care about inspired confidence in this project. The third founding member whose ethos and perspectives made a lasting impact on me was Bertrand Collomb. I cannot recall a conversation with any of the three that failed to yield insight, warmth, and caring guidance.

On a “marathon” project such as this, one needs at least a few ardent friends to believe, to boost, and to keep bidding well. On this score, I thank Rabih Abouchakra, Ron Adner, Antonio Batista, Aldemir Drummond, Dan Elron, Alison James, Jeremy Jurgens, and Mel Rogers. I’d like also to acknowledge a special set of individuals and figures who were not directly involved in this volume, but whose ethos and work have informed and inspired me and shaped my aspirations and ideas on this project. They include Mugheer Al Khaili, Emerson Almeida, Pascal Berend, Henri Claude de Bettignies, James Buchanan, John Dewey, Ernst Fehr, Pierre Force, Amy Gutmann, Albert Hirschman, Emmanuel Kant, Robert Lawrence, Nitin Nohria, Indra Nooyi, Vilfredo Pareto, Karl Polanyi, John Rawls, Hilde and Klaus Schwab, Adam Smith, Jamsetji Tata, C. K. Venkataraman, Raymond Vernon, and Sheikh Zayed.

One person whose support has been immediate and invaluable in bringing this project to fruition is the young Laura Payet, who joined INSEAD just some 24 months ago. Even as she juggled her various duties at the strategy department here, she brought renewed energy and excitement to the project. Without her push and effective supervision, I would scarcely have been able to tie together the numerous ends necessary to complete this large and seemingly unending project.

I share the soul of this project with Ebba Abdon Hansmeyer whose conviction and collaboration brought to life the Society for Progress. Her fellowship and commitment enabled us to plod through the uncertainty and deferment of the Covid years. Her candor and capacity to ask essential questions have been pivotal and enriching.

x Acknowledgments

It only remains for me to thank my family, and most especially my wife Nalini. Any project as mildly ambitious as this is built on some sacrifice, of which her share has been large and long-standing. I am truly grateful, fortunate, and blessed.

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Bertrand Collomb was Honorary Chairman of Lafarge, a world leader in building materials that merged with Holcim to form LafargeHolcim of which he was a director. He was a member of the Institut de France and chairman of the Académie des sciences morales et politiques in 2013. A graduate of the École Polytechnique and the École des Mines in Paris, he obtained a French law degree and a PhD in Management (University of Texas). He founded the Center for Management Research at the École Polytechnique. From 1966 to 1975, he worked with the French government in various positions. He joined Lafarge in 1975. After several responsibilities in various areas of the group, including CEO of Lafarge Corporation, the North American arm of the group (1985–1988), he was appointed chairman and CEO of Lafarge in August 1989. He was chairman of Lafarge from 2003 to 2007. He led Lafarge to become a global leader, while maintaining a people-oriented culture. He was a proponent of sustainable development and a founding member of the World Business Council for Sustainable Development (WBCSD), of which he was the chairman from 2004 to 2005. He was also a member of the European Round Table of Industrialists (ERT) and chairman of Institut de l'Entreprise and AFEP (the association of French large international companies). He was a director of several international companies including Allianz, Unilever, DuPont, and Total.

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Itzhak Gilboa studied Mathematics and Computer Science (BSc, 1982) and Economics (BA, 1982, MA, 1984, PhD, 1987) at Tel Aviv University, with graduate studies under the supervision of David Schmeidler. He works in decision theory and other fields in economic theory such as game theory and social choice. His main research areas are decision under uncertainty, focusing on the definition of probability, notions of rationality, non-Bayesian decision models, and related issues. He has been teaching a variety of courses on microeconomics, decision theory, game theory, psychology and economics, and related fields at the undergraduate, graduate, and MBA levels. He is the author of several books such as *Analogies and Theories: Formal Models of Reasoning* (Oxford University Press, 2015); *Theory of Decision under Uncertainty*

(Cambridge University Press, 2009); *Rational Choice* (MIT Press, 2010); and *Making Better Decisions* (Wiley-Blackwell, 2010). His recent research papers have been published in prestigious scientific journals such as *American Economic Review*, *Games and Economic Behavior*, *Annual Reviews in Economics*, *BE Journals in Theoretical Economics*, *Econometrica*, *Economics and Philosophy*, *Journal of Economic Theory*, *Journal of Economic Perspectives*, *Mathematical Social Sciences*, *Review of Economics and Statistics*, and *The Journal of Econometrics*. Gilboa is also the holder of the AXA Chair in Decision Sciences.

Ravi Kailas is the chairman and founder of the Mytrah Group, with interests spanning renewable energy, electric vehicles, and technology. Ravi has been a serial entrepreneur in India for over thirty years, seeking “tangential solutions” to build innovative business models during the telecom, software, and infrastructure revolutions in the country. He is a master pacer, meditator, and family man. In 2019 Ravi authored *Myth of the Entrepreneur* (HarperCollins), a book on corporate trusteeship and value creation for modern-day entrepreneurs. He is passionate about the ways in which the competitive spirit engendered by capitalism can be reformed or channeled to promote a more equal distribution of outcomes across society. He is Trustee of the Pravaha Trust and is dedicating the next decades to building a new model for philanthropy/wealth redistribution in emerging economies.

Edward H. Kaplan’s research has been reported on the front pages of *The New York Times* and *The Jerusalem Post*, editorialized in *The Wall Street Journal*, recognized by the *New York Times Magazine*’s Year in Ideas, and discussed in many other major media outlets. The author of more than 150 research articles, Professor Kaplan received both the Lanchester Prize and the Edelman Award, two top honors in the operations research field, among many other awards. An elected member of both the National Academy of Engineering and the National Academy of Medicine of the US National Academies, he has also twice received

the prestigious Lady Davis Visiting Professorship at the Hebrew University of Jerusalem, where he has investigated AIDS policy issues facing the State of Israel. Kaplan pioneered the application of operations research to public health issues such as HIV prevention and bioterror preparedness, and also played a leading role applying operations research to problems in counterterrorism and homeland security. More recently, as a member of Yale's Covid-19 Public Health Committee, Kaplan developed novel models to understand, monitor, and prevent the spread of SARS-CoV-2. In 2014, Kaplan was elected to the presidency of the Institute for Operations Research and the Management Sciences (INFORMS), the world's largest society of operations research and analytics academics and professionals. He served as President-Elect in 2015, President in 2016, and Past-President in 2017.

Philip Kitcher is John Dewey Professor Emeritus of Philosophy at Columbia University. Before coming to Columbia, he taught at the University of California, San Diego, and before that at the University of Minnesota. Early in his career, he was primarily interested in philosophy of mathematics and general philosophy of science. During the late 1970s, he became very concerned with the philosophy of biology. That concern led him to investigate not only conceptual and methodological issues in biology but also questions about the relations of biological research to society and politics. During the 1990s, his interests broadened further to embrace the role of scientific inquiry in democratic societies. Since coming to Columbia, that line of investigation has been further elaborated in relation to pragmatism (especially William James and John Dewey). Part of this work advances a program for naturalistic ethics. Professor Kitcher has also developed a program of research in philosophical themes in literature and music, focusing so far on Joyce and Wagner, and, in a recent book, on Thomas Mann and Mahler. He has recently written books on moral progress, on philosophy of education, and on John Stuart

Mill. *What's the Use of Philosophy?* explores the question posed in the title.

Philip Kotler is the S. C. Johnson Distinguished Professor of International Marketing at the J. L. Kellogg School of Management. He has been honored as one of the world's leading marketing thinkers. He received his MA degree in Economics from the University of Chicago and his PhD in Economics from MIT and has received honorary degrees from twenty-two universities including Stockholm University, the University of Zurich, Athens University of Economics and Business, Budapest School of Economics and Administrative Science, the Krakow School of Business and Economics, and DePaul University. He is author of over 150 articles and ninety books, including *Marketing Management*, *Principles of Marketing*, *Marketing for Hospitality and Tourism*, *Strategic Marketing for Nonprofit Organizations*, *Social Marketing*, *Marketing Places*, *The Marketing of Nations*, *Confronting Capitalism*, *Democracy in Decline*, and *Advancing the Common Good*. His research covers strategic marketing, consumer marketing, business marketing, professional services marketing, and e-marketing. He has been a consultant to IBM, General Electric, AT&T, Bank of America, Merck, Motorola, Ford, and others. He has lectured several times in Italy, Sweden, China, Japan, India, Indonesia, Australia, Mexico, Brazil, Chile, and many other countries.

James G. March was Professor Emeritus at Stanford University, where he was on the faculty since 1970. He held appointments in the Graduate Schools of Business and Education and in the Departments of Political Science and Sociology. He received his BA degree from the University of Wisconsin and his MA and PhD from Yale University. He received honorary doctorates and honorary professorships from several European and North American universities and was elected to membership in the National Academy of Science, the American Academy of Arts and Sciences, the American Philosophical Society, the National Academy of Public Administration, and the National Academy of Education, as well as several

overseas academies. He received the Wilbur Cross Medal from Yale University in 1968, the Academy of Management Award for Scholarly Contributions to Management in 1984, the Walter J. Gores Award for Excellence in Teaching from Stanford University in 1995, the John Gaus Award from the American Political Science Association in 1997, the Distinguished Scholar Award from the Academy of Management in 1999, the Viipuri Award from the Viipuri Society in 2004, the Aaron Wildavsky Award from the Public Policy Society in 2004, the Herbert Simon Award from Laslo Raik College (Budapest) in 2005, and a Progress Medal from the Society for Progress in 2016. In 1995 he was made a Knight First Class in the Royal Norwegian (Olav V) Order of Merit, and in 1999 he was made a Commander of the Order of the Lion of Finland. He was a member of the National Science Board (1969–1974) and the National Council on Educational Research (1975–1978). From 1984 to 1994 he was a member, and from 1991 to 1993 chair, of the Board of Trustees of the Russell Sage Foundation. He is best known professionally for his writings on decision-making and organizations, including *Organizations*, *A Behavioral Theory of the Firm*, *Leadership and Ambiguity*, *Ambiguity and Choice in Organizations*, *Decisions and Organizations*, *Rediscovering Institutions*, *The Pursuit of Organizational Intelligence*, *Democratic Governance*, *A Primer on Decision Making*, *The Dynamics of Rules*, *Explorations in Organizations*, *On Leadership*, and *The Ambiguities of Experience*. He also wrote thirteen books of poetry and two films.

Ramón Mendiola has extensive experience leading companies in the food and beverage industry. In the 1980s and 1990s he worked for local and multinational consumer goods companies. In 2003, he joined as CEO of FIFCO, a Latin American company with three business divisions in Central America, Mexico, and the United States: food and beverage, retail, and real estate/hospitality. During the last twenty years, he led a transformational journey at FIFCO, including the growth of financial results (revenues and profits) more than

tenfold, finding corporate purpose, and becoming a sustainability champion. After twenty years leading FIFCO, Ramón stepped down as CEO in December 2023. He has a Bachelor's degree in Business Administration with a concentration in Marketing and Entrepreneurship from Babson College, and a Master's degree in Business Administration with a concentration in International Business and Marketing from J. L. Kellogg School at Northwestern University.

John W. Meyer is Professor of Sociology, Emeritus, at Stanford. He has contributed to organizational theory, the sociology of education, and the study of globalization. He has studied the impact of models of society (*World Society: The Writings of John W. Meyer*, Oxford University Press, 2009; Jepperson and Meyer, *Institutional Theory*, Cambridge University Press, 2021). His main foci have been on the worldwide expansion of education (Frank and Meyer, *The University*, Princeton University Press, 2020), the worldwide expansion of science (Drori et al., *Science in the Modern World Polity*, Stanford, 2003), and the organizational impact of globalization (Bromley and Meyer, *Hyper-Organization*, Oxford University Press, 2015). He has honorary doctorates from the Stockholm School of Economics and the universities of Bielefeld and Lucerne. He received American Sociological Association awards for lifetime contributions to the field generally, the sociology of education, and the study of globalization, and the Academy of Management's organizations award for a distinguished scholarly career.

Susan Neiman is an American philosopher and writer. She has written extensively on the Enlightenment, moral philosophy, metaphysics, and politics. Her work shows that philosophy is a living force for contemporary thinking and action. Born and raised in Atlanta, Georgia during the Civil Rights Movement, Neiman dropped out of high school to join American activists working for peace and justice. Later she studied philosophy at Harvard University, earning her PhD in 1986 under the direction of John Rawls and Stanley Cavell. In the 1980s she

spent six years in Berlin, studying at the Free University and working as a freelance writer. She was professor of philosophy at Yale and Tel Aviv University. In 2000 she assumed her current position as Director of the Einstein Forum in Potsdam. Neiman has been a Member of the Institute for Advanced Study in Princeton, a Fellow at the Rockefeller Foundation Study Center in Bellagio, and a Senior Fellow of the American Council of Learned Societies. She is now a member of the Berlin-Brandenburg Academy of Sciences and the American Philosophical Society. She is the author of nine books, translated into fifteen languages, which have won prizes from, among others, PEN, the Association of American Publishers, and the American Academy of Religion.

Philip Pettit is L. S. Rockefeller University Professor of Human Values at Princeton University and Distinguished Professor of Philosophy at the Australian National University. He has worked in a range of areas, including ethical and political theory, the theory of collective and corporate agency, and the philosophy of mind. He has published a number of books in those areas, including *The Common Mind* (1996), *Republicanism* (1997), *The Economy of Esteem* (with G. Brennan 2004), *Made with Words* (2008), *Group Agency* (with C. List, 2011), *Just Freedom* (2014), *The Robust Demands of the Good* (2014), *The Birth of Ethics* (2018), and *The State* (2023). Among many such series of lectures, he gave the Tanner Lectures in Human Values in Berkeley in 2015, the John Locke Lectures in Philosophy in Oxford in 2019, and the Einstein Lectures in Bern in 2022. *Common Minds: Themes from the Philosophy of Philip Pettit* appeared from Oxford University Press in 2007, edited by Geoffrey Brennan et al. Pettit is a Fellow of the Academy of Social Sciences (1987) and the Humanities Academy (1988) in Australia, a Fellow of the American Academy of Arts and Sciences (2009), an Honorary Member, Royal Irish Academy (2010), a Corresponding Fellow of the British Academy (2013), and Correspondant en Philosophie de L'Académie des Sciences Morales et Politique (Institut de France) (2019). He holds the following

honorary degrees: DLitt Politics, National University of Ireland, 2000; PhD Political Science, University of Crete, 2005; PhD Philosophy, Université de Montreal, 2006; DLitt Philosophy, Queen's University, Belfast, 2007; DPhil Philosophy, Lund University, 2008; PhD, Philosophy, University of Athens, 2014; and PhD Law, University of Buenos Aires, 2019. He was made a Companion of the Order of Australia in 2017.

Hilke Plassmann is Octapharma Chaired Professor of Decision Neuroscience and Professor of Marketing at INSEAD, which she joined in 2008. She is also a Principal Investigator in the Social Affective Neuroscience Team at the Brain and Spine Institute (ICM) of Sorbonne University and has been an Affiliated Faculty at the Cognitive Neuroscience Unit of the École Normale Supérieure. She has been a visiting faculty at the Wharton School, New York University's Stern School of Business, the Rady School of Management at the University of California San Diego, and Bonn University. In 2005, she earned a PhD in Marketing and Neuroscience (Dr.rer.pol) from the University of Münster's School of Business and Economics, and then was a postdoctoral scholar at Stanford University and the California Institute of Technology. Hilke is one of the pioneers in the field of decision and consumer neuroscience. Her primary research areas are consumer decision-making and its strategic marketing implications at the intersection of neuroscience, psychology, and economics. She is specifically interested in why consumers make disadvantageous decisions such as overeating, overspending, and unsustainable consumption. Her research has appeared in leading academic journals such as *Proceedings of the National Academy of Sciences* of the USA, *Journal of Marketing Research*, *Journal of Consumer Research*, *Journal of Consumer Psychology*, and *Journal of Neuroscience*. Her work has received several awards such as the Early Career Award from the Society for Neuroeconomics and the AMA-EBSCO-RRBM Annual Award for Responsible Research in Marketing. Her work has received international newspaper, radio, and TV coverage. Hilke has

written several award-winning cases and has worked with several large companies and start-ups. At INSEAD, Hilke teaches marketing management, behavioral and brain science for businesses, caring consumption, and neuromarketing. She co-directs the [Business Foundations Certificate \(BFC\) program](#) at INSEAD.

Ellen Quigley is a Research Professor and the Special Adviser (Responsible Investment) to the Chief Financial Officer at the University of Cambridge. Her work centers on the mitigation of climate change and inequality through the investment policies and practices of institutional investors. She is from Saskatoon, Saskatchewan, Canada, and holds an AB in English literature from Harvard College, an MSc in Nature, Society, and Environmental Policy from the University of Oxford, and a PhD in economics education from the University of Cambridge. Her article, “Universal Ownership in Practice: A Practical Investment Framework for Asset Owners,” won the GRASFI Paper Prize for Potential Impact on Sustainable Finance Practices in 2020 and will be published as a volume in the Elements series through Cambridge University Press in 2025.

Raghuram Rajan is the Katherine Dusak Miller Distinguished Service Professor of Finance at the University of Chicago’s Booth School. Prior to that, he was the 23rd Governor of the Reserve Bank of India from 2013 to 2016, as well as the Vice Chairman of the Board of the Bank for International Settlements from 2015 to 2016. Dr. Rajan was the Chief Economist and Director of Research at the International Monetary Fund from 2003 to 2006. Dr. Rajan’s research interests range from banking and monetary policy to corporate finance, political economy, communities, and economic development. He co-authored *Saving Capitalism from the Capitalists* with Luigi Zingales in 2003. He then wrote *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, for which he was awarded the *Financial Times*/Goldman Sachs prize for best business book in 2010. In 2019, his book, *The Third Pillar: How Markets and the State Leave*

the Community Behind, was a finalist for the *Financial Times*/McKinsey Business Book of the Year Award. His most recent book, with Rohit Lamba, is *Breaking the Mold*, on reimagining India’s economic future. Dr. Rajan was awarded the inaugural Fischer Black award for the best financial economist under the age of forty in 2003, the Deutsche Bank prize for financial economics in 2013, the Euromoney Central Bank Governor of the Year in 2014, and *Banker* magazine’s Global Central Bank Governor of the Year in 2016.

Subramanian Rangan is Professor of Strategy and Management at INSEAD, where he serves as the Abu Dhabi Crown Prince Court Endowed Chair in Societal Progress. He received an MBA from the MIT Sloan School of Management and a PhD in political economy from Harvard University. His research explores the evolution of capitalism and in particular how enterprises and all economic actors may better integrate performance and progress. In his teaching, he is developing a curriculum that aims to deepen not only the competence but also the character of business students and executives. In 2013 he initiated the Society for Progress, a fellowship of eminent philosophers, social scientists, and business leaders. He edited *Performance and Progress* (Oxford University Press, 2015), the first collection of essays from the Society. In 2018 he edited *Capitalism beyond Mutuality?* (Oxford University Press), their second volume. Subi’s other research explores the political sociology of discrimination of foreign transnational firms and these firms’ non-market strategies. In 1998 he won the Academy of International Business’ Eldridge Haynes Prize for the best original work in international business. In 1995 that academy awarded their Best Dissertation Award to his doctoral thesis. In 2010 his research won the Emerald award for Top 50 papers in management. His articles appear in *Administrative Science Quarterly*, *Academy of Management Review*, *Brookings Papers on Economic Activity*, *Journal of International Business Studies*, *Strategic Management Journal*, *Sloan Management Review*, and *Harvard Business Review*. Subi is co-author of two

books: *Manager in the International Economy* and *A Prism on Globalization*. He was associate editor of the *Academy of Management Review* and the *Global Strategy Journal*. He is a member of the board of trustees of Fundação Dom Cabral, a leading business school in Brazil; and a member of the Board of the World Economic Forum's Schwab Foundation for Social Entrepreneurship. Subi directs INSEAD's top executive seminar AVIRA: Awareness, Vision, Imagination, Role, and Action. He is a recipient of the Outstanding Teacher award and Dean's Commendation for Excellence in Teaching.

Mathias Risse is Berthold Beitz Professor in Human Rights, Global Affairs and Philosophy and Director of the Carr Center for Human Rights Policy at Harvard University. His work primarily addresses questions of global justice ranging from human rights, inequality, taxation, trade, and immigration to climate change, obligations to future generations, and the future of technology, especially also the impact of artificial intelligence on a range of normative issues. He has also worked on questions in ethics, decision theory, and nineteenth-century German philosophy, especially Nietzsche. Risse is the author of *On Global Justice* (Princeton University Press), *Global Political Philosophy* (Palgrave Macmillan), *On Trade Justice: A Philosophical Plea for a New Global Deal* (Oxford University Press, with Gabriel Wollner), *On Justice: Philosophy, History, Foundations* (Cambridge University Press), and *Political Theory of the Digital Age: Where Artificial Intelligence Might Take Us* (Cambridge University Press).

David Schmidtz is Presidential Chair of Moral Science and Director of the Social Philosophy and Policy Center at West Virginia University's Chambers College of Business and Economics. He aspires to pick up where the Scottish Enlightenment left off, treating ethics as a subject that begins with observation: specifically, observation of the human condition and of what seems to improve it. Today's moral theories often focus on questions of what to do, whereas David Hume and Adam Smith focused on what works: that is, on which

principles have a history of demonstrably being organizing principles of actual thriving communities at their best.

Amartya Sen is Thomas W. Lamont University Professor and Professor of Economics and Philosophy at Harvard University, and was until 2004 the Master of Trinity College, Cambridge. He is also Senior Fellow at the Harvard Society of Fellows. Earlier on he was Professor of Economics at Jadavpur University Calcutta, the Delhi School of Economics, and the London School of Economics, and Drummond Professor of Political Economy at Oxford University. Sen has served as President of the Econometric Society, the American Economic Association, the Indian Economic Association, and the International Economic Association. He was formerly Honorary President of OXFAM and is now its Honorary Advisor. His research has ranged over social choice theory, economic theory, ethics and political philosophy, welfare economics, theory of measurement, decision theory, development economics, public health, and gender studies. Amartya Sen's books have been translated into more than thirty languages and include *Choice of Techniques* (1960), *Growth Economics* (1970), *Collective Choice and Social Welfare* (1970), *On Economic Inequality* (1973, 1997), *Poverty and Famines* (1981), *Utilitarianism and Beyond* (jointly with Bernard Williams, 1982), *Choice, Welfare and Measurement* (1982), *Commodities and Capabilities* (1985), *The Standard of Living* (1987), *On Ethics and Economics* (1987), *Hunger and Public Action* (jointly with Jean Drèze, 1989), *Inequality Re-examined* (1992), *The Quality of Life* (jointly with Martha Nussbaum, 1993), *Development as Freedom* (1999), *Rationality and Freedom* (2002), *The Argumentative Indian* (2005), *Identity and Violence: The Illusion of Destiny* (2006), *The Idea of Justice* (2009), *An Uncertain Glory: India and Its Contradictions* (jointly with Jean Drèze, 2013), and *The Country of First Boys* (2015). Amartya Sen's awards include Bharat Ratna (India); Commandeur de la Legion d'Honneur (France); the National Humanities Medal (USA); Ordem do Merito Cientifico (Brazil); Honorary Companion of Honour (UK); the

Aztec Eagle (Mexico); the Edinburgh Medal (UK); the George Marshall Award (USA); the Eisenhower Medal (USA); the Johan Skytte Prize in Political Science; and the Nobel Prize in Economics.

S. D. Shibulal is co-founder, former CEO, and Member of the Board of Infosys Ltd. Prior to becoming CEO and Managing Director, Shibu served as the Chief Operating Officer from 2007 to 2011. Earlier, Shibu held a number of senior leadership roles including Head of Worldwide Sales and Customer Delivery. From 1991 to 1996, Shibu had worked with Sun Microsystems in the US, where he led the team that designed and implemented Sun's first e-commerce application. Shibu retired from Infosys on 31 July 2014. In 2014, he co-founded Axilor Ventures—a new-generation platform to improve entrepreneurs' odds of success. With three distinct programs—accelerator, scale-up, and early-stage funding—Axilor provides infrastructure, mentoring, and capital for high-impact, India-focused start-ups (in the areas of e-commerce, healthcare, and cleantech). Driven by his passion for education and developing the leaders managing the K-12 government schools across India, Shibu incorporated ShikshaLokam, an Education Leadership Development platform, in 2016. Now active in multiple states, ShikshaLokam offers open-source technology capabilities and learning and management resources to more than 300,000 leaders, in partnership with state governments and leading civil society organizations.

Jim Hagemann Snabe is a Danish businessman and is currently the chairman at Siemens and member of the board at C3.ai. Jim is a member of the board of Trustees at the World Economic Forum; Member of the advisory board of Deutsche Bank; Member of the advisory board of Allianz; and Member of the European advisory board of Temasek. As co-CEO of SAP (2010–2014) together with Bill McDermott, Jim was instrumental in driving the strategic development of SAP to double the value of the company and play a more responsible role in society. After leaving SAP in 2014, Jim joined

the board of Allianz, Siemens, and A. P. Moller—Maersk. Jim became chairman of Siemens in 2018. He was chairman of A. P. Moller—Maersk (DK) (2017–2022) and Vice Chairman Allianz SE (D) (2014–2021). Snabe received a master's degree in operational research from the Aarhus School of Business in Denmark. In 2016 he was appointed Adjunct Professor at Copenhagen Business School based on his work around digital transformation and its impact on business and society. In his capacity as a global business leader, Jim is involved in a number of activities focused on societal progress, decarbonization, and the role of business in society. Snabe's views on leadership are shaped by his commitment to solving societal issues and his trust in human potential. In 2017, Snabe wrote with Mikael Trolle a book entitled *Dreams and Details: Reinvent Your Business and Your Leadership from a Position of Strength*. Drawing from their leadership experience, Snabe and Trolle set out to offer a new leadership model, which unites inspiration, ambition, innovation, and employee empowerment to succeed in a rapidly developing world. The model builds on Snabe's conviction that businesses constantly have to reinvent themselves to combine profits with responsible and sustainable conduct. In November 2018, Snabe and Trolle founded the Dreams and Details Academy, aiming to change leadership through consulting and educational services.

Marti G. Subrahmanyam is the Charles E. Merrill Professor of Finance, Economics and International Business in the Stern School of Business at New York University, and Global Network Professor of Finance at New York University Shanghai. He holds a degree in mechanical engineering from the Indian Institute of Technology, Madras and a postgraduate diploma in business administration from the Indian Institute of Management, Ahmedabad. Both institutions conferred on him their Distinguished Alumnus Award. He earned a doctorate in Finance and Economics from MIT. Professor Subrahmanyam's research interests include valuation of corporate securities, asset pricing

(particularly in the context of derivatives markets), market microstructure, and fixed-income markets. Professor Subrahmanyam has published over 150 articles and several books in the areas of corporate finance, capital markets, and international finance. His publications include papers in leading international journals in economics and finance, including *Econometrica*, *The Quarterly Journal of Economics*, *Journal of Economic Theory*, *Journal of Finance*, *Journal of Financial Economics*, and *The Review of Financial Studies*. His books include *Financial Options: From Theory to Practice* and *Credit Default Swaps*. Professor Subrahmanyam currently serves or has served on the editorial boards of *European Financial Management*, *Journal of Banking and Finance*, *Journal of Business Finance and Accounting*, *Journal of Finance*, *Management Science*, *Journal of Derivatives*, *Journal of International Finance and Accounting*, and *Japan and the World Economy*. He was the founding editor of an academic journal specializing in derivative securities and markets entitled *Review of Derivatives Research*. Professor Subrahmanyam has served as a consultant to several corporations, industrial groups, and financial institutions in the US, Europe, Asia, and Latin America. These include many of the largest global financial institutions. He has served as an adviser to international and government organizations and serves as an adviser to several start-up companies in India and the US. He has served as an expert witness in several important legal cases involving topics such as equity swaps and interest rate benchmarks. More recently, Professor Subrahmanyam has shifted his attention to non-profit organizations and now serves on several boards, including the United Nations Foundation, the Indian School of Business, the Snow Leopard Trust, and the IIT Madras Foundation.

Valerie Tiberius is Professor of Philosophy at the University of Minnesota, which she joined in 1998. She has published numerous papers, as well as five books: *Deliberation about the Good: Justifying What We Value*; *The Reflective Life: Living Wisely with Our Limits*; *Moral*

Psychology: A Contemporary Introduction; *Well-Being as Value Fulfillment: How We Can Help Each Other to Live Well*; and *What Do You Want Out of Life? A Philosophical Guide to Figuring Out What Matters*. Much of her work has taken a practical, empirical approach to philosophical questions, trying to show how these disciplines can change the world for the better. Tiberius's work has focused on ethics and moral psychology, with a special interest in applying Humean principles to modern philosophical questions. Much of her work is centered at the junction of practical philosophy and practical psychology, examining how both disciplines can meaningfully improve lives. Much of her work takes a non-traditional empirical approach to traditional philosophical questions.

Jean Tirole is Honorary Chairman of the Foundation JJ Laffont-Toulouse School of Economics (TSE) and of the Institute for Advanced Study in Toulouse (IAST), and scientific director of TSE-Partnership. He is also affiliated with MIT, where he holds a visiting position, and the Institut de France. Professor Tirole's research covers industrial organization, regulation, finance, macroeconomics and banking, and psychology-based economics. Jean Tirole has published over 200 articles in international reviews, as well as twelve scientific books. Published in English in 2017, his latest book entitled *Economics for the Common Good* is accessible to a wide audience and available in a number of other languages. He is laureate of numerous international distinctions, including the 2007 CNRS gold medal and the 2014 Sveriges Riksbank prize in economic sciences in memory of Alfred Nobel.

James P. Walsh (PhD, Northwestern University) is Arthur F. Thurnau Professor and the Gerald and Esther Carey Professor of Business Administration at the University of Michigan's Ross School of Business. His research explores cross-level relationships—the influences between and among individuals, organizations, and society—with a clear eye on bettering our world. He studies corporate governance, exploring how organizations

enhance or undermine our well-being. In particular, he has studied purpose, responsibility, accountability, and control of the firm (and even more generally, business itself) in society. More recently, he has worked on the moral foundations of business. With questions of accountability front of mind, he is interested in understanding the nature of—and place for—apology, atonement, forgiveness, and reconciliation in business life. Contemplating

these issues with his students, he does his best to prepare them to lead in and for society. A recipient of the Academy of Management's Career Distinguished Service Award, he has served both as the Dean of its Fellows Group and as its sixty-fifth president. The Academy of Management comprises nearly 20,000 management scholars from well over one hundred countries.

Introduction

Subramanian Rangan

Ronald Coase opens his seminal 1937 article on transactions costs with the lament that “Economic theory has suffered in the past from a failure to state clearly its assumptions.” In that simple and significant article published in *Economica*, Coase goes on to contend that correcting this problem “is ... essential not only to prevent ... misunderstanding ... but also because of the extreme importance for economics of good judgment in choosing between rival sets of assumptions.”

While the neglect of transaction costs that Coase highlighted has since been redressed, his broad concern about assumptions in economic theory remains rather relevant. Indeed, in the intervening near-century, millions of people have been educated on and enact modern economic theory, which we know is normative and performative. In this sense, the concern may be more grave today. Even the staunchly market-leaning weekly *The Economist* (26 June 2021: 64) concedes: “Theory built on unrealistic assumptions has proved less illuminating than economists a century ago might have hoped ... Economists still working with equilibrium models out of habit should consider the ... potential of a new ... approach.”

To be clear, among systems that humans have pioneered (including cultural and political systems), none arguably has been as elegant and effective as the modern economic system. In the 250 years since Adam Smith and *The Wealth of Nations*, microeconomic theory has been formalized, deepened, and refined by a stream of brilliant successors. The resulting decentralized market-centric paradigm has, to varying extents, been adopted the world over. Its greatest application has been found in that field referred to as business. Schools of business, now ubiquitous, educate economic actors the world over and economic production and consumption have transformed the world. At an estimated 105 trillion dollars in 2023, world GDP has never been higher.¹ At more than \$13,000, world mean per capita income has in all history never been higher.

Yet, the world seems fraught with anxiety. Some call it a paradox of abundance. Mountains of regulations notwithstanding, and many stakeholder pledges later, trust in capitalism and business frays with every new scandal. Let alone start-ups like FTX and Theranos, stalwarts of business such as Boeing and McKinsey seem prone to errors of character and not just competence. Even for skeptics, it seems shocking to apprehend the extent to which money prevails (from airplanes to banking, from mining to pharmaceuticals, and from media to sports). Understandably, one may point to specific firms and specific individuals, but it would be imprudent and immature to not entertain and explore the proposition that the problem is systemic. Systemic not just in the sense that the problem is widespread in

¹ International Monetary Fund (IMF). See www.imf.org/external/datamapper/profile/WEOWORLD (accessed 27 June 2023).

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practice—which it is. Systemic rather in the sense that the problem pervades not just practice but also the *paradigm* of business.

It is this premise that motivated our efforts and undergirds this work entitled *Core Assumptions in Business Theory: A Wedge between Performance and Progress*. This volume is the third in a trilogy composed of contributions from an eminent set of social scientists and moral/political philosophers. We have been collaborating for nearly a decade under the aegis of the Society for Progress.² Our first volume, *Performance and Progress* (Oxford University Press), was published in 2015, and our second, *Capitalism Beyond Mutuality?* (Oxford University Press), was published in 2018.

In the first volume we explored and developed the premise that business theory and practice have focused overly on performance and neglected *progress*, which, for our purposes, we operationalize as greater fairness, well-being, and sustainability. Performance has been achieved often at the expense of progress. Thus, as profits and stock prices soared over the past decades, concerns relating to people (fairness and well-being) and planet (sustainability) have soared too. Because progress is a philosophical notion, we invited and engaged eminent moral/social/political philosophers in this business economics discussion. In our second volume, we explore remedies. There, we propose the concept of *integration*. Just as innovation has been a key driver of performance, we develop the idea of integration as a key driver of progress. The central question in that second volume was: how might business better integrate performance and progress, market and society, and the present and the future? Whereas in our first volume, contributions were single authored, in the second contributions were co-authored by pairs of social scientists and philosophers. Our aim was to integrate prudential and moral reasoning.

In this third volume, we explore core *assumptions* in business theory. The aim is to understand why business education and practice seem to neglect integration. As gigantic as the modern economy has become, it has also produced harmful if unintended consequences for the dimensions of people and planet. This is a puzzle because, as a familiar cliché maintains, “economic actors don’t wake up saying, today I’m going to harm people and planet.” The puzzle is deepened because it is even less likely that theorists were prone to such intentions as they elaborated the business economics paradigm. Yet, economic actors neglect (and even hurt) progress, and they seem to do so disconcertingly regularly. The hypothesis that we probe in this third volume is that the flaws and failings may lie in stated and unstated assumptions in business theory. Errant assumptions perhaps act as a “wedge” cleaving apart performance and progress.

Why Scrutinize Business Theory and Its Assumptions?

There are at least three related reasons—reality, regulations, and reform—as to why we need to earnestly examine business theory and its core assumptions.

First, although the superiority of the market-based decentralized economic system (relative to state-guided and other resource allocation arrangements) is not in debate, the empirical economy (i.e., the real world) is producing patterns that are at best mixed. The

² See www.societyforprogress.org.

modern economy has generated wealth but neglected well-being. It has mastered efficiency but not equity. It boasts size but not sustainability. Economic actors have, in other words, delivered performance but neglected progress.

There is little need to rehearse the litany of concerns from climate to consumption to concentration (especially the skewed capital-labor shares in the distribution of economic surplus). Fairness is now a three-alarm fire. Fairness, that is, to workers, to consumers (in terms of internalities and privacy, for example), to the future, to animals, and to nature more broadly. Likewise, while wealth is clearly rising, the news is not rosy when it comes to well-being. Concerns related to mental health are on the rise, and, in the US, life expectancy itself appears to be in decline. Families have become work-centric and have little time and energy for care (of children and elders, let alone self), a reality that may be reflected in the demographic decline and rise in loneliness in affluent societies. Some refer to this as a crisis of care. The empirical economy is, in other words, revealing serious shortcomings on the people and planet dimensions.

Does business economics theory assume these away? In theory, markets are meant to be self-correcting. In reality, as has long been acknowledged, markets self-correct unsatisfactorily. The central remedy proposed for the shortcomings of the invisible hand has been and continues to be regulation (i.e., the visible hand). Whether for concerns related to worker safety or wages, concentration or conservation, disclosure, and now AI, the appeal is to the state, which is presumed to possess sufficient power and omniscience to regulate optimally (see, for instance, [Acemoglu and Johnson, 2023](#)). Alas, for a variety of reasons (that I outline in the first chapter of this volume), regulatory and government failure seem as evident and widespread as market failures. No doubt, we need smart regulations. But, given lobbying and other limitations, we have to look beyond. It is time to scrutinize the workings of the economic system from the inside and resist reflexively pinning our hopes for satisfactory solutions on external entities or effects. As Eastern mystics might counsel, “the only way out is in.”

In particular, we propose here to focus more on education than regulation. The content of the education, however, has to correspond better to the actual workings of the economy and the evolving needs of society. Smart regulations are necessary but they are not sufficient. This then is a second reason why it is important to reevaluate (and righten) business theory and its core assumptions.

Indeed, business scholars and practitioners have been proposing helpful reforms. In the main, they perceive the problem as originating in practice. Consequently, the reforms put forth focus primarily on improving *practice*—beginning a couple of decades ago with CSR or corporate social responsibility, then “shared value,” and now stakeholder-centricity enshrined in targets on ESG or environment, social and governance dimensions. The much-heralded “CEO letter” addressed to business leaders by Larry Fink, a co-founder of BlackRock, the asset management giant, provides a fine illustration of this mindset and approach. There is merit in aligning incentives via impact-weighted accounting and “double materiality” reporting and valuation. Klaus Schwab, founder of the World Economic Forum, has long argued for a multi-stakeholder model of enterprise operation and development (see [Schwab, 2021](#)).

More recently, a subset of scholars is advocating a direct focus on the problems. They suggest that business education can improve its “relevance” by directly treating such topics as climate, diversity, and mental health. In response, we witness a mushrooming of research

and courses on sustainability, inclusion, and well-being. These too are meaningful developments. Still, a practice- or problem-centric approach risks addressing symptoms rather than root causes. Not to mention, ESG management and measurement have become a cottage industry prone to instrumentalization and skepticism (“greenwashing”). Accordingly, the present effort aims to complement the practice- and problem-centric approaches by reexamining the business *paradigm* and core assumptions therein.

Why Focus on Assumptions?

Accepting that business theory and education merit scrutiny, the question arises: where to look? Given the keen intellect of seminal theorists, *faiblesse* is unlikely to be in the logic *per se* of the models. Rather, as Coase (1937) perceptively contended, *faiblesse* may be obscured in the theory’s assumptions.

Assumptions are suppositions, caveats, or pre-conditions entered by declaration or default but without proof. They are made for tractability, boundary setting, and characterizing actors and context. We are less likely to be troubled by assumptions made primarily for tractability (e.g., two factors–two goods; constant returns to scale), although these limit the generalizability and the insights granted by the theory. Likewise, we may not be so troubled by purely boundary-setting assumptions (e.g., theory that examines inter-firm conduct and sets aside intra-firm conduct). Difficulties arise with the third category of assumptions; that is, those that purport to characterize actors and the context (for, e.g., full and perfect information). When theory is built on an over-simplified or flawed (i.e., incomplete or incorrect) characterization of actors or the context, then, in the real world, practice that adheres to or enacts that theory may well lead to unsatisfactory conduct and consequences.

The distinguished Ken Arrow, our friend and mentor, put it thus in our first volume, *Performance and Progress* (2015: 40): “The problems of the economy arise, for the most part, from its failure to satisfy the conditions of the ideal standard model.” Accordingly, lest we throw out the proverbial baby with the bath water, we must revisit and, where necessary, revise the core assumptions underlying important (ideal) models and theories in business economics. Given that business economics theory tends to be prescriptive and performative, this exploration merits more concrete and more collective effort than has been devoted to it hitherto.

Prior Work on Assumptions

Concerns and complaints about assumptions are not novel. From Ken Arrow to Paul Samuelson, from Ronald Coase to James Buchanan, and from Amartya Sen to Jean Tirole, a string of distinguished scholars (Nobel Laureates all) have underlined the importance of and their doubts about some core assumptions. In a famous paper written nearly half a century ago, Sen (1977: 322) cautioned: “The primary concern [in modern economic theory] is not with the relation of postulated models to the real economic world, but with the accuracy of answers to well-defined questions posed with preselected assumptions ... the realism of [which] is simply not a part of [the] inquiry.”

Yet, for a variety of reasons, few have paused to do much about these concerns. Milton Friedman famously retorted that it matters not whether assumptions are realistic so long as the model's predictions are realistic. This might be okay for models that are descriptive and explanatory, but it's not okay for theory that is normative/prescriptive. In his chapter in this book, Jean Tirole observes that among the human sciences, economics is perhaps the most normative field, akin in this sense to moral philosophy, which is even more so. Still others shrug off concerns about assumptions asserting that policymakers and economic actors know that the assumptions are shaky, and that they will, by implication, correct for this in their actual policies and actions. Alas, going by what we observe in reality, such confidence seems misplaced. In the few works, such as [Sen \(1977\)](#), [Ackerman and Nadal \(2004\)](#), and [Schlefer \(2012\)](#), that have taken up the tedious task of scrutinizing dubious assumptions, the critiques are eloquent but unaccompanied by practicable alternatives. An important exception is [Stiglitz, Sen, and Fitoussi \(2010\)](#), which I build on in [Chapter 1](#).

Our Approach and the Merits of This Volume

Against that background, I would like to review our approach and underline three merits—relating to structure, substance, and scholars—of the present volume.

The first merit, relating to structure, arises from the approach that we have taken. Sparse as the existing work on assumptions is, as just noted, it tends also to be abstract and general (see, for instance, [Ackerman and Nadal, 2004](#) or [Schlefer, 2012](#)). In contrast, we adopt a “first principles” approach that is structured around business theory and education. A business is essentially a bundle of activities. Some of these are regarded as primary and others as support activities. Schools of agriculture, mining, engineering, and the trades are where training for primary activities tends to be offered. Schools of business, on the other hand, focus primarily on support activities—such as strategy, marketing, operations management, and leadership. These latter, in fact, constitute the *fields* around which business theory and education are organized. Accordingly, it is along these fields that we structure our exploration of core assumptions in business theory. In each focal field (e.g., marketing), we asked one or more leading social scientists in that field to reflect on and articulate core assumptions in that field. Subsequently, we invited one or more philosophers to read and comment on those assumptions from a moral/social perspective. Employing such an approach, we canvass nearly ten fields of business theory (including the central ones such as economics, strategy, marketing, and leadership). This approach is novel, systematic, and coherent with both our intended audience for the volume—viz., business scholars and students—and with the aspiration of the project—to evolve business theory and education in a manner that enables and encourages the integration of performance and progress.

A second merit of this volume relates to substance. The approach, as explained above, is to highlight core assumptions in the fields that constitute business theory and probe whether and to what extent these might be acting as a wedge in cleaving apart performance and progress. We believe and hope this will spur business research and education in a helpful direction. That said, to be candid, we conceived of and worked on this project in an exploratory spirit. Perhaps with the exception of the first chapter, our efforts were not particularly infused with “remedial” or “solution” fervor. Nonetheless, the efforts at structured

reflection by social scientists and reaction by philosophers have yielded some rather useful insights for business theory and education. To illustrate, I will briefly cite three instances.

In the chapter on assumptions in operations research (OR), Ed Kaplan's central message is that the field of OR is oriented to real-world problems. OR assumes "problem-centricity." No matter "the problem," it may be addressed fruitfully by formal structuring and then the use of math, statistics, and engineering to identify optima. While appreciating the field's dispassionate rigor, Philip Kitcher, the philosopher reacting to the chapter, expresses the concern that OR's problem-centricity inclines it to advance performance but not necessarily progress. He invokes the example of an Amazon warehouse where OR-inspired workflow and productivity standards may—as alleged—trump human considerations. The philosopher proposes: why not evolve OR to adopt a "two-stage" rationality? In a first stage, OR solves on the techno-economic parameters of "the problem." Then, in a second stage, OR professionals could, in consultation with relevant others, adapt or prune the feasible set factoring in people and planet concerns. OR analysts do not have to abdicate moral agency. They can bring to bear competence *and* character in their analyses. In this manner, by relaxing the narrow if orthodox assumption of "problem-centricity," the field of OR could evolve to integrate performance and progress.

To take a second instance, in a chapter on core assumptions in marketing, Philip Kotler (a seminal contributor to that field) affirms that "marketing is essentially about managing *demand*." He goes on to confess: "This means that marketing also covers 'demarketing,' namely trying to reduce demand. We must influence people to conserve water and avoid overfishing and overtimbering." The broader point that comes through is that in addressing the shortcomings of modern economic theory and practice, the bulk of the attention has tended to be on the supply side (dealing with firms and investors—hence ESG). Kotler's chapter reminds us that it also behooves business theory and education to address the demand side. Inspired by this, Hilke Plassmann, a neuroscientist marketing professor at INSEAD (and a contributor to this volume), has doubled down on her research exploring the influence of emotions/status/addiction in (immoderate) consumption. She has co-developed and recently launched a course entitled "Thoughtful Consumption." The first run of the course was over-subscribed and well received.

As a final illustration of insight emerging from our exploration, I will cite one from [Chapter 1](#). In that chapter I explore an assumption embedded in the general equilibrium approach developed in the 1890s by Smith's successors Walras, Pareto, and Edgeworth. They frame production as the canonical problem of the economy and adopt "minimum means" as the standard of rationality in economic action. Lionel Robbins would call this "economizing." For those seminal theorists, the purpose of the economy was to generate output, and rational economic actors would do so efficiently. Minimum means rationality undergirds the notion of productivity. In the real world, beyond money and machines, the "means" in question are ultimately constituted of materials and labor—that is, natural and human capital. In practice, minimizing costs on these dimensions means shortchanging, if within legal bounds, environmental and human concerns. The Boeing 737 Max tragedy, the Vale mining and environmental disaster, and the wrenching and chronic gap between living and minimum wage are all reflections of this "minimum means" mentality, which has become core to business economics theory and education. I propose in my chapter that we broaden the assumption of rationality to integrate "minimum means" *and* "minimum harm." This, in turn, implies a change in the objective function of the firm (which change I develop and

present in my chapter). It was hardly evident at the inception of the project that probing fundamental assumptions might point to such “goal innovation.”

To recap, a second merit of this volume is that it surfaces several substantive insights. The insights are submitted in the spirit of an opening and an invitation for further debate and development. We believe and hope this will spur scholars in the diverse fields of business to reflect at a more fundamental level in both their research and teaching.

Beyond structure and substance, a third merit of this volume relates to the authority of the scholars who’ve contributed to it. We elicited contributions, of course, from the fellows of the Society for Progress. For a variety of reasons, the project attracted the interest and engagement of other renowned scholars as well. For instance, the chapter on assumptions in OR comes from Ed Kaplan, a distinguished scholar at Yale University, doyen in the field, and former president of INFORMS (the Institute for Operations Research and the Management Sciences). A chapter on assumptions in marketing comes from Philip Kotler, recognized as a father of the field. (Kotler trained as an economist at MIT under Paul Samuelson and Robert Solow.) Jean Tirole contributed an extremely thoughtful chapter on assumptions in economics. Among fellows of the Society, the late Jim March of Stanford contributed a thought-provoking chapter on assumptions in decision theory.³

Matching the eminence of the social science contributors to this volume are the philosophers who read and reacted to the chapters. They include such distinguished thinkers as Elizabeth Anderson, Anthony Appiah, Joshua Cohen, Philip Kitcher, Susan Neiman, Philip Pettit, Mathias Risse, David Schmidtz, and Valerie Tiberius.

Prudential reasoning in business depends largely on prices, technology, and marginal and inter-temporal effects. To this logic based on self-regarding “consequences,” it is useful to integrate moral reasoning oriented to other-regarding “appropriateness.” Moral philosophical thought is indispensable because we will need to reason about ends and not only means; and because we will need to discuss multiple values, not all of which can be compared or exchanged. Further, the typical units of analyses in business research and education tend to be firms, workers, functions, consumers, products, and markets. If we are to evolve toward a better paradigm, then we must integrate units of analysis more typical in moral and social philosophy; viz., humans, roles, society, and nature, including other living creatures. Ideas such as care, respectful relationships, dignity, voice, fairness, well-being, sustainability, and regeneration all attach to these latter units of analyses.

All this is to say that the intellectual authority of the contributors to this volume is a non-negligible merit of the current volume. The resulting collection is unique in its focus on a neglected issue of fundamental importance, in the influence and stature of its contributors, and in its orientation toward interdisciplinary engagement. To my knowledge, there is today no scholarly work that attempts to integrate rigor and relevance in such a manner.

The Style and Spirit of the Chapters

The chapters in this volume are organized around the core fields of business theory and education. I encouraged the contributors to articulate their reflections and reactions in a

³ March, to whom we dedicate this volume, prophetically entitled the concluding section of his chapter “Last Words.” To my knowledge, this is March’s last scholarly writing before his passing.

manner attuned to the aspiration of the project. What I received reflects both broader and narrower interpretations. In some fields (especially economics), we received more than one essay on the topic, and in others (such as strategy and marketing) just one or two. The extra attention for economics reflects its centrality in business theory and education, as well as the training/home discipline of the contributors. All of the chapters were drafted specifically for this volume, and some of the work reflects a novel direction in the authors' thinking.

Related Publications

There are no doubt related publications that discuss business economics theory in a constructively critical spirit. These include volumes by [Ackerman and Nadal \(2004\)](#), [Schlefer \(2012\)](#), and, most recently, the thoughtful and wide-ranging essays guest edited by Levi and Farrell and published in the 2023 winter issue of *Dædalus* (the journal of the American Academy of Arts and Sciences). There are several kindred articles too, including the much-cited ones by [Sen \(1977\)](#), [Ghoshal \(2005\)](#), and [Bowles and Carlin \(2020\)](#).

As alluded to earlier, the [Ackerman and Nadal \(2004\)](#) volume is richly abstract and oriented primarily to an economist audience interested in general equilibrium models. The [Schlefer \(2012\)](#) book is oriented to a general audience and hence more accessible. Its richness lies in its treatment of seminal figures in the development of core ideas in economics. The [Levi and Farrell \(2023\)](#) volume pulls together reflections from an eclectic set of contributors (including Joshua Cohen, who's written here as well). That set of essays, akin to the present effort, anticipates a moral evolution of the economic paradigm. Its editors affirm too that "the creation of a new moral political economy requires theorists to set aside assumptions that are no longer valid." They propose an "expanded community of fate" enacted on the premise of "reciprocity and cooperation." (In our 2018 volume, *Capitalism Beyond Mutuality?*, we submit that it is time to widen the fulcrum of morality beyond cooperation to include caring. It is challenging to think about "reciprocity" in the context of distant future generations, or "cooperation" with fauna headed to a kitchen cutting board.) As for the articles cited above, they are deeply insightful and I refer to and build on them in [Chapter 1](#).

Pertinent as these works are, with the exception of [Ghoshal \(2005\)](#), they mostly offer a macro-political, sociological, and historical perspective. Business firms tend to be in the background. Assumptions are mentioned but are not the focus. Where they are the focus, the exploration concentrates on a singular assumption (as in [Sen, 1977](#)), or it is thin and broad (as in [Schlefer, 2012](#)). In contrast, our orientation to business theory and education is sharp and deep, in a manner that honors and advances the ardor on this topic of the late management scholar Ghoshal. In our work, business firms and other economic actors are front and center. For all these reasons, I see our proposed volume as a complement to this related work also concerned about the evolution of our economic system.

Intended Readership

At business schools worldwide there is a burning and growing need for rigorous treatment of concerns regarding the paradigm and practice of capitalism. While practice understandably

receives considerable attention, the paradigm could benefit from more discussion that is relevant, rigorous, and reflection-provoking.

The current volume aims to address this and benefit three audiences: business scholars, business students, and business practitioners. There is now an established interest among scholars in business schools to study, develop, and deepen the corpus of intellectual work on the issue. Yet, as argued above, there seems to be too little theoretical and philosophical grounding in this research and the published work tends to be applied and empirical. The chapters in this volume provide useful and meaningful grounding for future research. The fact that the chapters here are authored by mainstream disciplinary scholars is likely to trigger future contributions from other mainstream scholars. The volume will, we hope, elevate both the quantity and quality of research. Our target scholars work in such areas as strategy, economics, marketing, technology, operations, and decision science, as well as management, leadership, and organization theory.

Business school students too would benefit both at the graduate and undergraduate level. It is not often that they have a chance to learn from seminal thinkers about the tenuous assumptions of modern microeconomics and markets, to hear from modern philosophers about the basis and limits of prudential rationality, and to reflect on moral reasoning in addressing the chronic dilemmas of interdependence and trust. This hampers curiosity and receptivity and leads to pre-judgment or resignation. For students, it is still unclear whether challenges related to human and natural capital are even the proper realm of business and markets. If need be, they admit, some regulation and involvement of non-governmental organizations might be useful. The chapters in this volume are likely to make students more receptive to the necessary evolution of the paradigm of business, and, importantly, to their future roles as entrepreneurs, executives, and economic actors more broadly in integrating performance and progress. Our hope is that MBA will come to stand for “Master of Better Alternatives.”

Given the standing of the authors, I anticipate that chapters of the book will be used in PhD programs. The chapters deepen and enable the framing of future academic research in business economics and management. I can foresee parts of the book becoming recommended reading for students in philosophy. While contemporary moral and social philosophy contains extensive reflection on questions of social justice in the abstract, there is little work that addresses such systemic concerns in the specific context of the modern business paradigm and practice.

Last but not least, chapters of the book would also make suitable reading in executive education programs. In particular, the chapters written by business leaders combined with a couple of appropriate chapters from the scholars would make a good reading packet.

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PART I
ECONOMICS

From Market-Pareto to Moral-Pareto

Seven Problematic Assumptions in Business Economics Theory

Subramanian Rangan

Not being able to make simple what is true, one has decided to hold for true what is simple.

Bertrand Collomb, Chapter 31 of this volume

Two and a half centuries ago, Adam Smith (1776) registered his famous observation that humans have an innate propensity to truck, barter, and exchange. Noting self-interest as a reliable motive force in economic action, Smith posited that a liberal market system enabling its pursuit—via specialization, exchange, and competition—was, paradoxically, the superior path to productivity and prosperity.¹ Since then, the *efficiency* of the “invisible hand” has been formally theorized and empirically corroborated, and today market-based economic systems have been widely adopted. Indeed, one may be tempted to regard modern business theory and practice as settled and humdrum.

In reality, while efficiency may be settled, sufficiency remains another matter. As three real-life cases that I outline below show, modern business practice can be stranger and alas more troubling than fiction. In fact, beyond particular illustrations, too much seems awry in modern business to castigate merely the actors in the specific cases concerned. *Business theory and education merit scrutiny too*. Given the keen intellect of seminal theorists, *faiblesse* is unlikely to be in the logic per se of market models. Rather, it might be obscured in the assumptions implicit and explicit therein. Lest we throw out the proverbial baby with the bath water, it behooves us to probe core assumptions on which modern business theory and practice are founded. Business economic theory tends to be prescriptive and performative, and such exploration merits more concrete and more collective effort than has been hitherto devoted to it. That is the aim and spirit of this project.

1.1 Three Real-Life “Tales from the Crypt”

To motivate our inquiry, let us consider three real-life vignettes from the world of practice, starting with the 1MDB (First Malaysia Development Berhad) finance scandal. A twist

¹ For helpful discussions on this chapter, I am thankful to Philippe Aghion, Chris Avery, Michael Brimm, Antonio Fatas, Ebba Hansmeyer, Ilze Kivleniece, Donald MacKenzie, John Meyer, Felipe Monteiro, Laura Payet, Urs Peyer, Alexandra Roulet, Metin Sengul, Tim Van Zandt, and Peter Zemsky.

in this tale even involves the Hollywood celebrity Leonardo DiCaprio, who in 2016 surrendered to US authorities paintings by Picasso and Basquiat (estimated at some \$12 million) that he'd received as gifts from one Jho Low, the alleged architect of this scam.² Low, a globally networked and now fugitive businessperson, is believed to have hatched in 2009 the idea of a sovereign wealth fund for Malaysia and persuaded that country's leaders to follow through. With the declared aim of accelerating development through major public investments, the then prime minister authorized the raising (by borrowing) of monies to create a multibillion-dollar sovereign fund. Goldman Sachs, the prominent investment bank, secured the mandate to raise the funds through sale of bonds. For its expertise and efforts in raising some \$6 billion, the bank reaped \$600 million in fees, which, reportedly, was ten or more times the rate typical for such work. Tim Leissner, a chairman then for Goldman Sachs in Asia, scored the suspiciously generous deal. Alas, soon after the billions were raised, much of it vanished. Meanwhile, the prime minister, Low, Leissner, and others came into obscene amounts of wealth. One tabloid portrayed Leissner as a colorful character who had drifted to the dark side.³ Smitten with a model and wife-to-be, Leissner apparently wished no longer to just make deals for the players; he determined to become a "player" himself. In 2018, Leissner pleaded guilty in the US to bribery, money laundering, and related charges. As of May 2024, his sentencing remained to be announced. The former prime minister was convicted too, and, having exhausted his appeals, commenced a long jail sentence. Goldman Sachs admitted failings of internal controls and has been set back a staggering \$6 billion in global penalties, fee claw-backs, and settlements.⁴ Drawing on court hearings, *The New York Times* reported that Leissner and associates were "willing to pay bribes because they knew getting the bond deal was a big win for Goldman and they would look like 'heroes' inside the bank."⁵ *The Wall Street Journal* reported that, indeed, the "1MDB bond deal ... won one of Goldman's most prestigious internal awards, praised for its 'spirit of creativity and entrepreneurial thinking.'"⁶ Mastermind Jho Low remains at large but has secured a place at the top; at the top, that is, of the FBI's most-wanted list, for "one of the largest economic crimes in the history of the world."⁷ Greed, gold, and glory can make a toxic cocktail.

Consider next the scrambled launch of the Boeing 737 Max. Like the failure of the tiny O-rings that doomed the Space Shuttle Challenger in 1986, damage to a small part—the angle-of-attack sensors fastened to the side of the fuselage near the cockpit—compounded by a kludgy but potent piece of software triggered the calamitous crashes of two 737 Max

² See Eileen Kinsella, 16 June 2017, "Leonardo DiCaprio Surrenders \$3.2 Million Picasso and \$9 Million Basquiat to US Government." *Artnet News*. <https://news.artnet.com/art-world/leonardo-dicaprio-gives-pack-jho-low-picasso-basquiat-996377> (accessed 2 August 2022).

³ See Michael Kaplan, 19 February 2022, "Tim Leissner Wanted 'Rich Guy' Image to Be with Kimora Lee Simmons." *New York Post*. <https://nypost.com/2022/02/19/tim-leissner-needed-to-be-rich-to-be-with-kimora-lee-simmons> (accessed 3 August 2022).

⁴ See Rose Goodman, 9 November 2020, "Goldman Sachs to Pay Approximately \$6 Billion in Settlements Over 1MDB Scandal." *Berkely Law*. <https://sites.law.berkeley.edu/thenetwork/2020/11/10/goldman-sachs-to-pay-approximately-6-billion-in-settlements-over-1mdb-scandal> (accessed 6 August 2022).

⁵ See Matthew Goldstein, 8 April 2022, "Ex-Goldman Sachs Banker Convicted for His Role in a \$4 Billion Fraud." *The New York Times*. www.nytimes.com/2022/04/08/business/1mdb-goldman-sachs-roger-ng.html (accessed 4 August 2022).

⁶ See Dave Michaels, Liz Hoffman, and Bradley Hope, 20 October 2020, "Goldman Sachs to Pay \$2.8 Billion, Admit Wrongdoing to Settle 1MDB Charges." *The Wall Street Journal*. www.wsj.com/articles/goldman-sachs-to-pay-2-8-billion-admit-wrongdoing-to-settle-1mdb-charges-11603202983 (accessed 26 August 2022).

⁷ See Scott Cohn, 28 January 2022, "Take the Money and Run: These Fugitives Accused of White-Collar Crimes Are Among the World's Most Wanted." *CNBC*. www.cnn.com/2022/01/28/these-white-collar-fugitives-are-among-the-worlds-most-wanted.html (accessed 2 August 2022).

planes in October 2018 and March 2019, shattering the lives of 346 passengers and crew. One aviation magazine reported: “Not since the launch of the world’s first commercial jet airliner, way back in 1952, has the introduction of a plane been so tarnished by tragedy ... In fact, to find a fatal accident rate worse than that of the 737 MAX, you’ll need to look exclusively at models no longer in production.”⁸ To be sure, pilot error is often cited as a common cause of crashes and the 737 Max disasters too have attracted this hypothesis.⁹ By most accounts, though, the case here goes beyond any pilot error and engineering oversight.

In a January 2021 press release, the US Department of Justice charged Boeing with fraud conspiracy. “The tragic crashes of Lion Air Flight 601 and Ethiopian Airlines Flight 302 exposed fraudulent and deceptive conduct by employees of one of the world’s leading commercial airplane manufacturers ... Boeing’s employees chose the path of profit over candor by concealing material information from the FAA [Federal Aviation Administration] concerning the operation of its 737 Max airplane and engaging in an effort to cover up their deception.”¹⁰ The charge stated that Boeing test pilots “deceived the FAA ... about an important aircraft [software] part called the Maneuvering Characteristics Augmentation System (MCAS) that impacted the flight control system ... Because of this deceit ... airplane manuals and pilot training materials ... lacked information about MCAS.”

The trigger for the hasty development of the ill-fated 737 Max was a CEO-to-CEO phone call in the spring of 2011. That’s when, reported *The New York Times*, “Boeing faced an unthinkable defection ... American Airlines, an exclusive Boeing customer for more than a decade, was ready to place an order for hundreds of new, fuel-efficient jets from [archival] ... Airbus.”¹¹ W. James McNerney Jr., then CEO of Boeing, was the one taking the phone call from his counterpart at American Airlines, a top-three Boeing customer. The *Times* went on to report, “To win over American, Boeing ditched the idea of developing a new passenger plane, which would take a decade. Instead, it decided to update its workhorse 737, promising the plane would be done in six years. The 737 Max was born roughly three months later.” Project engineers were instructed that speed was of the essence. The plane had to be more fuel efficient (to counter the Airbus 320 NEO), but it had to be designed, produced, tested, and *certified* in record time. While bigger engines would address fuel efficiency, their exact positioning on the wings had to be adjusted to accommodate the physics and aerodynamics. During early tests the plane “wasn’t flying smoothly, partly because of the ... bigger engines.” That’s when the software fix came into the picture. While it addressed initial problems, the software was rejigged late in the game to address another residual hitch; viz., “stalls at low speeds.” Another report in *The New York Times* explained, “A year before the plane was finished, Boeing made the [software] system more aggressive and riskier. While the original version relied on data from at least two types of sensors, the final version used just one, leaving the system without a critical safeguard. In both doomed flights, pilots struggled as a

⁸ Oliver Smith, 11 July 2019, “Revealed: The World’s Safest, and Least Safe, Planes.” *Traveller*. www.traveller.com.au/revealed-the-worlds-safest-and-least-safe-planes-h1g4ka (accessed 27 August 2022).

⁹ See the seemingly clairvoyant reporting by William Langewiesche, 18 September 2019, “What Really Brought Down the Boeing 737 Max?” *The New York Times*. www.nytimes.com/2019/09/18/magazine/boeing-737-max-crashes.html? (accessed 26 August 2022).

¹⁰ United States Department of Justice, 7 January 2021, “Boeing Charged with 737 Max Fraud Conspiracy and Agrees to Pay over \$2.5 Billion.” www.justice.gov/opa/pr/boeing-charged-737-max-fraud-conspiracy-and-agrees-pay-over-25-billion (accessed 26 August 2022).

¹¹ David Gelles, Natalie Kitroeff, Jack Nicas, and Rebecca R. Ruiz, 23 March 2019, “Boeing Was ‘Go, Go, Go’ to Beat Airbus with the 737 Max.” *The New York Times*. www.nytimes.com/2019/03/23/business/boeing-737-max-crash.html (accessed 26 August 2022).

single damaged sensor sent the planes into irrecoverable nose-dives within minutes, killing 346 people.”¹² The kludgy software relied on a single angle-of-attack sensor. It was a design choice that exposed the aircraft to an avoidable and invariably avoided single-point failure. In defense aircraft, Boeing used multiple sensors (the military wouldn’t tolerate single-point failure risks). If, however, two sensors were used on the Max and if their indications conflicted, then the software would have to issue an alarm and obtain inputs from other sensors. Importantly, pilots would have to be alerted and trained to interpret and respond to the eventuality. All this would make the software and cockpit instrumentation more cumbersome and, crucially, necessitate greater scrutiny by the Federal Aviation Administration (FAA) and imply some pilot training. The gameplan, however, was to get the plane (a) certified rapidly (by declaring minimal changes) and (b) adopted rapidly by airlines (by offering the sought-after fuel efficiency but without the costly pilot retraining). Cheaper, better, faster—that was the management mantra of the era. Indeed, Boeing was an early adopter of “agile,” a successor to “lean” principles. Whereas lean drove down costs, agile drove up speed. The point was to “deliver value quickly.”

Boeing had long been renowned as an engineering and pilot-centric company. A platitude among pilots was “If it ain’t Boeing, I ain’t going.” Then, in the late 1990s alumni of GE took the helm at Boeing. They shifted the firm’s culture and priorities in a markedly financial and commercial direction. McNerney’s predecessor put it thus: “[Boeing] is a great engineering firm, but people invest in a company because they want to make money.”¹³ Shareholder value and its precepts were brought to the fore. In 2015, a reputed aviation industry expert wrote in *Forbes* an article presciently entitled, “Boeing Will Pay High Price for McNerney’s Mistake of Treating Aviation Like It Was Any Other Industry.”¹⁴ In a rebuke of the firm’s culture and governance, a January 2020 article in *Fortune* magazine lamented: “For all of Boeing’s business coups and innovation, one stark statistic has come to symbolize the company’s priorities: Over the past six years, Boeing spent \$43.4 billion on stock buybacks, compared with \$15.7 billion on research and development for commercial airplanes. The board even approved an additional \$20 billion buyback in December 2018, less than two months after the first 737 Max crash, though it subsequently shelved that plan.”¹⁵ In November 2021, drawing on “hundreds of hours of interviews,” a journalist writing for *Bloomberg Businessweek* summarized employee sentiments thus: “Among themselves, they complained about how a company that had once been ruled by engineers who thumbed their noses at Wall Street now celebrated managers for cost-cutting, co-opted regulators, and pressured suppliers with relentless, Walmart-style tactics to cut their prices. The Max, first delivered in 2017, fit right into this mindset.”¹⁶

¹² Jack Nicas, Natalie Kitroeff, David Gelles, and James Glanz, 1 June 2019, “Boeing Built Deadly Assumptions into 737 Max, Blind to a Late Design Change” *The New York Times*. www.nytimes.com/2019/06/01/business/boeing-737-max-crash.html (accessed 27 August 2022).

¹³ Patricia Callahan, 29 February 2004, “So Why Does Harry Stonecipher Think He Can Turn around Boeing?” *Chicago Tribune*. www.chicagotribune.com/chi-0402290256feb29-story.html (accessed 28 August 2022).

¹⁴ Richard Aboulafia, 24 June 2015, “Boeing Will Pay High Price for McNerney’s Mistake of Treating Aviation Like It Was Any Other Industry.” *Forbes*. www.forbes.com/sites/richardaboulafia/2015/06/24/boeing-mcnerney-and-the-high-price-of-treating-aircraft-like-it-was-any-other-industry/?sh=4fc76316579c (accessed 27 August 2022).

¹⁵ See Dan Catchpole, 20 January 2020, “The Forces behind Boeing’s Long Descent.” *Fortune*. <https://fortune.com/longform/boeing-737-max-crisis-shareholder-first-culture> (accessed 26 August 2022).

¹⁶ Peter Robison, 16 November 2021, “Boeing Built an Unsafe Plane, and Blamed the Pilots When It Crashed.” *Bloomberg Businessweek*. www.bloomberg.com/news/features/2021-11-16/are-boeing-planes-unsafe-pilots-blamed-for-corporate-errors-in-max-737-crash?sref=5JzLFdzD (accessed 27 August 2022).

Our third and final vignette pertains to the US opioid crisis, whose catastrophic consequence was conveyed in the opening sentence of an article in *Nature*: “In 2015, something happened in the United States that hadn’t occurred there in the past 100 years: life expectancy entered a period of sustained decline ... This time, the culprit has been a surge of drug overdoses and suicides, both linked to the use of opioid drugs.”¹⁷ A more recent review underlined, “Since 2000, more than a million people in the United States have died of drug overdoses, the majority of which were due to opioids.”¹⁸ Noting that the brunt of the epidemic has befallen white Americans without college degrees, the economists Anne Case and Angus Deaton in their acclaimed book *Deaths of Despair and the Future of Capitalism* “tie the crisis to the weakening position of labor, the growing power of corporations, and, above all, to a rapacious health-care sector that redistributes working-class wages into the pockets of the wealthy” (Case and Deaton, 2020: 191). That is, the full picture reveals more than a public health tragedy; it also reveals economic hopelessness that accompanies deindustrialization, outsourcing, and automation (i.e., business decisions related to trade, technology, and skill bias).

Acute and chronic pain are related to a whole host of proximate causes including injury, surgery, childbirth, cancer, repetitive physical labor, active military duty, obesity, and aging. In modern times, sedentary lifestyles and economic and social stress also contribute to the condition. What changed, during the 1990s, was attention to and management of pain by actors in the medical sector. The opioid crisis “arose through a confluence of well-intentioned efforts to improve pain management by doctors and aggressive—even fraudulent—marketing by pharmaceutical manufacturers.”¹⁹ The problem emerged in the mid-1990s “when pharmaceutical companies introduced new opioid-based products—and, in particular, OxyContin, a sustained-release formulation” manufactured and marketed by the now infamous Purdue Pharma. Intriguingly, the prevalence of pain was reckoned to be similar in France and Italy as it was in the United States. “But according to data from the United Nations, US doctors [were writing] five and half times more prescriptions for opioids than ... counterparts in France, and eight times more than ... in Italy.”²⁰

This is where the story is joined by professionals in the healthcare practice at the influential consulting firm McKinsey. A stark June 2022 report in *The New York Times* was entitled, “Behind the Scenes, McKinsey Guided Companies at the Center of the Opioid Crisis.” The article’s tagline read, “The consulting firm offered clients ‘in-depth experience in narcotics,’ from poppy fields to pills more powerful than Purdue’s OxyContin.”²¹ Partners at the firm engaged with the entire ecosystem, from poppy to opium raw material producers such as Tasmanian Alkaloids (a subsidiary of Johnson & Johnson) to branded opioid manufacturers such as Endo (which made Opana) and Purdue (which made OxyContin), to generic producers such as Mallinckrodt, to distributors such as CVS and Anthem, all the way to drug

¹⁷ Sarah DeWeerd, 11 September 2019, “Tracing the US Opioid Crisis to Its Roots.” *Nature*. www.nature.com/articles/d41586-019-02686-2 (accessed 6 September 2022).

¹⁸ Claire Klobucista, 12 May 2022, “The U.S. Opioid Epidemic.” Council on Foreign Relations. www.cfr.org/background/us-opioid-epidemic (accessed 6 September 2022).

¹⁹ Klobucista, “The U.S. Opioid Epidemic.”

²⁰ Klobucista, “The U.S. Opioid Epidemic.”

²¹ Chris Hamby and Michael Forsythe, 29 June 2022, “Behind the Scenes, McKinsey Guided Companies at the Center of the Opioid Crisis.” *The New York Times*. www.nytimes.com/2022/06/29/business/mckinsey-opioid-crisis-opana.html?referringSource=articleShare (accessed 6 September 2022). The article states that its analysis draws on “a repository of more than 100,000 documents” and “more than 15 years of emails, slide presentations, spreadsheets, proposals and other documents.”

regulators such as the Food and Drug Administration (FDA). Ostensible conflicts of interest so raised the ire of Congress that a US House of Representatives' Committee on Oversight and Reform conducted a special investigation into the firm's conduct. In its interim report released in April 2022, the Committee stated: "Over the past 15 years, McKinsey has reaped hundreds of millions of dollars in fees from consulting for the federal government and opioid manufactures, sometime simultaneously ... From 2004 to 2019, McKinsey played a pivotal role in increasing Purdue's sales of OxyContin, the prescription pain killer that netted Purdue sales of more than \$35 billion and was a major driver of the opioid epidemic ... McKinsey proposed strategies to 'Turbocharge Purdue Sales Engine' for OxyContin and recommended that Purdue offer rebates to insurers and [pharmacies] ... for opioid overdoses attributable to OxyContin."²²

The chair of that US House Committee was quoted thus in *The New York Times*: "Today's report shows that at the same time the F.D.A. was relying on McKinsey's advice to ensure drug safety and protect American lives, the firm was also being paid by the very companies fueling the deadly opioid epidemic to help them avoid tougher regulations of these dangerous drugs."²³ That article featured a partner, Jeff Smith (a PhD in biophysics), as having "worked on more than 40 projects for the FDA between 2007 and 2019, while also serving Purdue on at least a half-dozen initiatives." In one instance in 2011, the article noted, Smith was helping the FDA office overseeing drug companies safety plans on medicines such as opioids, "while also advising Purdue on an effort that would ... demonstrate whether OxyContin was meeting those requirements." Jeff Smith also featured prominently in the interim report of the US House Committee on Oversight and Reform. McKinsey refuted the charges of conflict of interest, stating that its work was focused on "performance management, not drug regulation."²⁴

The interim Congressional report also spotlighted McKinsey partner Dr. Arnab Ghatak (an Ivy League-trained medical doctor) for his leading role in the firm's engagement with Purdue. Reportedly, in 2013 in a pivotal meeting that Dr. Ghatak and colleagues held with the owners of Purdue Pharma (the Sackler family), the consultants recommended aggressively marketing OxyContin.²⁵ Despite reservations expressed by Purdue's own executives, the family owners endorsed the plan. The House interim report directly connects the "turbocharge" opioid sales strategy adopted by Purdue to Dr. Ghatak's guidance to this client. The consultants even devised an anticipatory "rebate" plan in which Purdue would compensate dispensers like CVS for eventual claims related to overdose casualties.

In 2022, the Massachusetts attorney general (who in 2023 became the state's governor) testified: "We learned that McKinsey consultants worked directly with the Sackler billionaires

²² Committee on Oversight and Reform, US House of Representatives, 13 April 2022, "The Firm and the FDA: McKinsey & Company's Conflicts of Interest at the Heart of the Opioid Epidemic." <https://oversight.house.gov/sites/democrats.oversight.house.gov/files/2022-04-13.McKinsey%20Opioid%20Conflicts%20Majority%20Staff%20Report%20FINAL.pdf> (accessed 10 September 2022).

²³ Chris Hamby, Walt Bogdanich, Michael Forsythe, and Jennifer Valentino-DeVries, 13 April 2022, "McKinsey Opened a Door in Its Firewall between Pharma Clients and Regulators." *The New York Times*. www.nytimes.com/2022/04/13/business/mckinsey-purdue-fda-records.html (accessed 10 September 2022).

²⁴ Chris McGeal, 27 April 2022, "McKinsey Denies Illegally Hiding Work for Opioid-Maker Purdue Pharma While Advising FDA." *The Guardian*. www.theguardian.com/us-news/2022/apr/27/mckinsey-denies-illegally-hiding-work-purdue-pharma-fda-opioids (accessed 6 September 2022).

²⁵ *Global Indian Times*, 28 November 2020, "Arnab Ghatak of McKinsey Named in U.S. Opioid Case." www.globalindiantimes.com/globalindiantimes/arnab-ghatak-while-at-mckinsey-allegedly-advised-purdue-pharma-on-boosting-opioid-drug-sales (accessed 6 September 2022).

who controlled Purdue. We found that McKinsey told the Sacklers to target the most dangerous prescribers who put the patients on opioids at the ... highest levels and at the highest doses for the longest periods of time. We found that McKinsey did not want the world to know what it was doing. But when I sued the Sacklers, McKinsey consultants ... planned to delete their documents and ... were going to destroy the evidence.”²⁶ This investigation eventually led McKinsey to an agreement with forty-nine US states to pay nearly \$600 million “to address the impact of the opioid” crises.²⁷ The firm dismissed partners including Dr. Ghatak. Likewise, Jeff Smith no longer appears in the firm’s roster of partners.

Appraising the appalling saga, an ex-McKinsey consultant-turned-commentator for *The New York Times* quipped: “This is the banality of evil, M.B.A. edition.”²⁸

1.2 Business Education and Business Conduct

Without succumbing to sensationalism or cliché, the MBA and business school insinuation is not uninteresting in the context of our three vignettes. Leissner of the 1MDB scandal had an MBA. That scam’s alleged mastermind, Jho Low, attended the Wharton Business School (at the University of Pennsylvania).²⁹ Likewise, Jim McNerney, the Boeing CEO who triggered the hasty development of the 737 Max, was MBA educated (at the Harvard Business School). The McKinsey partners implicated in the opioid scandal—Jeff Smith and Arnab Ghatak—held MBAs too (both from Wharton).

Now, it would be silly to assert based on a handful of selected cases a blighted connection between business education and business misconduct. Beyond the anecdotes, though, lie broader developments that are harder to brush off. Consider: (i) trust has declined in modern business—from mining to food, from chemicals to cars, from banking to tech—and rising regulation notwithstanding, there is much that is unsatisfactory and even broken in our so-called “age of abundance”;³⁰ meanwhile, (ii) over the past decades much more of modern business is led by MBAs and guided by consultants with MBAs.³¹ Last but not least, (iii) anxiety and anger due to profit-greedy “techno-global” business conduct have in significant parts of the world spilt over into politics, and illiberal nationalism no longer seems fringe or unfashionable. These developments, to which the anecdotes give concreteness and color, oblige us to consider anew this question: *to what extent might conventional business theory and education be contributing to the concerning conduct of business executives, entrepreneurs, consultants, and other economic actors?*

²⁶ McGeal, “McKinsey Denies Illegally Hiding Work.”

²⁷ McKinsey & Co., 4 February 2021, “McKinsey Reaches Agreements with 49 State Attorneys General to Resolve Investigations into Past Work for Opioid Manufacturers.” www.mckinseyopioidfacts.com/settlement-press-release (accessed 10 September 2022).

²⁸ Anand Giridharadas, quoted in Walt Bogdanich and Michael Forsythe, 27 November 2020, “McKinsey Proposed Paying Pharmacy Companies Rebates for OxyContin Overdoses.” *The New York Times*. www.nytimes.com/2020/11/27/business/mckinsey-purdue-oxycontin-opioids.html (accessed 6 September 2022).

²⁹ See https://en.wikipedia.org/wiki/Jho_Low (accessed 3 October 2022).

³⁰ See Vibhas Ratanjee and Jennifer Robison, 2022, “Trust Is in Decline: Here’s How to Rebuild It.” Gallup. www.gallup.com/workplace/393401/trust-decline-rebuild.aspx (accessed 12 October 2022).

³¹ Revenues and staff at the three major consulting firms expanded immensely over the past years (increasing some ten-fold between 1990 and 2020—see “Bulletproof Suits,” 8 October 2022, *The Economist*). Further, in the United States the proportion of public firms led by CEOs with MBAs doubled between 1980 and 2020 from 20 to nearly 40 percent (see Acemoglu and colleagues, 2022). See [Jaspan and Guselli \(2024\)](#) on the influence of consulting in the public sector.

The preceding question gains strength in light of analysis reported in a recent and large empirical study by [Acemoglu, He, and le Maire \(2022\)](#). This event study, which impugns business schools and business education, looks at CEO succession in nearly 10,000 publicly listed firms in USA and Denmark over the 1980–2020 forty-year period. It asks whether it matters that the incoming new CEO is business school-educated (or not). Based on elaborate empirical analysis (relying on instrumental variables, difference in difference specifications, and other checks for causality), the authors report that when a CEO with a business degree takes over from one without a business degree, firm performance and valuation (five years on) rise disproportionately. They find, however, that the gains come largely at the expense of workers whose wages are cut (even as CEO compensation rises). Crucially, business school-educated managers “are not more productive than their non-business [school-educated] peers” (p. 1). Nor do they increase innovation and investment when they take the helm. The improved performance comes from “a significant decline in wages and the labor share of the firm.”

Acemoglu et al. interpret their findings “as capturing the impact of management practices and values imparted by business schools and business degrees.” In particular, they point to well-worn business theories of “shareholder value maximization” and “lean,” and they postulate that business school-educated managers are taught to view “workers not as stakeholders in the corporation but rather as sources of costs to be reduced” (p. 4). They conclude by stating: “Wage growth has slowed down and the labor share in national income has declined in many advanced economies over the last three decades ... [A] contributing factor has been changes in wage policies of firms associated with business education of their managers/CEOs” (p. 28). The authors caveat, “this is no more than an interpretation, since we do not have any direct evidence on the micro channels through which business education changes managers’ overall approach.” They suggest, “It would be very interesting to [examine] ... the curriculum ... of business schools to shed more light on this question” (p. 29).

Our work commenced much before Acemoglu and colleagues’ incendiary empirical study was released. All the same, it responds well to their exhortation to critically explore the content of business theory and education. To be sure, from Marx to modern times, writers have critiqued market-centric economic theory and practice (see, for instance, [Polanyi, 1944](#); [Boulding, 1969](#); [Sen, 1977](#)). In his presidential address to the American Economic Association in 1969, Boulding put it thus: “We have assumed all too easily in economics that because something paid off it was therefore automatically legitimate.” As our vignettes vividly illustrate, not everything that “pays off” is legitimate, and society wants business to take heed and course-correct. In this century, [Ackermann and Nadal \(2004\)](#) penned an exasperated critique of general equilibrium analysis (on which rest claims and belief in the superiority of market-based economic systems). More recently, [Bowles and Carlin \(2020\)](#) have articulated a comprehensive and constructive appraisal of introductory economics with a proposal for curriculum reform (emphasizing attention to the “grand challenges” of our times, such as climate change and inequality).

In the field of management too, scholars have critiqued business education and business schools (see, for instance, [Bennis and O’Toole, 2004](#); [Ghoshal, 2005](#); [Khurana, 2007](#); [Mintzberg, 2015](#)). Bennis and O’Toole reproach the neglect of relevance in academic work: “In business research ... the things routinely ignored by academics on the grounds that they cannot be measured—most human factors and all matters relating to judgment, ethics, and morality—are exactly what make the difference between good business decisions and bad ones.” [Ghoshal \(2005\)](#), mirroring Boulding’s concerns, wrote an impassioned essay in which

he lamented: “In the desire to create and protect the pretense of knowledge—in our venture to make business studies a science—we may have gone too far in ignoring the consequences not only for our students also for society” (p. 88). His essay contends cautiously, “Ultimately if the trend in management theory is to be reversed, only business school academics can do so. This is not going to be easy” (p. 83).

I find considerable merit in and have learnt much from the arguments contained in these aforementioned works. Critiques by economists tend, however, to be oriented to regulation and policy and less to business scholars, business students, business firms, or business managers. Further, those critiques tend to highlight errors of omission. Thus, for [Bowles and Caitlin \(2020\)](#), as for the management scholars [Bennis and O’Toole \(2004\)](#), the problem is less with the rigor than the relevance of the research and teaching. They wish for greater and explicit focus on climate change, inequality, and such.

For Ghoshal, on the other hand, rigor in social sciences is itself a “pretense” motivated by “physics envy.” He contends that core assumptions, such as “self-interest,” opportunism, and agent malfeasance, are not only “gloomy,” they are also invalid and, worse, performative (in that, once taught, they tend to become self-confirming). As corroboration, Ghoshal cites empirical evidence from ultimatum game experiments in which proposers are found to be more generous and acceptors more tough than a naïve self-interest theory might predict. Apparently, the self-interest assumptions are either not so performative after all or self-interest is alive and well, just more enlightened than naïve. Near the conclusion of his essay, Ghoshal pleads (p. 81), “Why don’t we actually acknowledge in our theories that companies survive and prosper when they simultaneously pay attention to the interest of customers, employees, shareholders, and perhaps even the communities in which they operate?” In hindsight, it is hard to figure out whether such a plea reflects the “power of positive thinking” or feigned ignorance of the Walmarts, Amazons, and Volkswagens that have survived and prospered without necessarily adhering to these platitudes. Ghoshal proposes that the way forward might be “pluralism” in business research, stewarded no less by deans and donors. Acknowledging the nebulousness of his remedy, Ghoshal concedes (p. 87), “It would not, therefore, be entirely inappropriate to dismiss my concerns as an irrelevant rant.”

Ghoshal’s much-cited essay is eloquent and heartfelt. It is problematic nevertheless to regard self-interest, opportunism, and agency as evidently invalid assumptions or premises. The point is not whether we like or dislike the assumptions but whether they are broadly valid or not. Appeal to self-interest is central in Smith’s logic of the marvel of market-based exchange and the productivity gains it can unleash. Likewise, if opportunism were not rather prevalent, contract lawyers, auditors, rating agencies, the lock industry, and now the cyber-vigilance industry would scarcely exist, let alone thrive. Equally, if normative theory and education did not have a performative aspect, they would lose much of their value. Language and cultural education, to take two examples, are intended to be performative.

While I am unpersuaded on the specifics of Ghoshal’s critique, I concur with his beseeching to look more closely at core *assumptions* in business economics theory. The models in business economics might be logical. Yet, if the assumptions and premises on which they are based are unsound or inappropriate, in that they do not correspond to the real world or they elide important moral questions, then practice based even on such “logical theory” can lead to unsatisfactory and even disastrous consequences.

Concerns and complaints about assumptions are also not novel. From Ken Arrow to Paul Samuelson, from Ronald Coase to James Buchanan, and from Amartya Sen to Jean Tirole, a string of distinguished scholars (Nobel Laureates all) have underlined the importance of and

their doubts about some core assumptions. In a famous paper written nearly half a century ago, [Sen \(1977: 322\)](#) cautioned: “The primary concern [in modern economic theory] is not with the relation of postulated models to the real economic world, but with the accuracy of answers to well-defined questions posed with preselected assumptions ... the realism of [which] is simply not a part of [the] inquiry.”

Yet, for a variety of reasons, few have paused to do much about these concerns. Milton Friedman of course famously retorted that it matters not whether assumptions are realistic so long as the model’s predictions are realistic. This might be okay for models that are descriptive and explanatory, but it’s not okay for theory that is normative/prescriptive. In his chapter for this volume, Jean Tirole observes that among the human sciences economics is perhaps the most normative field, akin in this sense to moral philosophy, which is even more so. Still others shrug off concerns about assumptions, asserting that policy-makers and economic actors know that the assumptions are shaky, and that they will, by implication, correct for this in their actual policies and actions. Alas, going by what we observe in reality, such confidence seems misplaced. In the few works, such as [Sen \(1977\)](#), [Ackerman and Nadal \(2004\)](#), and [Schlefer \(2012\)](#), that have taken up the tedious task of scrutinizing dubious assumptions, the critiques are eloquent but unaccompanied by practicable alternatives. An important exception is [Stiglitz, Sen, and Fitoussi \(2010\)](#), on which I build below.

To summarize, there is too much that is awry in business conduct to simply castigate individual actors and entities in the specific cases concerned. Business theory and education merit scrutiny too. The faiblesse is less likely to be in the logic of the models (such as ones establishing the superiority of market-guided resource allocation or the benefits of international trade). Rather, the faiblesse is likely obscured in the models’ core assumptions (such as frictionless labor adjustment post free trade). As Ken [Arrow \(2015: 40\)](#) observed not too long ago, “The problems of the economy arise, for the most part, from its failure to satisfy the conditions of the ideal standard model.” Accordingly, lest we throw out the proverbial baby with the bath water, we must probe the core assumptions underlying important models and theories in business economics. Given that economic and especially business theory tends to be prescriptive and performative, this exploration merits more concrete and more collective effort than has been devoted to it hitherto.

The plan for the remainder of this chapter is as follows. I will first sketch very briefly the nature and role of assumptions in theory development. I will then take up and discuss seriatim seven core assumptions in business theory that I believe are problematic and ought to be urgently remedied. Examining these problematic assumptions helps us comprehend why trust in business has declined and illuminates likely causes in the vignettes outlined at the top of this chapter. In each of the seven instances, I attempt to outline alternatives and implications.

1.3 The Nature and Role of Assumptions in Theory Development

Assumptions are suppositions, caveats, or pre-conditions entered by declaration but without proof. Aids in theory development, assumptions are made to simplify, bound, or situate

the analysis, and characterize the context, the actors, and their preferences. They enable the theorist to wade forward in a realm that may be complex and incompletely observable or specifiable. Some assumptions are self-evident (e.g., people have feelings/sentiments; people have needs); some hew to common sense and experience (e.g., people are loss-averse; prices are non-negative); and some reflect values and beliefs (e.g., actors are rational, as in their actions are reasoned and goal-oriented; actors are free and trades are voluntary; pay-offs in the present matter more than those in the future—whither positive discount rates). Not all assumptions are explicit; even important ones, by virtue of long practice and convention, may (as we will see below) remain implicit. Other assumptions are unstated not due to convention but due to the oversight or convenience of theorists (as, for instance, was the implicit neglect of transaction costs, which Coase and others fruitfully exposed and corrected). Such assumptions may be taken for granted, but, left uncorrected, they contribute to unsound theory and misguided practice.

To summarize, assumptions are made for several reasons, prominent among which are these three: (i) tractability; (ii) boundary setting; and (iii) characterizing actors and context. We are less likely to be troubled by assumptions made primarily for tractability (e.g., two factors—two goods; constant returns to scale), although these limit the generalizability and the insights granted by the theory. Likewise, we may not be so troubled by purely boundary-setting assumptions (e.g., a trade model that considers goods only and excludes services). Difficulties arise especially with the third category of assumptions; that is, those that purport to characterize actors and the context (e.g., full and perfect information). When theory is built on an over-simplified or flawed (i.e., incomplete or incorrect) characterization of actors or the context, then, in the real world, practice that adheres to or enacts that theory may well lead to unsatisfactory conduct and consequences. (See [MacKenzie, 2006](#) on how this dynamic unfolded in the world of financial derivatives, leading eventually to calamitous crises. For a broader and cautionary exegesis on models and assumptions, see [Thompson, 2022](#).)

To be sure, some assumptions may be valid even when they are antecedent to or in the vicinity of unsatisfactory consequences. Think of positive discount rates that reflect the assumption that people tend to value the future less than the present. Or think of the assumption that actors value payoffs to themselves more than they value payoffs to others. In these instances, our unease cannot so much be with the validity of these assumptions as with the inherent nature of the actors. To evolve the latter is the role of cultural and moral philosophical education. In other words, the task there is to elevate the nature and our expectations of economic actors. As [Sen \(1977\)](#) exemplifies, probing and refining the problematic assumptions without naively denying or decrying them may be a useful way to do this. That is the approach we aspire to adopt here.

I will spotlight and explore seven assumptions in the mother field of business theory—economics—that I believe drive a wedge between performance and progress. Among others, these assumptions, I submit, lie at the root of much of our dissatisfaction with modern market-based economic systems. They also help us appreciate better the “why” and “how” in the real-life vignettes outlined at the top of this chapter. To the extent we are able to amend these unsatisfactory assumptions, then the improved business theory and education can go a long way toward encouraging and enabling economic actors to better integrate performance and progress. Such reflection and remedy are essential if we are to restore trust in the market-based economic system (that is, capitalism).

The seven assumptions that I spotlight and explore below are headlined as follows:

1. Purpose of the economy: output versus outcomes
2. Rationality: minimum means versus minimum harm
3. Managerial conduct: the influence of agency versus status
4. Information: price versus non-price sources
5. Labor adjustment: smooth versus sticky
6. Market failures: regulation versus education
7. Optimality: market-Pareto versus moral-Pareto

1.4 Purpose of the Economy: Output versus Outcomes

At least since Adam Smith's *Wealth of Nations*, a core assumption is that the purpose of the economy is to generate income and wealth via the production and trade of saleable *output*. Yet, by the twenty-first century, it is clear that output does not have an unproblematic correspondence with *outcomes*. In the empirical economy, the former often tends to displace the latter (see the tellingly entitled manuscript *Mismeasuring Our Lives* by [Stiglitz, Sen, and Fitoussi, 2010](#)). It is time for us to evolve from an output-centric to an outcome-centric economic system. I elaborate below.

Historians estimate, based on anthropological evidence, that the practice of counting emerged as far back as some 60,000 years ago ([Barras, 2021](#)). The emergence of counting implies that there was something worth counting. One can speculate that this points to the early if obscure emergence of the notion of private possessions; that is, of private property. “Those [putative communities] with elaborate systems [of counting] always had a richer array of possessions.” Once private possessions are conceived of, and once there is a rudimentary accounting of such possessions, then the notions of gain and loss can come to the fore. We wish to gain, not lose, possessions. Once notions of gain and loss are recognized, then the ideas of max and min emerge as useful. We wish to maximize our gains and minimize our losses.

Nuts and grains, tools and trinkets, precious objects, weapons no doubt, and eventually land and animals were perhaps the categories of early “wealth.” Foraging, fishing, hunting, crafting, migrating, exploring, trading, and pillaging were likely the early activities related to the acquisition of this wealth. Possession, after all, was “nine-tenths of the law.” Then, gradually, merchants, markets, and surplus production emerged, and later, supported by rudimentary institutions of contracts, guild governance, and finance, this became elaborated into what we refer to as a market economy. Its purpose: to spawn income or wealth by skillfully allocating resources to the production and trade of goods and services, which for nearly a century now we measure as GDP or *output*. (Classical economists maintained, not wrongly, that output permitted consumption, which contributed to utility and welfare.)

Over the past century, the belief and assumption that output (or income) is the purpose of the economy has come to be widely adopted and taken for granted. Thus, all around the world exist official bureaus that track and measure output. These generate banks of statistics purporting to indicate levels of and trends in output. Sophisticated and complex models have been developed to forecast output (especially because it influences employment and

most economic activity). Policies are made with a focus on GDP (a point that reflects the original *raison d'être* of GDP or national income accounting). Nations compare themselves on output per capita as a veritable indicator of their relative success. Sentiments of confidence and gloom are indexed on how the GDP goes.

Yet, as Stiglitz, Sen, and Fitoussi (2010: xvii) have warned: “In the quest to increase GDP, we may end up with a society in which citizens are worse off. Too often we confuse ends with means.” Indeed, the progenitors of GDP and national income accounting, including Simon Kuznets, cautioned that the GDP cannot be regarded as an omnibus indicator of societal success. But, as an old adage maintains, you can’t beat something with nothing. Now, as the unintended consequences of mass production and mass consumption become more palpable, we realize that our assumption about the very purpose of the economy has been mis- (or at least under-) specified.

What, beyond output, can be a better supposition about the purpose of the economy? The primary purpose of the economy, we now realize, ought to be better *outcomes*. Thus, whereas cars are output, mobility is the outcome desired. Similarly, medicines and surgeries are output, but health is the outcome desired. Thus, as opioid production and consumption rose, GDP or output rose. But outcomes (including addictions and mortality) were, as we see, a different story. Mining and metal production may be geared toward output, but affordable housing and clean air, clean water, and clean soil are the outcomes we care about. Other outcomes that we care about include a fair distribution of wealth and power (and by implication some parity across social categories such as gender and race), trust, dignity, mental and physical health, sustainability, privacy, and more. The sooner economic actors (i.e., producers, consumers, investors, employees, and regulators) can absorb the message that we ought to care more about outcomes and not just about output, the better. Business economics theory and education can lead the shift. (Revisiting the opioid vignette reviewed above, if business education was more oriented to better outcomes rather than bigger output, then the consultants in question might *perhaps* have been less oriented to a “turbocharge sales” counsel.)

Because of changes in demography, resources, preferences, and experience, each era is likely to have its own set of preoccupying outcomes. In the twentieth century, economic development and the alleviation of material poverty received great attention. In the current era, three broad categories of outcomes merit our attention: fairness, well-being, and sustainability. If we wish the economic system to be trusted, then economic actors must make fairness central to their economic choices and arrangements. Less abstractly, if we are to address the challenge posed implicitly in Acemoglu and colleagues’ recent study, then we must attend to fairness more explicitly. Alas, economic theory hides behind the assumption of voluntary trades and tends to elide distributional issues. In reality (as I discuss later), power regulates the distribution of surplus. The steadily declining labor share in total income is one reflection of this empirical reality. The Arthashastra stated more than 2,000 years ago that a just king attracts loyalty not because he is king, but because he is just. In other words, power itself is not the problem; it is the (ab)use of power that is the problem. Think of the power that firms like Boeing possess when it comes to engineering and design choices. Fairness is a chronic and ubiquitous problem. In the context of tech firms, fairness may be related to the outcome of privacy; in the context of resource exploitation and energy production, fairness may relate to the health and possibilities of future generations; and in the food industry, fairness may relate to human health and animal welfare. Taking inspiration

from Rawls, I would submit that as truth is a prime virtue in science, fairness (as much as size) ought to be a prime virtue when it comes to the economy.

A second fundamental outcome that societies increasingly care about is well-being. Income is of course one important component of well-being, but so are physical and mental health. This perspective on well-being reflects the axiom that money may be the currency of the economy, but time is the currency of life.³² Time for sleep and social relations is key to well-being, which, of course, may mean less time to work more and earn more. As the moral philosopher Elizabeth Anderson has written in her chapter in this volume, we ourselves, our feelings, and our social relations are outcomes of the economy. How we feel about our life and our capacities are priceless reflections of and influences on our well-being. In the output-centric twentieth century, families grew to be work-centric. In the twenty-first and hopefully outcome-centric century, the economy ought to evolve so that work becomes family-centric (see [Goldin, 2021](#); [Nooyi, 2021](#)). In other words, to a significant extent our feelings and capacities are influenced by the workings of the economy. If workplaces and bosses are oppressive, we may be trading off the misery of poverty for the misery of indignity, dependence, and exploitation. Indeed, a recently released report from the US Surgeon General confirms that toxic workplaces harm employees' mental and physical health. The Surgeon General's well-being-oriented framework urges "organizations to rethink how they protect workers from harm, foster a sense of connection among workers, show workers that they matter, make space for their lives outside work, and support their growth."³³

In empirical terms, too, there is a methodological advantage to dwelling on well-being. [Stiglitz and colleagues \(2010: xx\)](#) write, "We care about many dimensions of the quality of life. Current metrics suggest ... tradeoffs—one can improve the environment [say] only by sacrificing growth ... But if we had a comprehensive measure of well-being ... we would see this as a false choice." They continue (p. 10), "a unifying theme of [our] report is that the time is ripe for our measurement system to shift emphasis from measuring economic production to measuring people's well-being." That is, to shift emphasis from output to outcome. After all, the sale of new iPhones or Netflix subscriptions may register as increases in output, but, for reasons now familiar (screen addiction, sleep deprivation, diminished and depraved social interactions), they may cause a decline in well-being.

A third category of outcomes—one related to nature—is something we care about more and more urgently in our times. By now there seems little need to elaborate or belabor this point. Sustainability is an outcome of concern that emerged already half a century ago in 1970 with the first Earth Day (and the creation of the Environmental Protection Agency in the USA). Since then, we have come to register vividly that our economic activities of production, distribution, and consumption leave footprints on our natural ecosystem. With rising populations compounded by rising incomes, rising urbanization, and rising globalization, not to mention the emergence and adoption of AI, our need for energy and our draw on resources has become gigantesque. Whether one looks at the health of oceans (and depleted stocks of fish and feed), the melting of the poles and glaciers, the quality of soil around the world, the decline in biodiversity and extinction of species, the patterns of climate and attendant natural disasters (floods, fires, droughts, heatwaves, snowstorms), or the quality

³² For an impassioned philosophical exegesis on this idea, see [Hägglund \(2019\)](#).

³³ United States Health and Human Services Department, 22 October 2022, "U.S. Surgeon General Releases New Framework for Mental Health and Well-Being in the Workplace." Press release. www.hhs.gov/about/news/2022/10/20/us-surgeon-general-releases-new-framework-mental-health-well-being-workplace.html (accessed 29 October 2022).

of air and water, the outcomes are alarming. The leading causes are that the modern market-based economic system, our choices therein, and our economic activities (including the production of fossil energy, the cultivation and consumption of animal protein, and the shrinking of product cycles—e.g., fast fashion and electronic novelties) are all oriented primarily to output. This is now changing, and governments are regulating and taxing economic actors and activities to factor in outcomes. Beyond smart regulation, though, business theory and education can catalyze and consolidate this shift (including, importantly, on the demand side).

It is high time we evolve our assumption about the economy's purpose, which should be to generate better outcomes and not just bigger output. The Organisation for Economic Co-operation and Development's (OECD's) *Better Life Index* (a consequence of the [Stiglitz, Sen, and Fitoussi, 2010](#) report) is an important step in that direction. The United Nations' pedantically labeled Sustainability Development Goals (a motley basket of some seventeen items that collectively enshrine dignity, development, and durability) is also useful. In the private sector, the emergence and adoption of so-called Triple Bottom Line thinking (profit, people, planet) is also a step in the right direction.

In the real world, some firms, such as Lindéngruppen of Sweden, are now estimating and reporting "true value" as opposed to solely "economic value."³⁴ In a fascinating 2021 book entitled *Bridgital Nation*, Chandrasekaran and Purushothaman write about how digital technologies may be designed and deployed to improve vital dimensions of life outcomes including financial inclusion, employment, health, education, and even justice. That work is an inspiring call to fashion a future economy where intentions, investments, innovations, and incentives are all outcome-centric. It is in a similar spirit that people are assessing positively such innovations as the smart watch (which spotlights and endogenizes the outcome of personal health) and electric car (that delivers the outcome of mobility with fewer tailpipe emissions). Other presently aspirational outcomes such as "couple equity" will require firms to rethink how they organize work and travel schedules. Such an evolution in the economic system is necessary if we are to enable greater fairness, well-being, and sustainability (not only in terms of ecology but also in terms of demography).

In sum, the sooner we evolve to an "ends" orientation in what we assume to be the purpose of the economy, the better we can reduce the disheartening disconnect between economic performance and societal progress. Fortunately, relative to our current output-centric economy, we need the same factors—natural, human, physical, financial, intellectual, and cyber capital—to produce better outcomes. The one factor that we need in addition to these traditional factors of production and consumption is *moral capital*. I say more about this in a subsequent section.

1.5 Rationality: Minimum Means versus Minimum Harm

For the founding fathers of modern economics—including Smith, Walras, Pareto, and Edgeworth—self-interest was a *sine qua non* of economic action. This starting point informs the very notion of rationality in the economic realm. In Latin, *ratio* (the root in the term

³⁴ See p. 12 of Lindéngruppen Annual Review, 2021, https://uploads-ssl.webflow.com/5b111856881083479880dc6c/630867a951e4de5f81006365_Lindéngruppen%20Annual%20Review%202021.pdf (accessed 30 October 2022).

rational) refers to reckoning and calculating. It refers also to reasoning. In modern management, rational action implies goal-oriented action. Given that self-interest is regarded as the primary (if not sole) goal in the economic realm, then rationality implies action that is expected to maximize self-interest.

What is self-interest when the actor in question is not a person (a biological entity) but is a firm (a juridical entity)? Setting aside nuance, a firm's self-interest is specified as profit. Indeed, profit or firm performance is the dominant dependent variable in business school curricula. Business theory focuses on profit maximization or high performance. Equivalently, finance scholars might state that the proper goal of a firm is to maximize the "residual" (i.e., its free cash flow).

Profit (or the residual) is what remains after costs are subtracted from revenues. Revenues are central in the field of marketing, but in economics the prime focus has tended to be on costs. Revenues, relative to costs, are less under the "control" of management. Revenues are shaped by such external factors as consumer preferences and subjective assessments of benefits on offer (i.e., which influences the willingness to pay), income (ability to pay), and competition (available alternatives). Costs, on the other hand, are regarded more as a choice variable (and hence under the influence) of the firm. Accordingly, the production function has long occupied a central place in business economics.

Indeed, for seminal mathematical economists such as Walrus, Pareto, and Edgeworth (who, a century after Smith's *Wealth of Nations*, formalized the theory of market-based economic systems), the "minimum means" logic was the essence of rational economic action (see Mornati, 2013). Reflecting this conviction, the prominent twentieth-century theorist Lionel Robbins would go on to define economics as being centrally concerned with the proper allocation of *scarce* resources to alternative uses. Even today, the term "economizing" refers to reducing costs, or to frugality.

Minimum means rationality is, arguably, the most "performative" assumption in economics. On a blackboard, the things one is minimizing are abstract "factors." Raw materials, equipment, labor costs, and support activities, all represented via symbols in a production function. In the real world, the practice of minimum means rationality implies curtailing wages and keeping them as low as legally permissible (i.e., offering minimum wage). It means bargaining hard with suppliers even if that means the livelihoods of the latter might become precarious (e.g., farmers in the supply chain of large multinationals). It means attending to safety but doing so thriftily (as might have been the case in the Boeing 737 Max launch). Under the minimum means mindset, compliance becomes the byword. No surprise, then, that mining companies (like Vale of Brazil which has, in the span of a few years, been implicated in two large accidents) may prefer to contain tailings on site rather than ferry them down to safer zones and treat them before disposal into the soil or water. When speed and throughput are key as in the factories producing iPhones, then stress and occasionally even suicides may be fallouts in the relentless pursuit of efficiency. Amazon's demanding warehouse systems and practices also come to mind. Likewise, a manic drive for efficiency under the rubric of PSR—precision-scheduled railroading—has been fingered in the deadly derailment of and hazardous spill caused by the Norfolk Southern-operated train in February 2023 in the US state of Ohio.³⁵

³⁵ Esther Fung, Kris Maher, and Paul Berger, 30 March 2023, "'Hurry Up and Get It Done': Norfolk Southern Set Railcar Safety Checks at One Minute." *The Wall Street Journal*. <http://www.wsj.com/articles/railroads-are-a-lot->

Minimum means rationality is an assumption and mindset that is understandable but no longer acceptable. It is a taught and learnt mentality, and it is the nub of the insinuation in Acemoglu and colleagues' empirical study linking MBA education to (in that case) declining wage shares in GDP. The consequences for people and planet have been disappointing and sometimes devastating.

If we are to evolve to an economic system that is more fair and sustainable, then the assumption of minimum means rationality ought to be complemented and moderated by a "minimum harm" rationality. Minimize harm to people and harm to planet. One could interpret the emergence of ESG (environment, social, and governance) expectations and assessments in the world of business and investment as a reflection of this realization. ESG, in other words, is a sort of attempt to bridge minimum means and minimum harm rationality.

What does this change in assumption about rational action imply for theory and practice? It implies "goal innovation." In other words, it means we need to re-specify the objective function of the firm as follows:

$$\pi = (p - \theta c) \times n$$

In the familiar equation above, π refers to profit, p to price, c to cost, and n to number of customers/units sold. The additional term θ refers to *harm* (to people and planet). Now, we know from experience that at any given point in time firms work with a given level of technology. At that given level of technology there will be a tradeoff between cost and harm. Lower costs tend to be related to greater harm and vice versa. Over time, advances in technology may mitigate the tradeoffs. But what ought a firm to do meanwhile? It ought to minimize the *joint product* of costs and harm.

To concretize, consider the controversy over the abhorrent "gestation crates" in which pregnant pigs are held for weeks, unable to even turn let alone walk. The activist shareholder Carl Icahn has tussled with McDonald's to eliminate in that restaurant's sourcing chain this callous efficiency-driven practice, whose adoption has grown since the late 1960s. If gestating and lactating sows were instead allowed more natural "family feeding," then animal harm declines but costs rise (for extra land, feed, and maintenance).³⁶ Such a tradeoff between cost and harm may be depicted as in [Figure 1.1](#). Without any regulations, harm to pigs could be very high (say, at an 8 on the chart) but costs would be super low (say, at 1.5). With minimal regulation (say, against tethering pigs at the neck, which used to be practice), harm might decline to 5 and costs might rise to 2. If we now assumed and taught that rationality meant minimizing the joint product of means and harm, then, reading off the stylized tradeoff curve in [Figure 1.1](#), we would see that optimal choice is in the area of the coordinates (3, 3) where θc is minimized.

Having noted the nub of the idea, let us consider a couple of points that merit attention in the figure. First, note that the origin of the axes in [Figure 1.1](#) is set at 1 and not 0. Beyond making the math simple, this is to reflect the idea that in reality there is always some cost to economic activity and there is always some irreducible harm as well. Second, what the choice of "joint min" means for final profits is unclear. If we go by findings in a burgeoning corpus of

more-efficient-are-they-also-less-safe-7c5d2a60 (accessed 9 April 2023). See also [Pearce and Tombs \(1998\)](#) on the notorious safety lapses in the chemical industry.

³⁶ John J. McGlone, undated, "The Crate: Its History and Efficacy," Pork Industry Institute, Texas Tech University. www.depts.ttu.edu/animalwelfare/research/sowhousing/documents/TheCrate.pdf (accessed 3 November 2022).

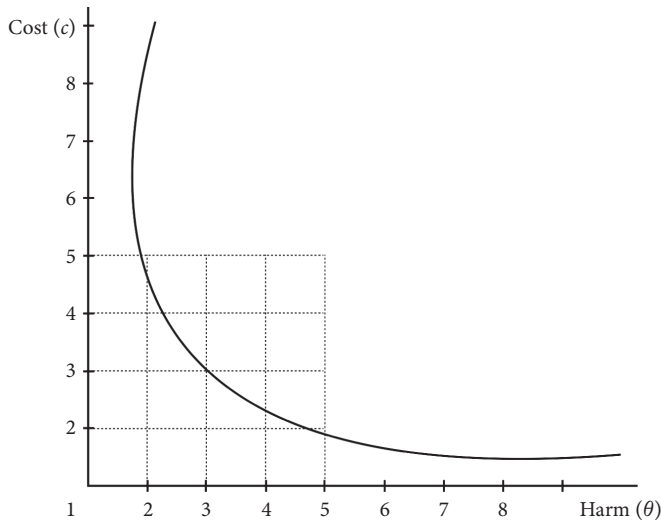


Figure 1.1 A stylized cost-harm tradeoff frontier (at a given level of technology).

surveys,³⁷ one could imagine that greater attention to and concern for animal welfare might cause a rise in consumers' willingness to buy from producers that cause less harm. That is, perhaps, $n^\theta \geq n$. Further, because such a firm's products may be regarded as better and because their employees may be more motivated and offer better services, consumers' willingness to pay might also be higher for products made by "good" firms. That is, $p^\theta \geq p$. (Such reasoning is often part of the "business case" highlighted by proponents of self-regulatory initiatives such as the B Corp.) All this noted, we must suppose it unlikely that there are big dollar bills lying on the sidewalk. We should in turn anticipate that the net impact on profits is indeterminate and, in the near term, $\pi^\theta \leq \pi$.³⁸

Ironically, even if profits may decline at firms adopting a minimum harm approach, their market value might be higher if shareholders are willing to offer higher multiples either because they anticipate the firm will face fewer legal and reputational risks and penalties down the road, or because they are willing to pay a premium for their "warm glow" preferences. This, among other factors such as a different business model and the targeting of more affluent customers, could be one of the reasons why the retailer Costco, reputed for its better treatment of employees, has a much higher P/E multiple than rival Walmart.³⁹

³⁷ Afdhel Aziz, 7 March 2020, "The Power of Purpose: The Business Case for Purpose." *Forbes*. www.forbes.com/sites/afdhelaziz/2020/03/07/the-power-of-purpose-the-business-case-for-purpose-all-the-data-you-were-looking-for-pt-1/?sh=81c59b830baf (accessed 5 November 2022).

³⁸ The above noted, a longitudinal 2013–2020 study finds that higher ESG tracks higher earnings growth at the firm level. See MSCI Research, 9 December 2020, "Is ESG Investing a Price Bubble? Probably Not." www.msci.com/www/blog-posts/is-esg-investing-a-price-bubble/02231869256 (accessed 27 November 2022). Also, note that we may also scale other terms in the traditional profit function by θ . Wrong/high prices could cause harm. Think of Covid vaccines. Likewise, the target market and hence n could contain harm too. Think of soft drink manufacturers like Coca-Cola and PepsiCo withdrawing vending machines from grade and middle schools.

³⁹ On the question of the proper objective function of the firm, Hart and Zingales (2017), going a step further, have argued that firms might maximize shareholder welfare rather than market value. They note that increasingly shareholders value extra-financial factors (such as social inclusion, fair wages, lower environmental footprint, etc.). The pushback from coal and oil states in the United States on ESG-prioritizing asset managers like BlackRock

In the two previous sections, I have reviewed and proposed revisions to assumptions at the level of the economy (output vs. outcomes) and the level of the firm (minimum means vs. minimum harm). Moving down a unit of analysis, I take up an assumption at the level of individuals inside the firm.

1.6 Managerial Conduct: The Influence of Agency versus Status

As we noted above, at least since Smith it is canon in economic thought that self-interest is an innate drive that can be harnessed to make economic exchange attractive and stable (see Hirschman, 1977; [Force, 2003](#)). Acknowledging this point in their classic *The Modern Corporation*, [Berle and Means \(2009 \[1932\]: 9\)](#) wrote:

Such self-interest has long been regarded as the best guarantee of economic efficiency. It has been assumed that, if the individual is protected in the right both to use of his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess.

They go on, however, to highlight and underscore a grave caveat:

In the [modern] corporation, such an assumption no longer holds ... Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree ... It consequently challenges the fundamental economic principle of individual initiative in industrial enterprise. It raises for reexamination the question of the motive force.

Subsequent thinking, including on incentive compatible contracts ([Hurwicz, 1960](#)) and agency theory ([Jensen and Meckling, 1976](#)), has contributed to the fields of corporate governance, incentive, and information theory. Correspondingly, in the real world, to address agency concerns there has been a boom, especially during the 1980s and 1990s, in the practice of granting managers company stock options (see [Frydman and Saks, 2010](#)). Today, equity-based compensation and career progression are deployed as two big levers to elicit and align (unobservable) managerial effort with the firm's interests. Falling in the former category, stock-based evaluation and compensation has been widely adopted.

Alas, the practice of aligning managerial compensation to the stock price may be helping neither performance nor progress. Empirical research suggests that this creates incentives for executives to manage earnings per share, say by engaging in share buybacks (see [Bens and colleagues, 2003](#)). This is a form of capital diversion. In other words, a central response to

should give us pause. Given huge and polarizing heterogeneity in investor preferences, it is hardly evident that shareholder democracy will be a useful approach to influencing in desirable ways the choices and conduct of publicly held business firms.

agency concerns—viz., the granting of stock options—may not only be ineffective in addressing the concern it is meant to address, but it may also be compounding that very problem (see [Bebchuk and Fried, 2003](#)) and creating others.⁴⁰ Recall the size of and concerns about stock repurchases in the Boeing vignette outlined above.⁴¹

Be that as it may, and without denigrating the validity of agency concerns, I want to submit that the attention to money gains misses and masks a more widespread and deeply seated motivation in the conduct of humans; viz., the innate pursuit of peer esteem (i.e., the approbation of other members of the organization). Organizations are social groups. In group settings the conduct of members is influenced by the esteem within the group that conduct may elicit. Such ingroup regard and identification are causally linked to pro-social behavior. This no doubt is a central reason why humans tend to form and maintain social groups such as firms, communities, and countries. *The only problem is that conduct that is pro-social may not necessarily be pro-societal.* Indeed, what is good for the group's pride and performance may be incompatible with and even come at the expense of societal progress.

Recall the vignettes sketched at the top. I would submit that more than agency-related lapses, esteem-related factors contributed to conduct in all three cases. Recall that in the Goldman 1MDB scandal, *The New York Times* reported that Leissner and associates “knew getting the bond deal was a big win for Goldman and they would look like ‘heroes’ inside the bank.” Leissner reportedly received praise and a prestigious internal award. We can likewise imagine the esteem experienced by partners who bring large and steady business at organizations such as McKinsey (where utilization rates of professionals are crucial to the firm's ability to pay, attract, and retain talent). Such heroic over-achievers are commonly referred to as “rain makers” (echoing the criticality of water for human groups' survival and growth). We can imagine too the pride Boeing's leaders might have felt in scrambling and striving to retain American Airlines, a top-three customer for the company. Which CEO wouldn't want to be a “mission impossible” hero in the eyes of the board of their company?

Even more vividly than those vignettes, the investigation and fallout of a massive bribery scandal at the giant German multinational Siemens illustrates the point. For decades Siemens had been paying millions in bribes to bureaucrats, politicians, their families, and fixers all around the world—from Nigeria to Norway—to secure large contracts, especially in its public-sector facing businesses (such as energy generation, transportation, and telecommunications).⁴² According to investigators, bribery had become a part of “Siemens' business model.” Indeed, in Germany, foreign bribery was not regarded as illegal. Then, in 1999 the country joined the international convention banning it. Bribery at Siemens continued nevertheless, and managers devised ways to cover it up. To handle the intricate organization of making payments via shell firms, Siemens' telco division turned to one Reinhard Siekaczek, “a man renowned within the company for his personal honesty, his deep company loyalty, and his experiences in the shadowy world of illegal bribery.” Eventually, in 2008, for his role

⁴⁰ See Tânia Alves and Ana Isabel Morais, undated, “An Empirical Review of the Benefits and Controversies of Employee Stock Options.” <https://intercostos.org/documentos/apellidos/Alves.pdf> (accessed 9 November 2022).

⁴¹ The Biden administration in the US plans to “quadruple” the tax on share repurchases. For a retort, see Jason Zweig, 17 February 2023, “Stock Buybacks Aren't Bad. They Aren't Good, Either.” *The Wall Street Journal*. www.wsj.com/articles/stock-buybacks-arent-bad-they-arent-good-either-6b63356a (accessed 20 February 2023).

⁴² Siri Schubert and T. Christian Miller, 20 December 2008, “At Siemens, Bribery Was Just a Line Item.” *The New York Times*.

in the misconduct, Siekaczek was prosecuted, fined, and given a two-year suspended sentence. Asked why he did it, Siekaczek told *The New York Times*: “We thought we had to do it, otherwise we’d ruin the company.” In the event, the scandal cost the then CEO and chairman their posts. The firm paid over \$1.5 billion—“the largest fine for bribery in modern corporate history.” The story, reported the *Times*, revealed “how entrenched corruption had become at a sprawling, sophisticated corporation that externally embraced the nostrums of a transparent global marketplace built on legitimate transactions.”

What is remarkable in this case is that Siekaczek was neither compensated nor otherwise furthering his career even as he took personally risky actions to advance the interest of his firm. This contravenes the standard assumption about agency risk. The beneficiary of the furtive conduct was not the manager himself; it was the organization. To understand Siekaczek’s conduct, we must bring in *status*. In a study referring to the Siemens case and more broadly exploring “unethical pro-organizational behavior,” Lee, Schwarz, Newman, and Legood (2019: 110) find “organizational identification” and “status striving and moral disengagement fully mediate” unethical conduct by employees. Employees feel a sense of pride in demonstrating to peers that they have the guts to “do what it takes” in support of the group. People like both gold and glory, but, if forced to choose, people in organizations/groups seem more drawn by the latter.

In his chapter in this volume, Jean Tirole writes: “Social scientists must engage in more research in order to understand how incentives ... impact human behavior in alternative institutional contexts (markets, hierarchies, etc.).” We recognize that markets wield so-called high-powered incentives. We must acknowledge also that firms do so too: if not in financial terms, in status terms. That is, while markets reward in gold, organizations can reward in *glory*. We have long known that for a variety of reasons, humans value status greatly, and sometimes as much as or even more than they value money. One recent experimental study set up to expressly test this found that people were systematically willing to forgo money for social status (Kurschilgen and Marcin, 2019). A separate large-scale empirical study published in *Nature* reported that academics in the United States, despite experiencing wage compression (induced by new salary transparency statutes in state universities), did not reduce their publication productivity (Obloj and Zenger, 2022). Money surely matters; but peer standing apparently matters as much if not more. From Siemens to Goldman Sachs, the role of ingroup status and vanity cannot be neglected in understanding the behavior of individuals.⁴³

Adam Smith (1976 [1759]) himself had this to say:

For to what purpose is all the toil and bustle of this world? What is the end of avarice and ambition, of the pursuit of wealth, of power, and preeminence? Is it to supply the necessities of nature? The wages of the meanest labourer can supply them ... It is the vanity, not the ease, or the pleasure, which interests us. But vanity is always founded upon the belief of our being the object of attention and approbation. The rich man glories in his riches, because he feels that they naturally draw upon him the attention of the world, and that

⁴³ The draw of status is reflected in the striking recent story of the young airman who, “eager to impress,” is alleged to have shared sensitive military information with his social media group. See Aric Toler, Malachy Browne, and Julian E. Barnes, 21 April 2023, “Airman Shared Sensitive Intelligence More Widely and for Longer Than Previously Known,” *The New York Times*. www.nytimes.com/2023/04/21/us/politics/jack-teixeira-leaks-russia-ukraine.html?auth=login-email&login=email (accessed 22 April 2023).

mankind are disposed to go along with him in all those agreeable emotions with which the advantages of his situation so readily inspire him. At the thought of this, his heart seems to swell and dilate itself within him, and he is fonder of his wealth, upon this account, than for all the other advantages it procures him.

Dupuy (2008: 86) qualifies, “Vanity begins only when we desire and seek from others praise that we do not deserve.”

What does this imply? If we are to bring back trust in capitalism, then we must cease to disregard an innate part of human motivation—the quest for social esteem. There is a lot of research on social identity, much of it positive research explaining the social psychology of ingroup processes and behaviors. Social identification and affiliation are vital to well-being and collaboration. At the same time, managerial conduct triggered by the same processes can, as we have seen, create a wedge between organizational performance and societal progress. The operations of gangs and the brutal behavior of gang members toward the outgroup offers an extreme illustration of the idea that “pro-social” can be severely anti-societal.

If we are to remedy this via business theory and education, then we need to study and teach more not about just social identity but *moral* identity. Business education currently trains managers for functions. We need to train managers also for *roles* (i.e., moral roles). Educating for functions means deepening competence, whereas educating for roles will require that we also deepen character. In terms of business research, we need to develop and deepen our understanding of role theory, which remains a stunted field. If business education cannot make aware and train business managers and consultants to recognize and assess moral dilemmas inherent in conduct that may be pro-social but anti-societal, then business theory and education are failing them and society. Corporate values such as “customer-centricity” or “performance-centricity” or “growth-centricity” must be qualified. Managers must be expected to and know how to assess whether and when advancing the organization’s or any one stakeholder’s interests might detract from broader interests. Consultants must be expected to and know how to assess whether and when advancing the firm or clients’ interests might detract from societal interests. They must be trained to address these tradeoffs and to eschew improper choices (such as those made in the Boeing 737 Max, the McKinsey opioid, and the Goldman–IMDB cases).

In the face of incomplete and hard-to-enforce contracts (difficulties that lie at the root of the agency problem), moralizing actors via better theory and education is indispensable. We can take inspiration from John Dewey’s call for moral pragmatism. The philosopher Elizabeth Anderson explains: “Dewey argued that ethical inquiry is the use of reflective intelligence to revise our judgments in light of the consequences of acting on them. Value judgments are tools for satisfactorily redirecting conduct when habits fail ... We make moral progress by adopting habits of reflectively revising our value judgments in response to the widest consequences for everyone of following them” (Anderson, 2019: n.p.). In the human sciences we must develop role theory further, and business schools ought to train not only for managerial functions but also for moral roles. Over-attention to concerns related to agency and under-attention to the draw of ingroup status and social esteem must be corrected. Otherwise, self-interest enacted via the means of group interest will continue to drive a painful wedge between organizational performance and societal progress.

1.7 Information: Price versus Non-Price Sources

The emergence of spontaneous order in market-based decentralized economic systems has long awed theorists. How do dispersed egoistic agents possessing private, heterogeneous, local information about endowments, preferences, and technologies come to allocate and transact resources in a relatively coherent and efficient manner? [Ken Arrow \(1972: 110–111\)](#) put it this way in his Nobel acceptance remarks: “How this coordination takes place has been a central preoccupation of economic theory since Adam Smith and received a reasonably clear answer in the 1870s with the work of Jevons, Menger, and above all, Leon Walras: it was the fact that all agents in the economy faced the same set of prices that provided the common flow of information needed to coordinate the system. There was, so it was argued, a set of prices, one for each commodity which would equate supply and demand for all commodities; and if supply and demand were unequal anywhere, at least some prices would change, while none would change in the opposite case.”

Economic theory assumes that the things we value have positive and proper prices. Prices are regarded in theory, and expected in practice, to play the role of the “invisible hand” that Adam Smith invoked. Prices enable the cost–benefit analysis held as the rational basis for resource allocation. Starting with Walras, economists incorporated this assumption in their formal models of the economy. Indeed, to demonstrate that a competitive market economy could achieve a Pareto-efficient general equilibrium, theorists assumed that all relevant prices exist and further that those prices were correct.

It is true that business managers (and all economic actors including workers, consumers, investors) must regularly make decisions on where and how much to allocate resources. These include what products to produce, what technologies to employ, how much capital to employ in relation to labor, where to locate operations, which activities to internalize, and so on. Sound (or rational) decision-making in an unknown and uncertain world depends on efficiently inferring current and anticipated preferences, technologies, capacities (of supply and demand), and such. The pro-market theorist Friedrich Hayek underlined that such information was not only distributed but difficult to stay current with because the world was inherently characterized by change rather than constancy. Given this, [Hayek \(1945\)](#) argued in his Nobel-winning work, market prices and changes therein were efficient and adequate signals to convey complex, dispersed, and dynamic facts on the ground. Prices, Hayek maintained, economized on the need to know and think. They enabled market-based economic systems to be more productive and more adaptive (relative to central planning).

While theorists made prices central in the development of pro-market thought, they noted its limitations too. Arrow, in his 1972 Nobel acceptance speech, stated this caveat: “even in the most strictly neoclassical version of price theory, it is not precisely true that prices alone are adequate information to the individual agents for the achievement of equilibrium.” Going further, a couple of decades later, Arrow cautioned: “Markets are not, in my opinion, a full solution to any problem.”⁴⁴

Such reservations notwithstanding, the role of prices in determining production, consumption, regulation, and more broadly the allocation of resources has come to be taken

⁴⁴ Federal Reserve Bank of Minneapolis, 1 December 1995, interview with Kenneth Arrow. www.minneapolisfed.org/article/1995/interview-with-kenneth-arrow (accessed 12 November 2022).

for granted in economic theory *and* in business education. In the empirical economy, however, in important situations, prices can be notoriously incorrect (often biased downward) or non-existent. What, we may ask, is the price of clean air?⁴⁵ What is the price of good health (or freedom from addiction)? What is the price of economic inclusion and equal opportunity? What is the price of fairness or privacy or gender parity? What price might we put on the absence of corruption? What is the price of preventing animal suffering (caused by convention and callousness in the animal protein, fashion, cosmetic, pharma, and tourism industries)? Recall that things like clean air, fairness, health, inclusion, and cruelty-free production are among the myriad outcomes that we care about increasingly and to which we want economic actors and economic action to be better oriented.

To take a mundane illustration, consider the relatively low price of fast food (and meat and dairy, for that matter). These low prices have influenced diets and caused ill-health, especially for those on the lower scales of income. A similar thing can be said about the throwaway prices prevalent in the “fast fashion” industry (where knickers can be had for \$1 and T-shirts for a paltry \$3.50⁴⁶). Harm to people and harm to planet tend to be elided in these sectors. Part of the explanation for the low prices resides of course in process innovation and competition. But, as much as if not more than competition, these low prices also reflect the influence of power—bargaining power, lobbying power, and market power more generally. If the permits to exploit natural resources (say, land and water) can be obtained via lobbying and political power, if the welfare of animals and of the future can be treated with little regard (since they have little to no bargaining power), and if payments to workers and suppliers can be squeezed (for familiar reasons including the use of low-paid foreign workers), then final prices can indeed be super low. Notice that the invisible hand of prices is working its “magic,” but the net results include immoderate consumption, obesity, and ill-health, along with sizable profits and expansion for the industry. (The US Centers for Disease Control, based on a 2016–2018 survey, reports that on any given day more than one in three Americans consumes fast food (US Centers for Disease Control and Prevention, 2018).)

Consider similarly the case of the billions of fish trapped haplessly and killed annually in cooling water intakes in power plants around the world.⁴⁷ It is evident that the energy sector (and the fishing sector for that matter) has sufficient bargaining and political power so that the price of fish welfare is set pretty close to zero. To be sure, there is a solid literature on externalities and now internalities. The usual remedy there is an appeal to regulation and taxes, both of which are alas themselves subject to lobbying and political power,⁴⁸ not to

⁴⁵ An obscure but important agency dubbed OIRA for Office of Information and Regulatory Affairs is “effectively the gatekeeper and final word on all new federal regulations” in the United States, reports a recent article. It has discretion to adjust how the government weighs harm to the future or to poorer communities. Thus, under Obama, the harm from CO₂ was priced at \$50 per ton; under Trump it was lowered to \$5; and now in 2023, under Biden’s OIRA, the price is headed to \$200. See Coral Davenport, 28 May 2023, “You’ve Never Heard of Him, but He’s Remaking the Pollution Fight,” *The New York Times*. www.nytimes.com/2023/05/28/climate/ricky-revesz-oira-regulation-biden.html (accessed 4 June 2023).

⁴⁶ See *The Economist*, 21 October 2021, “How Primark Makes Money Selling \$3.50 T-Shirts,” www.economist.com/business/2021/08/21/how-primark-makes-money-selling-350-t-shirts (accessed 16 November 2022).

⁴⁷ See Kari Lydersen, 3 May 2011, “Power Plant Cooling Rules Aim to Reduce Fish Kills,” *Energy News Network*. <https://energynews.us/2011/05/03/power-plant-cooling-rules-aim-to-reduce-fish-kills> (accessed 9 April 2023).

⁴⁸ The point is illustrated vividly in a recent article reporting on the success of the gambling industry lobby to “get the legislation they want.” See Eric Lipton and Kenneth P. Vogel, 20 November 2022, “Cigars, Booze, Money: How a Lobbying Blitz Made Sports Betting Ubiquitous,” *The New York Times*. www.nytimes.com/2022/11/20/business/sports-betting-lobbying-kansas.html (accessed 27 November 2022).

mention that they are also subject to the dubious art of estimating “existence values” (see the critical and revelatory exposition in [Ackerman and Nadal, 2004](#)). One is reminded of the disparaging quip: “an economist is a person that may know the price of everything but the value of nothing.”

It is time that we relax our rigid attachment in theory and practice to the increasingly untenable assumption that market prices are *sufficient* information for rational economic action. Sensible economists have long confessed that markets may be efficient, but they are not sufficient. In Latin, the word *inform* means “to shape.” Information, in other words, is meant to shape our actions. That noted, there are important *non-price* sources of information that matter. One such source is convention. We eat at certain times of the day more by convention than due to the lower price of food at that time. Tipping is another example of economic action shaped by convention. Another non-price source shaping our economic actions is our social relations (what sociologists refer to as embeddedness). We may choose to work with certain co-authors (or business partners) because we have good relations with them and like working with them, and not necessarily because we have established via cost-benefit analysis that they are at the margin the most creative or hardest-working colleagues known to us. Likewise, our sentiments play a role too. When a family opens its home to refugees, it is on the basis of fellow-feeling, not cost-benefit analysis.

Beyond these familiar non-price sources of information that shape our actions lies one more that I would submit is relatively important yet relatively neglected; viz., *moral reasoning*. To be sure, rationality refers to reasoning, and economic actors engage in this act routinely. But, as economic actors, the reasoning that we typically engage in tends to be what philosophers refer to as prudential or self-interested reasoning. Moral reasoning, on the other hand, is other-interested reasoning. Whereas prudential reasoning is crucial to making better decisions, moral reasoning is crucial to making better choices. Decisions turn on payoffs, whereas choices turn on principles. Decisions depend on information about the world; choices depend on information about ourselves; that is, our identity. The question is not only “what’s in it for us?” but also “who are we (or who do we want to be)?” In other words, information pertinent to decisions is how the world shapes our actions; information pertinent to choices is how our actions shape the world. As the philosopher Elizabeth [Anderson \(2015\)](#) has articulated, economic actions have moral dimensions, and business enterprises (and not only individuals) can and ought to be regarded as moral agents too.

Take, for instance, a mobile phone producer’s choice to make the devices accessible to visually impaired individuals. There is arguably a non-trivial opportunity cost to allocating engineering time to enabling this feature (vs., say, making a trendy game or some better photo-editing software). Or consider cutting-edge AI technologies being developed by a private firm like Apple to battle child pornography. This is a costly resource allocation both in terms of time and reputation (since a private firm wading into sensitive societal issues is, for many, not regarded as legitimate). Or, sticking with Apple, consider the firm’s choice to forsake the targeted-advertisements revenue model (despite the fact that some \$1 trillion of market value may be left on the table). Targeted ad-driven business models can be money spinners, but they tend to compromise privacy. We may, likewise, think of the Tata Group in India. This enterprise has for over 150 years eschewed corruption in a country where that was commonplace. These are instances in which consequential economic action is being guided

by non-price information, and in a direction that is arguably counter to what the price-based information might point to. Such anomalies point, abductively, to a role for moral reasoning.

Admittedly, moral reasoning may not have the elegance and efficiency of the price system. There are no closed-form equations to be solved when moral issues (such as the use of animal fur in garments) enter the picture. Yet, if a capitalism founded on better information is to enable progress and not only performance, then economic actors ought to be educated and encouraged to integrate moral reasoning and not only market prices and regulation in choosing their economic actions. This is clearly not the place to outline what the content of that integration would look like, but suffice to say that, *prima facie*, moral reasoning is teachable albeit if less naturally than prudential reasoning.

Notice that the suggestion here runs counter to what Hayek held, which is that economic actors must not have to know or think much in choosing their economic actions. Alas, that era of innocence (or studied ignorance) is past. The economy today touches health, ecology, society, politics, culture, and more. If economic actors are to better integrate performance and progress, then they will have to know *and* think more before they act. In the context of a business firm, especially one held publicly, moral reasoning will have to be collective or public. That is, moral choices will have to meet standards of dialogue and public reasoning *à la* [Habermas \(2023\)](#) and [Rawls \(1999\)](#). The consumer-tech pioneer Apple in its approach to addressing the bane of child pornography fell short on this and encountered pushback. Otherwise, firms may end up being accused of advancing private preferences with public money (as reflected in the opposition that BlackRock has experienced in its ESG campaign).

Returning to the vignettes reviewed at the top, it would appear that if the consultants in the opioid case or the Boeing executives had been educated to employ non-price sources of information (especially moral reasoning) in shaping their economic choices and actions, things might have turned out differently. This is not to walk away from information or cost-benefit analysis; rather, it is to rigorously broaden the basis of both and arrive at a fuller and more proper assessment of costs and benefits. This will help shift economic actors away from a too-narrow cash and compliance culture.

I must underscore that the odd if obligatory ethics class at the start or end of a course of study in business is unlikely to suffice. This is partly because discussions in such courses tend to be too case focused. The cases discussed tend often to be a bit extreme and dramatized, provoking heroic responses (that are prone to dismiss rather than discuss tradeoffs). They highlight moral lapses and contrast good versus bad conduct. They tend not to relate back in coherent and persuasive ways to models taught in finance, economics, and strategy. Most of all, ethics classes tend to focus excessively on progress while giving short shrift to performance. Making money in these discussions is largely neglected or regarded as a questionable thing. Whatever else students enrolled in business schools may be unclear on, they are certain, and rightly so, that making money is something firms ought to do. What would be much more useful is to teach students to reason about and prioritize intrinsic (vs. instrumental) ends and morally appropriate (vs. merely compliant) means. In other words, in economic actors (including business executives, entrepreneurs, consumers, and investors) moral reasoning must, where appropriate, be an activity that *complements* prudential reasoning. In this sense, we need more, not less, rationality. Non-price information must take its place alongside and sometimes even above price information. (By implication, at business schools the Prices & Markets introductory microeconomics course might be more appropriately titled Information & Markets.)

1.8 Labor Adjustment: Smooth versus Sticky

If the world were relatively stable or predictably unstable, then central planning could deliver a more optimal allocation of resources. In reality, the world is characterized by unanticipated shocks and shifts—positive and negative. Shocks, such as slowdowns or booms, may be cyclical. Decentralized economic systems, as we noted above, cope better with such unanticipated swings due to their more autonomous structures of decision rights and information and incentive properties.

Beyond cyclical shocks, though, are other shifts that can be more secular and structural. Take the signing of major trade agreements like the North American Free Trade Agreement (NAFTA), or the accession of China to the World Trade Organization (WTO), or greater openness to foreign trade and investment. Or consider climate change and shifting demographics. And now the emergence and adoption of digital technologies and their derivatives such as generative AI. Such structural developments can be gradual but they can provoke prolonged disorientation. They entail a redirection of resources across sectors, geographies, factors (capital vs. labor), technologies (internal combustion vs. electric engines), and occupations (such as has been triggered by the emergence of, say, cloud computing and now AI). They call for “structural adjustment,” which refers to shifts in the composition of inputs and outputs in an economy. Some occupations and sectors may shrink or even be abandoned, and new ones may emerge and expand. We can see this with climate change and the contrasting prospects for the fossil versus renewable energy sectors. Likewise, we can see this in international openness and the outsourcing shift it triggered. Assembly and other labor-intensive activities shifted from the West to the East in such sectors as apparel, electronics, software, and call centers. Now, with the advent of “large language” AI models (like ChatGPT), it is anticipated that a significant proportion of the workforce (including accountants, writers, software developers, and medical and legal professionals) will face the prospects and perils of augmentation and automation.⁴⁹

Structural adjustment has been occurring since the birth of the modern economy. Still, in recent decades the pressure seems to have accelerated. Changes seem to be more time-compressed. More and more occupations and industries are becoming “contested,” say due to trade and technology. Economists confess that it is hard to forecast which activities (in services as well as manufacturing) are going to become contested. Technology is shifting the boundaries of tradables and non-tradables and blurring sectoral boundaries (think of fintech where telecommunication firms engage in money transfers, risk scoring, and consumer lending).

In the process of structural adjustment, some factors such as financial capital tend to be more mobile across regions and sectors. Labor, however, tends in general to be significantly less mobile and adaptive, both across sectors and especially across geography. This inconvenient truth is assumed away in most theorizing. While all markets are prone to some failures, the labor market is especially afflicted. Labor tends to adjust in quantities more than prices. Depending on the level and specificity of human capital, labor’s outside options tend to be limited. In the case of trade, if I wish to keep my job, I may have to take a steep wage cut. If I

⁴⁹ See Lauren Weber and Lindsay Ellis, 28 March 2023, “The Jobs Most Exposed to ChatGPT” *The Wall Street Journal*. www.wsj.com/articles/the-jobs-most-exposed-to-chatgpt-e7ceebf0 (accessed 23 April 2023).

take a job elsewhere, I may have to relocate and often still take a wage cut. Structural adjustment is good for efficiency but not for workers in established economies, especially those workers without a college education (which tends to provide general and versatile skills). Recall the opioid addiction tribulations (“deaths of despair”) befalling non-college-educated workers in the United States.

While the experience across countries is heterogeneous, in general, during this last era of globalization that began in the 1980s (with the opening of China, Mexico, etc.), the share of national income going to workers has been declining markedly (by more than ten percentage points in countries like Spain, Italy, and the United States; and more than fifteen points in countries like Turkey).⁵⁰ Since capital tends to be more concentrated than labor, the decline in labor’s share in national income⁵¹ has been associated with an increase in inequality within societies. That is, the Gini coefficient—a measure of inequality—has in many societies been rising.

One prominent study of these patterns concluded, “globalization is a driving factor behind income inequality” (Doan and Wan, 2017: 11). Importantly, trade-related loss of work seems sizable and costly in its broader consequences. The economists Autor, Dorn, and Hanson (2019) underline that it also has significant negative consequences for family and community. They report, based on an analysis of US data between 1990 and 2014, that:

On average, trade shocks differentially reduce employment and earnings of young adult males. Consistent with Becker’s model of household specialization, shocks to male’s relative earnings reduce marriage and fertility. Consistent with prominent sociological accounts, these shocks heighten male idleness and premature mortality, and raise the share of mothers who are unwed and the share of children living in below-poverty, single-headed households.

Further, unions in many parts of the world are today smaller and weaker.⁵² In the US, the empirical pattern that has captured the attention of observers is a divergence between worker productivity and wages. Even as productivity rose during the 1990s and 2000s, wages did not keep up (OECD, 2015). On balance, the owners of capital come out ahead. This concern is central in Acemoglu et al. (2022). Here is how Paul Samuelson, in his waning years (2004: 144), critiqued theory in his own field:

Contemplate a scenario where Schumpeter’s fruitful capitalist destruction harms a really sizable fraction of the future US population and, say, improves welfare of another group and does that so much as to justify a calculation that winners could be made to transfer some of their gains and thereby leave no substantial US group net losers from free trade. Should noneconomists accept *this* as cogent rebuttal if there is no evidence that compensating fiscal transfers have been made or will be made? Marie Antoinette said, “Let them

⁵⁰ Estimates of changes in labor share in national income of selected countries can be found here: www.oecd.org/g20/topics/employment-and-social-policy/The-Labour-Share-in-G20-Economies.pdf.

⁵¹ National income (or the GDP) is divided between labor and capital. The labor share is compensation for work and the capital share is profits for investment.

⁵² Jaumotte and Buitron (2015) explore the influence of unionization on the distribution of income.

eat cake.” But history records no transfer of sugar and flour to her peasant subjects ... The economists’ literature of the [past] ... perpetrates something of a shell game in ethical debates about the conflict between efficiency and greater inequality.

Trade and technology are not intentionally unjust, but if they unintentionally lead to unjust *outcomes*, then the economic system builds discontents. There is undoubtedly a hint of retributive justice in developments such as Brexit and, more broadly, the rise of nationalism (and what is currently referred to as home-shoring). The rapid adoption of digital technologies (especially data intelligence and AI) threatens to compound the pattern. To be sure, thanks to emerging technologies, service sector productivity, a historical laggard, is set to rise robustly. A billion workers in routinized jobs in consumer banking, retail, accounting, transport, health administration, and even manufacturing will need to be reskilled. With the dawn of generative AI, even non-routinized work may be executed more efficiently by intelligent self-learning machines. Beyond trade and technology, shifting consumer preferences also loom large. If tomorrow meat consumption and production are in decline (say, in response to concerns about climate change, personal health, and animal welfare), then millions of cattle farmers will need assistance to find new livelihoods and neighborhoods.

The upcoming adjustment in human capital (reskilling and redeployment of adults) portends to be the largest ever in human history. It will affect workers in developed and developing countries. If addressed with care, investment, and discipline, it can be a boon to workers and the economy. If not anticipated and addressed seriously, it will unleash political dynamics of internal cleavage. Its mental health and anxiety-provoking consequences threaten to be large. No universal basic income or 35-hour work schedules and task-sharing are likely to be an adequate remedy. It will exacerbate the paradox of job openings and joblessness.

All this notwithstanding, as David Autor highlights in his chapter in this volume, in current economic models it is standard to neglect and often outright disregard labor adjustment challenges and costs. Given a generation, labor adjustment is feasible and even natural. Given just five or ten years, it seems oppressive and infeasible. Especially for adults, this may discourage continued participation in the labor force.⁵³ To the extent this is happening, we are simply “kicking the can down the road.” We need to better understand adult labor adjustment and mobility. A focus on adult education—including upskilling, reskilling, and labor mobility—has to be front and center for the foreseeable future. At the individual level it is hard even for experienced adults to tackle the labor mobility challenge confidently and independently. As retirement ages mount due to pressures on social safety nets, this will become more urgent and more important.

As Autor notes, work promises to remain an important part of our conscious existence and research shows that it is crucial to well-being. If employment and employability become chronic sources of anxiety rather than well-being, then management scholars will be guilty of neglecting one of the most important contributors to positive life outcomes. Even if we could make financial transfers to displaced workers over a certain age, their social connections

⁵³ See Jenna Smialek, Lydia DePillis and Ben Casselman, 2 December 2022, “Why Are Middle-Aged Men Missing from the Labor Market?” www.nytimes.com/2022/12/02/business/economy/job-market-middle-aged-men.html (accessed 15 December 2022).

in the workplace would atrophy. This could morph into a problem of time and purpose. Alcoholism, and other personal and social ills that mounted during the Covid lockdowns, could become chronic. Economic migration, already a fraught topic, could be another major consequence.

Alas, governments may be singularly unsuited to address the issue. It may be that practical solutions lie at the local, regional, sectoral, and enterprise level.⁵⁴ What can we assume about *enterprise engagement* when it comes to the reskilling, mobility, and adjustment of employees? What can we learn from private-sector practices in Germany, Denmark, and Switzerland about regional and cross-firm engagement in the production of human capital?

As Autor implores, the first step is to abandon the patently false assumption that labor adjustment is frictionless and automatic. Public and especially *private* policies ought to address friction beyond any fiction of transfers from winners to losers. Enterprises need to start enabling workers to transition to the “quarternary” sector. This work cannot be done alone by traditional institutions such as schools and colleges. It requires partnerships and ecosystems of reskilling and reemployment.

This points also to the need for more and better research on adult occupational adaptation. It is understandable that experts are studying the future of work; but to ignore the future of *workers* will be devastating. Perhaps as firms are granted tax credits for R&D, they ought to be granted such credits for worker reskilling. The quantum of funds dedicated to the education of prime working-age adults (thirty-five to sixty-five years old) might have to match and exceed that allocated to K-12 and tertiary education. Perhaps this is just a generational challenge. But it is daunting to contemplate that if “prior work experience” depreciates abruptly, then adult unemployment may match or beat youth unemployment.

In business, a core implicit assumption is that firms compete for and consume human capital for which they pay wage w . Firms do not produce human capital. Now imagine we modify that and assume instead that firms also *produce* or augment human capital and pay wage w and augment skills at cost s . Now unit labor costs become $[(w + s) * h] / q$, where h is hours employed and q is output. Empirical studies suggest that higher labor costs (especially if accompanied by higher productivity, lower turnover, and greater flexibility) do not automatically dampen employment or profits.⁵⁵ Given demographic trends (and stretched social security funds), such enterprise engagement could be obligatory and tax deductible and perhaps matched with funding by states. Like health insurance, firms may invest in skill insurance. Enterprises as diverse as AT&T, Boliden mines, Siemens, and Starbucks have made moves in this direction.⁵⁶ The economic theory of labor and assumptions about the ability of labor to adapt spontaneously have to be revisited (see Caballero and Hammour, 1998). Theory and practice must evolve in a direction that reflects the need for deeper and more serious enterprise engagement with labor augmentation and adaptation. Otherwise, we face potentially calamitous prospects in terms of economic dislocation and political instability. Fairness and well-being (not to mention peace and security) hang in the balance.

⁵⁴ The former boss of IBM, Ginni Rometty, has useful insights to offer on this challenge. See Ammerman, Groysberg, and Rometty (2023).

⁵⁵ For an illuminating if dated comparison of labor practices and performance across two major US retailers, see Cascio (2006).

⁵⁶ See reporting on Siemens retraining and reskilling by Jane Stock, 2 December 2022, “World of Work: Retraining and Training Instead of Quitting and Looking,” *24 Hours World*. <https://24hoursworlds.com/economy/306175> (accessed 20 February 2023).

1.9 Market Failures: Regulation versus Education

It is well established that decentralized market-based economic systems deliver better economic performance than centrally planned ones. That said, it is also well established that market-based systems are imperfect and incomplete, often with grave effects. Consequences may be reflected in terms of both output and especially outcomes. Problems related to market “failures” include externalities, internalities, agency, moral hazard, concentration, free riding, business cycles, involuntary unemployment, and such. In the main, these originate in difficulties related to information, power, coordination/transaction costs, excessive self-interest (opportunism/distrust), and inadequate self-interest (internalities). In terms of remedies, beyond optimal contracts, mechanism design, and hierarchies (or private ordering), theorists look in the main to regulations, taxes, and transfers to mitigate market failures. Indeed, in business economics theory it is conventional to assume that the shortcomings of the “invisible hand” may be referred to and dealt with by the “visible hand” of public authorities (i.e., governments).

The hope and belief that regulations, taxes, and (ex-ante or ex-post) transfers can and ought to remedy market failures and optimize outcomes is at least as old as Adam Smith. From Smith to Pareto to Arrow, market theorists have underlined the need for and assumed the support of the *visible* hand. And, undeniably, over the past century, regulations and taxes have played a significant (if often belated) role in corralling the worst instincts of actors in a *laissez-faire* market system. Consider regulations addressing auto safety and emissions (to address externalities), or those related to tobacco advertising and “sin taxes” (internalities), insider trading (asymmetric information), mergers (to check concentration), or, lately, carbon taxes and tariffs.

Alas, as ample experience shows, regulators and regulations are neither omniscient nor reliable. Recall the ill-fated Boeing 737 Max. It made its maiden flight in January 2016 and was certified by the US FAA in March 2017. Yet, not long after, due to design and software flaws two of the planes crashed, killing 346 passengers and crew. “Investigations faulted Boeing *and* lapses in the FAA’s certification of the aircraft ... Further investigations also revealed that the FAA and Boeing had colluded on recertification test flights, attempted to cover up important information and that the FAA had retaliated against whistleblowers.”⁵⁷ Whereas existing versions of the Boeing 737 averaged 0.2 accidents per 1 million flights, the Max version at launch had an accident rate twenty times higher at “four per million flights.”

Similarly, OxyContin, the branded opioid launched in 1996 by Purdue Pharma, was an FDA-regulated Schedule II drug. Its adoption and abuse were registered by 2004. Yet serious regulatory attention was not forthcoming until almost ten years later. A key feature in the promotion and marketing of OxyContin was the minimization of addiction risk. When OxyContin was marketed in 1996, the FDA approved its original label, which stated that addiction was very rare (see Van Zee, 2009). The rest, as we know, is a tragic story. To take another example, consider Vale, a mining giant in Brazil. Its operations too, as for all mining firms, were regulated. Safety inspections and certificates are meant to be a regular and core element in mining operations, and the firm had these. Yet, Vale was implicated not once but

⁵⁷ Wikipedia entry on Boeing 737 Max, https://en.wikipedia.org/wiki/Boeing_737_MAX (accessed 15 December 2022).

twice in a span of four years (2015–2019) in grave mining disasters with significant loss of life and environmental damage.

Ironically, a common response to such tragedies is this: we need *more* regulation. Yet, as there are market failures, there are also chronic regulatory or government failures. One cause of failures of regulations and policies lies in ignorance and model uncertainty. Even in the case of well-intentioned policies, their aggregate and dynamic consequences are often hard to forecast (Reiff, 2012). The policy of lending savings from rich to poor countries was attempted over decades by such august institutions as the World Bank. Alas, after nearly half a century of doing that ineffectively, we appreciate the crucial role of complementarities in economic development. Investments without corresponding governance institutions tend to leakage, wastage, and debt traps.

Another failing of the regulatory system is due to gaming. Parties that are regulated are understandably motivated to work around and game the system. They may operate in a zone of “compliance” where they adhere to the letter rather than the spirit of the rules. In the context of taxes, this means “most taxes are avoided rather than evaded.” It has taken decades for governments the world over to jointly address “base erosion and profit shifting” by multinational firms. (The effectiveness of the pledged policies and practices remains to be seen.)

Another drawback of the visible hand is the difficulty of enforcing regulations. This was certainly part of the challenge in the Boeing and opioid case reviewed above, and the mining disasters. Ditto for the recurrent crises in one of the most regulated industries: banking and finance. The FTX crypto-currency exchange’s meltdown is just one more case that illustrates that the visible hand is neither functional enough nor reliably fair and forward-looking (think, for instance, of the difficulties regulators are confronted with given the emergence of artificial generative intelligence and “deep fakes”⁵⁸). Deforestation and poaching also offer vivid illustrations where ideal regulations may exist but are dreadfully difficult to enforce. Constant monitoring and surveillance are costly and make a great platform for bribery.

Indeed, beyond gaming and problematic enforcement, the most fatal failing of the regulatory system is due to self-dealing, lobbying, and corruption. In self-dealing, public authorities may borrow and spend to maintain incumbency. Here, public actors are passing the buck to the future. Further, regulators may themselves be interested and hence conflicted parties. In a BBC World Service news segment marking the fifth anniversary of the Panama papers scandal (which outed wealthy people’s abuse of tax shelters in that city state), the presenter asked his guest why little had changed since the publications. With some chagrin, the expert explained that a not small proportion of the offshore accounts belonged to politicians and officials who also held the power to tighten reporting and regulations. This recalls the irony of expecting foxes to be reliable guardians of the hen house. Similarly, a 2021 feature-length story in *The New York Times* on tax regulations in the United States narrated how professionals from the big accounting firms representing lucrative clients waltzed through the revolving door between business and government.⁵⁹ When in government (say,

⁵⁸ See Tiffany Hsu, 22 January 2023, “As Deepfakes Flourish, Countries Struggle with Response,” *The New York Times*. www.nytimes.com/2023/01/22/business/media/deepfake-regulation-difficulty.html (accessed 27 January 2023).

⁵⁹ See Jesse Drucker and Danny Hakim, 19 September 2021, “How Accounting Giants Craft Favorable Tax Rules from Inside Government,” *The New York Times*. www.nytimes.com/2021/09/19/business/accounting-firms-tax-loopholes-government.html? (accessed 17 December 2022).

at the Treasury Department), these high-flying accountants and lawyers shaped rules favoring private clients whom they returned to serve after their brief but bountiful tour of “public service.” In other words, copious regulations may come to exist, but in real life, they may be made or shaped by the very entities they are meant to regulate (Pistor, 2019). Online gambling provides one more recent illustration of what the political theorist Boucoyannis (2013: 1055) refers to as “unopposed actions by the rich.” A November 2022 article in the *Times* stated bluntly: “The gambling industry and its allies got their way with lawmakers after showering them with donations, gifts and dubious arguments.”⁶⁰

It is time to resist if not abandon altogether the assumption that (i) when necessary, optimal regulations and taxes will be crafted and passed; (ii) if passed, such regulations will be enforced; and (iii) the preceding will actually shape in the manner intended the behavior of the economic actors who are the object of the regulations (rather than provoke cynical gaming and perfunctory compliance).

Furthermore, let us note that taxes and regulations (like many of the Ten Commandments) tend to be better suited to errors of commission. They are less suited to errors of omission. Think of youth unemployment and the promising role of apprenticeships and mentoring by firms. In Germany, the country best known for this practice, there is no legal obligation on firms to offer this service, which nevertheless results in a productive workforce and enviably low youth unemployment rates.⁶¹ Likewise, there is no mandatory minimum wage in Denmark, and yet even workers at McDonald’s there earn a living wage (that is nearly twice as high as that paid to their counterparts in the US⁶²). We can likewise think of initiatives to promote well-being at work by organizing more predictable and flexible work schedules, or of inclusion, or worker participation in the enterprise goals, strategy, and operations. Regulation and tax incentives alone are unlikely to deliver these outcomes. In reality, regulations often respond to the past abuse of trust and market freedoms. Thus, low-trust countries may have the highest regulations but not (even eventually) the highest trust. Distrust spawns regulations, but regulations do not spawn trust.

It is high time that we acknowledge and address the reality that there will always be serious shortcomings with the *invisible* hand that are not going to be satisfactorily addressed by assuming a well-functioning *visible* hand. There is, without doubt, a need and role for smart regulation. But, for the reasons just outlined, regulations are a grossly incomplete solution to the problem of market failures. To assume otherwise is to sustain a big wedge between performance and progress.

What is the alternative? The alternative is to undergird smart regulation with serious education. I will attempt to put this alternative in context.⁶³ In comprehending socio-economic outcomes, a simple starting point is contained in the equation $O \cong f(P \times I) + \varepsilon$. Outcomes (O)

⁶⁰ See Eric Lipton and Kenneth P. Vogel, 20 November 2022, “Cigars, Booze, Money: How a Lobbying Blitz Made Sports Betting Ubiquitous.” *The New York Times*. www.nytimes.com/2022/11/20/business/sports-betting-lobbying-kansas.html (accessed 17 December 2022).

⁶¹ See Franz and Soskice (1994).

⁶² See Liz Alderman and Steven Greenhouse, 27 October 2014, “Living Wages, Rarity for U.S. Fast-Food Workers, Served Up in Denmark.” *The New York Times*. www.nytimes.com/2014/10/28/business/international/living-wages-served-in-denmark-fast-food-restaurants.html (accessed 20 December 2022). See also Nicholas Kristof, 8 May 2020, “McDonald’s Workers in Denmark Pity Us.” *The New York Times*. www.nytimes.com/2020/05/08/opinion/sunday/us-denmark-economy.html (accessed 20 December 2022).

⁶³ In this section, I draw on my introductory chapter in *Capitalism Beyond Mutuality?* (2018: 4–8). This material is not covered by the terms of the Creative Commons licence of this publication. For permission to reuse, please contact the rights holder: <https://global.oup.com/academic/rights/permissions/?cc=gb&lang=en&>.

tend to be principally a product of power (*P*) and interests (*I*). If we can comprehend who has the power and what their interests are, then we may comprehend actions and outcomes. A corollary of the preceding is that if we wish to shape outcomes, then we must vigilantly check, assign, and/or seek power. Indeed, from Plato's *Republic*, to the English "magna carta," to Hobbes's *Leviathan*, to the French revolution, to US antitrust legislation, the role of power has been central in the human quest to shape and redress socio-economic outcomes. The evolution of formal and informal institutions is in large part a response to the risk and reality of misuse and abuse of power. In the economic realm, at least since Adam Smith (who begrudged collusion and cartels), a central approach and action has been to check economic power with political power via regulation and occasionally even nationalization. Thus, the market economy evolved to a regulated *political economy*.

What about interests, though? It is typically (and not wrongly) taken as self-evident that the term interests may be regarded as a truncation of self-interests. Interests shape attention and goals. Rational actors are thought to be goal-oriented; and their goals generally pertain to their *own* interests. Thus, national leaders pursue their power and the national interest; business leaders may pursue their entrenchment, compensation, and the business interest; employees may pursue higher wages, benefits, and shorter working hours; investors may pursue higher and growing after tax returns; consumers may pursue quantity and quality at low prices; and so on.

Even in more recent arguments about stakeholder interests and "shared value," the reason for deviating from short-term egoism is meant to reside in actors' own, albeit long-term, interest. This is sometimes termed as the "business case" for doing the right thing. Fundamental though it is, does the anticipation and exchange of own-interests—that is, mutuality—need to be the defining extent of economic actors' interests? After all, if power is coupled with what is essentially own-interest, then we should not be surprised to see in practice the limit extent of mutuality. Why, for instance, should enterprises ponder a living wage when minimum wage plus a dollar might do the job? Why might enterprises abstain from pursuing tax inversions so long as they're not illegal? Why not market and distribute dubious but profitable financial products after first lobbying for the right to do so? Why not raise the price of pharmaceuticals when one has the market power to do so? What appreciable mutuality might one plausibly enact with distant future generations whose climate and resources we may forbear from despoiling? Or with animals whose humane treatment costs more?

Although in the minority, there are enterprises and entrepreneurs that exercise their power in ways that would appear to go beyond mutuality in this sense. For instance, Starbucks, a major US coffee chain, has trained and recruited veterans and pledged that it would recruit and train 10,000 international refugees in the US and 2,500 in Europe. It has urged similarly placed firms to do the same. Natura, a large Brazilian cosmetics firm, was among the earliest to cease animal testing. This is now the industry practice. These enterprises attempt to employ business principles and creativity to do "good" while operating without the traditional and not always sustainable financial dependence on the philanthropy of benevolent individuals and organizations.

What these illustrations permit us to imagine is that interests are not only heterogeneous but also endogenous (as the great organizational theorist Jim March maintained). This is what a long list of moral philosophers and moral psychologists (Smith, Kant, Rawls, Sen, Pinker, Appiah, and Anderson, to name a few) have also suggested. We need to integrate their ideas and ideals in business education so that moral roles and reasoning inform and influence interests in a systemic manner.

The moral education of economic actors is likely to be a better bet in addressing both errors of commission and errors of omission. In the growing attention paid to ESG (i.e., environmental social and governance dimensions), the E stands for planet and the S for people. What does the G stand for? The G presumably stands for power. And, *rather than just regulate power, we must also educate power*. Perhaps then our economy may evolve to be modern and moral, and it will do better at integrating income and impact. Otherwise, the design of the state as protector and buffer between the market and society will remain the sole if unsatisfactory remedy. This will tend to overshoot into unproductive regulation and authoritarianism (witness government leaders' incantations in China on "common prosperity" and the fallout there for entrepreneurs and enterprises).

In order to do this, we need to better understand the processes of moral reasoning, including those suggested in constructivist philosophy. Constructivism supports idealized processes of moral reasoning to arrive at proper courses of action. Rather than take a substantivist perspective of discovering the "right" answer, constructivism recommends moral reasoning to develop it. Rather than relying primarily, let alone solely, on external governance, this approach recommends the self-governance of an "impartial agent" who is able to reason with integrity from a reflective distance. Importantly, moral reasoning has a powerful role in informing and influencing such important turns in our thinking, especially when education is the preferred vehicle of transformation. This approach is much closer to focusing on interests and the *exercise* of power, rather than on power itself.

To what extent can such moral reasoning and character-abiding reflection cause desirable actions and outcomes? How and to what extent can business education shape and influence economic actors' goals, interests, and conduct in a manner that is more morally oriented? Leading business schools attract students with the promise of a speedy passage into the corridors of corporate power. Via courses on power and politics, tyros are acquainted with such classics as Machiavelli's *The Prince* (to learn how strategically to exercise power to obtain and retain fortune). But can business schools also educate and shape the *aspirations* of high-flyers who often have the ambition and intelligence to ascend the ladder of power? Properly educating economic power, it would seem, is the recommendation implicit in [Acemoglu et al. \(2022\)](#). If maximizing profit is the only goal, then compliance and legal counsel (supplemented by the payment of sporadic fines) will be business as usual. For good measure, we can throw in some lobbying too.

Although philosophical ideals and principles have influenced law and politics, their influence on business economic theory remains limited. Given the prominent and even pre-eminent role of enterprise in modern society, and given the nature of the dilemmas at hand, it is apropos and even essential that moral philosophy and moral psychology also contribute to shaping the evolution of our economic system. If philosophers can't be kings, perhaps kings can be (educated to think and act like) philosophers. This is not a novel proposition: the ageless *Bhagavad Gita*, which relates Lord Krishna's moral dialogue with Prince Arjuna on duty and sacrifice in the proper exercise of competence and power, famously adopts such an approach. It is time for smart regulation to be regarded as a complement to but not substitute for serious education. We must bet less on the assumption that regulation is the optimal answer to market failures and bet more on the promise of appropriate education.⁶⁴

⁶⁴ At my home institution, INSEAD, a moral psychologist and I led some thirty MBA students in a short course entitled Choosing to Care and Caring to Choose. The course explored moral character and moral identity, and how the preceding influence and are influenced by our economic choices and tradeoffs. The course dealt with the

The *exercise* of power clearly plays a primary role in shaping economic outcomes. This fact is central in the next and last assumption that I will address and amend.

1.10 Optimality: Market-Pareto versus Moral-Pareto

Modern welfare theory proposes that if agents in an economy are informed, rational, and free, then a market-based competitive price system can achieve an equilibrium distribution of outputs, and that “any distribution so achieved is *optimal*” (Arrow, 1951: 529; emphasis added). At such an “optimal” distribution, (i) no one would be worse off than in a no-trade (autarky) situation; and (ii) no one can be made better off without making someone else worse off. Referred to as “Pareto optimal,” such an allocation implies “unimprovability” in the realized distribution. The Pareto criterion is ingenious for assessing economic allocations and arrangements and it is regarded as a gold standard in market models. Some note that it contributes to the free-market model’s normative standing.

In any given situation, however, there may be several different allocations, each of which satisfies the Pareto criterion of unimprovability (in the sense stated above). Sen (1977: 320) has referred to this indeterminateness as “the problem of choice between different competitive equilibria.” Importantly, as has long been known and acknowledged (including by its originator), Pareto is, strictly speaking, a criterion of efficiency but not equity. The latter is assumed to lie outside the economic model and is generally left to politics/policies to remedy either *ex post* via taxes and transfers (i.e., via re-distribution) or *ex ante* via adjustments to initial endowments of the actors in the economy (*pre*-distribution). The actual workability of such remedies is, as noted earlier, fraught, and greater skepticism on the matter is warranted when exchanges are cross-border. To visualize the problem, consider the stylized Edgeworth box drawn in Figure 1.2.

In this simple illustration there are two inputs/outputs—viz., time and money; and two representative agents C (capital) and L (labor) whose initial endowments are indicated by a black diamond (located in the northwest quadrant of the box). The origin of the axis for agent Capital is the (conventional) southwest corner. For Labor, the origin of the axis is the northeast corner. Accordingly, allocations for Capital are assessed from the southwest corner; and for Labor from the northeast corner. The agents’ respective indifference curves (shown in the figure) are, for Capital, oriented upward from the southwest and, for Labor, downward from the northeast.

The highest indifference curves passing through (and hence permitted by) the initial endowments are drawn in dark. These indicate the highest level of utility attainable by each C and L in the no-trade situation. The elliptical (oval) region inside the intersection of these two indifference curves contains all the points that reflect opportunities for mutual gains from trade. At points in this oval region agents Capital and Labor may both reach higher indifference curves (with revised allocations of time and money that they would both prefer relative to their initial endowments).

themes I’ve been discussing in this chapter. To our pleasant surprise, the students engaged with enthusiasm and sincerity. They evinced curiosity and relief that at a mainstream business school they were invited to reflect on and develop their moral identity and reasoning.

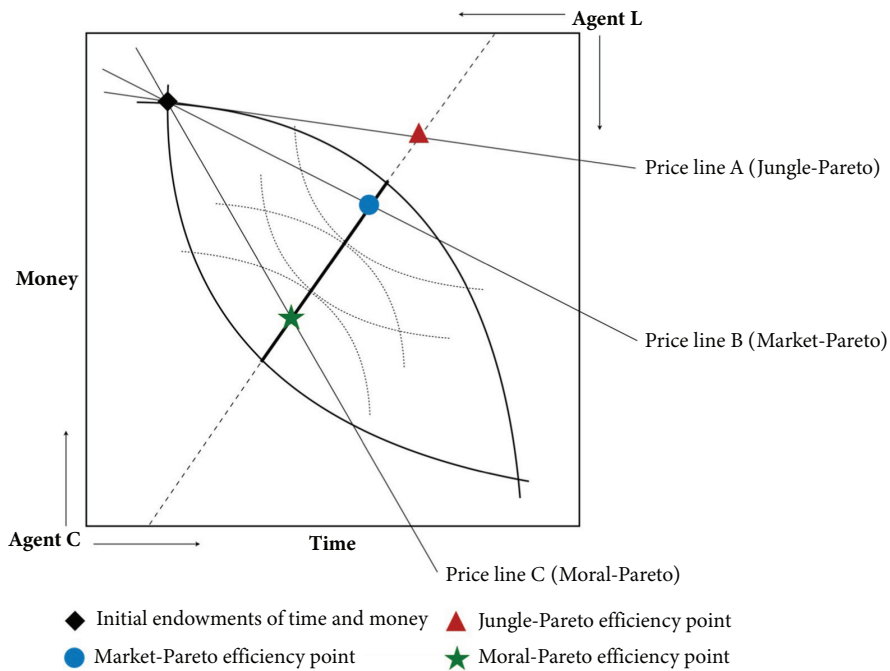


Figure 1.2 An Edgeworth box depicting initial endowments of time and money across two agents C (capital) and L (labor). Shown also are the agents' indifference curves, the "contract curve," and three stylized price lines and corresponding points of "Pareto-efficient" allocations post trade.

Inside the oval trading region, the dark line sloping upward (from southwest to northeast) is referred to as the *core*, and it represents the best of these possibilities for mutual gains from exchange. Points that are inside the oval region but not on the core are allocations that can be improved upon through voluntary trade. The core is itself a segment of a longer *contract curve*, which is obtained by tracing all points of tangency between the two agents' indifference curves. At points of tangency of the indifference curves (i.e., at any point on the contract curve), the marginal rates of substitution across the two goods for the two actors are equalized. As shown in the figure, the contract curve, or what we can refer to as a Pareto frontier, continues beyond the core on both ends of the oval region. It is indicated by the dashed lines extending to the top right and bottom left of the box. Every point on this long frontier satisfies the unimprovability Pareto criterion.

All this given, at which point on the Pareto frontier will a final distribution occur? What, in other words, will determine the outcome in a two-agent setting such as the one shown in Figure 1.2? This depends on the agents' budget constraints, which in turn depends on the endowments and relative prices of the two goods, in this case of time and money. The slope of the price line is given by the price of y in terms of x , which, in our illustration, will be the ratio of money per unit of time. The more that time (i.e., labor effort) is valued in money terms, the steeper will be the slope of the price line, and vice versa. Accordingly, without belaboring technical details, it is sufficient to note that an efficient allocation equilibrium obtains at the point where the price line going through the initial endowment (and thus

reflecting the budget constraint) intersects the Pareto frontier. The best mutual opportunity that also satisfies the budget constraint is the indicated efficiency point.

The upshot: given initial endowments, it is prices that are crucial in determining the *distribution* of gains from trade. In other words, equity depends on relative prices. In business terms, while value creation is a function of trade given initial endowments (including, especially, of capabilities), value capture is a function of relative prices. To see the import of this, consider the three stylized price lines drawn in [Figure 1.2](#). At price line A, the efficient allocation is indicated by a red triangle (“Jungle-Pareto” point) that is outside the oval region; at price line B, the efficient allocation is indicated by a blue circle (“Market-Pareto” point) that lies in the northeast of the oval region; and at price line C the efficient allocation is indicated by a green star (“Moral-Pareto” point) near the southwest of the oval region.

Each of these three post-trade allocations is “efficient” in the technical sense of unimprovability. However, as the labels suggest, they differ in terms of the *fairness* of the distribution of gains from trade. At the Jungle-Pareto allocation (indicated by the red triangle), labor is presumably worse off than even in the no-trade situation. To be sure, labor has more money than initially, but at the expense of a whole lot of time (or effort). This harkens the plight of front-line workers who toil to afford bare necessities and whose well-being is, in the process, blighted. For migrant workers, the deal may be starker. (We may recall that on the occasion of the football World Cup 2022 there was controversy and soul-searching regarding the terms and treatment extended to the foreign workers whose labor erected the fancy stadia.) As one political theorist has noted, “such price distortions often result from coercive relations between capital and labor” ([Boucoyannis, 2013: 1053](#)).

A long list of esteemed thinkers (including Smith, Pareto, Edgeworth, Arrow, Buchanan, Sen, and Rawls) have noted this problem in the economic system. Smith indignantly lamented that the persons that toiled the most often got the least. Even Pareto, who favored private order, acknowledged a societal role beyond the economy to address distributional issues (see [Mornati, 2013](#)). [Buchanan \(1962: 343\)](#) observed that

Most of the actual discussion among welfare economists has concerned a rather well defined ‘region,’ but almost no attention has been given to the requirement that, to be relevant at all, this regional must be defined by ‘constitutional’ limits placed on ... [the] rules of the game ... Should ... one man ... make all his fellow citizens ... slaves ... the content of the classification scheme becomes relatively empty ... Coerced games, that in which the individual is forced to play, quite independent of his possible preference for withdrawing have not been fully discussed ... Overwhelming emphasis ... has been placed on voluntary games.

[Buchanan \(1962\)](#), an institutionalist, argued, logically, that we must not be fixated on the assessment of specific outcomes in any given situation. Rather, we should concern ourselves with the rules of the game—that is, we must focus on organizational and procedural principles rather than on any specific distributional outcome. If the overall arrangement and processes are fair, then the outcomes over a series of instances may be accepted collectively as the social best, even if in any given instance the outcome may be deemed unsatisfactory (and temptingly improvable⁶⁵).

⁶⁵ Buchanan illustrates by noting that stop signs oblige drivers to adhere even in the dead of night with no traffic around.

While evidently sensible, claims about the optimality of arrangements and processes may provide a fig-leaf logic for but cannot justify sustained distributional unfairness. Sooner or later this leads to angry calls for government intervention in the form of more transfers (as we have witnessed in the UK recently) and higher taxes on the wealthy “winners” (as is being discussed worldwide). Regrettably, as reviewed above, government failure seems no less common than market failure. In reality, with few exceptions (as perhaps in the Nordic countries), governments have not been able to address satisfactorily such issues as income concentration and climate change (the counterfactuals notwithstanding). This is because, in the real world, distributional issues are influenced in predictable ways by the existence and self-interested exercise of *differential power* among actors in the economy.

Prices may be the invisible hand in modern welfare theory, but prices are influenced (in a predictable manner) by differential power. With rare exceptions (of near perfect competition), prices are not the product of impartial let alone immaculate processes. Power influences the terms of trade and the final allocations in a manner that may be assessed as efficient but cannot in the general case be characterized as *optimal* (the convention in economics terminology notwithstanding). This is writ large in the [Acemoglu et al. \(2022\)](#) study, which spotlights the skewed distribution of pains and gains in modern business (and is reflected in the widening gap between CEO and median worker income).

Adam Smith, our pioneering proponent of a liberal economy, was himself alert to the pernicious role of differential power. Reflecting the epoch in which he lived and wrote, Smith highlighted four sources of differential power in markets: landowner or wealth power, monopoly power, employer power, and political power (see [Elliott, 2000](#)). Each of these related powers was a fulcrum on which the powerful could and invariably did pivot the price line in their own favor. “[I]n standard models of market relationships ... power is conceived as external to or beyond the scope of economy ... Market exchange and power, Smith believed, are interdependent, not separate topics ... Specifically, monopoly power and monopoly exchange coalesce because monopolists exercise power through control over quantities and prices in the exchange process” ([Elliott, 2000](#): 453–454).

Yet, thanks to modern economic theory and education, we are habituated to thinking that if trades are voluntary and markets are allowed to work their magic, then outcomes will be optimal (at least in the sense of Buchanan). Meanwhile, in many parts of the world and in many sectors (e.g., agriculture, construction, apparel, food service, domestic help, healthcare, home delivery, and such), exchange reflects “jungle economics” where differential power is commonplace and its use perpetrates chronically unfair distributions. “The exercise of power is pervasive in every society and takes several forms,” note [Piccione and Rubinstein \(2007\)](#), who offer an illuminating and formal exposition on the role of power in markets. Substituting power for price in their analysis, they show that “under standard assumptions, a jungle equilibrium exists and is Pareto efficient” (p. 883). Indeed, experience and experiments (as in ultimatum or dictator games) show that power influences terms of exchange.

In our times, the findings in [Acemoglu et al. \(2022\)](#) suggest starkly that business managers are willing to squeeze workers and their wages to make shareholders and themselves better off. More than voluntariness, then, when it comes to shaping outcomes in market-based transactions, it is differential power that matters. The Melian dialogue in Thucydides’ history of the Peloponnesian war of 416 BC seems apropos. Athens explains its siege and sacking of Melos island with this zinger: the strong take what they can and the weak yield what they

must. It is in this light that the philosopher Reiff (2012) has called not only for a minimum wage but also a maximum wage.

As grim as the situation appears, a ray of hope can be given aperture if we consider and accept that it is not power per se but the *exercise* of power that matters. *Uneducated power* is a chronic and invisible wedge that drives apart performance and progress. But if, as discussed in the previous section, we can relax the assumption that power and maximizing self-interest are inexorably coterminous, and if we can reform business theory and education on the exercise of power, then we may be able to better integrate economics and morality. Even the educated exercise of power will be discretionary (i.e., it will reflect choice), but it will be less arbitrary (i.e., not just reflect chance).

To see how we may accomplish this, let us return to the Edgeworth Box in Figure 1.2 and consider the blue circle allocation labeled Market-Pareto. In this allocation, which lies inside the oval region, both Labor and Capital are better off relative to their initial endowments. But what exactly does “better off” mean? Is it better off relative to an outcome *ex ante* (i.e., prior to the trade)? If so, the answer in this case is yes. But is better-off relative to some standard of well-being? A person on minimum wage may be better off than if they were unemployed. Yet a living wage would be even better and fairer.

The fairness question is stark in a recent story reported in *The New York Times* (20 March 2023).⁶⁶ The article narrates the sordid plight of workers at a plant in Monterrey, Mexico that recycles lead in used car batteries coming from the US. “Workers in these plants are being poisoned day in and day out, and often without even their own knowledge of that,” declares a non-governmental organization to the reporter. The article notes that the beneficiary, Milwaukee-headquartered Clarios, “the world’s largest car battery maker,” saved some 25 percent in recycling costs through this cross-border operation.

The story raises the notion of exploitation, which is described as “playing for advantage in situations where it is inappropriate to do so,” and which involves a violation of the moral norm of “protecting the vulnerable” (Robert Goodin, cited in Zwolinski et al., 2022: 39).⁶⁷ To be clear, “Exploitation ... does not necessarily harm its victim in the sense of making her worse off than she would have been, had the exploiter never interacted with her at all. Rather, it makes its victim worse off than she should have been, had she been treated fairly” (Zwolinski et al., 2022: 22).

Aware of such issues in the workings of liberal markets, Arrow (2015: 40) cautioned: “There are clearly many cases when a reasonable judge would have a clear judgement not reachable by the Pareto ordering ... I can only say [that] the formal theory by which individual valuations are combined into a social valuation has met with many as yet insurmountable obstacles.” Sen (1977) is more scathing in his classic “Rational Fools” article, wherein he confesses that conventional reverence notwithstanding, in terms of social welfare, there is nothing terribly impressive about an allocation being in “the core” and qualifying as Pareto efficient. As scholars like Farber (2005: 5), echoing Arrow, exclaim: “Pareto ... seems to be ... a necessary condition of the best outcome, though far from being a sufficient condition.”

Assumptions, like theories, are performative, and it is high time that we rectify the assumption of Pareto as a *sufficiency* criterion or the gold standard of optimality. Specifically, we

⁶⁶ Steve Fisher, 20 March 2023, “Americans’ Old Car Batteries Are Making Mexican Workers Sick,” *The New York Times*. www.nytimes.com/2023/03/20/world/americas/car-batteries-lead-mexico.html (accessed 23 March 2023).

⁶⁷ The maxim that vulnerability triggers duties of protection and justice is related to the obligations of power (see Sen, 2018).

need to redress the elision of differential power in the Pareto approach. Of course, the question arises: by what moral logic might we guide the more powerful economic actors to enable and enact more equitable outcomes that might actually be regarded as *optimal* and not merely efficient? [Sen and Williams \(1982\)](#) have cautioned that this is a hard problem. “The characteristics of rationality are not easy to identify even for prudential theories and the problem is certainly no easier for evaluating moral theories” (p. 17). Still, they add, “most human beings have needed, and assuredly will need, to use notions which utilitarianism can neither accommodate nor explain” (p. 21).

We can, I believe, make some progress on this long-standing challenge by applying integratively three principles that owe inspiration, one each, to the moral philosophers Rawls, Smith, and Kant. Enacted jointly, I submit, these principles can usefully help guide economic actors in going beyond Pareto efficiency to something more akin to Pareto optimality. The approach, as we will see, privatizes transfers and, paradoxically, it implies more rather than less freedom for economic actors (which ought to placate adherents of Friedman and Hayek who might be concerned about maintaining “free” markets).

The first of the three tenets is encapsulated in the “difference principle,” which Rawls expounded in his famous tome *A Theory of Justice* (1999 [1971]). The idea is that the more powerful party in an exchange ought to exercise their power in a manner that tends toward delivering “the greatest benefit” to “the least advantaged.” Make the worse-off better. We can imagine how different things would be for worker wages in the [Acemoglu et al. \(2022\)](#) study if business school-educated CEOs were acting broadly in line with this principle. Admittedly, there is no formula here, but the principle recommends that in the division of surplus emanating from the exchange or economic action, one should err on the side that is inequality dampening. To be clear, as so many have clarified, this does not imply something excessively noble, such as altruism or selflessness.

Applying this first tenet to the illustration in our stylized Edgeworth box should make it clear that while the price line leading to the blue circle (Market-Pareto) outcome is fairer than the red triangle (jungle-Pareto), it doesn’t quite satisfy the Rawls difference principle. In the blue circle outcome, the bulk of the gains from exchange are still going to capital. (Think of the firm Amazon and the wages of its warehouse workers relative to the income—in capital gains—enjoyed by its shareowners.) To align with the difference principle, the more powerful party needs to offer a price line that is steeper—one that may lead to the green star (labeled moral-Pareto) in [Figure 1.2](#).

But how might even a morally inclined powerful actor know how much is enough? This is where we may find guidance from the second moral principle that reflects on the assessment of an “impartial spectator,” as expounded by Smith in his *Theory of Moral Sentiments*. The idea, roughly applied to our situation, is that an impartial spectator knowing the facts and observing the actions of the more powerful party (in our model, the one in a position to influence the slope of the price line) might make one of three assessments of the final allocation: deem it as acceptable; as praiseworthy (meriting and eliciting approval); or as blameworthy (meriting and eliciting disapproval). The guidance implied is to exercise power in a manner that avoids the spectator’s disapproval. Ideally, the action chosen would be praiseworthy. For this principle to work, it is assumed that neither the actor nor the spectator is a moral cynic—that they are, in other words, morally intact. ([Dupuy \(2008\)](#) offers an excellent exegesis on Smithian logic, including on the importance of moral imagination and reasoning to enact the impartial spectator and the role of self-love as self-command in its practical application. As

he explains, “in Smith’s social theatre, everybody is at once a spectator and an actor,” p. 94).⁶⁸ We may supplement the impartial spectator principle by the principle of non-exploitation, as discussed above and expounded in Reiff (2013).⁶⁹ Reiff defines exploitation “as the unjust extraction of value from another as part of a voluntary exchange ... not otherwise prohibited by law.” This is another way of reasoning which distributions (i.e., competitive equilibria) may be considered blameworthy or praiseworthy.

Finally, to the above two moral principles, we may integrate a third, this one inspired by Kant. I often think of this as an “imitative equilibrium.” In this case, the more powerful actor is encouraged to reflect on this question: if other economic actors were to exercise power as I am doing in this instance and more generally, then would the global outcome be one that is desirable and sustainable? Or, if others, in their own turn, acted as I am doing in this instance, would the whole system tend toward fragility and dissatisfaction?

Thus, whereas the first principle turns on the obligations of power, and the second principle on fairness assessed from a vantage point of impartiality, this third principle integrates a systemic and dynamic view (across actors and over time). The inspiration for this principle lies in Kant’s maxim to act in a manner that we wished were moral law to which all would have to abide. The real world is rife with many examples of powerful actors’ conduct (from tax evasion and corruption to pushing risky securities and pollution) that violate this principle. Educating and expecting powerful economic actors to factor this in systematically in the exercise of their discretionary power could go a long way toward migrating from merely Pareto efficient to Pareto optimal.

We can now return to Figure 1.2 and apply the trio of moral principles just discussed. At the blue circle Market-Pareto allocation, agent Labor is on a higher indifference curve and better off than in the pre-trade condition (and clearly better than in the Jungle-Pareto allocation). However, the terms in this blue circle allocation favor agent Capital (who ends up on a much higher indifference curve relative to the initial one). By contrast, if we apply the trio of moral principles, then we may observe a steeper price line (due to the moral exercise of differential power) and in terms of final allocation we may end up at something like the green star allocation labeled moral-Pareto where effort is well compensated and the terms of trade favor agent Labor more than they do agent Capital. One may think of workers at the big box retailer Costco in the United States (which since its inception has tended toward paying living wages over minimum wages).

Besides Costco in the USA, firms such as Tata in India, Natura in Brazil, Stella McCartney in the UK, and Lindéngruppen in Sweden all provide instances where the more powerful economic actor exercises power in both monetarily and morally coherent ways. That is, in ways that we may characterize as Pareto *optimal* and not just Pareto efficient. If Boeing, McKinsey, and Goldman were to adhere to and apply these principles, we would almost certainly have averted those costly and unfair outcomes discussed at the top of this chapter. Indeed,

⁶⁸ It is not unimportant that this second principle integrates sentiments/emotions in the mix. I am now persuaded that given human nature, in thinking about practical reasoning (prudential or especially moral) we cannot neglect emotions and expect to be very right, let alone very useful. I suspect that this is one of the reasons that, with exceptions such as Smith, moral philosophers including stalwarts like Rawls and Sen have had scant uptake in the real world. There is great scope, I reckon, for productive integration across moral psychology and moral philosophy.

⁶⁹ Roberto Veneziani (2015) provides an insightful review and critique of Reiff’s 2013 book on exploitation. See <https://qmro.qmul.ac.uk/xmlui/bitstream/handle/123456789/11268/Veneziani%20Exploitation%20and%20Economic%20Justice%20in%20the%20Liberal%20Capitalist%20State.%20By%20Mark%20R.%20Reiff%20review%202015%20Accepted.pdf?sequence=1> (accessed on 3 June 2023).

had we been educating business students and executives in this manner, then it is likely that the empirics in the [Acemoglu et al. \(2022\)](#) study would have yielded different results. It is time we start doing so now. I suspect Smith, Pareto, Arrow, and our other intellectual forebears would approve.

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Assumptions in Economics

Jean Tirole

2.1 What Economists Do

As with most academic disciplines, research in economics builds on a combination of theory and empirical evidence.¹ Theory provides the conceptual framework. It is also the key to understanding the data. Without a theory—that is, without a system of interpretation—data is at best a set of interesting observations and correlations without clear implications for economic policy. Conversely, a theory is enriched by empirical evidence, which may invalidate its hypotheses or conclusions and thus can improve or overturn it. That empirical work has expanded to dominate mainstream economics is actually good news for theory, due to their complementarity.

For readers trained in science, the analogy with modeling in engineering may prove useful. Economists start with a real-world problem, whether it is already well identified or a new question posed by public or private decision-makers. The engineer's quest is driven by some goal, such as energy efficiency, speed, low maintenance, sustainability, manufacturing cost concerns, or most likely a combination of these. The economist is driven by some goal as well: social welfare is the most common one, but normative analysis may be associated by other goals. There is perhaps more discretion in economics in specifying the goals, as one might argue that those in engineering may be broadly supplied by profit considerations.² In any case, there is a large literature in philosophy and economics on alternative welfare criteria, and for the purpose of this discussion we will just assume that the analyst has settled on one.

Like in engineering, little can be done without theory.³ Economists therefore identify the substantive core of the problem in order to focus on the essentials: is the market concentrated? What are the informational asymmetries or externalities? Can we count on extended relationships (across time or within a social network), or alternatively on binding contracts

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² Unless the firm engages in corporate social responsibility (see chapter 7 in my *Economics for the Common Good* (2017) for an economic view of this concept), or is plagued with agency problems.

³ There are exceptions, of course. Big data analysis allows Netflix or Amazon to predict which movie or book you will like. No theory as to why you will like them is a priori needed for this. But big data without theory and causality analysis has clear limits, such as a poor performance when the data set does not account for changed circumstances, and a low ability to build public policy on big data analysis only. More on this below.

to generate proper social behavior? Could image concerns suffice to counteract socially detrimental material incentives in the specified realm of activity? And so on, and so on. The theoretical model is said to be *ad hoc*: it is never an exact representation of the truth, but a simplification thereof, and its conclusions can never explain reality as a whole. There is always a tradeoff between a theoretical model describing behavior in a detailed and realistic way and the much greater difficulty of analyzing such a model in its generality.

The economist's construction of a model needs a description of the agents' (or "players") goals as well as hypotheses about their behavior. For example, we can assume, as a first approximation, that capitalist enterprises seek to maximize their profits so as to satisfy their shareholders. This calculation is, of course, intertemporal: it is often in the long-term interest of shareholders to sacrifice short-term gains—for example, establish trust by respecting the interests of employees, suppliers, or customers and spend money on equipment or maintenance—in order to reap profits in the long term. If necessary, we can refine the simplistic hypothesis of profit maximization thanks to enormous bodies of knowledge about the governance of business and about the effects of the (necessarily imperfect, and occasionally perverse) incentives offered to CEOs and boards of directors.

Similarly, we can first posit that consumers act in a rational manner—that is, in their best interests, whatever they have been assumed to be—given the limited information available to them. Once again, we can refine this basic analysis thanks to recent research into behavior that exhibits limited or bounded rationality. We can also add imperfect self-control when relevant (overconsumption of drugs, gambling, unhealthy foods, under-savings, etc.). Finally, we need to model the way in which multiple actors, for example competitors in a market, interact. For this, game theory is key.

Even a good model may have limited predictive power for (at least) two reasons that are absent in physical sciences: self-fulfilling phenomena and behavioral uncertainty. First, economists, and more generally social scientists, have long emphasized that “strategic complementarities” may result from the interdependence of behaviors: in the same way that revolts require coordination among rebels to have a chance to succeed, or that building a house near an airport proves profitable only if others also do so (thereby creating a political opposition to the expansion of the airport), economic agents often have stronger incentives to adopt a behavior when other agents also do; this applies to many economic strategies, such as attacking a currency, and to many behaviors subject to social norms. However, while the multiplicity of “self-confirming behaviors”/“equilibria” rightly fascinates social scientists, it also hinders prediction. Second, economic agents often exhibit behavioral biases; while many such biases have been embodied in economic models in the last thirty years, we also know that agents are very heterogeneous with respect to such biases, and we have limited information about the distribution of biases in the population.

2.2 Utilitarian and Consequentialist Bent

Economics, like all human and social sciences, is both positive and normative. It attempts at documenting, describing, predicting, and understanding individual behaviors and social patterns, especially in the realm of economic interactions. This activity already covers a rich set of approaches, depending on how deep one wants to go into understanding the

phenomena. Take big data; many of its successful contributions so far have been concerned with predicting individual tastes for a movie or a piece of music, traffic flows, the spread of viruses, or what we are looking for using a search engine. Much of the associated effort has focused on correlation, not causation. This black-box approach is fine for such applications. But for a number of public policies, it is not: we need to know why we are acting in a specific way and how our environment affects our well-being, not only how we act.

This is where the normative dimension enters. While economics, like all human and social sciences, is about making the world a better place, it, perhaps with the exception of philosophy, has a more normative focus than the others. This may be due to the strong involvement of economists in economic policy design. But regardless of the reason for this obsession with normative implications, the normative dimension, which for me is central, requires making value judgments on how to evaluate policies.

It is fair to say that most (but not all) of the economics literature adheres to the utilitarian paradigm. It starts from individual preferences, either posited or revealed, builds from there predictions about behavior (using game theory), and draws normative implications.

2.2.1 Do Economists Always Respect Individual Preferences?

Economists do not always respect preferences. Besides the obvious point that people's actions may hurt others (externalities), there is a concern that people also do not necessarily act in their own self-interest. Not only because of the equally obvious point that people may be poorly informed about the consequences of their actions (a point that has been amply studied in the last half-century as a branch of information economics) but also because they may fail to stand for their long-term interests (internalities), as has been stressed for centuries by other social scientists, most notably philosophers and psychologists. When temptation is strong and self-control weak, the individual may privilege their short-run pleasure over the long-term consequences. Economists have studied this and their conclusions are probably in tune with those of most policymakers and other social scientists, advocating a rather paternalistic approach to the shortage of savings (which are heavily subsidized or forced onto people⁴ in most countries) or the overconsumption of alcohol, drugs, tobacco, gambling, or unhealthy food. Still, even for consumptions marred by self-control problems, there is a sense in which economists respect preferences: they distinguish between the short-term, impulsive self and the long-term one (one who rationally looks at their interest, unaffected by temptation), and stand for the latter.

2.2.2 Comparing Utilities

Much of economic evaluation is implicitly based on the idea of the veil of ignorance, a concept dating back several centuries in philosophy. The veil-of-ignorance thought experiment allows us to transform an interpersonal comparison of utilities into the evaluation of a single person's utility: behind the veil of ignorance, I could be you or me, and therefore in order to

⁴ Through pay-as-you-go pension schemes or mandatory health insurance, for instance.

assess policy I have to put myself in your shoes as well as mine, and more generally to figure out in what kind of society I would like to live in if I were not yet assigned a specific position within it.

Economists strive to find “Pareto improvements,” policies that benefit all. This generally requires compensating the losers of a specific policy move either through money or other policy moves that benefit them. Unfortunately, such comprehensive policy moves rarely exist as most policies are designed in a silo approach and involve choices that hurt some people while benefiting others. This raises the issue of how to weigh the gains of winners and the losses of losers. This assessment is usually made by looking at monetary equivalents of those gains or losses (how much would winners be willing to pay for this policy to materialize and losers be willing to pay to avoid it). This approach, however, ignores the political economy problem raised by the absence of compensation of losers.

Philosophers have long reflected on our reluctance to confront these utilitarian calculations. One of the most famous philosophical dilemmas of this type is the Trolley Problem: would we be prepared to push someone under a tram to derail it if that meant that five people further down the line would be saved?⁵ Or, to put the dilemma another way, would a surgeon be prepared to kill someone in good health to save five people who will die if they do not receive an immediate organ transplant? Or what would we do if asked to choose between saving our own child from drowning and saving five others, if saving all of them were infeasible? These hypothetical choices make most people uncomfortable; when forced to make a choice, they often, but not always, argue that they would not sacrifice one life to save five others.⁶ Yet, behind the veil of ignorance, we are five times more likely to be among the beneficiaries of such choices than to be the victim.

In a few years, driverless cars will appear on our roads. This is a good thing. Our streets and roads will be much safer, and our travel time more pleasant. But our societies will have to make some morally sensitive choices. Suppose that I am driving my car alone, and I find myself in a rare situation in which I cannot avoid an accident. My choice is limited to two options: sacrificing myself by steering into the ditch or killing five pedestrians who are on the road. Today the driver makes this kind of decision in a split second. Tomorrow, it will be an algorithm installed in the car, programmed in advance to react dispassionately to the situation. The algorithm will make the decision one way or the other. Would I prefer a car that would sacrifice its driver or one that would run down five pedestrians? Intuitively, I would perceive the first car/software as more “moral,” but which car would I choose for myself? Behind the veil of ignorance, my chance of being one of the pedestrians is five times greater than my chance of being the driver of the car, so I would pick the car that would create fewer victims. This is indeed what most subjects pick as the “moral choice.” But things would be very different if I was choosing a car in real life. I would have to decide whether I

⁵ Of course, for answers to this question to make sense, people must answer the question actually asked and not alter its content by adding questions that naturally come to mind, such as “But are we really sure that we need to kill this person in order to save the five others?” For example, any answer to the question of “whether we would be willing to let a terrorist be tortured in order to find out where they put the bomb, thereby saving numerous innocent lives” must abstract from the obvious agency concern that granting the right to torture would enable sadistic or biased law enforcers to abuse this power; rather, for the philosopher’s question to make sense, one must abstract from reality and assume that a benevolent social planner or judge is in charge of enforcing the process that results from whatever is our philosophical choice. For an alternative reason for why the utilitarian decision may not be appealing in such dilemmas, see my 2011 discussion paper with Roland Bénabou on “Laws and Norms.”

⁶ Their choice depends on how the problem is framed, though.

am prepared to make this kind of ethical choice explicitly. In experiments, many people who are faced with this question refuse to allow the choice to be dictated by the state. As shown by [Bonnefon et al. \(2016\)](#), here is a clash between our abstract ethical position (which here differs from our position in relation to the Trolley Problem) and our actual stance, which is driven by our self-interest as a driver.

The veil-of-ignorance analysis does not always put the majority's viewpoint ahead of the minority's interests. Actually, it underlies much of the constitutional safeguards protecting religious, ethnic, or other minorities. We want to prevent a majority from oppressing (understood as "imposing high costs on") a minority because it does not like the latter's sexual orientation, racial types, or religious beliefs. Scholars may prefer to invoke the notion of liberty to vindicate such protection of minorities, but somehow some rough cost-benefit analysis necessarily plays a role in deciding which minorities are protected and which are not: the minorities who like to drink while driving or to assault others are not to be protected by the law despite the fact that their freedom is impaired by laws prohibiting such behaviors. Somehow, we (perhaps unknowingly) assess that discrimination and violence against sexual or ethnic minorities is very costly to the latter while bringing minor benefits to the perpetuating majority (or benefits we assess as immoral), while the reverse is true in the case of drunk drivers or violent individuals. All cases in between these two may be considered, giving rise to pragmatic choices (a social event or party enables a group of people to enjoy life while creating noise pollution affecting a broader set of people). Again, the question posed by the veil of ignorance is: "in what society would I like to live if I did not yet know the position that I would occupy in that society?"

2.2.3 Consequentialism

Economists look first, but not only at consequences. Most of them would not be shocked by or probably, I submit, would adhere to philosopher Peter [Singer's \(2015\)](#) views on impact investment. Singer offers some perhaps unsettling recommendations such as the desirability for a talented graduate wanting to devote their life to others to choose to be a trader rather than a social worker. As a trader, the argument goes, the graduate can make a big salary (while of course acting as a whistleblower for some unethical behaviors), give 90 percent of it to charitable causes, and thereby have a much bigger impact on society than by becoming a social worker, an occupation for which there are many substitutes (who indeed will be able to operate thanks to the charitable gifts).

Whether you agree with this particular position or not, Singer makes an indisputable point: people are too preoccupied with their own self- and social image and too little with the good they actually deliver. In this respect, his anti-posturing views fit well with those of Adam [Smith \(1759\)](#). His utilitarian point of view has deep implications for public policy (e.g., health or military choices), and not only for the definition of our moral choices.

Another case in point is the publication in a leading economics journal of an article on ivory trade, recommending that a non-governmental organization (NGO) that confiscates ivory resell this ivory on the market ([Kremer and Morcom, 2000](#)). Let's suppose an NGO confiscates ivory from traffickers who kill endangered elephants for their tusks. The NGO has to choose between destroying the ivory or selling it discreetly on the market. The

immediate reaction of many is that the latter choice is reprehensible ... But let us think the issue over.

The NGO would receive revenue from selling the ivory, which it could use to devote more resources to detect and investigate, or to provide additional vehicles to limit the traffic in ivory. Selling the ivory might also have the immediate effect of lowering its price. The price would be a little lower if not much was sold, and a lot lower if a lot of ivory was put on the market. Traffickers are economically rational actors: they consider how much money they can make from their activity and consider the risks they take (in this case, prison or meeting armed police). If the price of ivory falls, it would therefore discourage some of them from killing elephants.

Given this, would the NGO's sale of ivory be immoral? Possibly. A conspicuous sale by an organization with a respectable reputation might legitimize the trade for potential buyers who would otherwise feel guilty about their desire to purchase ivory—hence my emphasis on a “discreet sale” in this scenario. But at the very least, we ought to think twice before we condemn the choice of selling the ivory, especially since doing so would not prevent the government from exercising its sovereign authority to prosecute poachers or retailers of ivory or rhinoceros horn, or from communicating to the public the importance of protecting endangered animals in the hope of changing the accepted social norms.

A last illustration of the same point is supplied by our attitudes to the Clean Development Mechanism (CDM) that was instituted at the Kyoto 1997 environmental summit. To make it simple, if a company in a rich country, say in Europe, provided funds to save a forest in Indonesia from deforestation, it could get a credit for an equivalent amount of CO₂ using the price in the European tradable emission permits market. The CDM was a well-meaning policy, trying to both bring money to less developed regions of the world and combat pollution using a market-based mechanism. Alas, it ignored general equilibrium effects: the absence of deforestation—good news for the environment—leads to a rise in the price of wood or soy (depending on why this forest was about to be cut), encouraging deforestation elsewhere. More generally, the lesson is that one must look at consequences, not symbols. A socially responsible citizen who would have put money into a fund of CDM actions would have had little impact on global warming, despite an apparently green behavior.

Economists, of course, do not assert that intentions do not matter. If I shoot at you but miss you because of poor shooting skills⁷ or a distraction, I still intended to kill you. You (and society) should draw the consequences of my act, even though no physical harm resulted from it; and, in fact, you would. More generally, signaling has been a central topic in economics for the last half-century. And we do have solid experimental evidence that intentions matter.⁸ But note the route for apparently deviating from a consequence-based approach: even though the action had no physical consequence, there has been some learning. And the trust that existed between you and me, or that of society in me, has evaporated.

What about inequality? Do we care only about its magnitude and consequences, or do we care also about its source? A few comments are here in order. First, inequality can be viewed as a market failure: there is no reason why the market will deliver the income and wealth distribution that one would have wished behind the veil of ignorance: just like in the realms

⁷ Especially if I am overoptimistic about these shooting skills.

⁸ A large literature in experimental economics studies the information conveyed by behavior; see, e.g., [Falk and Kosfeld \(2006\)](#).

of equal opportunity and health coverage, the market is likely to deliver “too little insurance” against life’s mishaps.

Second, an economist will not view all forms of inequality in the same way: regardless of their views on/aversion to inequality, the economist will probably have less aversion to income inequality that results from innovation and the supply of socially useful products and services than to income inequality that stems from lobbying, connections, self-dealing, corruption, abuse of dominant position, and so on. In the former case, inequality will have at least a redeeming feature, that of being an incentive for the creation of social well-being; in the latter case, inequality is bad along all dimensions (behind-veil-of-ignorance insurance against income realizations *and* impact on behavior).⁹ This distinction might seem to violate consequentialism, but it does not. Consequences include the impact of social rewards on incentives to create or destroy social value. And so the source of inequality matters to a consequentialist.

This being said, identifying inequality with income and wealth differences (or even their implications in terms of access to education, healthcare, and other amenities, as well as to information) is too narrow. They are also linked to social status; and while economists have made some progress in embodying social status in their analyses, they still have much to learn from philosophers, sociologists, and other social scientists who have also been concerned with inequality for a long time.

Finally, there has been little work in economics to reconcile consequentialism with the notion of incommensurability of all goods dear to [Durkheim \(1976\)](#). This is an area in which more research is warranted.¹⁰

2.3 Methodological Individualism versus Social Construction of Preferences

A more significant difference between economists and other human and social scientists is the extent to which they on average adhere to the principle of methodological individualism, according to which the incentives and behavior of individuals must be the starting point for understanding the behavior of the groups they belong to.

Economists are of course not oblivious to social interactions (nor are they accused of being so). Indeed, game theory, the conceptual tool to study such interactions, has been central in economics for at least forty or fifty years. Game theory, combined with field and lab experiments, allow economists to see how individuals are affected by others and in turn affect them. People:

- learn from and mimic each other;
- influence each other through formal incentives and the more implicit demands they formulate;

⁹ Similarly, many economists will view inequality from inheritance differently from identical inequality stemming from one’s own hard work. This distinction may be captured from a consequentialist viewpoint by looking at differences in welfare at birth, as in Emmanuel Farhi and Ivan Werning’s classic articles “Progressive Estate Taxation” (2010) and “Inequality and Social Discounting” (2007).

¹⁰ Roland Bénabou and I briefly touch on this issue in “Identity, Morals and Taboos: Beliefs as Assets” (2011) and “Over My Dead Body: Bargaining and the Price of Dignity” (2009).

- yield to conformism and fashions, behave gregariously, and succumb to groupthink;
- have substantial image concerns that make them want to look good, generous, beautiful, or intelligent because they look for desirable jobs and partners or simply because they seek the esteem of others (and of themselves); these image concerns may be a foundation for the role of social norms in determining behavior, but this is certainly not the only one;
- inherit stereotypes, either as a result of the past collective behavior of their peers or because of prejudices;
- invest in identities;¹¹
- are actors in complex webs of organizational hierarchies or societies.

The fact that humans are social animals provides another source of context-dependent behavior. But even in social isolation, our behavior may be affected by apparently irrelevant cues. An economist who aims at making sense of context-dependent behavior may want to take the point of view that at the moment of decision-making only a small fraction of what we know comes back to awareness; and so, any apparently irrelevant cue may remind us of something else that will influence our decision, or put differently alter our beliefs. Experimental economists have provided evidence suggesting that reminding people of their identity (e.g., gender or ethnic group) or values (e.g., reading the Ten Commandments) affects behavior, even though such reminders would seem to have no new informational value. Another reason why apparently irrelevant information matters is that it in fact may contain information about alternative choices: I may prefer A to B when confronted with an {A, B} choice, but choose B when offered a choice in {A, B, C}, even though this may seem to violate the axiom of independence of irrelevant alternatives: the presence of C may say something regarding whether A or B is best for me.¹²

Social life multiplies the number of cues that we are confronted with, and it is therefore not surprising that, beyond the direct influence exerted by our peers' norms and demands, our behavior is heavily context-dependent.

A fair characterization of most contemporary economics is that *it views preferences as socially influenced, but not socially constructed*.¹³ Somehow, the economist assumes that there are deep preferences; for instance, the individual prefers to create a good impression of themselves—how much will depend on the social context, for instance one behaves differently in the company of strangers one will never encounter again and among people one has incentives to impress—and if some “anomaly” arises—the individual deliberately tries to generate a poor image—some explanation is looked for rather than just to say that “it can go either way.” But one should admit that this is an assumption (no direct evidence is provided for the existence of these deep preferences exists), and conversely one should not

¹¹ For a view of identity as a belief about oneself, see my paper with Roland Bénabou, “Identity, Morals and Taboos: Beliefs as Assets” (2011).

¹² See Kamenica (2008).

¹³ At one extreme of the spectrum is situationism (according to Wikipedia, “Situationism is the theory that changes in human behavior are factors of the situation rather than the traits a person possesses. Behavior is believed to be influenced by external, situational factors rather than internal traits or motivations”). Another extreme view would hold that individual traits are all that matter to predict behavior. Very few scholars would hold either position.

conclude from the heterogeneity of behavior in different social contexts that such deep preferences do not exist. In the end, the proof of the pudding is in the eating: which approach has the most predictive power and enables policy analysis?

Whether right or wrong, the economists' attitude is indeed closely related to their normative emphasis. To be able to draw policy implications, a paradigm must be parsimonious—at the risk of being simplistic—and not allow too many degrees of freedom. Otherwise, “anything goes.” Most economists therefore would agree with the statement that “culture matters,” but would feel uncomfortable with attributing differences in behavior among social groups simply to “it’s cultural.” Put differently, the challenge is to understand why in the end one social group converged on a specific norm of behavior and the other not, for example how history, context, or group dynamics led group members to adopt certain beliefs, identities, and norms. This is not an easy task, but a normative approach seems to require moving away from a black-box approach.

2.4 Worshipping Markets?

Starting with Adam Smith, economists have noted the virtues of markets; markets bring some allocative efficiency (the price mechanism selects the most efficient producers and directs goods and services toward the consumers with the highest willingness to pay for them), incentives (a competitive market creates high-powered incentives to reduce cost and to offer more attractive products), and integrity (the state cannot mingle in an arbitrary way in the allocation process).

Yet many economists' attention is turned to market failures, trying to understand why markets may fail and what to do about it. There are externalities, as when I pollute the air or a river. There is market power, on the goods and services side as well as possibly on the labor side. Information may be asymmetric among parties, leading to various phenomena such as market freezes, credit rationing, or fraudulent behavior. And, as we have noted, even inequality can be considered a market failure, as the distribution of income generated by the market has no reason to coincide with what we would like to be confronted with behind the veil of ignorance.

All these market failures motivate policy interventions; illustrations include:

- antitrust and public utility regulation to prevent abuses of dominant position (market power)
- consumer protection to remedy our informational shortage (we are unable to monitor the bank in which we have our deposit, our insurance company, or the food safety along the supply chain leading to the restaurant we have dinner at, or to understand the full implications of the consent we give to share our data when we visit a website; neither would it be desirable to do such monitoring even if we had the expertise and access to the relevant data, due to the public good feature of such monitoring)
- redistribution, universal health coverage, and universal access to a good education, policies that all are de facto insurance policies against the vicissitudes of life, and that we would long for behind the veil of ignorance.

2.5 Ethics and Markets

Whether markets promote the common good has been the object of a time-honored debate. Montesquieu and many eighteenth-century thinkers viewed markets as creating trust among otherwise unrelated individuals. Today (and ironically, given that almost all economies in the world now obey some form of market mechanism), public opinion, politicians, and religious leaders often express a strong distrust of markets, which, they feel, promote unethical behavior.

And indeed, it is easy to point at the many examples where the profit motive has led to rather unpalatable behaviors: excessive risk-taking in finance (the 2008 financial crisis) or in manufacturing (using cheap components or cutting on maintenance at the risk of casualties or environmental disasters), environmental damages, abuses of loopholes (corporate tax optimization, opioids, car manufacturers' environmental tests), outright fraud or misrepresentation, and so on ...

The market is a specific type of incentive, and it is in fact incentives that are under attack. There is no question that incentives in the form of money, promotion, or just glory may lead humans to sacrifice the common good and promote self-interest. Indeed, many misbehaviors occur in contexts that most would not think of as being classical market environments. The terrible environmental mismanagement of the Soviet bloc is a case in point. The many examples of fraud in science or simply sloppy craftsmanship to publish noticeable research ahead of others and put one's name on an invention or idea is another.

Forgoing markets and incentives would be throwing the baby out with the bath water. But we need to be wary of their potential impact on behavior. This is an old lesson in regulatory economics. The introduction of incentives for regulated firms has to go hand in hand with stricter monitoring of maintenance and safety procedure (think about nuclear plants or a railroad network): incentives promote low costs and prices as well as innovation, but they also lead firms to cut corners. More generally, an economic system must pay attention not to create wrong incentives, as has been the case for the regulation of the banking system. It is unavoidable that unscrupulous actors lose no time in stepping into a breach opened up by the regulation. While many view markets and regulation as alternatives, they really are complements; markets need smart regulation to fulfill their potential.

Institutions must also contribute to reducing the occurrence of such behaviors. One of the most damaging corporate behaviors is short-termism. The latter is often created by wrong incentives, ones that reward short-term rather than longer-term performance. It is easy to see what kind of biases such schemes (which clash with the classical economics' vision of value as being intertemporal value) may induce. Here the governance is key in the enforcement of deferred compensation.

Finally, let me say a few words about a specific criticism of incentives in markets and organizations. Bad behavior is often "justified" by the "replacement excuse":¹⁴ "If I don't do it, someone else will." This excuse is used by countries to vindicate their selling weapons or nuclear technology to a dictatorial regime. It was used by some Nazi employees to rationalize their participation in the Holocaust. Perhaps less dramatically, it is used routinely by doctors who over-prescribe opioids or provide certificates for sick-leave days to healthy employees,

¹⁴ Only recently have economists started to devote attention to this mechanism. See, e.g., [Bartling and Ozdemir \(2017\)](#); [Dufwenberg et al. \(2011\)](#); [Falk et al. \(2020\)](#); and [Dewatripont and Tirole \(forthcoming\)](#).

by firms that corrupt government officials, or by newspapers that violate celebrities' right to privacy. The replacement excuse, together with the "I was only following orders" one, are two of the most powerful rationalizations of socially detrimental behaviors. Social scientists must engage in more research in order to understand how incentives and excuses impact behavior in alternative institutional contexts (markets, hierarchies, etc.).

2.6 Concluding Comment

Any scientific discipline, any theory (formal or informal), rests on assumptions. And these assumptions do matter. I do not subscribe to [Friedman's \(1953\)](#) view that in the end only conclusions/predictions matter. There are several reasons for that. First, normative analysis requires some conceptualization of why agents adopt (or do not adopt) certain types of behavior. Second, data are most often imperfect and assumptions are then informative about the plausibility of an analysis: the analysis might offer a good fit for the sample at hand but should be treated with circumspection if it is highly dependent on¹⁵ assumptions that we know are unlikely to hold. Third, and a closely related point, the environment may change: a war may break out, the USSR may disintegrate, the telecommunications industry may be deregulated, a new privacy law may be enacted, Covid may create a pandemic, and so on; data are not available for the new environment generated by the change in the law, the geopolitical situation, the technology, or the social norm. We must extrapolate using existing knowledge, but how? Our thinking is then guided by our theory, and whatever empirical knowledge is not affected by the change in environment.

The process of explicating assumptions is crucial. It allows us to understand whether these assumptions are made for mere analytical convenience or to the contrary drive the very conclusions we want to highlight. Clearly stating our assumptions enables others to adhere to, reject, or propose improvements to these assumptions. This is part of the scientific method.

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¹⁵ Note that I use "is highly dependent on" rather than "makes." An analysis often makes simplifying and unrealistic assumptions for tractability (for example, "there is a continuum of firms or consumers" to capture the inability of economic agents to impact the terms of trade or to be able to use the law of large numbers (instead of its messy approximations) when there are numerous players on their side of the market: we know that the assumption is plainly wrong, and at the same time have little concern about making it, as many studies have shown that quasi-competitive behavior results from a low market concentration and that the law of large number holds approximately in finite samples; so nothing essential will be introduced or missed when making this "unrealistic assumption."

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A Half-Dozen Assumptions That Have Led Economists Astray

Robert H. Frank

1. The self-interest model favored by economists assumes that people will cheat if there is sufficiently little chance of being caught and punished. But this prediction is inaccurate for many people you know.

Consider the following thought experiment:

You have just gotten home from a crowded concert and discover you have lost \$10,000 in cash. The money had been in your coat pocket in a plain envelope with your name and address written on it. You now remember the sound the envelope made when it fell from your pocket as you got up to leave the event. Do you know anyone, not related to you by blood or marriage, who you feel certain would return it to you if he or she found it?

Most people respond confidently that they know many such people, and these beliefs are generally well grounded. Once we get to know people, evidence suggests that we can make reasonably accurate character judgments about them. Being regarded as someone who wouldn't cheat even when no one is looking is an extraordinarily valuable economic asset. It makes you an attractive candidate for assignments that require trust—which is to say, for almost any important job you might aspire to hold.

A young person would be well advised to remember that the person in charge of their next promotion will probably have an opinion about whether they would return their lost envelope full of cash if they found it. The surest way to earn an affirmative answer to that question is to be someone who actually would return the envelope. Contrary to the implications of the self-interest model, honest people not only enjoy greater peace of mind than others but they often do quite well even in purely material terms.

2. Standard economic theory assumes that choices are driven by preferences that originate within us. But that assumption ignores the central link between context and evaluation. Taking account of that link alters many of the conclusions of traditional economic models.

Context shapes every assessment we make. It applies to distance. (Are we almost there yet? No, if 10 miles remain on a 12-mile journey; but yes, if the same 10 miles remain on a 120-mile journey.) It applies to temperature. (Is it cold out? No, if it's 60° on a March afternoon in Montreal; but yes, if it's a 60° November evening in Miami.)

Once we take context into account, there can no longer be any presumption that self-interested choices by fully informed rational individuals will lead to socially benign outcomes.

Visualize the skyscape around a busy “strip mall” junction in a suburban landscape. Is a commercial billboard on the sidewalk there big enough? Because its ability to command attention depends on its relative size, businesspeople are rational to install signs that stand out relative to those of rivals. But that doesn’t mean that the resulting (visually polluting) landscape should command our approval. On the contrary, many communities have decided they get outcomes they like better by enacting zoning laws that restrict signs.

Context also shapes our evaluations of goods. Is my house OK? The answer, of course, depends on context. Long ago, as a peace corps volunteer in Nepal, I lived in a house with two rooms, no electricity, and no plumbing. If I lived in such a house in the United States, my children would have been ashamed for their friends to see where we lived. Yet in Nepal it was a completely satisfactory house, and I never hesitated to invite friends over.

In absolute terms, my house in Ithaca is very different. If my Nepalese friends could see it, they’d think I’d taken leave of my senses. They’d wonder: why would anyone need such a grand house? Why so many bathrooms? But most Americans don’t think that. In fact, most of my friends live in houses that are bigger than mine.

Standard economic models assume that each person’s spending is completely independent of what others spend. But that can’t be right if context matters. Growing income inequality in recent decades has changed the contexts that shape spending decisions in ways that have made it more expensive for most families to achieve basic goals.

People at the top are building bigger houses, for example, simply because they have more money. Those houses shift the frame of reference that defines what the near-wealthy consider necessary or desirable, so they, too, build bigger, and so on, all the way down the income ladder. Without invoking this process, which I call expenditure cascades, there’s no way to explain why the median new house in the US is now 50 percent larger than in 1980. Failure to keep pace with what peers spend on housing means not just living in a house that seems uncomfortably small. It also means having to send your children to inferior schools, because better schools are almost always those in more expensive neighborhoods.

3. Traditional economic theory’s neglect of context implies that a person’s loss in utility when they alone suffer an income decline is the same as their utility loss when everyone’s income declines by the same proportion. In fact, their loss in utility is much smaller when everyone’s income declines.

Traditional theory’s mistake is important because it causes people to overestimate the pain they’ll suffer if they pay higher taxes in support of public goods. It’s totally natural to think that if you have less money, you’ll find it more difficult to buy the things you want. That’s because most of the events in life that cause us to have less money—think home fires, job losses, business reverses, divorces, serious illnesses, and the like—are ones that reduce our incomes while leaving the incomes of others unaffected. In such cases, we really do find it more difficult to buy what we want. Only half of the houses are in top-half school districts, for example, so we’re less likely to be able to bid successfully for those houses when we have less money relative to others who also want them.

But it’s a completely different story when everyone’s spendable income goes down at once, as when we all pay higher taxes. Because across-the-board declines in disposable income leave relative purchasing power unaffected, they don’t affect the outcomes of the bidding for houses in better school districts.

This is a garden-variety cognitive error. When we try to forecast how an income decline will affect us, we rely on the previous income declines that are most accessible in memory. And since most the income declines we actually experience leave the incomes of others

unchanged, we tend to forecast similar pain when thinking about the possibilities of a tax increase.

This cognitive error reinforces the tax resistance that has made it so difficult to restore our crumbling public infrastructure. The following simple thought experiment illustrates the point that because across-the-board declines in disposable income don't affect relative purchasing power at all, prosperous families could actually pay higher taxes without having to make any painful sacrifices at all.

Imagine that you are a wealthy car enthusiast facing two options: driving a Porsche 911 Turbo (purchase price: less than \$160,000) on well-maintained highways or driving a Ferrari F12 Berlinetta (purchase price: more than \$320,000) on roads riddled with foot-deep potholes. Which would you choose?

It's an easy question. Suppose that the Ferrari would universally be judged better if both cars were driven on good roads. But since the Porsche already has every design feature that affects performance significantly, the Ferrari's edge would be tiny at most. No one could reasonably claim that the Ferrari would be more pleasing to drive on pothole-ridden roads than the Porsche on well-maintained ones.

Yet, among the super-wealthy, the actual quality mix of cars and highways in the United States more closely resembles Ferraris on potholes than Porsches on smooth asphalt. That's puzzling, since the latter combination could be achieved at much lower total expense. This distortion is in large part a consequence of the cognitive error just described: what happens when any one person spends less on a car is very different from what happens when everyone spends less. In the former case, the buyer feels deprived. But when everyone spends less, the relevant frame of reference shifts, leaving drivers just as satisfied as before. The same logic applies not just to cars and highways but also to a broad mix of personal and public priorities.

4. Almost every nation has laws and regulations that attempt to limit the risk of injury and death in the workplace. Economic theory insists that such measures would be welfare-reducing if labor markets were competitive. But because of the link between context and evaluation, safety regulation would be welfare-enhancing even in the perfectly competitive labor markets assumed in textbooks.

Because safety devices are expensive, additional safety necessarily means lower wages. Reducing risk to zero is impossible, so the practical question must always be: how much safety is enough? Since Adam Smith's day, classical economic theory has held that well-informed workers in competitive markets will navigate this tradeoff sensibly. They will accept additional risk in return for higher pay only if the satisfaction resulting from their additional buying power is greater than the corresponding loss in satisfaction from reduced safety. Adam Smith's invisible hand theory holds that safety regulation makes workers worse off by forcing them to buy safety they value at less than its cost.

But why, then, does virtually every country in the world regulate workplace safety? (Even the poorest countries have at least rudimentary safety requirements.) Classical economic theory does not have a good answer. It either portrays such regulations as anomalous or else needed only because workers are uninformed or markets are not competitive enough. Yet we regulate many safety risks that workers clearly understand, and most safety regulations have their greatest impact in precisely those markets that are most competitive by conventional metrics.

The mystery is resolved when we recognize that context shapes evaluations of safety less heavily than it does for other goods like housing. In that case, even well-informed workers in perfectly competitive markets will tend to buy too little safety on their own. The forces that underlie this distortion are nicely captured in a pair of thought experiments involving choices between two environments.

In World A, your family lives in a neighborhood with 4,000-square-foot houses, while everyone else lives in neighborhoods with 6,000-square-foot houses. In World B, you live in a neighborhood with 3,000-square-foot houses, while everyone else lives in neighborhoods whose houses measure just 2,500 square feet. If conditions were otherwise identical and would persist indefinitely, which world would you choose?

Classical economics, which says that only absolute values matter, portrays World A as the uniquely correct choice because you would have a larger house there. But when researchers confront real people with variations on this hypothetical decision, most of them choose B. Once houses expand past a certain size, it seems, relative advantage trumps absolute size.

Now suppose you need to choose between levels of workplace safety.

In World A, you would have a two-in-100,000 chance of dying on the job this year, while everyone else has a one-in-100,000 chance. In World B, you would have a four-in-100,000 chance of dying, versus a six-in-100,000 chance for everyone else.

Here, too, people face a choice between absolute advantage (World A) and relative advantage (World B). But this time almost everyone chooses World A. For safety, it seems, choice patterns affirm the classical theory's assumption that only absolute quantities matter.

This asymmetry explains why the invisible hand goes off the rails. Suppose a worker accepts a slightly riskier job for slightly higher pay. The extra money buys a bigger house whose size, in absolute terms, is not enough to compensate for the reduction in safety, but because that house is also larger in relative terms, the exchange looks attractive on balance. But similar incentives apply to everyone else, and when all workers sacrifice safety in the hope of buying a relatively larger house, no one moves forward. They are like spectators in a sporting event: all stand to get a better view, yet no one sees any better than before.

The problem here isn't that workers are ill-informed, or that markets are insufficiently competitive, as conventional explanations of safety regulations maintain. Even if every worker had full knowledge, and even if all markets were perfectly competitive, individual workers could still do little to change matters on their own. And that makes it easier to understand why virtually every society attempts to regulate safety in the workplace.

5. Traditional economic theory assumes that preferences originate within the individual and are not shaped by what others say and do, and that when individuals are free to express their preferences in competitive markets, socially benign outcomes generally follow. Abundant evidence contradicts this assumption.

The collective knowledge and experience possessed by any group of people is necessarily far greater than that of any individual group member. And because we must often make important decisions without time for careful reflection, we may gain considerable advantage by taking advantage of social cues.

Consider a Pleistocene hunter-gatherer busily foraging for berries when two members of his clan run by at full speed with looks of terror on their faces. What should he do? Possibly

the runners are being chased by others in a dispute that doesn't concern the forager. In that case, he should ignore the runners and continue with the task at hand. But it's also possible that the runners are fleeing from an angry tiger. The forager's best option in that case would be to experience the runners' fear vicariously and immediately join their flight. Since the forager's cost of inaction would be so much higher in the second case than in the first, taking flight is probably the prudent choice.

This perspective suggests why the psychological forces favoring conformity are often so powerful, even when no obvious reasons favor conforming. A vivid case in point was portrayed in Alan Funt's 1970 film, *What Do You Say to a Naked Lady?* The film is a series of vignettes like those portrayed in Funt's long-running television series, *Candid Camera*. In one, Funt places an ad inviting candidates to interview for an attractive, high-paying position, then arranges appointments to speak with those who respond. As the scene unfolds, Funt's camera focuses on a candidate who arrives for his interview and is directed to a waiting room in which several others are already seated. Funt's experimental subject naturally assumes that the others are also there to be interviewed, but viewers know them to be confederates of Mr. Funt.

After some moments elapse without incident and at no apparent signal, Funt's confederates rise unbidden and begin removing their clothing. Funt's camera zooms in on his subject, whose face initially conveys bemusement but gradually transforms into an expression of concern as he struggles to figure out what's going on around him. But after a few more moments pass, he reaches a tipping point. He, too, rises and begins taking off his own clothing. As the scene ends, he and the others are standing naked, waiting for some indication of what comes next.

Many people who witness this scene feel confident that they would not have behaved as Funt's subject did. And since we don't know how many times Funt ran this experiment before he got the footage he wanted, perhaps they are right. But think about the decision problem from the perspective of the subject. He is hoping to land an exciting job that pays significantly more than he currently earns. Because the others in the experiment got to the waiting room before he did, he can reasonably assume them to be better informed about what comes next. So it would be reasonable for him to conclude that the next step in the interview process requires taking off his clothes. The others have already begun doing so, and since it is reasonable for him to believe that they know more than he does, it is also reasonable to conclude that they have reason to believe that the next steps in the protocol are worth it. So, his apparent options are either to conform or abandon his chance at a substantial pay raise. And if he thinks that conformity entails only a risk of minor embarrassment, it may seem prudent to go along. But as in this instance, there should be no presumption that free choice by rational individuals generally leads to efficient outcomes.

Consider, for example, how the impulse to conform influences the decision about whether to smoke. When I started smoking at fourteen in 1959, many of my friends had already been smoking for several years. Some 60 percent of American men were smokers then, including my parents. They weren't happy that I took up smoking, but they were ill-positioned to object. Smoking was just something that most people did. To say that context influenced me to become a smoker would thus be a gross understatement. Yet there is nothing presumptively optimal about individual decisions to take up smoking. More than 93 percent of smokers say they wished they had never started, and their attempts to quit often fail repeatedly. I count myself fortunate to have quit after several failed attempts.

6. Many economists assume that externalities entail significant welfare consequences only in relatively narrow domains, such as air and water pollution or traffic congestion. But the disruptive effects of behavioral externalities are both stronger and more pervasive.

In almost every domain, context heavily shapes our choices, sometimes for the better, but often for the worse. But causation also flows in the opposite direction. Context is itself the collective result of our individual choices. But we typically ignore that link because the effect of each individual action is negligible. The good news is that taking context explicitly into account can support better public policy choices.

Consider smoking regulation. The best predictor of whether someone will smoke is the percentage of their closest friends who smoke. If the smokers in your daughter's peer group rise from 20 to 30 percent, for example, the probability that she will smoke rises by about 25 percent. That's by far the greatest injury that smokers impose on nonsmokers. If you smoke, you increase the proportion of smokers in the peer groups of everyone you know. And by so doing, you make it significantly more difficult for parents to achieve the perfectly legitimate and laudable goal of raising their children to be nonsmokers. The high cigarette taxes and heavy smoking regulations we impose are completely justified by the importance we attach to that goal.

But because economists have been reluctant to acknowledge behavioral externalities, their defense of steps to limit smoking rests heavily on the pollution model. By a wide margin, the example of harm to others most often cited by regulators has been that secondhand smoke causes injuries that bystanders cannot easily avoid. This explanation resembles the rationale for requiring catalytic converters on cars: we need them to prevent pollution that would otherwise cause undue harm to others.

Health hazards from exposure to secondhand smoke have in fact been conclusively documented, but unless you work in a crowded bar with no ventilation, the damage caused by secondhand smoke is very small compared to that from actually being a smoker. For example, more than 85 percent of American deaths from lung cancer are attributable to smoking, but only a fraction of the remainder has been linked to passive smoke exposure. In terms of their actual impact, then, smoking regulations do vastly more to protect smokers from themselves than to protect innocent bystanders from secondhand smoke. Regulators' narrow focus on damage caused by secondhand smoke is thus an unpersuasive justification for the onerous taxes and regulations we have enacted to discourage smoking.

But the damage from secondhand smoke greatly understates the harm that smokers impose on others. By far the greatest injury caused by someone's decision to become a smoker is the harm caused by making others more likely to smoke as well. When someone becomes a smoker, every friend of that person will have one more smoker in their peer group. Every member of every one of those groups will then become more likely to smoke as well. Those who take up smoking will then make each member of their own peer groups more likely to smoke, and so on. And in addition to causing still others to become more likely to smoke, every one of those new smokers will inflict the traditional harms associated with secondhand smoke. When we take full account of the behavioral externalities associated with smoking, the anti-smoking measures we have enacted appear not too harsh but too lenient.

4

Some Assumptions in Labor Economics

David Autor

Every undergraduate who has taken Economics 101 can cite for you chapter and verse on the implausible, reductive character traits of the standard economic man (*homo economicus*, AKA Homie) that populates all of neoclassical theory:

- Homie is a perfectly selfish maximizer, pursuing with unswerving focus whatever it is that maximizes their personal utility function;
- Homie is hyper-rational, unerringly making “optimal,” self-interested choices at every instant, regardless of the seemingly super-human feats of calculation required to derive these choices (these calculations are implicitly assumed to be effortless, instantaneous, and infallible);
- Homie’s knowledge of their own preferences is complete and eternal. They do not face doubts about their choices (even in the face of uncertainty),¹ do not experience indecision or preference reversal, and do not manifest any intemporal inconsistencies (e.g., planning today to start their diet tomorrow, but then deciding tomorrow to start the next day, and so on ...).

4.1 A Defense of Parsimony

Economists have been defending the basic model against these critiques for decades, and I don’t have anything to add to this defense. In a nutshell, this reductive representation of human behavior is not meant to be entirely realistic. It’s an “as if” scenario: Homie acts if they are maximizing a well-defined objective function with full knowledge of the parameters of the problem and limitless calculating capability. Random deviations from this benchmark are not problematic for the basic model. And the model’s barebones logic has significant virtues:

- The model—and economics generally—treats people respectfully rather than patronizingly. In a phrase, the neoclassical model posits that people are *trying to do the best they can with what they have*. This view of human agency is far more appealing (to me) than the frequent alternative of assuming that people are irrational, gullible, and in some sense in the thrall of a set of unconscious forces of which they are at best dimly aware. (I would argue that these patronizing assumptions are endemic to sociology, psychology, and, to some degree, anthropology.)

¹ In conventional economic models, uncertainty means *knowledge* of the set of *probabilities* over all possible outcomes; although the future is unknown, the probability of every outcome is known. Thus, there is no doubt, only uncertainty.

- Abundant evidence suggests that the predictions of this basic model are roughly right on average. While the model does not capture all of the relevant variation, it hits the key targets much of the time. One can refine it further for special cases, but why build in all of that machinery for everyday usage?
- The *homo economicus* model yields emergent properties that are clearly correct and enormously important, and yet hard to understand outside of economics—specifically, the notion of market equilibrium. A large population of *homo economicae* self-interested maximizers interacting in a competitive, free market setting will unintentionally reach a market equilibrium that is Pareto efficient—meaning that all gains from trade are exhausted and that no person can be made better off without making at least one person worse off. Similarly, the collective result of each business seeking relentlessly to maximize profits (each run by a Homie) is that none makes profits in equilibrium, and again, all gains from trade are exhausted. This emergent order stems from nothing more than the competitive interaction of a decentralized community of utility maximizers (Homies), each pursuing their own self-interest.

I'd argue that the parsimony of this model is its strength. And this parsimony has laid a foundation for further elaboration. In most of the fertile gaps left unfilled by the basic model, a productive literature has grown. These literatures include risk preference, game theory, incomplete markets, externalities, industrial organization, search theory, behavioral economics, collective choice, and social preference, to name just a few.

4.2 Where It Goes Awry

In the realm of labor economics, which is my specialty, there are two key “takeaways” of the basic model that make me distinctly uncomfortable. I stress that these takeaways are not intrinsic implications of the model but rather are assumptions made when applying it.

1. A *first* fundamental assumption that pervades all of economics—including my beloved field of labor—is that work is a “bad,” something that people dislike but nevertheless perform because it generates income (which enables consumption). I believe this assumption is fundamentally incorrect, but paradoxically, many laypeople might nevertheless behave as if they agree with it:
 - a. Most adults would likely agree, if asked, that work provides numerous, essential non-pecuniary “goods” alongside income: structure and purpose; a community of coworkers and associates; social standing; intellectual engagement, and moral satisfaction; cognitive, social, and physical challenges that offer occasions to excel; and an identity (“role”) that may be as central to our self-conceptions as our roles as spouses, parents, lovers, friends, neighbors, and volunteers;
 - b. Yet, if most adults would agree with point (a)—that is, the view that work offers important non-pecuniary benefits—most adults nevertheless act “as if” work were a bad. Few adults would work without pay, even if they didn’t need the income. This suggests that in all likelihood, most people dislike work *at the margin* if not on average;

- c. Based on (b), I would surmise that most (though far from all) workers would willingly give up their jobs in exchange for a life of leisure, assuming that they could continue to receive their current salaries;²
- d. But if we believe point (a)—that is, that work provides many non-pecuniary goods—then we must also believe that a large fraction of those who would choose leisure over labor as in (c) would ultimately be worse off for making this choice.

The paradox to my mind is that while the majority of people would strongly *disagree* with the economist's presumption that work is a "bad," most people act as if that view is precisely right. This suggests either that economists are right after all, or that people's own understanding of what brings them satisfaction is deeply off-base. If so, this does call into question the foundation of the canonical model.

2. A *second* assumption—frequently invoked, rarely stated—is that workers who are involuntarily displaced from their jobs find new productive uses for their time as rapidly and efficiently as do conventional inanimate "factors" such as energy, land, and machinery. If this assumption were correct, involuntary job loss would be costly only to the extent that it temporarily reduced income—and even that would overstate the psychological cost of job loss to the degree that temporarily displaced workers value their leisure. For the assumption that involuntary displacement involves only non-pecuniary costs to be correct, the following would need to be true:
 - a. Displaced workers aren't psychologically "damaged" by job loss. That is, job loss does not inhibit their ability to find new work, build skills, or perform productively in their next positions;
 - b. Potential employers do not view displaced workers as damaged goods that should be discounted accordingly;
 - c. Displaced workers can accurately assess their outside alternative employment options and, when their old work disappears, identify their "next best use";
 - d. Displaced workers seeking reemployment can readily repurpose their old skills toward new applications, and efficiently invest in skills that they lack;
 - e. Displaced workers are not often constrained by cash flow needs to make suboptimal skills investments and job search decisions, such as forgoing long-term career investments to meet short-term financial commitments.

Almost no one—neither lay person nor economist—would argue that the conditions above are entirely or regularly satisfied. Nevertheless, most economic models that are *not* specifically focused on the plight of job losers will assume (without explicit statement) that the labor reallocation process is frictionless and instantaneous, and has almost no durable psychological or economic costs.

My two concerns raised above are symmetric: I question the view that the entire benefit that people receive from work is pecuniary; it then follows that it cannot be correct that the entire psychological/social cost of worker displacement is potential loss of income.

² To be clear, the exchange would be paid leisure *instead* of work; working another job while continue to receive the first salary is precluded.

I stress that my objection to these basic assumptions applies in the *best-case scenario* where the stringent conditions of the First Welfare Theorem apply—full information, no transaction costs, no externalities, and no market power—so market competition leads to Pareto-efficient outcomes. The presence of deception, market power, externalities, or labor coercion would of course exacerbate these concerns, but non-controversially so. My claim is not that *imperfect* labor markets can be exploitive (who would disagree?) but that notionally perfect labor markets as portrayed in the economics canon fail to recognize that work has non-pecuniary value (to workers), and that employment relationships are almost never exclusively instrumental.³

4.3 Why This Unrealism Matters

The assumption that labor markets are purely instrumental is not merely unrealistic; this misunderstanding of labor market operation has policy consequences. A case in point: for decades, US policymakers had operated on the assumption that job “reallocation” precipitated by international trade policies imposed only modest transitional costs on the workers employed in trade-impacted industries and the communities that housed these industries. Much recent evidence shows that these assumptions are far off the mark. The cost of involuntary adjustment falls hard on the workers directly in the path of trade adjustment, as well as on the surrounding communities.

This recent evidence should *not* have come as a surprise. A seminal, widely replicated study in labor economics published more than twenty-five years ago established irrefutably that involuntary job displacement imposes large, durable economic costs on displaced workers—including sustained earnings losses, substantial risk of permanent labor force exit, and elevated rates of mortality.⁴ Yet the “canonical” assumptions embedded in the reasoning and policy advice of trade economists never confronted this evidence. Why not?

My hunch is that this failure reflects economists’ excessive reliance on the parsimony of the canonical model. Most economists will happily concede that the canonical model is too simple, too stripped down to be applied without embellishment to real-world situations *within* their domain of expertise. But for problems *outside* of their domain, economists will invoke this model as a default. Trade economists are no different. Advising policymakers on the intricacies of trade policy, these economists would surely augment and refine the canonical model to reflect the intricacies of *trade* treaties. But when considering the *labor market* implications of these treaties, trade economists would naturally default to the canonical model; it’s the baseline scenario.

Parsimony is valuable when applied judiciously. Applied blindly in the absence of expertise, it risks being dangerously reductive. This risk looms especially large in the realm of

³ One might argue that Sherwin Rosen’s (1986) implicit markets (AKA, compensating differentials) framework correctly accounts for the non-pecuniary aspects of work and, moreover, implies that these non-pecuniary job attributes are correctly priced and implicitly traded in the labor market. While Rosen’s insight is brilliant and broadly applicable, it falls entirely within the instrumental view of labor as exchange. The Rosen framework demonstrates that workers must be paid extra to do unpleasant work and vice versa for pleasant work. It does not encompass the notion that work is “good” for workers’ well-being, and that job loss reduces worker welfare through channels beyond income loss. My argument is that these non-pecuniary components of work are *not* fully traded in implicit markets—although I imagine that if Rosen were around to offer a counterargument, he would gladly do so.

⁴ See Jacobson, LaLonde, and Sullivan (1993); and the follow-up paper, Sullivan and von Wachter (2009).

labor economics. The canonical model invites practitioners to view workers instrumentally, akin to all other inputs (e.g., energy, land, materials). In that instrumental view, price and quantity is arguably all there is: land doesn't get satisfaction from working, it doesn't value leisure, and it doesn't feel devalued when it is left fallow; capital does not lose social standing or self-esteem when it becomes obsolete. These non-pecuniary factors are first-order in the human realm, however. While the tangible remuneration that workers receive for their work is a critical component of the exchange relationship, the canonical model misleads us if it allows us to believe that money is all that is at stake.

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Reflection on Tirole's Chapter

Joshua Cohen

In his thoughtful and wide-ranging reflections in [Chapter 2](#) of this volume, Jean Tirole highlights five assumptions in economics: economists work like engineers, with models focused on particular problems, models that—in the case of economics—are given analytical tractability in the first instance by rational-maximizing hypotheses for different agents; they tend to be consequentialists, concerned about impact, not about etiology or intentions; they are methodological individualists who think that preferences are “socially influenced, but not socially constructed”; they understand the virtues of markets, but are not market fundamentalists; and they think incentives are important, but can go awry when incentives are misaligned with social goals (the common good)—misaligned in part because we fail to achieve what Bentham called “the artificial identification of interests,” and in part because we are not good enough creatures to achieve the kind of internalization of social goals—the sense of unity with our fellow creatures—that Mill saw moral education as aspiring to, and that would render extrinsic incentives irrelevant.

I will make four comments on Jean's remarks: two quick observations on methodological individualism and the engineering analogy, and then two about consequentialism.

On methodological individualism, Jean says that economists understand that preferences are socially influenced but resist the idea that they are *socially constructed*. I am not sure that I fully grasp the distinction. Perhaps the point is in rejecting social construction is to deny a particularly strong form of what social psychologists call “situationism.” According to this strong form of situationism, behavior is fully a product of circumstances, perhaps determined by norms or scripts associated with a position in a relationship or a role in an organizational setting, and not a product of the internal cognitive or affective states of the agent. So this brand of situationist does not think that situational factors prime some antecedent belief or motive, or raise its salience. Instead, they might be seen as arguing that no antecedent internal state matters at all. I am not sure that anyone is a situationist in that sense, so I am correspondingly unsure that I am understanding social construction the way Jean does. So I am not sure what he means to be denying, thus not sure what precisely he is affirming about methodological individualism. But I mean this not as criticism, but as a request for clarification.

On engineering: when the Large Hadron Collider was built at CERN, it was an engineering project. They knew what they were looking for—a spin zero boson with a mass greater than 100 GeV—and designed a collider with the collision energies and luminosity needed to find the Higgs, if it existed. But everything they did on the project was guided by a quantum field theory—the Standard Model—which predicted the Higgs, and identified its production and decay modes. Nothing they did on the engineering project could possibly have been done without that theory, which was consolidated in the 1970s and further developed

through the 1990s. As a consumer of economic theory and analysis, I would have thought that, while much work is an engineer's practically focused problem-statement and problem-solving, that work proceeds against the background of a theory of markets and their welfare properties that is not like engineering.

Here, again, I am asking for clarification. I do not want to be in the absurd position of instructing Jean Tirole about what happens in economics! But I think that many economics consumers like me would find the exclusive emphasis on engineering a little surprising and would welcome some clarity on the role of both normative and positive theory as framing the problem-solving work that Jean emphasizes.

Coming now to consequentialism as the normative framework for most economists: here I want to make two points, about how to think about inequality, and about how to think about the veil of ignorance as a device for moral thinking about institutions and policy.

Starting with inequality, then, here a very interesting remark from Piketty's *Capital in the 21st Century* (2014: 19): "the key issue," he says, "is the justification of inequalities rather than their magnitude as such. That is why it is essential to analyze the structure of inequality." In particular, as he explains, there are two paths to great income inequalities: hyperpatrimonialism, in which inequalities grow from inherited wealth; and hypermeritocracy, where peak incomes come from the labor market rather than from inherited wealth. The idea is that we have two different paths to very large and unjustified inequalities and two different reasons that the inequalities are unjustified.

In both cases, part of what makes the inequalities unjustified is their source, not their magnitude or their consequences. Hyperpatrimonial inequalities—the ones that grow from inherited wealth—are unjustified because they confer advantages at birth—at the starting gate—on their beneficiaries. "Every night and every morn, some to misery are born; every morn and every night, some are born to sweet delight. Some are born to sweet delight; some are born to endless night." Thus Blake. Inequalities of advantage that grow from those hyperpatrimonial birth privileges are unfair. It is their etiology—that some people start off much better off than others—not their magnitude or their consequences that marks them out for criticism. As Rawls puts it, distributive shares are influenced by factors that are "so arbitrary from a moral point of view."

With hypermeritocratic inequalities, the story about process is different. These do not grow from inherited advantages, though they may lead to such. Instead, they come from self-dealing, which enables executives to effectively set their own compensation. Here, again, the concern about "justification"—or the lack of justification—points to the process that generates the inequalities, and a kind of unfairness in the process.

To be clear: I do not mean to say that the only reason for objecting to inequalities has to do with unfairness in the social processes that generated them. Regardless of how they came about, inequalities might be so great that they give rise to status differences that conflict with our standing as equals. I also do not mean at all to be dismissing consequentialist concerns about great inequalities. Instead, I mean to be observing that there are other, nonconsequentialist reasons for objecting to inequalities, that economics does not rest on the assumption that consequentialist reasons are the only concern (thus Piketty), and that there might be closer collaboration between economists and others concerned about inequality (including philosophers, lawyers, political scientists, and sociologists) if the normative framework were more open-ended and less insistently consequentialist.

Last point. In his comments and in his book, Jean uses the device of a veil of ignorance to explain his moral thinking on a variety of issues. For example, he defends the idea that—in Trolley Problems—we should kill one rather than letting five die because we would choose that rule behind a veil of ignorance. We would choose it because we would judge that we would be less likely to end up dead if we adopted a rule that requires people always to kill the smaller number.

I think this account of the way the veil of ignorance works flattens the normative terrain in ways that are not intrinsic to using a veil of ignorance as a device of moral reflection and decision. To explain what I mean: let's consider the decision behind the veil of ignorance about whether to adopt a principle of religious toleration. I might think: well, I am more likely to be in a religious majority than a religious minority, or anyway, unlikely to be in a small religious minority. So will adopt a relatively intolerant attitude to religious minorities because I am unlikely to be in a minority, and if I am not, I will be freed from the distractions and irritations of being around the religious minority.

This of course neglects the importance of religious convictions. If I think that I might be in a religious minority, then I think that a policy of intolerance will require that I violate my most fundamental obligations. I cannot agree to that. That is how Rawls (1971), using the veil of ignorance, makes the case for the right to religious liberty. No judgment about the likelihood of being in the minority enters into the case. So similarly, it may be relevant behind the veil of ignorance to consider the fact that adopting a rule will *require me to actively kill someone*—to be the agent of their death—and not simply how the adoption of the rule will bear on the probability of my own death. It is not intrinsic to the veil of ignorance as a device for moral reasoning that models the conception of persons as equals that issues about convictions and agency are irrelevant to the rules that we would adopt. If economists make this assumption—essentially an assumption about the commensurability of all goods—then I think they are making a mistake. But I do not see why they need to make that assumption.

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Reflections on Autor's and Frank's Chapters

Philip Pettit

6.1 Comments Motivated by David Autor's Chapter on Assumptions in Economics

David Autor's [Chapter 4](#) is extremely rich and stimulating but I shall restrict myself here, for reasons of space, to comments on the three guiding assumptions, as he sees them, in the canonical model of *homo economicus*. The first assumption is that economic agents are selfish, the second that they are rational, and the third that they are more or less stable over time.

The striking thing about these assumptions is that they are not supported by the rational-actor theory that many philosophers take to be embodied in folk psychology and that they take decision theory to explicate. The assumptions represent substantive variations on the ordinary lore about rational agents, even the lore that is formalized in decision theory. Autor may not disagree with this view, as we shall see, but it is still worth spelling out.¹

6.1.1 A Standard Theory of Agency

Analytical philosophers generally assume that according to our ordinary view of agency, and as a matter of fact, all agents satisfy two constraints. First, they must have at least one purpose—normally, they will have many—that they can pursue across different contexts, where a purpose is an effect that the system is organized by evolution or design to generate reliably. Second, agents must be organized so that as context changes, their internal states change and ensure that they operate in a pattern that is situationally suited to realize that purpose. This constraint requires that agents must form representations of the different contexts where they pursue their purposes, where representations are simply states of an agent that vary with environmental variations and help shape the behavior it takes under such variations, in pursuit of its purposes.

These two observations support an appealingly simple account of agency. An agent is any system that is organized to pursue certain purposes reliably according to reliably formed representations of its environment; this, at any rate, in conditions that count independently as normal.

That specification is satisfied even by a simple robot. Imagine a little artifice that registers glasses or bottles on a table—we may stipulate that it has bug-like eyes on its head—and that

¹ I draw in this piece on ideas in [Pettit \(1991, 2005, 2006\)](#) and in [List and Pettit \(2011: ch. 1\)](#).

acts so as to put upright any such object that lies on its side; we may stipulate in addition that it moves on wheels and uses arm-like limbs to raise an object. The robot reliably pursues its purpose—as it happens, its one and only purpose—according to reliably formed representations. Or at least it does so in normal conditions: it may knock bottles or glasses off the table, if they are too near the edge, and it may not operate at all in the dark. Thus, it counts on the simple theory sketched as an agent.

The robot is an extraordinarily simple agent, of course. It has only one purpose and one (sensory) mode of processing information from the environment. It acts only on its immediate environment, and has only purposes and representations that bear on this. In the case of frustration, it is not disposed to try other routes at random with a view to forming a new belief and achieving its end; it is not as clever even as the fly that applies trial and error in the fly-bottle. And, of course, it has no language and no capacity to interact with other agents.

On standard philosophical accounts, the simple model of agency is generalized in the sort of decision theory that was introduced by the Cambridge philosopher Frank Ramsey (1990) in the 1920s, building on the work of Thomas Bayes in the eighteenth century.² The assumption in that theory is that the purposes and representations of the agents to which it applies come in degrees—another complexity our robot fails to instantiate—and can be modeled as degrees of utility and credence respectively. Decision theory argues that well-functioning or rational agents—that is, agents that satisfy various background conditions—must update their credences according to a suitable procedure and must act on the basis of those credences to maximize expected utility. The philosophical gloss is that this is merely a way of formalizing the idea that such agents form representations of their world reliably and act reliably to realize their purposes according to those representations.

6.1.2 The First Assumption

Back now to the three elements that David Autor identifies in the canonical model of economics. The first assumption is not just that the economic agent maximizes their expected utility—“whatever it is that maximizes their personal utility function”—but that they are “perfectly selfish” in the things to which they attach utility. This is a notable break with decision theory, and with the broad conception of agency that it is taken by philosophers to formalize.

I agree entirely with Autor, although as an observer rather than a practitioner, that economists generally do take the utility function that their subjects seek to implement to be a selfish one, reflecting self-interested preferences only. But it is important, as I am sure he would agree, to recognize that this selfishness is not built into the decision-theoretic or rational-actor model as such, something that Amartya Sen (2002) has long taken pains to argue.

We may assume that an agent must enact their own utility function—Sen himself, it must be said, might question this³—but we need not make any assumptions about how

² A classical version of that model is presented in Jeffrey (1983). I ignore the various amendments to that model, for example in causal decision theory (Joyce 1999) or in the risk-weighted version of Buchak (2015). For an overview, see Steele and Stefansson (2016). I also ignore the relation of the model to the version of decision theory, more influential in economics, associated with Leonard Savage; see Savage (1954); Luce and Raiffa (1957).

³ See Pettit (2005) and Sen's response.

self-interested or altruistic the rational agent is. There is nothing in the model that prevents decision-theoretic agents for ascribing a high utility to how things will turn out for other creatures, or for the world at large, even when there is no particular benefit to them associated with things turning out that way.

6.1.3 The Second Assumption

Autor's second assumption is that economic agents are "rational"—in that they make "calculations" that are "effortless, instantaneous, and infallible." This may be true but not, I think, in a sense that supports the view that such calculations would involve "super-human feats," as he puts it. I think that Autor may mislead readers by the use of that phrase, although he may not be misled himself.

On the decision-theoretic model of agency, agents may not make any calculations whatsoever, let alone super-human calculations. For all that the model assumes, agents may more or less automatically register what they take to be matters of fact with suitable degrees of confidence; and, given those credences, they may more or less automatically act for results that have suitable degrees of utility. In doing this, they do not need to calculate or reason about what holds as a matter of fact—how the evidence weighs up—and they may not have any beliefs about the degrees of utility that various prospects hold out for them; the prospects may attract them in a more or less mechanical, unconscious way.

For all the decision theory assumes, in other words, agents may maximize expected utility as a result of their sub-personal make-up, not on the basis of super-human calculations. They may maximize expected utility in as unthinking a manner as that in which I determine where to put my hand when I dive to catch a falling ball. In diving to catch the ball, I do no calculation but rely on my sub-personal competence and, for all the theory supposes, the same thing may hold for my acting in a decision-theoretically appropriate way. It is the decision theorists who calculate, on this picture, not necessarily the agents about whom they theorize.

People certainly reason or calculate about things, of course, conducting the sort of mental activity exemplified in Rodin's statue, *Le Penseur*; indeed, they may be the only natural agents that do so. But reasoning is not presupposed in the economic or decision-theoretic model, which can apply to other animals too. And if human agents reason about what to do, the reasoning they perform is very unlikely to engage with the notions employed in decision theory.

When I reason about whether to go to the cinema or the ball-game, for example, I do not reason in a formal manner. I do not work out the utilities that different films or different ways the game turns out would have for me; identify the probabilities attached to the different scenarios; and then derive the expected utility of going to the cinema or going to the ball-game. Indeed, I am very unlikely to be able to tell what the relevant utilities and probabilities are.

In making my choice, I simply think about the options and register their rival features—I may do this, of course, more or less conscientiously—and find that by grace of my sub-personal psychology I am attracted to one rather than the other. If I am operating as decision theory says I am, then in forming my preference I will maximize expected utility. But that will be a product of the unconscious processing that my conscious reasoning stimulates. It will represent a sub-personal competence, not a super-human feat.

These observations about the status of decision theory or rational-actor theory to conscious psychology are important for an understanding of the status of that theory. They guard us against the business-school fallacy, as I am inclined to describe it: the assumption that sophisticated agents should seek to emulate consciously what decision theory stipulates that rational agents do without any awareness.

However, my observations may register a difference of expression rather than substance with David Autor. For perhaps all that he means to document in his second assumption is that human beings are taken in economics to be capable of the sub-personal processing and computation that the maximization of expected utility requires. On this construal, the assumption is still highly idealized since agents will be representable as maximizing expected utility only if they are rational or well-functioning in quite a demanding sense. Such agents must have only transitive preferences, for example—they must prefer x to z , whenever they prefer x to y and y to z —and their preferences must meet other more formal but demanding conditions of continuity and completeness if they are to be representable as utility maximizers.

6.1.4 The Third Assumption

What, finally, of Autor's third assumption—that agents are more or less stable over time? Here I have less to say. Decision theory in the strict sense has nothing to say about how rational agents perform over time and, in particular, whether rationality itself imposes various inter-temporal constraints. Thus, for all that the theory presupposes, rational agents may occasionally be subject to shocks to their credence and utility functions, which transform what they believe and desire in a way that is decision-theoretically inexplicable.⁴ An example might be the transformation of someone's utility function that is associated with having a baby or with undergoing a religious conversion. The third assumption in the canonical model of economics, as Autor characterizes it, rules out such transformations, presumably on the basis that they cannot be predicted systematically. The third assumption also rules out the many failures of decision-theoretic rationality that have now been documented as a result, for example, of the work of Amos Tversky and Daniel Kahneman.⁵ Is it defensible of traditional economics to do this?

It may well be that we human beings regularly succumb to the failures of rationality identified by these and other authors. But two things are worth stressing, which may help to support a qualified degree of reliance among economists on this assumption. I conclude with these observations and have to say nothing about the other enormously interesting parts of David Autor's chapter.

The first is that most of the failures documented are not just failures of rationality by a decision-theoretic measure but failures by almost any plausible metric of what is required for being a rational or well-functioning agent. And the second is that while people may frequently fail in these ways, they are unlikely to do so systematically in types of decision that they recurrently face, particularly decisions in which there is a cost attached to failure. "Once

⁴ See, e.g., Sen (1981) and Paul (2014).

⁵ See Kahneman, Slovic, and Tversky (1982) and Gilovich, Griffin, and Kahneman (2002). Such work has given rise, of course, to now well-known approaches in behavior economics, as it has come to be called.

bitten, twice shy” is a proverb that suggests that in such recurrent, important choices, we may expect human beings to conform, however roughly, to the third economic assumption.

6.2 Comments Motivated by Robert Frank's Chapter on Assumptions in Economics

Bob Frank's [Chapter 3](#) is packed full of ideas and canvasses a variety of lessons to which his work has directed attention over much of his career. Those lessons have not been generally learned in the economics profession, or so at least he suggests. Whether or not that is the case, they are well worth reiterating and illustrating in the way he does here.

Focusing on the lessons he wants to convey, rather than on the assumptions made by economists that neglect them, I take the liberty of recasting his claims. I distinguish five lessons that he teaches in his discussion of the six assumptions targeted and offer some comments, for what they are worth, on each. This is how I see the lessons:

1. context affects people's virtues (assumption 1)
2. context affects the options they face (assumptions 2 and 4)
3. context affects their policy preferences (assumption 3)
4. context affects their personal preferences (assumptions 5 and 6)
5. context affects their personal judgments (assumption 6).

6.2.1 Context Affects People's Virtues

To have a virtue like honesty is to tell the truth, not just contingently—not just when it suits, for example—but reliably or robustly. Absent excuses, it is to be disposed to tell the truth robustly over regular sorts of temptations to lie, although not robustly over cases where there are distinct, presumptively more important goods at stake; by most lights, if not by Kant's, you are not dishonest just because you would to lie in order to mislead a would-be murderer.⁶

Absent excuses, the heroically honest person will tell the truth whenever the relevant reasons are present and not trumped by other considerations, regardless of any personal costs. Thus, this sort of person would tell the truth even if they could lie without any chance of being detected or penalized. Few of us are honest in that measure. But most of us assume as a default that we live amongst others and can never be sure of escaping detection if we lie or commit a similar offence. And, as a result of being scaffolded by the network of our fellows, we develop a habit of more or less automatically telling the truth with something like the robustness that honesty demands.

This habit gives us the virtue of honesty to the extent that we can be depended on, at least in normal circumstances, to tell the truth whenever there is good reason to do so. But we display that virtue on a provisional basis, as it were. We are dependable when it comes to telling the truth—in suitable circumstances, as dependable as the heroically honest person—but our honesty is not as durable as that of such a paragon. It continues to exist only under the

⁶ On the robust demands made by honesty and many other goods like friendship and respect, see [Pettit \(2015\)](#).

proviso that we live under the actual or potential gaze of others. This may not be much of a shortfall from heroic honesty, however, since the felt presence of other people is as inescapable for most of us as the force of gravity. The shortfall might only show up insofar as regularly honest persons, unlike their heroic counterparts, might lose their virtue under the conditions that the ring of Gyges would introduce: under conditions where there is no chance of detection or penalty.

What sustains us in this provisional sort of virtue? Bob Frank suggests, congenially, that the required nourishment is provided by the desire we all have to enjoy the acceptance or esteem of others and, in particular, to avoid shame or disesteem. “Being regarded as someone who wouldn’t cheat even when no one is looking,” he says, “is an extraordinarily valuable economic asset. It makes you an attractive candidate for assignments that require trust—which is to say, for almost any important job you might aspire to hold.”

The infrastructure of everyday virtue, as we might say, is an economy of esteem. Let standards like those of honesty be in place in a society, as a matter of common awareness. Let it be equally a matter of common awareness that there is almost always some chance of being detected in breaching any such standard. That will put in place a powerful esteem-based pressure to live up to accepted standards. And that pressure will remain in place even when the chance of detection is low: to be discovered to have been dishonest in a case like that will carry a greater than normal sanction of disesteem; such a breach will be unquestionably strategic, not accidental, and will eloquently testify to the person’s lack of virtue.⁷

For these reasons, I am deeply disposed to go along with Frank’s claim that the assumption that people will cheat if they get a chance to do so is largely unfounded. It is much more likely that they will opt almost by default to act honorably. And if they opt by default to do this, they are likely to develop a habit of acting appropriately that will operate without thinking in their psychology. It may be for this reason, as Tom Tyler (1990) has long argued, that people obey the law without any calculation whatsoever.

Since it is common nowadays to argue that economic incentives for acting virtuously are likely to crowd out virtue (Frey, 1997; Frey and Jegen, 2001), it is worth adding that the economy of esteem does not seem to raise this worry. If I give you an incentive, say a financial incentive, to tell the truth, then that may sharpen your sense of doing so for the sake of that distinct reward and even make you dependent on its presence: even dispose you not to be honest where there is no reward in sight. But the incentives for telling the truth in the economy of esteem do not direct your attention away from truth-telling, toward a distinct reward. On the contrary, they are incentives to simulate honesty and, far from being likely to undermine the disposition to tell the truth, they hold out the prospect of inducing that disposition as a matter of second nature.

6.2.2 Context Affects the Options People Face

Here is a familiar puzzle in decision theory or rational-actor theory.⁸ The theory supposes that if you are rational, then your preferences will be transitive: if you prefer x to y and y to z , you will prefer x to z . But imagine now that x is a big apple, y an orange, and z a small apple, and that in each case your preference will determine what is left for someone else. You

⁷ On the economy of esteem, see Brennan and Pettit (2004) and Frank and Pettit (2018).

⁸ For a discussion, see Pettit (1991).

choose the big apple over the orange, we suppose, and you choose the orange over the small apple. Will you choose the big apple over the small apple? Well, if you are well raised, you probably won't. You will rather choose the small apple and leave the big one for the other person. You will display, or so it seems, an intransitivity in preference.

It does not take much reflection to see that this appearance is misleading. The reason is that taking the big apple when the alternative is a small apple has a property, and one presumably relevant to your preferences, that taking a big apple rather than an orange does not. That property is impoliteness. Since size is a presumptively attractive property and there is no other difference between a big and a small apple, taking the big apple involves clearly putting yourself before the other person, in contravention of standards of politeness. You prefer x to y and y to z but you do not breach transitivity by preferring z to x . In that last choice according to the story, x is not present but rather a different option: x -minus, as we might describe it, having- x -and-being-impolite.

What this little example shows is how context—in this case, the context provided by the alternatives in the choice—can change the identity of the options that an agent faces. It can mean, in a familiar philosophical idiom, that the options are individuated differently. And that is the second lesson that I take Bob Frank to support, both in his critique of the second economic assumption and of the fourth.

In critiquing the second assumption, his argument shows in essence that what it is to buy an acceptable house—own a home in which you can take pleasure—varies with the standard of housing generally available. What counts as an acceptable home in Nepal does not count as an acceptable home in the United States. And, as Frank adds in his critique, this relativity to context may have a deleterious aggregate effect. Seeking to surpass the neighbors, people may drive one another toward increases in the houses they seek and buy. And those increases may not leave anyone better off.

The point made here is very like the point that Amartya Sen (1983) cites from Adam Smith in developing his metric for poverty. Smith (1976: 351–352) holds that what makes someone poor may vary from society to society, arguing in line with the economy of esteem that to be poor is not to be able to live without shame among your compatriots. Illustrating the point for his own time and place, he says of leather shoes that the “poorest creditable person of either sex would be ashamed to appear in public without them.” His idea is that while having leather shoes may have been a luxury in earlier times, it had become a necessity in nineteenth-century Britain: something you could lack only at the cost of shame.

Frank draws on the same lesson about the individuation of options in his interesting discussion of safety regulation. His point here, as I construe it, is that options differ in how far their appeal and identity varies with context and that while safety at work is relatively stable across contexts—you are unlikely to care less about it to the extent that others have less of it—that is not true of other goods like housing: “context shapes evaluations of safety less heavily than it does for other goods like housing.” Thus, it is no surprise that this asymmetry shows up in the sorts of effects he documents.

6.2.3 Context Affects People's Policy Preferences

The third lesson underlines a policy-relevant consequence of the fact that people's options are often individuated in context, and that they vary in their appeal and identity, depending

on contextual variations. Frank derives the consequence with the help of a plausible, independent assumption. This is that when we consider how far certain changes in our own lives—say, an increase or decrease in income—would matter to us, we tend to assume that nothing else will change at the same time: for example, that other people's incomes will not increase or decrease simultaneously with ours. This cognitive error is intelligible because, to take the case of income, “most of the income declines we actually experience leave the incomes of others unchanged.”

The policy-relevant consequence of these two factors—context relativity and the cognitive error—is that we are likely to be irrationally hostile to the government's imposing higher taxes when those taxes would improve the social infrastructure and make us individually happier than we would otherwise have been. We are hostile to higher taxes because when we envisage the decline in income that it would impose on us, we overrate the loss that would involve. We forget that others will suffer a similar decline, and consequently that our relative purchasing power—say, our power to purchase houses—will be unaffected.

6.2.4 Context Affects People's Personal Preferences

Frank's fourth lesson derives like the previous one from his thesis about the context relativity of options and appears in his critique of the fifth and sixth assumptions he indicts. To illustrate it, he takes the example of smoking.

It is one thing to smoke in a context, A, where that puts you in a minority, but quite another thing to smoke when it means, as in context B, that you are conforming to the mores of your peer group. Assume that like people generally, you want to conform to prevailing mores; after all, this will make you one of the gang and guard against a certain sort of disesteem. The option of smoking is bound to have an attractive property in context B—in particular, a property that makes it attractive to begin to smoke—that it lacks in context A. And to that extent it must count, plausibly, as a different option for you.

It is common in a case like this to speak of preference adaptation. Frank avoids that way of speaking and, at least with the sorts of examples he considers, I think that is a good choice. Talk of adaptive preferences suggests that for one and the same option, such as smoking, people are likely to adapt their preferences for the option in response to the general preferences in the group. But that is an unnecessarily complex story about the sort of case in question.

In every society people mostly share a generic preference for going along with their fellows, as the economy of esteem would predict. And so, the property of conforming to local mores is bound to have an appealing character by their lights, being capable of helping to explain the more specific preferences they form over options they face. Arguably, it is the activation of that stable, generic preference, rather than anything like an adaptation and change of preference, that explains why someone's smoking is more likely in a context where others generally smoke than in one where only a few do so.

Frank makes a very interesting observation in connection with the smoking example. This is that while people's smoking may impose a negative externality on others insofar as it forces them to smoke in a secondary way, the effect of making smoking into a more and more attractive option may represent a negative externality of an even more pervasive kind. This

is surely right and he argues strongly for public efforts to reduce the glamor of smoking, or even to stigmatize it as an activity.

6.2.5 Context Affects Their Personal Judgments

Frank's final lesson, on my way of counting his contributions, is the observation that the context in which people live, in particular the context of opinion, has a massive effect on the things they themselves believe and consequently on what they often choose to do. The source idea here is that on many of the issues on which we form views, from abiding issues to ones that bear on one or another specific situation, we take our cue from what others believe, whether they display those beliefs in what they do or in what they say. That idea does not register any sort of pathology or flaw in our make-up. On the contrary, time and evidence is usually so short for any one of us that it is a good heuristic to register what others seem to think and to fall in line. Reliance on that heuristic is also likely to be boosted by factors in the economy of esteem, but we may put aside that consideration here.

Versions of Condorcet's jury theorem support the use of the heuristic. Here is a rough-and-ready version of a lesson that recent discussions of the theorem support. If people in my group each have a greater than even chance of being right on any issue on which they form an opinion, then to the extent that they form opinions independently of one another, they are more likely to be right than the average member; moreover, as the size of the group increases, this likelihood will increase too. Thus, there need be nothing surprising about people's generally falling in line with what others think; that may be the most rational line to take in the formation of belief.

Frank focuses on a case where this tendency, rational though it may be, can lead people into doing bizarre things. In the Alan Funt case, for example, they undress publicly when others do so, assuming that others know something they do not. But there are other more standard cases that illustrate the same lesson.

Consider the widely cited fact, for example, that people vary enormously in what they choose to do as between two different, relatively unfamiliar scenarios. In one they can choose to opt into an arrangement they may have few personal resources to judge—say, agreeing to donate their organs for transplant in the event of a fatal accident—but the default is to stay out. In the other, things are reversed: the default is to stay in, agreeing to the transplant proposal, but they may choose to opt out.

A well-known finding is that many more people go along with the arrangement when it is the default than do so when staying out is the default (Thaler and Sunstein, 2008). And that is wholly intelligible on the principle that Frank presents. If you are unsure about what to do, as you are likely to be unsure when operating in an unfamiliar scenario, a reasonable assumption is that the safest thing to do is what others regard as safe. When a mode of action has become the default, that is a fairly sure sign that people generally regard it as safe; otherwise, you may think, there would have been widespread protest against the way the choice is phrased. Thus, it will be perfectly rational for you to follow the crowd.

This last lesson is of greater interest when it generates bizarre results, of course, than when it makes sense of a regular pattern like that displayed in this case. While Frank does not

mention them here, consider information cascades in which people tip one another into general patterns of belief that lack any plausible support.⁹ Each holds the belief, not on any personal evidential basis, but on the basis that so many others hold it. Like lemmings, they lead one another over the cliff and into the seas of wayward opinion. Not having his work to hand, I do not know whether Bob Frank has written on the phenomenon. But if he hasn't, I bet he will; it is grist to his very powerful mill.

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⁹ See, e.g., [Hendriks and Hansen \(2014\)](#).

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Reflections on Frank's, Kailas's, Rangan's, and Tirole's Chapters

Ellen Quigley

This collection of chapters is a rarity; it addresses questions seldom raised in neoclassical economics and business education, particularly those that sit at the fundament of these fields: their assumptions. Issues of power, social norms (including the pursuit of peer esteem and the avoidance of social shame), market failures, the performativity of theories, institutions, and trust receive thoughtful treatment. These works put economics and business education in context and highlights human behavior itself as contextual.

Indeed, it is clear from a growing body of evidence in evolutionary biology, experimental psychology, and behavioral science that humans, as social mammals, can think and behave markedly differently depending on the defaults, conventions, institutions, and cultures they interact with, and that these can change remarkably quickly. Yet some of the most powerful assumptions in economics and business education either run counter to these findings or ignore them. As Rangan lays out in the first chapter of this volume, assumptions can be performative; regardless of whether they describe human behavior and cognition accurately at the outset, they can prove themselves accurate through belief.

In this chapter I reflect on some of these assumptions through the lens of the available evidence on the influence of economics and business education on students' and graduates' behavior, attitudes toward policy, and the practice of corporate governance in the real world. These assumptions include economics and business students' (and graduates') views on self-interest, competition, and the value of other fields of study. We shall turn to each in turn.

As other chapters have made clear, the specter of *homo economicus* in economics and business education has persisted for some time. Its effects can be found in the classroom, the boardroom, and beyond, with implications for public policy, corporate governance, and even the criminal justice system.

Following a surprising result in [Marwell and Ames's \(1981\)](#) study of the “free-rider” phenomenon that found economics students to be substantially more willing to free ride than other study populations and a subsequent [Carter and Irons \(1991\)](#) study finding a selection effect for economics students, [Frank et al.'s classic \(1993\)](#) publication investigated the influence of economics education on students' pro-sociality, finding both indoctrination and selection effects in the results—in other words, economics students began their degrees with a higher-than-average level of self-interest, and became more so in the course of their degrees.

Some have argued that self-selection—the tendency of more self-interested people to choose business or economics as a field of study—explains the harmful effects of business education ([Frank and Schulze, 2000](#)). Indeed, self-selection does seem to form part of the picture ([Etzioni, 2015](#)). However, in studies specifically teasing out the self-selection effect

from the “indoctrination” effect—the extent to which exposing students (even non-business or -economics students) to the ideas commonly taught in business schools and economics programs changes their beliefs and behavior—the experimenters find that there is a marked effect even after relatively brief exposures to concepts such as agency theory and *homo economicus* (Wang, Malhotra, and Murnighan, 2011; Etzioni, 2015).

Some years on, Sumantra Ghoshal's posthumous article (2005), *Bad Management Theories Are Destroying Good Management Practices*, questioned the way in which modern business schools educate students, fearing that graduates would emerge with a newly acquired view of human beings as self-interested and untrustworthy. Because of the power of social norms, he feared such beliefs could begin to affect behavior itself, creating the phenomenon students had been taught to protect against.

In the generation since these issues first surfaced, further research has been conducted in the fields of economics and management education, unfortunately largely echoing Frank's findings and confirming Ghoshal in his fears: some of the most powerful graduates of higher education programs in business and economics education may be learning—via social norms—lessons that go beyond the curricula.

The body of work in this area has typically concerned itself with the (likely unintended) effects of treating *homo economicus* as a representative agent in economics, with the ironic results. While learning—explicitly or implicitly—that humans are more rational and self-interested than the evidence in fact suggests, economics students' susceptibility to social norms results in their tendency to express irrational levels of self-interest in experimental games. Indeed, economics students were some of the only study participants who made offers to fellow study participants that were so low that they were routinely refused, to the detriment of all involved.

Ghoshal laid out a set of damning judgments of business school education in his piece, which critiqued aspects of agency theory; control mechanisms to curb “opportunistic” behavior on the part of employees; and relentless competition as features of modern business education, among much else. In this volume, Kailas and Rangan lament some of the corporate failures of the previous decades, finding plenty of “opportunistic behaviour” among corporate managers, some potentially attributable to MBA training. Indeed, the empirical study Rangan cites as to the wage- (and cost-)cutting MBA-trained manager (Acemoglu, He, and le Maire, 2022), and surveys of MBAs that find a shift away from customer satisfaction toward shareholder value maximization in the course of their degrees (Pfeffer and Fong, 2004), suggest this is not an unfounded concern. As Kailas charts in his chapter, however, the corporation was originally intended to serve the public good, and this was embedded in corporate charters at the time; while the legal regimes governing the modern corporation have certainly changed, so has the conception of what a company's purpose is, and therefore what managers do to accomplish it.

The relentless competition Ghoshal laments may also be in evidence. Among fields of academic study, economists are uncommonly (perhaps uniquely)—occupied with rankings—of departments, journals, and personal standing (Fourcade, 2009; Fourcade, Ollion, and Algan, 2015). These rankings themselves appear to produce behavioral effects (Khurana, 2007), with particular circularity when it comes to prestige and future salary; a graduate's pay is by far the most significant factor in across a range of business school ratings publications (Pitt-Watson and Quigley, 2019), reinforcing its importance for recruiters in the business schools and for students deciding where to apply. A majority of business school deans surveyed in

one study did not consider the rankings to reflect program quality, yet the pressure to perform well according to those metrics had many fearing they would be fired if they slipped down the list (Athavale et al., 2017). Again, these challenges—and their effects—appear to apply disproportionately to economists and business education.

Ghoshal also observed the adoption of a set of ideas that assumed a “gloomy” view of human beings—that “managers cannot be trusted to do their jobs” (Ghoshal, 2005: 75) and that people have a fundamental tendency to behave opportunistically. As discussed by several of the chapters in this volume, the “gloomy” view of human nature is only contextually accurate. Humans are capable of both cooperative and uncooperative behavior, with social norms and context playing an outsized role in determining which path we take. These tendencies, and the social norms that shape them, have ageless—indeed evolutionary—roots.

Although the Darwinian view of natural selection has indeed formed part of humans’ evolutionary heritage, there is also now a significant body of evidence pointing to the presence of a second set of evolutionary pressures on our species. These pressures are at the group, rather than individual, level. It would appear that, throughout our collective development, cooperative groups of humans out-competed their uncooperative brethren (Wilson, 2012); groups that communicated better, and displayed altruistic and cooperative behavior toward one another—not just kin—were better able to feed and protect themselves. Indeed, humans are a highly social species; “[t]he past 20 years have seen startling discoveries that support the supposition that humans have an intuitive, default tendency towards some degree of pro-sociality” (Keltner et al., 2014: 25.6), not just self-interest. This pro-sociality can be found at the level of biochemistry, with cooperative or generous acts—and experiences of closeness with other people, kin and not—having been linked to the release of neurochemicals including oxytocin, serotonin, and dopamine, with concomitant benefits to physical and human health in the form of decreased stress (cortisol) levels, improved immune response, and indeed even a longer life (ibid.).

This evolutionary heritage is also evident in economics studies, even though people tend to cooperate less in economic scenarios than in non-economic scenarios (Pillutla and Chen, 1999). Humans reliably offer generous payouts to anonymous strangers, tend to punish unfair behavior even at their own expense, and reward cooperative behavior in others even if they do not benefit from it themselves (Folger and Salvador, 2008; Hammerstein and Hagen, 2005; Kahneman, Knetsch, and Thaler, 1986; Rabin, 1991, inter alia). As these examples illustrate, though, and as Rangan pointed out in his chapter, pro-social does not always mean pro-societal. In any case, rarely in these studies is *homo economicus* to be found among the real-life human population.

A battery of social science studies helps illustrate the almost comical degree to which norms shape human behavior and perception. In one classic study, repeated many times in the decades since, almost all study participants will claim that two sticks—of obviously different lengths—are in fact the same length if the other people in the room claim they are (Asch, 1951). The criminology literature corroborates this evidence of the power of social norms as well, observing the vastly differing effects of social norms on criminal behavior—even under very similar legal regimes. One of the more striking examples of this is that of the differences between the criminal justice system in Japan and the US. In Japan the relationship of a police officer with a perpetrator is that of a forgiving parent and a

penitent child; in the US, as we have been reminded with horror in the recent past, the role of the police is that of an authoritative, punitive parent (Braithwaite, 1989). The crime rate is vastly higher in the latter country, of course, even though the laws in both jurisdictions are similar.

What, then, is the context to which business and economics students are exposed, and how does that influence their ongoing orientation and the society (and policy frameworks) they disproportionately influence? In this volume, Rangan speaks of the role of power and esteem in influencing human interactions and business environments, factors that do not tend to enter into economic modeling, and Frank, co-author of one of the aforementioned seminal studies on the effects of economics education on levels of pro-sociality under experimental conditions, writes in his own chapter of this collection of the relativism, context, and reputational (esteem) effects that play into people's decision-making.

For humans as a highly social mammal, then, social norms are incredibly powerful—whether we are aware of their power or not. This is why, if business schools infuse in students a self-interest norm, this can actually encourage self-interested behavior; assumptions, as Rangan lays out in his chapter, can be performative. Indeed, “by propagating ideologically inspired amoral theories, business schools have actively freed their students from any sense of moral responsibility” (Ghoshal, 2005: 76).

The results of this appear to be self-reinforcing in other ways, too; people who behave selfishly or uncooperatively tend to invite uncooperative responses from other people, reinforcing the sense that humans are uncooperative, while cooperative people tend to induce cooperation in others (Ferraro, Pfeffer, and Sutton, 2005). One can be confirmed in whichever of the two beliefs one holds. This phenomenon may even help to explain why the effects of business and economics education persist; both in the classroom and in the career that follows, students and graduates are unlikely to be confronted with behavior that clearly clashes with their own.

Ghoshal feared that our otherwise pro-social tendencies had been effectively undermined in management education because of the teaching—both unconscious and conscious—of theories and norms that emphasized humans' competitive and self-interested tendencies. This is because, in his view, “[u]nlike theories in the physical sciences, theories in the social sciences tend to be self-fulfilling” (2005: 77); gravity will continue to exert its force regardless of how well the theory is known, but as a social species, humans have a tendency to conform to what they perceive to be the norm—whether they are aware of it or not. For example, it is often suggested (Ferraro, Pfeffer, and Sutton, 2005; MacKenzie, 2006) that the Black-Scholes theorem became more accurate once it became known and accepted; the theory created the reality it was meant to describe.

Perhaps the greatest assumption to combat, then, is the assumption that humans are—or are not—inherently self-interested one way or another, including the assumption that economics and business students need to be more self-interested—by nature or by training—than their peers in other disciplines. Indeed, the evidence in this regard leans away from assumptions. For those without economics or business training, self-interest still plays a role in the experimental games and surveys the field has conducted; the results simply suggest more cooperation and fairness than expected based on the self-interest model, not that humans are perfectly cooperative. Finally, as previously discussed, pro-social and pro-societal are not always the same thing.

Furthermore, some studies suggest that a “calculative mindset” can be induced such that non-economists produce results in line with those who have undertaken an education in economics or finance (Wang, Zhong, and Murnighan, 2014; Pfeffer and DeVoe, 2009; Molinsky, Grant, and Margolis, 2012). As Rangan, Frank, and Tirole express in various ways, human behavior is highly contextual. Power, norms, habit, culture, and defaults are some of the forces that act on the social mammal so as to render us capable of remarkably cooperative—or self-interested—behavior.

The same may turn out to be the case for economics and business students themselves. Although the literature does clearly find a selection effect for those who study in these areas (Miragaya-Casillas, Aguayo-Estremera, and Ruiz-Villaverde, 2023; Frank and Schulze, 2000; Carter and Irons, 1991; Frey and Meier, 2003; Frey, Pommerehne, and Gygi, 1993), and many studies also find an indoctrination effect (Wang, Malhotra, and Murnighan, 2011; Frank, Gilovich, and Regan, 1993; Haucap and Just, 2010; Ifcher and Zarghamee, 2018), some of the additional findings in the literature point to the extent that context matters here too. From the 1980s onwards, economics and business education had become ever more standardized even as it adopted a neoclassical approach (Augier and March, 2011). The bulk of the studies in this area have been conducted on students enrolled in standard neoclassical courses, and the findings reflect this.

But some of the studies made an effort to tease out the effects of different approaches to economics education. Frank et al. (1993) tracked students across two economics cohorts, one of which had a more pluralist bent, and found that the effects were moderated for the second cohort of students—in other words, the way economics is taught can at least somewhat prevent students from adopting a view of humans as self-interested or beginning to behave in a self-interested manner oneself. A second more recent study, rather uniquely, failed to find any of the effects documented in the rest of the literature (Girardi et al., 2024). The population under study, however, was a sample of students at one of the universities best known for heterodox economics thinking in the United States; the lack of effect may be due in part to this additional context.

What this shows is that context matters; the population as a whole, including economics and business students, can be induced to behave selfishly or cooperatively depending on contextual factors. The contextual factors, then, must be part of the curriculum such that the considerations laid out in this volume—those of power, social comparison, social norms, convention, and others—can form part of the cognitive model economics and business graduates take back out into the world. Indeed, there is some suggestion that a broader view of economics and business education may prompt a wider range of policy orientations and a greater openness to insights from other disciplines (Quigley, forthcoming). In sharing a broader view of human nature and the context in which humans operate, there may even be some performativity at play; the more students hear of these contextual factors, the less likely they may be to assume their peers and other human populations are uniformly self-interested, competitive, and unlikely to contribute to the common good—and the more likely they are to see change as possible. As noted by Keltner et al. (2014: 443), “Social institutions that value prosocial behavior—be they religious or civic—significantly enhance prosocial behavior within collections”; economics and business programs that acknowledge this, and educate students appropriately, may help to counter some of the disheartening trends evinced in this volume.

Accordingly, I will close this chapter with five recommendations to augment the usefulness of business and economics education in its contribution to society:

1. Rankings publications: reduce or eliminate the criterion measuring graduates' increase in salary; it has been found to affect which students business schools admit into academic programs, incentivize business schools to encourage graduates toward lucrative careers above impactful ones, and reinforce the centrality of income as the focus of business schools and their students.
2. Business schools and economics programs: introduce a measure of heterodoxy in economics teachings, especially institutional economics, to ensure that students emerge with a more complex view of how the economic system works and the norms that strongly influence human behavior and cognition.
3. Business schools and economics programs: cultivate a measure of respect for ethics and values such as fairness and trust as the basis of a functioning financial system and society. This may sound nebulous as a goal, but educators in finance and economics must be aware that what they imply about these fundamental topics—through eyerolling, dismissal, or even a lack of attention—can be more powerful than what is explicitly taught.
4. Business schools and economics programs: expose students to genuine interdisciplinarity, by teaching subjects such as sociology, psychology, and even evolutionary biology, to ensure that students gain a broader view of their subject and the context in which it sits. The caveat is that these classes must be shown respect, for the same reasons as in Recommendation 3.
5. Researchers and program administrators: experiment with modes of education that help students to think and behave more cooperatively, including pro-societally, including by cooperatively sharing forms of experimentation and results with educators from other institutions.

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PART II
STRATEGY

The Social Welfare Implications of Strategic Management Theory

Jay B. Barney

The first theorem of welfare economics asserts that the allocation of resources in complete and competitive markets will be Pareto efficient, in the sense that no one in such markets can be made better off without someone else in these markets being made worse off (Arrow, 1951; Debreu, 1959).¹ While an impressive intellectual achievement, this theorem has been criticized on numerous grounds including, for example, that Pareto efficiency is consistent with a variety of resource allocations—including slavery and extreme forms of wealth concentration (Bergstrom, 1971; Coles and Hammond, 1995)—that most would find morally wrong, and that markets are rarely as complete and competitive as required by the theorem (Mahoney and Qian, 2013).

Unlike economists, strategic management scholars have traditionally not been very interested in questions of social welfare (Rumelt, Schendel, and Teece, 1995). They are, however, quite interested in the extent to which markets are complete and competitive, or more precisely, in the ways that markets may be incomplete and/or imperfectly competitive (Mahoney and Qian, 2013). This is because firms in complete and competitive markets cannot be expected to generate economic profits, while firms that operate in incomplete and imperfectly competitive markets can expect to generate such profits. And strategic management scholars are interested in understanding how firms create and capture economic profits (Brandenberger and Stuart, 1996), and in particular, advice that can be given to managers to help in their efforts to create and capture such profits (Rumelt, Schendel, and Teece, 1995).

This chapter argues that the goal of helping managers find ways to generate and appropriate economic profits is inconsistent with strategic management's historical indifference toward the social welfare implications of how those profits are generated and appropriated. The logic for this conclusion is pragmatic: given increased transparency and scrutiny of both public and private firms, especially in developed economies, it is becoming more likely that firms that generate economic profits in ways that are inconsistent with social welfare will be discovered and will experience both adverse market and governmental reactions. In this sense, at least some of the profits that might have been generated by following the advice implied by strategic management theory may be offset by the costs imposed on a firm that generates these profits in ways inconsistent with social welfare. Thus, what is required are not only theories of profit generation but also theories that clarify the social welfare consequences of these theories of profit generation.

¹ Complete markets are characterized by perfect information, zero transactions costs, and prices for every asset in every possible state of the world. The closely related concept of competitive markets includes markets where there are large number of buyers and sellers, homogeneous products, and no barriers to entry. See Milgrom and Roberts (1992) for more detail on these definitions.

This chapter identifies two of the most important theories of profit generation and appropriation in the field of strategic management—positioning theory (Porter, 1980) and resource-based theory (Wernerfelt, 1984; Barney, 1986a, 1991)—and shows how these two theories identify and build on different types of market imperfections to explain the generation and appropriation of economic profits. Then, the social welfare implications of these two theories are examined. Whether or not public scrutiny of the social welfare implications of applying these strategic theories has an impact on the performance of firms that applied them is examined through a discussion of the recent experiences of several high-technology companies. The chapter concludes by identifying other theories of profit generation and appropriation in the field of strategic management and calls for the examination of the social welfare implications of these theories as well.

8.1 Two Important Profit-Generation Theories in Strategic Management

While there are several theories of profit generation in the field of strategic management (Mahoney and Qian, 2013), perhaps the two most influential—both intellectually, in generating empirical and theoretical research, and practically, in informing both teaching and practice (Barney and Mackey, 2018)—are positioning theory (Porter, 1979, 1980) and resource-based theory (Wernerfelt, 1984; Barney, 1986a, 1991). To explain the generation of economic profits, these theories each relax different parts of the complete/competitive market assumptions of the first welfare theorem mentioned earlier. This implies that the implementation of these two theories potentially has implications for the impact of profit generation on social welfare. The profit-generating logic of these two models is briefly discussed here.²

8.1.1 Economic Profits in Positioning Theory

Positioning theory was developed by Professor Michael Porter (1979, 1980) and applies a particular brand of economic theory—called the Structure, Conduct, Performance (SCP) (Bain, 1956) paradigm—that suggests that industry structure (e.g., the level of rivalry, product differentiation, concentration, etc. in an industry) determines the conduct of firms in that industry (i.e., their strategy), which, in turn, determines the performance of firms in that industry. Where SCP logic was originally developed to help government regulators identify less than perfectly competitive industries that could be subject to competition-enhancing regulation, Porter (1980) turned the objectives of the SCP framework “upside down,” and used it to help firms identify industries where they could earn economic profits.

The most popular manifestation of positioning theory—so called because earning an economic profit is all about positioning a firm in a competitively attractive industry—is called

² Note that firms can pursue multiple strategies simultaneously, some consistent with positioning theory, and others consistent with resource-based theory. Also, over time, the emphasis in the strategies pursued by a firm may shift from positioning to resource-based, or vice versa.

the “five forces framework” (Porter, 1979).³ This framework identifies five forces that increase the competitiveness of an industry and reduce the ability of firms to earn profits in that industry; that is, reduce its “attractiveness.” These forces are the threat of rivalry, the threat of substitutes, the threat of new entrants, the threat of powerful suppliers, and the threat of powerful buyers.

The five forces framework points to the complete/competitive market assumptions of the first welfare theorem that are relaxed in positioning theory. Two are particularly important: the first theorem’s assumption that there are large numbers of firms competing in an industry, and its assumption that there are no industry-level barriers to entry. In fact, positioning theory requires that rivalry (both direct competition and competition from substitutes) is lower than what would otherwise dissipate economic profits, and that the profits thus generated are not competed away by new entrants (including powerful buyers or suppliers) because of high industry-level barriers to entry.

Obviously, the underlying profit-generation logic in positioning theory is monopoly power. One way to see this is to ask: what is the most attractive industry according to positioning theory? Such an industry has no rivalry (i.e., one firm) and there are no close substitutes, no threat of entry (due to high entry barriers), no powerful buyers, and no powerful suppliers. Such an industry would be a monopoly (or a colluding oligopoly). The implication of this logic seems to be that firms seeking to generate economic profits should position themselves in industries that are monopolistic (or oligopolistic) in character or could be transformed into monopolies (or colluding oligopolies).

8.1.2 Economic Profits in Resource-Based Theory

Where positioning theory explains the generation of economic profits by relaxing the first welfare theorem’s assumptions of large numbers of competitors and no barriers to entry, resource-based theory explains the generation of economic profits by relaxing this theorem’s assumption that factor markets are complete and competitive.⁴ If the factor markets where a firm acquires access to the resources it needs to implement its strategies are complete and perfectly competitive, then the price of access to these resources will rise to equal their value in enabling a firm to implement its product market strategies (Barney, 1986a). In this way, it may look like a firm has an advantage in a product market, but the price of access to the resources needed to create this advantage will have fully appropriated any profits that advantage might have generated.

Resource-based theory observes that factor markets will often not be complete or highly competitive. In particular, these markets will often be characterized by high levels of information asymmetry: a firm acquiring access to a resource may have a better understanding about how this resource, when combined with resources it already controls, will generate additional value, compared to others who might be interested in acquiring access to this

³ There are other parts of positioning theory (e.g., generic strategies, value chain analysis) (Porter, 1985, 1996). However, these elements of positioning theory are less connected to the SCP model and so are not emphasized here. Moreover, because these elements of this theory are less connected to the SCP model, their social welfare implications are more similar to the social welfare implications of resource-based theory.

⁴ Later, in order to derive the social welfare implications of resource-based theory, the assumption that in complete/competitive markets consumer preferences are homogeneous is also relaxed.

resource and compared to those who currently control access to this resource. With this informational advantage, a firm can avoid acquiring access to a resource when the price of this access is greater than the value that this firm knows it will create, and this firm can acquire access to a resource when its price is less than the value this firm knows that access to the resource will create. In this way, a firm exploits its informational advantage to avoid losses and realize profits.

So, when can firms have this information advantage? Resource-based theory's answer is: when they control rare, inimitable, and non-substitutable resources (Barney, 1991). And when will a firm's resources be rare, inimitable, and non-substitutable? Resource-based theory's answer is: when those resources are intangible, socially complex, path dependent, or causally ambiguous in nature (Barney, 1986b, 1991; Dierickx and Cool, 1989).⁵

Where positioning theory has the "five forces framework," resource-based theory has the VRIO framework (Barney, 1991). To help managers identify resources and capabilities that have the potential to generate economic profits, they must identify resources (1) they can combine with access to new resources to reduce their costs or increase their revenues (i.e., create value) compared to what would be the case if they did not combine with these resources, (2) that few other competing firms have (i.e., that are rare), (3) that competing firms find costly to imitate,⁶ and (4) they must organize themselves to realize this value.

Note that while positioning theory depends critically on industry entry barriers to entry to generate and sustain economic profits, resource-based theory depends on firm-level barriers to imitation to generate such profits. Indeed, there may be no industry barriers to entry in resource-based theory. This implies that, in a given industry, more than one firm can generate an economic profit, and that the level of these profits can vary, depending on how much value they create, how rare they are, how costly they are to imitate, and the extent to which a firm is efficiently organized to create such profits.

8.2 The Social Welfare Implications of These Two Theories

Of course, there are numerous differences between positioning and resource-based theory. These differences have been the subject of many debates and discussions. However, here only the social welfare consequences of these two theories are emphasized.

8.2.1 The Social Welfare Implications of Positioning Theory

Positioning theory suggests that firms seeking to generate economic profits must operate in monopolistic industries, or industries that can be transformed into monopolies (or colluding oligopolies). The theory emphasizes reducing rivalry below the competitive level (which

⁵ Resources are intangible when they are not physical in nature. Intangible assets can be socially complex (i.e., dependent on trust and other interpersonal relationships within a firm), path dependent (i.e., built up over time so that early events have a profound effect on the nature of later events (Arthur, 1989)), or causally ambiguous (i.e., it may not be clear what actions need to be taken to create these resources (Lippman and Rumelt, 1982)). Resources often manifest several of these attributes simultaneously.

⁶ Imitation can take two forms: direct duplication or substitution (Barney, 1991).

generates economic profits) and protecting these profits by exploiting and/or erecting industry barriers to entry.

The social welfare consequences of monopoly (and colluding oligopolies) are well known. As compared to perfect competition, monopolists or colluding oligopolists can reduce output below the competitive level. This reduction in supply enables these firms to raise prices above the competitive level—without any improvement in the product or service that is being sold. This is unambiguously bad for consumers, who now have to pay more for the same product or service. It is usually good for producers: while their volume of production may fall, any revenue per unit of production forgone can usually be offset by higher prices.

Of course, these higher prices and associated higher profits would, normally, induce entry into these industries. However, when there are high barriers to entry, entry is not possible, and the incumbent monopolist or colluding oligopolists can earn economic profits for a sustained period of time—reducing consumer surplus all the while.

It follows from this logic that firms that use positioning theory as a guide to choosing and implementing their strategies—assuming they are successful—will reduce social welfare.

8.2.2 The Social Welfare Implications of Resource-Based Theory

Resource-based theory suggests that firms can generate economic profits by exploiting the rare, costly-to-imitate, and non-substitutable resources they already control in reducing their costs or increasing their revenues by acquiring access to new resources. Resource-based theory does not hold out the promise economic profits to all firms, but only to those firms that control intangible, socially complex, path dependent, or causally ambiguous resources that can be used to reduce costs or increase revenues when combined with access to new resources.

The social welfare consequences of competition among firms with heterogeneous and costly-to-imitate resources with no barriers to entry into an industry have been discussed primarily in the work of Harold Demsetz (e.g., [Demsetz, 1964, 1972, 1973, 1974, 1982, 1989](#); see also [Barney and Mackey, 2018](#)). The central conclusion of this work is that economic profits generated in these settings can be consistent with social welfare.

This conclusion is straightforward when no firms in an industry possess rare and inimitable resources and capabilities. Competition in these industries will come close to approximating the complete and perfect conditions identified in the first welfare theorem, and thus the implications of this theorem apply. Of course, there are also no economic profits for firms in these settings.

But, what about industries where at least some firms have rare and costly-to-imitate resources, and thus are able to generate economic profits, and no entry barriers? Is the existence of profits, in these settings, consistent with social welfare?

Such profits will be consistent with social welfare when consumer preferences vary. In particular, at least some consumers in this kind of industry must be willing to pay higher prices for products sold by firms with rare and costly-to-imitate resources and capabilities. This can happen precisely because these consumers value some aspects of the products they can purchase from these firms that they cannot obtain from products produced by firms

without rare and costly-to-imitate resources and capabilities. [Demsetz \(1972: 594\)](#) puts it this way:

Why do consumers purchase differentiated products when they can obtain non-differentiated varieties at lower prices? Utility maximizing consumers—at least some of them—must believe that the differentiated varieties, if they are purchased, are worth more to them than are non-differentiated varieties. Our problem is to understand the ... equilibrium from the viewpoint of utility-maximizing consumers who are free to purchase the “non-branded” product version if they so wish.

In these industries, firms with rare and costly-to-imitate resources and capabilities are efficiently using these to produce products. Consumers who prefer these products are free to purchase them; consumers who do not prefer these products can purchase from firms without rare or costly-to-imitate resources and capabilities. These firms, in turn, are using their resources and capabilities to efficiently produce the products they produce. In this setting, firms are maximizing their profits, and consumers are maximizing their utility—all in ways consistent with social welfare.

8.3 Public Scrutiny of the Welfare Consequences of Business Strategies

If consumers and governments are unaware of the social welfare consequences of the strategies pursued by firms, then firms could apply a theory to choose their strategies that reduces social welfare with impunity. However, given the lower cost of monitoring the actions of firms, this outcome is becoming less likely.

Consider, for example, the evolution of popular press coverage of some important high-technology companies of our day: Apple, Facebook, and Google. Initially, each of these firms was praised for their innovative technology, their approach to management, and their ability to anticipate and address consumer preferences sometimes even before consumers were aware of those preferences ([Galloway, 2017](#)). Using language developed in this chapter, these firms were exploiting their valuable, rare, and costly-to-imitate resources and capabilities to generate economic profits in ways that were consistent with social welfare.

However, over time, several of these firms reportedly began to exploit the market power they gained by efficiently meeting customer needs in ways more consistent with the actions of monopolists ([Tablin, 2017](#); [Moore and Tambini, 2018](#)). Apple, for example, acknowledged changing the charging efficiency of its older iPhones in ways that, among other things, created incentives for consumers to buy new phones—actions that led Apple to offer batteries at discounted prices ([Patel, 2017](#)). Facebook acknowledged that it sold information about its users without user permission—which led to congressional hearings that adversely affected Facebook’s market value ([Romm, 2018](#)). Google exploited its near monopoly on online search in Europe—which led to a \$2.7 billion fine from the European Union ([Tablin, 2017](#)). All of these actions exploited these firms’ monopoly positions and were, arguably, inconsistent with social welfare. Once revealed—ironically, often through social media—these actions had significant adverse consequences for these firms.

These recent events point out that making strategic decisions without regard to the social consequences of these decisions is no longer a viable strategy. On the one hand, increased transparency can benefit a firm if it generates profits by efficiently exploiting its rare and costly-to-imitate resources and capabilities—in ways consistent with resource-based theory—to provide products or services that consumers want. On the other hand, this same transparency means that engaging in activities that either create or exploit a monopoly position—in ways consistent with positioning theory—are becoming less tenable strategic options.

8.4 Other Strategic Management Theories of Profit Generation

While positioning and resource-based theories are two of the most influential theories of profit generation in strategic management, they are not the only such theories. Indeed, a variety of such theories exist, and include transactions cost theory (Williamson, 1985), incomplete contract theory (Hart and Moore, 1990), agency theory (Jensen and Meckling, 1976), and real options theory (Kogut, 1991).

Each of these theories explain the generation of economic profits through relaxing one or more of the complete/competitive market assumptions of the first welfare theorem.⁷ What makes these explanations of firm profits different is that they relax different items of these assumptions. For example, transactions cost economics relaxes the assumption of zero transactions cost, incomplete contracts relax the assumptions of perfect information and complete contracts, agency theory relaxes the assumption that a firm manager will act in the interests of a firm's owners, and real options theory relaxes the assumption that firms do not face uncertainty when they make strategic choices.

However, since these theories all relax at least one assumption of the first welfare theorem, strategies based on the application of these theories may have social welfare implications. Some may be consistent with social welfare, like resource-based theory, and others may be inconsistent with social welfare, like positioning theory. Scholars need to fully explicate how each of these theories explains the generation of economic profits and then analyze whether strategies based on these theories are consistent or inconsistent with social welfare.

8.5 Conclusion

Social welfare has not been a major concern of most strategic management scholars. The logic developed in this chapter, and the experience of increasing numbers of companies, suggests that it should be. This chapter examines the profit-generating logic of two popular strategic management theories—positioning theory and resource-based theory. It shows that the first of these theories generates strategies that are inconsistent with social welfare, and the second is consistent with social welfare.

⁷ All extant strategic management theories—including positioning theory and resource-based theory—adopt two assumptions that are inconsistent with the first welfare theorem: first, that firms seek to survive, and second, that they seek to create and capture economic profits. The social welfare implications of these two assumptions also deserve attention.

The conclusion is not only important in strategic management but it also suggests that the conditions under which the first welfare theorem of economics applies are broader than what is currently being taught. In particular, this theorem also holds when resources and capabilities are heterogeneously distributed among firms, and when these differences are stable over time.

That said, this chapter fails to discuss the first criticism of the first welfare theorem mentioned—namely, that Pareto efficiency is consistent with a wide variety of resource distributions that are generally seen as immoral. In the end, an analysis of the social welfare implications of different models of profit generation in strategic management will need to attend to the weaknesses of Pareto efficiency as applied in this context.⁸

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⁸ See the discussion on Pareto efficiency on Rangan's chapter 1 in this volume.

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Reflections on Barney's Chapter

Elizabeth Anderson

9.1 Normative Perspectives of Neoclassical and Classical Economics

The dominant normative framework for evaluating the principal private-sector institutions of advanced economies today—private property, markets, and for-profit firms—draws largely from neoclassical welfare economics. This theory assumes that individuals are rational utility-maximizers, that their voluntary choices reveal their preferences, and that the satisfaction of their preferences advances their welfare. It evaluates aggregate outcomes of the entire economic system in terms of Pareto efficiency (Debreu, 1959). It assumes that the sole goal and principal duty of private firms is to maximize profits (Friedman, 1970). It takes as given an appropriate framework of state laws and policies (including effective management of the central banking system and fiscal policy to ensure full employment with low inflation), such that individuals and firms will incidentally generate optimal aggregate outcomes by focusing on the satisfaction of their personal preferences and private goals. This assumes that most agents will comply with the laws and not attempt to evade or subvert them.

Some powerful results about the consequences of fully free and competitive markets can be derived from this normative framework. Under the right conditions, which include well-informed agents, an absence of externalities, and full employment, the outcome of a system of free and competitive markets is Pareto efficient (Debreu, 1959). Most critics of neoclassical welfare economics have focused on its indifference to distributive justice. A state of affairs in which a few people own nearly all wealth, and millions struggle in poverty, is consistent with Pareto efficiency. In response, defenders of the neoclassical framework assign to the state the task of establishing distributive justice.

Even this expanded normative framework of efficiency-plus-distributive justice is limited, however. Classical economists such as Adam Smith, David Ricardo, Karl Marx, and John Stuart Mill evaluated economic institutions using a broader normative framework.¹ In their view, the most important product of the economic system is ourselves. What do we make of ourselves, and of our relationships to others, in arranging production, commerce, and distribution through different institutions? Do our economic arrangements enhance or diminish our skills and other capabilities?² Do they promote antagonistic, domineering, and contemptuous or sympathetic, cooperative, and respectful relations with other people?³

¹ Satz (2010: ch. 2) offers an outstanding discussion of the contrasts in normative framework between classical and neoclassical economics.

² This has been a long-running worry; see, for instance, Smith, 1776; Marx, 1964; and Acemoglu and Restrepo, 2019.

³ See, for instance, Sunstein, 2009; Christakis and Shaky, 2017; and Solon, 2017.

How do our economic arrangements shape our dispositions and attitudes (and thereby our preferences) over time? Do they make us more close-minded, selfish, and suspicious, or more open-minded, generous, and trusting? Classical economists also thought that factor markets, especially for labor, operate differently, and have a more profound impact on the quality of social relations, than markets for consumer goods. They are not merely instrumental to consumer satisfaction, and deserve independent assessment.

The following discussion will examine the assumptions of strategic management theory and of technology industries from the normative perspectives of both neoclassical and classical economics.

9.2 Assumptions of Strategic Management Theory

Jay Barney in [Chapter 8](#) offers a promising argument within the neoclassical framework for paying attention to the social welfare implications of business strategies for generating economic profits—that is, returns in excess of the opportunity costs of the inputs. When all of the assumptions of market perfection needed to generate Pareto-efficient outcomes are satisfied, then economic profits are zero. Hence profits can be generated only when one or more assumptions about perfect markets are not satisfied. However, some strategies for taking advantage of market imperfection have better social welfare implications than others. Firms using positioning theory to try to generate profits by erecting barriers to entry, colluding with producers of similar products, or otherwise gaining a monopoly position in an industry. Such strategies reap profits in ways that reduce overall social welfare. By contrast, firms using resource-based theory generate profits by developing unique knowledge of how to deploy rare and inimitable resources under their control. Such strategies add to net social welfare when customers have heterogeneous preferences. For example, a firm may develop unique knowledge of the niche preferences of certain customers by cultivating long-term relations with them, and cater to those preferences with socially nuanced, difficult-to-imitate goods and services. The brand itself may have cachet due to the firm's reputation. Inimitable product differentiation secures a firm's ability to generate profits, while contributing to social welfare.

Barney offers a pragmatic argument for managers to pursue social-welfare-enhancing resource-based strategies rather than social-welfare-reducing positioning strategies. Under conditions of transparency, the latter strategies are liable to generate profit-reducing consequences such as consumer protests, lawsuits, boycotts, employee resistance, and state penalties for violating antitrust and other regulations. This argument has the merit of addressing managers with respect to a goal—generating profits—they are presumed to already share. However, purely pragmatic arguments invite alternative strategies for coping with the risks of social-welfare-reducing strategies. It may be cheaper to address political risks by undermining the disposition of the state to defend broader social interests, through strategic deployment of campaign contributions, lobbying, and regulatory capture. A public corporation may be able to reduce its transparency to both customers and the state by going private.⁴

⁴ See also [Hirschman, 1970](#).

Classical economics offers warnings about some resource-based strategies. Its broader normative concerns raise questions about product-differentiating marketing strategies that induce consumer preference change rather than catering to preexisting preferences. This is not a criticism of all product differentiation that induces preference change through artful marketing. Much of the utility of consumption comes from the ways it engages our imaginations and expresses our distinctive identities. Yet marketing that aims to make people feel bad about themselves in order to sell them products that assuage their artificially induced low self-esteem reduces social welfare. Products and services that promote competition for unequal esteem via conspicuous consumption induce wasteful spending and heighten social contempt and stigma (Frank, 2000). Product differentiation also assumes that more choice is better than less. Yet, as choices among finely differentiated products proliferate, we may suffer from cognitive overload, confusion, and wasted time in deciding what to buy, and greater regret over the imagined opportunity costs of forgoing so many other options (Schwartz, 2005).

The broader normative framework of classical economics may also offer an alternative perspective on management goals. Profits *do* send important normative signals. If a firm is losing money in conditions of full employment and no positive externalities, this is a sign that the factors of production it is using would be better allocated somewhere else. It also suggests that its business model may be unsustainable. Yet the goal of *maximizing* wealth, even beyond one's consumption possibilities, is questionable. Adam Smith (1759: I.3.2.1) argued that vanity—the desire for attention and esteem—drives the quest for endless wealth accumulation. The time and effort spent acquiring and tending to ever-increasing accumulation as an end in itself is hardly worth the effort, given the ways this distracts from real happiness, which consists in the consciousness of being loved, and cultivating love and deserved esteem among friends and family (Smith, 1759: III.1.7). Yet the quest for esteem is useful to the extent that it motivates productive work that enhances the lives of others (Smith, 1759: IV.1.10). If the pursuit of wealth is merely instrumental to gaining *deserved* esteem, then managers should seek the latter end directly, and limit the quest for profits to the extent that it *actually* promotes social welfare. The reputation of the firm in the eyes of the wider public, when its operations are transparent, may serve as a fairly good proxy for this (Akerlof, 1970). The sense of employees that they are doing meaningful as well as remunerative work offers possibly more probative evidence, insofar as workers have more intimate knowledge of how their employer is actually generating profits. Managerial aims and social utility could be more closely aligned if business leaders themselves cultivated an economy of esteem that only extolled profits gained by social-welfare-promoting strategies, and disdained other managers who gain profits through corrupt, predatory, or destructive methods.

Preference satisfaction, efficiency, and profitability supply significant normative standards for evaluating economic institutions and practices, including business strategies. Further normative insights into strategy can be gained by drawing on traditions in classical economics, which focus on the impact of economic arrangements on the capacities of human beings, the quality of social relationships, and the responsiveness of the state to broad human interests.

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Humanitarian Monopolists

Reflections on Barney's Chapter

Michael Fuerstein

10.1 Introduction

Suppose you are a manager who wants to increase profits.¹ Under what conditions would contributing further to societal welfare be a good way of doing that? That is the question that animates Jay Barney's analysis in [Chapter 8](#) of two prominent theories of profit. The question is of obvious importance given the massive proportion of human capacity contained within for-profit organizations. If improving the human condition is not conducive to increasing profit, then, under the present economic order, the prospects for the human condition are bleak. Of course, a naïve observer of the business world might also draw attention to the value of societal welfare independently of its profit-enhancing qualities. Shouldn't businesses try to use their capacities in socially beneficial ways, even if that entails some modest sacrifice to profits? Might we not, at least under some circumstances, see profit as an instrumentality to social welfare rather than the other way around? Couldn't/shouldn't a monopolist, for example, leverage their market power for humanitarian ends?

Barney does not take up these latter questions and, on its face, his analysis appears to be neutral on this matter. I will argue that, in fact, his analysis recruits a number of implicit assumptions that strongly imply that profit-driven organizations cannot and/or should not aim at social welfare independently of its profit-increasing attributes. Within the limited space permitted by this comment, I give some reasons to think that these assumptions are at best only contingently true and that, under a wide range of plausible conditions, they are false. The upshot is that any organization that takes societal welfare to be important and that enjoys healthy profits has good reason, within some reasonable margin of risk, to aim at societal welfare non-instrumentally. Put another way: monopolists can and should be humanitarians. Insofar as Barney's perspective is representative of business strategy more generally, this chapter serves as a commentary on some of the central assumptions of that field.

10.2 Humanitarian Monopolists and Other Exotic Creatures

I begin with a very brief summary of the two approaches.

According to positioning theory, profits derive from a firm's capacity to benefit from barriers to competition. If there are high barriers to entry in some industry, then a well-positioned

¹ I am grateful to my colleague Colin Harris for valuable feedback on this chapter.

firm can charge higher prices for the same product than it could under more competitive conditions. In this way, Barney argues, each marginal profit dollar comes directly at the expense of social welfare, since consumers are getting exactly the same (or worse) stuff as they otherwise would have, except they are paying more for it than they would in a competitive market. On this model of profit, a monopoly is the ideal.

According to resource-based theory, profits derive from a firm's capacity to leverage its unique capacities to deliver goods that are valued by consumers. Whereas positioning theory implies that firms should make competition more difficult in order to profit, resource-based theory implies that firms should work to better produce some consumer-desired output. If and when consumers are willing to pay more for qualities that are social-welfare-enhancing, profit-seeking organizations (with the relevant capacities) have good reason to improve on those particular qualities.

The implicit assumptions behind this analysis emerge most clearly from thinking about a number of apparent counter-examples. Below, I present four that seem particularly significant, and discuss the apparent lesson to be drawn from each.

- (1) *The Rent-Seeking Corporate Social Responsibility (CSR) Officer.* Our officer works in the CSR department of a large firm in an industry with high barriers to entry. The firm enjoys healthy profit margins that it maintains, to a substantial degree, through pressure on legislators to maintain a favorable regulatory structure. From time to time, public complaints arise about the quasi-monopoly of this firm, but it is consistently able to rally political allies to its side in virtue of its large portfolio of philanthropic activities: well-advertised school sponsorships, museum exhibitions, and high-profile efforts to help clean up the local watershed. When the CSR officer's colleagues complain about the cost of these efforts against profit margins, she encourages them to think of them as a "downpayment on the support of our friends in the capital."

This case shows that, on positioning theory, contributing to social welfare can sometimes be a good way of increasing profits. In this case, making some meaningful contribution to social welfare is instrumental to profit, since social welfare contributions play a crucial role in public relations, which, in turn, help preserve high entry barriers within the sector. Barney mentions the recent difficulties that Facebook has confronted with its public image, and the related threat of regulatory intervention that goes with that. In a recent book, for example, the prominent legal scholar Tim Wu has argued for breaking up Facebook (and a number of the other tech giants) in antitrust style (Wu, 2018). Confronted with such extreme blowback, Facebook is now engaging in various attempts to reduce its contribution to social polarization and disinformation. In this case, attending to social welfare is an essential aspect of its attempt to protect its quasi-monopoly in social networking.

The more general lesson of this example is that, because social implications will almost always have some effect on a firm's public image, and because public image, beyond some threshold, will almost always be consequential with respect to business, attending to social welfare implications in some degree will be a necessary aspect of any good profit-making strategy. Any plausible theory of profits should be consistent with this point, though the extent to which social welfare implications are instrumental to profit might vary significantly across particular industries and, perhaps, across different theories of profit.

- (2) *The Price-Gouging Heroin Dealer.* Through the usual coercive and violent means, the price-gouging heroin dealer has a monopoly on the local market. Because there is no competition, he gouges his customers as much as he can, so long as they keep coming back for more. Prices and profits are high.

The price-gouging heroin dealer cuts against a second conclusion that Barney draws about positioning theory. Because the heroin dealer has a monopoly, he is able to charge higher prices, and heroin supply and consumption are lower overall than they would be in a competitive market. Since heroin is bad for people, social welfare is improved relative to a competitive market. This presumes that the additional profits that the dealer makes as a result of being a monopolist are not used in a way that contributes even more disutility than would be caused by greater heroin consumption at lower prices. But that assumption is plausible in this case and a range of others where, for whatever reasons, consumers tend to desire things that are bad for them or others.

Even in cases where a product is on balance good for people, artificially inflated prices might still yield a net gain to societal welfare, just so long as desire for the product tends to exceed its social value relative to alternatives. Video games are perhaps a reasonable example of this. Suppose that people who desire to play video games are made better off by the ability to play video games up to some point. Yet many people have a tendency to play video games too much, thereby leading to harmful social isolation and a withdrawal from other important activities (like schoolwork) (Gentile, 2009). On this assumption, the socially optimal quantity of video game consumption is lower than the actual quantity of video game consumption.

The central issue in this example is irrational or uninformed consumer behavior and/or externalities. Given the fairly nasty externalities associated with plastic waste, for example, we would plausibly be better off if plastic bag prices were artificially high. Again, we have to assume in this case that plastic bag makers would not use the additional profits to do something even more socially harmful than creating monumental garbage islands in the ocean. We also have to assume that the disutility of higher plastic bag prices does not exceed the benefits of reduced plastic waste. So, there is some limit beyond which higher prices make society worse off, even in the case of relatively useless, harmful products like plastic bags. But, contrary to Barney's claim that position-theoretic increases in profits are always bad for society, externalities and consumer irrationality create cases in which those increases sometimes advance societal good.

- (3) *The Humanitarian Monopolist.* The humanitarian monopolist enjoys economies of scale that make it very difficult for anyone to mount a competitive challenge. Without any real competition, the monopolist's company is able to charge high prices and make a nice profit. She is a dedicated humanitarian who keeps up with the world's biggest problems and is well versed in the most promising policy solutions. In consultation with a variety of experts, she uses a substantial share of the firm's healthy profits to invest where she thinks she can make the greatest impact.

The humanitarian monopolist reveals a second way in which profits derived from suppressed competition can be better for society. In particular, society will be better off if the humanitarian monopolist does things with her profits that contribute more social utility than

would be created through the consumption of her products at competitive prices/quantities. As in the case of the price-gouging heroin dealer, that sort of situation will tend to arise when the humanitarian monopolist sells products with significant negative externalities or costs that are not reflected in consumer preferences. The externalities could be to a consumer's future self ("internalities") or to others.

Let's return to the case of Facebook. Beneath some threshold of consumption, Facebook probably yields a net positive to social welfare. But there also seem to be seriously diminishing, and probably negative, returns to investment in Facebook's activities past a certain threshold. Beyond that threshold, society would be better off if Mark Zuckerberg acted as a wise philanthropist rather than a wise builder of his business. If the social networking sector were hyper-competitive, Zuckerberg would not have the breathing room to invest his surplus in, say, remedies to malnutrition for which market demand is weak. He would be forced to leverage all residual gains for yet more competitive advantage, as would others in the sector. But, as a monopolist, he does have that breathing room, and if he were a wise social investor, the world would be better off.

The lesson I draw from this example is that the relationship between profit and societal welfare is a function not only of how the profits are created, but also of how they are invested and used. Whereas Barney's discussion treats social welfare as an instrumentality to profit, some economic actors may treat profit, within some margin, as an instrumentality to social welfare. To the extent that this is true, any mechanism by which profits are increased will be compatible, at least under some circumstances, with increased returns to societal welfare. Whether and when this is the case will depend on how well consumer preferences map on to the societal good relative to the humanitarian wisdom of business agents.

- (4) *The Fair-Trade Branding Guru.* The fair-trade branding guru understands the appeal of ethical principles to a certain class of educated, high-earning consumer. She works closely with her team to design the marketing and packaging for the highest impact among this group, charging a premium for products that advertise their ethical labor practices and slim environmental footprint.

The fair-trade branding guru leverages a competitive advantage on ethical behavior, which is appealing to a specific class of consumers. In this way she generates profits in a manner consistent with resource-based theory; that is, not by benefiting from suppressed competition but by differentiating herself from others on something that has a market value. Her marketing talents are useful as a way of maximizing the conversion of ethical behavior into consumer demand. As Barney observes, profiting from resource-based differentiation will be conducive to socially beneficial behavior whenever (a) one has resource advantages in socially beneficial dimensions, (b) consumers are aware of those advantages, and (c) consumers are willing to pay for those advantages. Barney argues that, as information about the social welfare implications of business behavior becomes easier and easier to acquire, the consequences of those implications for profit will become ever stronger.

While, in general terms, this line of reasoning looks plausible, it is also worth marking its limits. For one thing, the conversion of ethical behavior into profit is mediated by consumer perceptions, and those perceptions have a range of inputs, many of which are unreliable. Food marketers put phrases like "all natural" on their packaging, knowing that it will tend

to elicit confidence in the food's nutritional qualities. But, of course, lots of foods that do not contain artificial ingredients are also quite bad for you. Similarly, there is now a proliferation of labels available that purport to certify the humane treatment of animals. Yet there is wide variation in the nature of these standards and in their reliability. Some of these standards, for example, are awarded based on self-reporting, and are consistent with potentially deadly levels of ammonia concentration (in poultry houses²). Well-intended consumers, meanwhile, will be happy to accept the "humane certification" label at face value and will pay the corresponding premium.

The problem in this context is familiar from democratic politics. In 1957, Anthony Downs observed that "rational ignorance" is pervasive in democracies, since the costs of getting good information about candidates and policies are quite high, while the benefits (expressed through voting power) are low (Downs, 1957). In this context the primary difficulty is not the availability of information as such but, rather, the costs of filtering that information and assimilating it into rational decision-making. Likewise, we should expect that, in business, greater transparency about ethics will generate some positive returns to ethical behavior. But those returns will be bounded by the costs of tracking ethical information across a wide range of products, by limits to the price burden consumers are willing/able to bear for perceived ethical wholesomeness, and by the ability of firms to shape perceptions of ethical behavior independently of reality. At some point the marginal cost of doing what is good for society will exceed the marginal benefit in profits. And in many cases, that threshold will be crossed prior to the point at which societal welfare is adequately or appropriately served.

The general lesson of this example is that, under the imperfect conditions that characterize normal market operations, no purely instrumental approach to societal welfare—including resource-based theories of profit—is likely to generate market behavior that reliably serves societal welfare. Under those conditions, the adequate contribution of business to societal welfare will depend on some measure of activity that aims at societal welfare non-instrumentally; that is, as something worth pursuing independently of profit.

10.3 The Apparent Assumptions in Business Strategy

In different ways, the four examples above support conclusions different from those that Barney draws about the relationship between profits and societal welfare. I do not believe that this is because Barney has overlooked the kinds of possibilities identified in these examples. I think it is, instead, because Barney's perspective on theories of profit is informed by a number of crucial assumptions that my own interpretations abandon. Since I have no reason to think that Barney's perspective differs in this respect from others in the field of strategy (and, indeed, since he himself is among the most influential figures in this field), I think we can reasonably see these assumptions as representative of the field of strategy overall.

The assumptions are as follows:

Assumption 1: Aiming to satisfy informed consumer preferences is, in general, a more reliable way of improving societal welfare than aiming to improve societal welfare directly.

² See www.nytimes.com/2017/01/31/dining/animal-welfare-labels.html.

If this were true, then artificially high heroin prices would not make society better off since lower prices would enable consumers to satisfy their demand in greater quantities and at lower cost. Likewise, monopolists could not improve social welfare by being humanitarians; they would do better to invest in ever more market-competitive products. By contrast, Barney states that profits that derive from entry barriers always make society worse off. This claim makes sense on the view that any time higher prices result from some kind of inefficiency, society is worse off than it otherwise would be. The broader theoretical framework for such a view is a market philosophy that treats improvements in aggregate preference satisfaction as the definitive metric of societal welfare, subject only, perhaps, to some further distributional constraint (as Barney notes). If aggregate demand satisfaction is the definitive metric of social welfare, and if market demand represents the most efficient distribution of demands, then satisfying market preferences under healthy competition is the best way of advancing societal welfare. Do-gooders who would invest in activities that are non-market competitive would, on this view, be under the misguided impression that they are somehow better positioned to recognize what the world really needs against the best indications of the price signal. This Hayekian point explains one of the more famous lines from *The Wealth of Nations*:

By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. (Smith, 2000: 485)

Of course, Smith uses the word “frequently” above, not “always.” In reality, consumers are irrational and underinformed, and negative externalities abound. Thus, even if we assume that, under optimal market conditions, consumer demand is the best indicator of societal welfare, under real market conditions it is not difficult to recognize reliable deviations from that pattern. The heroin dealer, the philanthropic monopolist, and the fair-trade branding guru examples all reveal the disconnect between optimal market assumptions and real-world market imperfections. Maybe perfectly rational and informed consumers would price sustainable coffee sourcing appropriately. But real-world consumers do not, in part because the costs of unsustainable agriculture will be disproportionately born by future people (whose interests are at best indirectly represented in the preferences of present people). Perfectly rational and informed consumers would no doubt buy less heroin or fewer cigarettes in the aggregate. But people are irrational and have trouble assimilating good information into their decision-making even when it is available.

Market theory tells us that the existence of profits is dependent on various shortfalls in optimal market conditions. But since those shortfalls will always exist, there will always be profits. Similarly, however, shortfalls in market conditions—particularly externalities, information asymmetries, and irrationality—also imply that aiming at consumer preferences will always produce suboptimal consequences for societal welfare.

As a matter of practice, it is possible that, in spite of this fact, do-gooders who seek to advance societal welfare independently of market demand will wind up, through folly, hubris, and whatever else, underperforming relative even to modestly imperfect markets. Mark Zuckerberg donated \$100,000,000 to improving Newark’s failing public schools. So far as I am aware, pretty much all of that went down the tubes. On the other hand ... market forces were not working much magic in Newark’s schools either. In any case, the question of

whether and to what extent business organizations can better serve societal welfare by aiming at it non-instrumentally is principally an empirical rather than a theoretical question. As a general claim, assumption 1 is almost certainly false.

Assumption 2: Organizations that sustain themselves through profits acquired in the market will not sacrifice profits for the sake of some competing end.

Suppose you accept that, in at least some cases, treating societal welfare as a non-instrumental objective is a better way of advancing societal welfare than treating it as an invisible hand by-product of profitable activities. Still, you might think that business agents, for whatever reason, just won't aim at anything directly besides profit. If that were true, it would, once again, help to explain Barney's interpretations of different profit-making mechanisms. If business agents are comprehensively profit driven, then there could be no humanitarian monopolists because all monopolists would be maximizing their investment in whatever would be likely to earn them yet more profits.

It is possible that some such behavioral assumption is at work but, as a purely descriptive matter, it is hard to see why it would be true. Perhaps in larger organizations (publicly traded corporations) there are strong pressures toward a default profit motive, since—as Milton Friedman argued—there is likely to be wide disagreement among shareholders about which social uses of resources are going to be effective and appropriate (Friedman, 1970). But, descriptively, there is a fairly wide range of motivations at work in human behavior, and it is not particularly difficult to identify successful business agents who are sacrificing some margin of profit for the sake of charitable endeavors that lack any clear business rationale. As Tim Cook succinctly put it: “When we work on making our devices accessible to the blind, I don't consider the bloody ROI.”³

Regarding pressures toward the profit motive in larger governance structures, organizations display a substantial variation in their values and philosophy surrounding issues like justice and the environment, and—while I lack the space to make the argument here—it seems doubtful to me that all of this variation can be explained as a function of profit-driven market differentiation. In any case, this argument would not apply to privately held organizations with more concentrated decision-making powers. More broadly, this is a matter, once again, that requires empirical investigation.

Assumption 3: Market competition is a prisoner's dilemma in which any sacrifice to profit will yield an exploitable advantage to competitors, thereby threatening an organization's survival.

Assumption 3 holds not that business agents are motivationally disinclined to sacrifice profit for the sake of social welfare. It holds, instead, that the dynamics of market competition prevent them from doing this. The problem with do-gooder economic agents, following this assumption, is that they fail to make investments that will enhance their advantages over rivals. In that way they create existential threats to the business in proportion to the extent of

³ www.forbes.com/sites/stevedenning/2014/03/07/why-tim-cook-doesnt-care-about-the-bloody-roi/#9242d1a55f22.

the sacrifice to profits. Of course, the degree to which some sacrifice of profits creates an existential threat to a given business depends on the size of the sacrifice and the positioning of rivals. If profits are being extracted because a firm is at the top of an uncompetitive industry, then there ought to be some substantial margin within which directing resources to unprofitable but socially beneficial objectives entails relatively low levels of risk. In other words, there ought to be ample scope for monopolists to indulge their humanitarian impulses. In such a case, the very same market failures that facilitate profits—suppressed competition—are also those that facilitate doing unprofitable things. Similarly, if a firm enjoys profits because it has carved out a substantial resource-based advantage, then there is going to be some margin within which the risks created by unprofitable activities are acceptably small. In other words, on the assumption that the permissible level of business risk is greater than 0, the existence of profits itself entails the potentiality for some margin of acceptable pro-social sacrifices.

There is a second problem with assumption 3, which is that it takes for granted the non-cooperative structure of the prisoner's dilemma. In the wake of Nike's struggles with sweatshop labor in its supply chain, Nike has made major strides in improving its labor practices. Improving such practices has undoubtedly been costly in some respects. Rather than go it alone, however, Nike served as one of the founding members of the Fair Labor Association, which now includes many of the world's biggest apparel companies, and which commits organizations to a substantial accountability and compliance regime. Similarly, as part of an effort to reduce its environmental footprint, IKEA played a major role in devising the Better Cotton Initiative, an approach to sustainable sourcing which now has 1,175 participants in industry. In both cases, by forging a larger industry alliance, the companies were able to hedge some of the downside competitive risk that might otherwise have come from taking on higher costs for the sake of societal aims. And though calling upon the government is likely to introduce new kinds of problems, cooperation with regulatory agencies may in some cases be able to effectively reduce the downside risk of costly pro-societal behavior.

10.4 Conclusion

I have presented a number of counter-examples to Barney's analysis of profit theory, and I have argued that these counter-examples reveal several apparent assumptions of business strategy. The essence of these assumptions is the idea that business actors cannot, will not, or should not aim at social welfare independently of its instrumentality to profit. While I lack the space to mount a comprehensive challenge to those assumptions, I have argued that their validity is at best a matter of empirical contingency, and that there is very plausibly a wide range of real-world cases in which the assumptions are false. Barney begins by asking whether managers interested in increasing profits have good reason—according to some standard theories of profit—to attend to social welfare implications. The answer is, at least sometimes, “yes.” We might likewise ask whether managers interested in improving social welfare can and should pursue that objective independently of profit implications. The answer is, at least sometimes, and probably quite frequently, “yes.”

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PART III
MARKETING

11

Fundamental Assumptions in Marketing

Philip Kotler

Every discipline rests on a set of comfortable assumptions. Marketing is a discipline filled with many assumptions. My purpose is to discuss a subset of these assumptions and examine them more closely.

11.1 The Aim of Marketing Is to Sell

Much of the public confuses marketing and selling. I would say that these are different but related disciplines. [Peter Drucker \(2001: 20\)](#) alerted us to the difference when he proclaimed, to the shock of managers, “The aim of marketing is to make selling unnecessary.”

I would add that *hard selling* is a sign of a marketing failure.

The aim of selling is to satisfy a customer’s need through a product/service offering. The aim of marketing is to figure out the customer’s need. The marketer who first discovers a strong unsatisfied customer need will only need price, not promotion or distribution, to be successful. Customers will join long lines to buy the product even before it is available. Look at the number of customers who put down an advance payment for the new low-priced Tesla even before it was available.

Marketing is the homework that the company must do before making a product. It is the art of figuring out what to make and how to price it.

11.2 A Company Focused Mainly on Selling Today’s Products Will Not Be Around Tomorrow

The world is changing much faster than most firms can change. If your company is in the same business five years from now, you will be out of business. The firm’s current products become obsolete much faster. The job of the marketer is to recognize changing customer needs before competitors do, and to obsolete the company’s product before the competitors do. The marketer should be the main market disrupter. The marketer should care as much about tomorrow as today. The marketer must visualize what the market will need tomorrow. *Maximizing current profits is less important than maximizing long-term profits.*

11.3 Marketers Can't Make Money in a Mature Industry

This is a terrible misperception. Calling a market “mature” is evidence of incompetence. It shows a lack of imagination on the part of the marketing group. There is no such thing as a commodity. A commodity is simply a product waiting to be differentiated. The product is waiting for a redefinition. If you can differentiate a dead chicken, as Tyson did, you can differentiate anything.

11.4 Marketing Is a Commercial Subject Centered on the Art and Science of Demand Management

First, marketing is not only a commercial subject. In 2018 I published “Why Broadened Marketing Has Enriched Marketing” in the *AMS Review*. I fought hard to show that marketing is everywhere, not just in the commercial sector. Proposing marriage won't work without the proposer doing marketing homework on how to win the heart and mind of the proposee. Winning a job that has heavy competition calls for out-marketing the other candidates. Museums don't exist just by opening their doors: they have to attract visitors, funders, and new pieces to exhibit. Today we are seeing solid research in political marketing, religious marketing, place marketing, person marketing, idea marketing, and other areas of marketing.

Second, marketing is essentially about managing demand, especially its level, timing, and composition. This means that marketing also covers “demarketing,” namely trying to reduce demand. We must influence people to conserve water and avoid overfishing and overtimbering.

11.5 The Purpose of Marketing Is to Improve Customers' Lives

Marketers must be expert at creating value, value as perceived by the customer. The customer is buying something that they think will satisfy a need. It may be a lower need such as hunger or a higher need such as intellectual stimulation.

The problem arises when the customer needs something that is not good for the customer, such as cigarette smoking, a fourth shot of alcohol, or a hard drug. I have never agreed to do marketing consulting for a tobacco company. In this regard, marketers have to decide whether they believe that what they are marketing will improve customers' lives. If not, don't get involved in marketing that product.

Marketers should do more than market a product. They should be marketing a dream. The dream is expressed by the brand. The brand is an artifact of storytelling. Great marketers will supply a moving story about the product. Starbucks is a story, Nike is a story, Costco is a story.

I would go further and say that great marketing occurs when the company is marketing a cause, not just a business. P&G's dental products are aimed at making better and healthier teeth. Volvo's marketing is aimed at making not only safer cars but also safer drivers and safer roads.

11.6 A Company's Creativity in Promotion Is the Key to Success in Marketing

This is a safe half-truth. Many managers believe that a great creative promotion plan can overcome product deficiencies. The statement hides the basic axiom that success fundamentally lies in the first two Ps: product and price. If product and price fail to deliver value, then the product will fail. It may be covered up for a short time by creative promotion. But buyers will not only be disappointed, they will get on the internet to share their tale of disappointment with others. Word-of-mouth will deliver the death sentence to the company who only relies on creative promotion to sell the product.

11.7 Marketing Just Takes an Hour to Learn

I often tell others that marketing just takes an hour to learn. I would explain customer segmentation, targeting, and positioning and add a few words about pricing, promotion, and distribution. At least the person would have the right vocabulary to speak about marketing.

The truth is that marketing takes a lifetime to master! Every challenging marketing situation is different and needs so many qualifiers. I would be careful about hiring a chief marketing officer of a car company to take over marketing Starbucks' coffee business. I remember that Apple hired a very well-trained marketing expert at Pepsi to manage a computer company. Eventually he had to be replaced.

11.8 Marketing's Job Is to Research Customers and Then Set the Marketing Plan

This is half right. I would go further. I would like the customers to help drive and shape my marketing plan. I would want customer representatives participating in the shaping of my plan. The plan and my products should come from co-creation with my customers. I would like customers to see my company as a job shop where they join in on designing the product and the price. Two examples. Lego actively invites young and older people to participate in designing new Lego products. Harley-Davidson welcomes Harley-Davidson motorcycle owners to participate in improving Harley's motorcycles.

There are many more assumptions running our marketing thinking. They can be examined on another occasion.

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Three Assumptions Underlying Customer Value Management

An Interdisciplinary Perspective

Hilke Plassmann

Marketing is a business field that has that has changed fundamentally since its beginnings. In its early years, its focus was on informing customers about a company's offerings and selling them (Jones and Shaw, 2006). However, at least two important developments have led to fundamental shifts in the marketing paradigm over time: first, the industrial revolution increased competition and spawned the idea that an offering requires a competitive advantage to be successful in the marketplace. Second, the digital revolution has empowered customers, who now expect to be listened to and want to be understood. These developments have changed the goal of marketing from a strict focus on the selling of a specific product to an emphasis on fulfilling customer needs better than the competition.

In their early writings in the middle of the twentieth century, pioneers such as Peter Drucker, Philip Kotler, and Theodore Levitt called for marketing to be practiced as a management philosophy putting the customer and not products first, rather than as a business function to sell products (Drucker, 1954; Levitt, 1960; Kotler, 1967). Their concepts laid out the fundamental ideas of modern marketing thought today. The most central one is the idea of customer-centricity, the idea that a company's effort should revolve around creating an offering of value to its target customer rather than creating a product that will find its customers.

The central feature of customer value management is that companies see their offerings not in the light of their products' technical features, such as the motor and drill type used in a power drill, but in the sense of what their customers want to do (see Figure 12.1). Why should customers care about the product? Customers do not want to buy a power drill, but they need, for example, a hole in the wall to mount their favorite painting. An important role of customer value management is to translate technical features of products into benefits and then understand whether and how those benefits satisfy the needs of different potential groups of customers.

In this chapter, I focus on basic assumptions underlying customer value management and reflect on them from an interdisciplinary viewpoint. I take the individual-level perspective, defining customer value as the degree to which an offering's benefits satisfy a customer's needs. In related disciplines such as strategy and microeconomics, customer value is described as a customer's willingness to pay (WTP). In what follows, I describe what is underlying a customer's WTP and three of its basic assumptions.

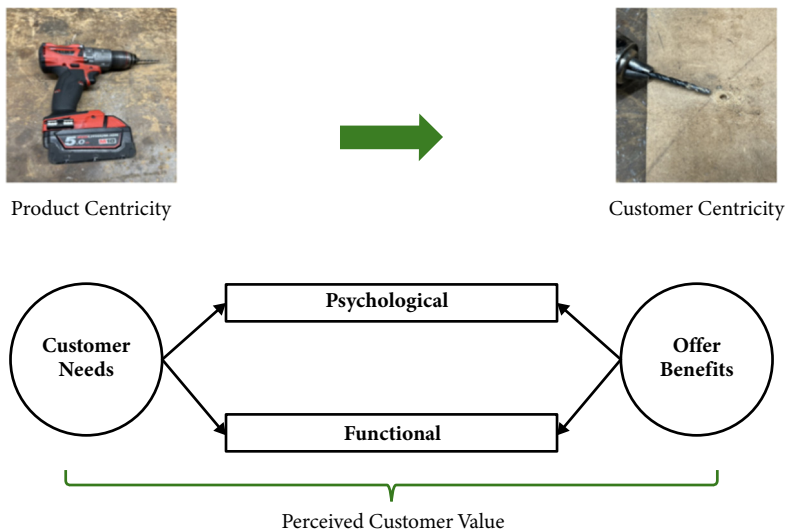


Figure 12.1 The concept of customer value.

Source: Author's rendition.

Assumption #1: *Most needs are not created by companies but can be tied into higher-order needs rooted in human biology.*

A common idea is that new products create new needs in customers' minds. I argue against this idea: foundational ideas in psychology propose that humans, as part of modern societies, have a countable range of needs (Maslow, 1943). These are basic needs such as food, water, shelter, and reproduction; safety needs such as health and well-being and financial and emotional security; social needs such as friendships and family; and higher-order needs such as the building of self-esteem and the signaling of one's place in the social hierarchy (Maslow, 1954). Companies create offerings with benefits that satisfy these needs in different ways. In other words, customers would have been thirsty without Evian offering their water bottles, hungry without McDonald's offering their Big Macs, and signaling social status without Rolex offering their watches. Those companies that are more successful satisfy customer needs better than their competitors do. Note that competition does not necessarily mean direct competition, such as Tag Heuer for Rolex. Competition means another company that potentially can better satisfy the need of status signaling—for example, different models of a Porsche car can be seen as a competitor of Rolex watches because both may satisfy status-signaling needs.

Human needs are fundamental and rooted in biology. For example, in a recent study my co-authors and I showed that the administration of the male sex hormone testosterone increased participants' need for status signaling through economic consumption (Nave et al., 2018). In this work, participants who were administered a single dose of testosterone preferred products with high (versus low) status-signaling qualities more than those participants who received a placebo. Importantly, the products had no perceived difference in quality associations. This finding implies that one driver of status product consumption can be linked to fluctuation in hormones.

The concept of customer value also has a biological foundation. In earlier work, I showed that the activation of a region in the brain, the ventromedial part of the prefrontal cortex (vmPFC), increases with a consumer's WTP (Plassmann et al., 2007, 2010; see Figure 12.2). After more than a decade of research in neuroeconomics, it is established that this region and another region called the ventral striatum form the brain's valuation system (BVS; Levy and Glimcher, 2012; Bartra et al., 2013; Clithero and Rangel, 2013).

The way consumers use their BVS is adaptive, in the sense that several studies have shown that the BVS assigns values to objects in the environment even without conscious awareness (Lebreton et al., 2009; Tusche et al., 2010). In other words, these results suggest that even without being explicitly asked to evaluate an option, our BVS might implicitly evaluate the options for choice in the environment.

Taken together, these ideas suggest that companies do not create needs; customers are equipped with those needs—mostly for good reasons.

Assumption #2: *The higher the value to the customer, the better.*

We assume that the higher the value the customer derives from a company's offering, the better it is for both the company and the customer: it will make the customer more likely to purchase and repurchase, make them more satisfied and happier with the purchase, and thus encourage them to talk more as well as more positively about the company's offering. In other words, a higher value should improve the customer's happiness and satisfaction along their entire customer journey. An interesting question from an interdisciplinary perspective is whether higher value also increases consumer welfare at large, or whether there could be a welfare limit to customer value maximization.

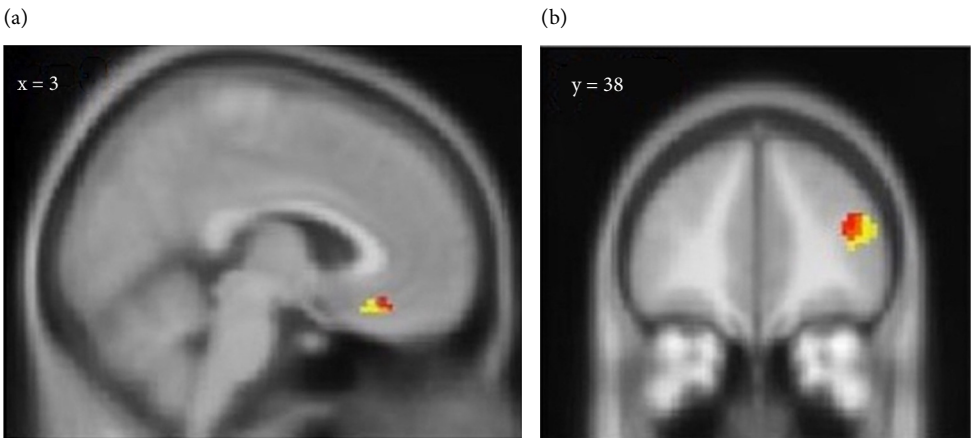


Figure 12.2 Brain regions that encode willingness to pay to receive (yellow) and to avoid (red) receiving a product in the brain's valuation (a) and cognitive control system (b). The higher the positive value assigned to the product, the greater the change in neural activity in these two regions and the higher the negative value assigned to the product, the more deactivation in these two regions.

Going back to the neural signatures of customer value, the brain regions of the BVS have a higher density of dopaminergic neurons and thus are linked to the dopaminergic pathways in the brain (Glimcher, 2014). Dopamine is a neurotransmitter linked to the motivational aspects of reward processing and their translation into actions such as choice (Rangel et al., 2008; Berridge et al., 2009; Nestler et al., 2009; Glimcher, 2014). The anticipation of most types of rewards increases the level of dopamine in the brain, and many addictive drugs increase dopamine release. Besides ingestion of psychoactive substances, other behaviors can produce short-term rewards that may result in diminished control over such behaviors. These findings gave rise to the conceptualization of “behavioral” addictions (Grant et al., 2010). Behavioral addictions potentially include economic behaviors such as gambling, compulsive buying, exercise, work, and excessive technological (i.e., internet and video gaming) consumption (Pinna et al., 2015).

Note that in contrast to the common notion of being “addicted to chocolate,” true addiction involves extreme behaviors neglecting the satisfaction of one’s basic needs. However, it is still an interesting and important question for economic progress to discuss whether too much value or happiness could be disadvantageous or even detrimental. For example, in a study investigating dietary decision-making and its control, we found that overweight participants at risk of obesity did not show a lack of willpower as compared to lean participants. However, they assigned significantly more value to food items (Pavlicek et al., 2014). These findings underline neuroscientific findings that when obese people are exposed to calorically dense foods, dopaminergic circuits in their brains are more recruited than those in the brains of lean people (Volkow et al., 2017). Marketers and researchers in food marketing are increasingly aware of such health risks and are looking for solutions that align customer, company, and societal welfare (Cornil and Chandon, 2016, 2018).

Assumption #3: *Customer value is not objective but subjective, and as such is state- and context-dependent.*

The concept of customer value has one central feature: it stems not from the *objective* value of an offering (if this exists at all) but from how the customer *perceives* the value (see Figure 12.1). In turn, the value a customer assigns to a company’s offering is subjective, and thus modern marketing is about managing customers’ perceptions. This subjective value is different for different customers and depends on the current state of the customer and the context in which the offering is presented. The former requires companies to group customers who value their offerings in a similar way—an exercise referred to as segmentation and targeting in marketing’s technical terms (see Kotler and Keller, 2016). The latter implies that the context, partly controlled by the marketer, might change the offering’s value.

We could show, for example, that the price of wine changes how much consumers report enjoying its consumption, and thus that customers get what they pay for. Notably, a high price tag does not merely change how much customers report enjoying the wine; underlying such effects is that price changes how the customer’s brain encodes the pleasantness of the taste of the wine (Plassmann et al., 2008; Plassmann and Weber, 2015; Schmidt et al., 2017). However, this does not imply that companies could sell their offerings at infinitely high prices, maximizing the value to themselves and their customers. Such price expectancy effects have been shown to work only within an acceptable range of product qualities, and

once the product is outside this range, a high price tag backfires: customers like the wine with the high price less than the same wine with a lower price (Gneezy et al., 2014). In other words, this study found that really awful wine was *less* pleasurable when it cost more. Less is known about what the exact quality boundaries are.

Another example of the context-dependency of customer value is that the choice set of options matters. A retailer or online store might be able to shift the value assigned to a product by curating what else is on the virtual or brick-and-mortar shelves surrounding that product. The idea is that such products, called “decoys,” would make the focal product look better on more dimensions (e.g., taste, price, size) than other products in the choice set by increasing its perceived attractiveness (Huber et al., 1982).¹ This potential irrationality in consumer valuation has recently been linked to the constraints of a limited number of neurons with limited firing range in brain regions involved in value coding that thus need to adapt to the “statistics” of the environment—a process referred to as divisive normalization (Louie et al., 2011, 2013; Louie and De Martino, 2014). This neuroeconomic model of choice has been inspired—similarly to prospect theory—by features of the visual system (Barlow, 1961; Heeger, 1992; Wainwright et al., 2002), but also suggests how such relative value coding could be quantified on a neural systems level (Landry and Webb, 2018).

In sum, there are interdisciplinary models showing how and explaining why values assigned to options for choice are not objective but rather subjective, and as such context-as well as state-dependent.

To conclude, in this chapter I have shed light on the biological underpinnings of the three main assumptions of customer value management that are important in modern marketing thought.

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¹ Economists call decoys irrelevant alternatives, and most decision-making models assume that valuation follows the independence of irrelevant alternatives (IIA) axiom. The IIA axiom holds that if an individual prefers oranges to apples when offered together, then they also prefer oranges to apples in any other choice set (e.g., adding bananas to the choice set of oranges and apples).

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Does Anyone Need a Rolex?

Reflections on Kotler's and Plassmann's Chapters

Valerie Tiberius

I want to start by quoting Kotler and Plassmann from their chapters in this volume. “The aim of marketing is to figure out the customer’s need” and “to recognize changing customer needs before competitors do” (Kotler). The goal of marketing is “fulfilling customer needs better than the competition.” “Most needs are not created by companies but can be tied into higher-order needs rooted in human biology.” “[C]ompanies do not create needs; customers are equipped with those needs—mostly for good reasons” (Plassmann).

The language of needs is a striking feature of the two chapters on marketing. Why is marketing marketed using the language of *needs*?

When philosophers talk about needs, they typically have in mind one of these contexts:

- Meeting basic needs as one of the goals of justice.
- Basic human needs as the metric for global justice.
- Basic needs as the limit on what can be demanded by others in a reasonable contract.
- Basic needs as the basis for a theory of well-being.

What these contexts have in common is that needs are taken to be a morally or politically significant category. They identify moral goals or limits, or they ground moral or political authority, or they undergird claims about what people have reason to do for themselves or for each other. According to none of these theories does anyone need a Rolex ... Or a Tag Heuer, or a Volkswagen, or, for that matter, most of the things that are marketed to the people who can afford to buy them.

13.1 Needs in Marketing

Here would be a quick way of ending this chapter: “Whatever marketing experts mean by needs, then, it’s not what philosophers mean by ‘needs.’” Strictly speaking, either we are talking past each other, or (to take the role of an arrogant philosopher) the marketing experts are just making a mistake. But ending things this way would be too easy and it doesn’t give the marketing experts enough credit. They know that no one, strictly speaking, needs a Rolex. It is plausible to think that we need to signal our status and to promote our own reputations, and the Rolex is a means to the fulfillment of this need. Hence Plassmann’s view that the needs met by many consumer products “can be tied into higher-order needs rooted in human biology.”

So, perhaps the needs addressed by marketing “can be tied into” the basic human needs considered by philosophers in the ways discussed above. What does this relationship amount to? To talk about this, I’ll need to introduce some terminology. But first, a note about the need to signal status or secure reputation. I suspect many philosophers who use the idea of basic needs as a basis for some moral or political theory would reject the idea that this is a basic need in the first place. I’m going to grant the assumption that it, or something very like it, is a basic need. Maslow talks about self-esteem needs; Rawls posits a basic need for respect and self-respect; Hobbes thought our need for reputation was quite important. These needs are at least in the same family as a need for signaling status, it seems to me. There is a further question about whether this particular need (even granting that it is a basic need) warrants membership in the set of needs that philosophers take as a basis for their theories, but we’ll get to that later.

Let’s call a basic biological need “basic need.” Basic needs, as I’m understanding them, are universal and the result of human evolution; they are needs for the things without which human life would be grossly impoverished, or unrecognizable as human life. They include, as Plassmann, paraphrasing Maslow, says, the needs for “food, water, shelter, and reproduction; safety needs such as health and well-being and financial and emotional security; social needs such as friendships and family; and higher-order needs such as the building of self-esteem and the signaling of one’s place in the social hierarchy.”

Needs that are not basic derive from basic needs in some way. The main way that non-basic and basic needs are related is as means to ends. So, let’s call needs that are not basic “instrumental needs.” I need a bottle of Perrier as a means to my basic need for water, so my need for Perrier is an instrumental need. I do not have a basic need for bottled water of any particular brand. Similarly, my need for a Rolex is an instrumental need that will (with luck) serve my basic need for signaling my social position.

The distinction between basic needs and instrumental needs has two implications worth noting. First, basic needs can typically be met by fulfilling any of a variety of instrumental needs. I can satisfy my need for food with carrot sticks, a Big Mac, or Pringles potato chips. My need for shelter can be met by meeting instrumental needs for a ranch house in California, a condo in Minneapolis, or a room at the Ramada Inn. Second, meeting an instrumental need may fail to meet the ultimate need to which it is taken to be a means. The carrot sticks may fail to satisfy my hunger, my ranch house may burn down and fail to provide me any shelter, and my Rolex may just make my academic friends think I’m a pretentious loser.

With this distinction in hand, I think we might want to be skeptical about Plassmann’s first assumption. At the end of this section, she says that “companies do not create needs; customers are equipped with those needs—mostly for good reasons.” I would suggest that companies do not create basic needs, but they do attempt to shape—and perhaps even create—instrumental needs. Human beings did not evolve to need Pringles, or Rolexes, or luxury condos; we evolved to need food, esteem, and shelter, which can be attained in myriad ways.

13.2 Does the Distinction between Basic and Instrumental Needs Matter?

Now, you might think that there’s not much difference between satisfying basic needs and satisfying marketing-created instrumental needs that “tie into” basic needs. Why does it

matter if marketing creates instrumental needs as long as those needs are connected to basic needs? And why do we care about needs anyway? I think the answer to this question is to be found in Kotler's assumption #5: "The purpose of marketing is to improve customers' lives." Kotler and Plassmann seem to agree about this, and also about the claim that this improvement should be characterized subjectively: what matters is the perceptions of the customer.

So, needs are important, in the end, because of their connection to how well a person's life goes; that is, to their well-being. This gives us one reason for thinking that the distinction between ultimate needs and instrumental needs is important. Ultimate needs are the ones that well-being really turns on: if we don't get these met, our lives will really be terrible (if you have no friends, your life is bad). Instrumental needs, on the other hand, are much more fungible (if you can't have a Rolex, a Volkswagen may do the trick). To say that marketing is simply tapping into and helping us to meet our basic human needs, then, is a little misleading. Although it isn't mentioned anywhere by Plassmann or Kotler, marketers must also make money for the companies that employ them. They must sell products, which means that when a marketing team ties into a basic human need, the well-being of the customer cannot be their only concern. Basic needs are directly tied to well-being (I've just defined them that way), but instrumental needs are not. Add this to the profit motive and the limits of production, and we have a good bit of room for a gap between consumption of marketed goods and human well-being.

To illustrate, let's take the case of luxury goods like the Rolex or the Tag Heuer. Do people who buy such watches thereby satisfy their basic human need for self-esteem and the signaling of their place in the social hierarchy? And, if they do, do they gain well-being by satisfying this need in this way? Maybe some do. But there are many reasons to doubt that this is the norm. We adapt to the pleasure we get from satisfying desires for new things; once I have a 2018 Rolex, I'll get used to it and start wanting the 2019 version. The phenomenon of hedonic adaptation suggests that satisfying a basic need for esteem or social signaling by way of a desire for some material item may not be a good long-term strategy. Further, even if the need for social signaling is basic (the universal product of human evolution), it may have a complex relationship to well-being. Social signaling is dependent on the actions of others and may be the kind of need that never brings us any felt satisfaction. In terms of well-being, human beings may be better off trying to sublimate their need for social status or trying to fulfill it other ways besides attaining more material goods.

The point that need fulfillment may come apart from well-being is acknowledged by the marketing experts. Kotler raises the possibility as a problem, the problem that "arises when the customer needs something that is not good for the customer, such as cigarette smoking, a fourth shot of alcohol, or a hard drug." (Insofar as desires for cigarettes or other drugs cannot be tied to any ultimate need, we might say that these are "addictive desires" rather than instrumental "needs," but let's leave this fine point aside.) Holding to the assumption that well-being is subjective, we must be thinking about cases in which the customer themselves perceives the drug as detracting from their well-being, but such cases are common. (Happy, well-adjusted drug addicts are not the norm.) Kotler's advice about such a problem is for marketers to stay away from marketing such products: "marketers have to decide whether they believe that what they are marketing will improve customers' lives. If not, don't get involved in marketing that product." This makes it sound like improving customers' lives is the *ideal* purpose of marketing or the purpose of *ethical* marketing (not the purpose of marketing per se). Surely it would be difficult to deny that the person who doesn't share Kotler's ethics and tries to help sell harmful addictive substances is indeed engaged in *marketing*.

In short, products can be tied to basic needs by the creation of instrumental needs for those products, even when the products will ultimately fail to satisfy the ultimate need. My central point about this is just that there is a tension within marketing: the tension is between seeing marketing as aimed at improving people's lives and seeing marketing as aimed at tying into people's basic needs in a way that produces a particular result for the seller of the good. This tension might be resolved by distinguishing between marketing and ethical marketing, but that would open the door to the possibility that much of what counts as marketing is unethical, which Kotler and Plassmann seem (quite reasonably) disinclined to do.

13.3 Marketing Marketing: Why Are We Talking about Needs?

The tension I just mentioned between the goal of improving human life and the goal of tying products to needs leads me to wonder why we're talking about needs in the first place. Why is the language of needs so prominent here? Why not talk about desires or consumer preferences instead? I suspect the reason has something to do with the connotation of needs as ethically or politically significant. If marketing were just about meeting people's desires, the tension would be reduced—and the connection to well-being would be far less obvious. Perhaps the marketing experts are marketing marketing by making it sound better, more noble, than it really is? Perhaps marketing itself is being tied into the basic need for social connection—marketers want to be seen to care about others' well-being, just like the rest of us!

That's the cynical take on it. There are grounds for less cynicism in both chapters. As I mentioned above, Kotler recommends that marketers not get involved in marketing harmful products. Kotler would like to see customers participate in marketing plans, which would introduce the possibility that individuals could help determine which instrumental needs are tied to their basic needs. He also reminds us that marketing is not just in the commercial sector: museums can (must) be marketed, and so too (we could add) sustainable environmental practices, healthy diets, and stress reduction habits. Plassmann mentions that marketers are increasingly aware of health risks of certain foods and are "looking for solutions that align customer, company, and societal welfare." These are encouraging remarks.

We shouldn't be too cynical, then, but we should also not be overly optimistic. I think that the way that marketing is marketed in the language of needs should alert us to its dangers. Marketers are good at tying into our basic needs; they are good at putting things in packages that make us think we will be better off if we have whatever is inside. But marketers are likely to make mistakes about which instrumental needs best satisfy our ultimate needs—in part because of competing motives (to make more money, impress a boss, retain a job ...), but also in part because it's just challenging for humans to figure out how best to meet their needs.

I “Need” a Rolex

Reflections on Kotler’s and Plassmann’s Chapters

Michael Fuerstein

14.1 Introduction

I own at least fifty shirts, and perhaps quite a few more than that depending on what might be stored in my basement. Arguably, there are few things that I need less than yet another one. Nonetheless, I do occasionally find myself possessed with the thought that I “need” a new one. And I might even express this thought to my wife (the only person who could conceivably care). Plausibly, I benefit in some way from the occasional new shirt. But “need”?

The word “need” has a peculiar function in industrialized market societies. We have reached a point where most people in countries like the United States, even of rather modest means, live surrounded by a kind of junk fossil record of their own previous consumer impulses: clothes, gadgets, toys, and so on. Many of these things present themselves as “needs” at the time of purchase, even though, barely a few months later, we can often find little use for them. This particular pathology is so pervasive that it fueled a hit show on Netflix—*Tidying Up with Marie Kondo*—devoted to documenting the ritualized expurgation of house junk (“does this old shaver bring me joy?”).

How should we think about the value and objectives of marketing in this context? Most of the soon-to-be-useless stuff that we buy is marketed to us as somehow vital to our lives. Both Hilke Plassmann and Philip Kotler describe marketing as a discipline that aims at meeting customers’ “needs.” And they suggest that, by doing so, marketers can help customers obtain value. At a minimum, the language of “need” presents a bit of a puzzle in the era of Marie Kondo. In this comment, I consider the way in which the marketing discipline—as construed by Plassmann and Kotler—understands the idea of customer “need,” and I suggest that the connection between what customers need—as they understand the term—and what contributes value to their lives is rather weak. Instead, I suggest, a marketing discipline focused on value creation would target well-being, and I briefly consider the implications of that reorientation.

14.2 “I Need a Rolex”

Plausibly, the ability to keep track of time is essential to living well. In that sense, people need a way of keeping track of time. But do they need a watch? Do they need a good watch? Are there some reasonable circumstances under which they need a Rolex? The word “need,” of

course, implies the existence of a necessity, a *sine qua non*. In this way, needs are normally understood to be different from mere wants, which may attach to anything, no matter how frivolous or harmful. When Kotler says that “the aim of marketing is to figure out the customer’s need,” he may simply be using the term as a synonym for “want.” If that is the idea, then saying that “I need a Rolex” just means that I want a Rolex. The role of marketers, then, would be to help figure out what customers want and to show them that a particular product can satisfy that want.

One problem with this approach, however, is that people want all kinds of things that are not good for them. If the purpose of marketing is to make customers’ lives better, then helping them satisfy desires is at best a rather indiscriminate instrument. I return to this point below.

But, in fact, I do not think that Plassmann and Kotler see needs and desires as equivalent in the marketing field. Plassmann explains the basic approach of “customer-centricity” (which she attributes to Kotler) through the example of a drill. The customer-centric marketing strategy involves focusing not principally on the drill itself, but instead on the hole in the wall that it can create. In this way, the marketer helps the customer to see how the drill will add value; that is, how it will satisfy a “need.” This example helps to clarify the difference between targeting needs versus mere wants in a marketing strategy. Unlike statements of want, statements of need have an objective dimension. If I say that “I need a drill” but, unbeknownst to me, there is already a properly placed hole in the wall, then my statement is false. By contrast, if I say that “I want a drill,” nothing can falsify this statement short of my own insincerity in expression, or perhaps an examination of my Freudian unconscious.

Plausibly, the connection between need-fulfillment and the value of marketing is as follows: if fulfilling my objectives is good for me, then it is good for me to get things that help me fulfill my objectives. Since marketing helps me identify what it is that will help me fulfill those objectives, marketing adds value.

Of course, people have lots of objectives that are not particularly good from either a social or selfish point of view. Assault rifles satisfy the needs of mass-murderers for an effective killing weapon. As Kotler notes, tobacco and alcohol likewise satisfy their own kind of need. And some objectives, though perhaps unproblematic in themselves, at least represent a misalignment of priorities. This brings us back to the Rolex case. The preponderance of research suggests that luxury consumption does not make durable contributions to our happiness, and that we would, in general, be happier working less, consuming experiences rather than goods, and spending more meaningful time with our families and friends (Frank, 2010; Kasser, 2002). If people care about status, then having a Rolex might be good for them insofar as it advances that end. But it would be better for them not to care about status, or at least to care about it much less relative to other things. From this perspective, the need for a Rolex reflects my commitment to a set of objectives that are not good for me. Marketers who reinforce my attachment to this objective are making me worse off by satisfying my need; not better off.

On one understanding of “need,” needs are by their nature conducive to the human good. Thus, there might be certain kinds of needs—for respect, sustenance, companionship, and so on—that are indispensable to the possibility of human flourishing. These kinds of needs are conducive to well-being. We might call this a *thick* notion of need. That is sometimes what people seem to have in mind when they differentiate between needs and mere wants. But Plassmann and Kotler extend the concept to encompass drills as much as food or health,

and so any notion of need in this context is *thin*. That is, it is strictly relative to background objectives, whatever they might be.

In general, therefore, the fact that some product fulfills a thin need does not tell us anything about whether or not it makes the customer better off, so long as we recognize that thin needs are relatives to objectives, and objectives themselves can be good or bad for people. Marketing cannot make customers better off merely by helping them fulfill thin needs, though they might make a valuable contribution when the underlying objectives are good ones. And perhaps marketers can contribute in vital ways to shaping the objectives that people adopt. I return to that thought below.

14.3 The Objective Dimensions of Value

This brief discussion of need positions us to comment on the three assumptions that Plassmann identifies in her chapter. One of those assumptions is that “customer value is not objective but subjective, and as such is state- and context-dependent.” In support of this, Plassmann gives the example of the value of wine. She notes that people’s subjective experience of wine varies in part depending on the price. Wine is a good example of the subjectivity of value precisely because the primary good associated with wine consumption is the pleasure of the experience itself. If raising the price enhances pleasure, then it looks like raising the price might itself cause the consumption value of the wine to go up.

Plassmann notes that a subjective understanding of value comports with a broader assumption in business scholarship that “willingness to pay” (WTP) serves as a good metric of value. Wine consumption seems to me a case where the WTP metric works. But most goods are not like wine because they have effects on our good that go beyond experience. Consider the value of a CAT scan, for example. I may have the subjective experience of getting a useful procedure when, in fact, the scan exposed me to needless risks. Later on, the consequences may be fatal, but I also might never find out. The absence of value may never be reflected in my experience or attitudes.

To choose a different kind of example: some students in my classes will walk away believing that they understand what deontological ethics is all about, even though they don’t. The value of their education is not limited to their perception or experience of having learned something. It matters whether they actually learned something. Their WTP may be quite high if I can present myself as some kind of guru even while spoon-feeding them nonsense. But value creation is low. Plassmann observes that some marketers are able to improve consumers’ subjective enjoyment of a product by placing it next to inferior “decoys” (thereby accentuating its apparent benefits). If their enjoyment of the product derives from a misperception of its attributes, then we would ordinarily say not that they received a better product, but instead that they have been manipulated into overpaying.

The idea that value has objective dimensions does not require appeals to an exotic notion of moral reality. Some philosophers defend an “objective list” of factors that contribute to well-being that is independent of subjective experience (Finnis, 2011; Parfit, 1984). Such lists include not only happiness, but also items such as life, knowledge, friendship, and rational activity. Happiness might be a comprehensively subjective achievement, but knowledge and rational activity—and probably friendship as well—certainly are not. Having a good life is not only a question of believing that one is having a good life or experiencing life as good.

The defense of such an approach is more involved than space permits. But even if we accept, for present purposes, that the only thing that really has value is what people desire or what they believe is good, we can still recognize how those desires might fall short in at least two ways: first, because of a lack of information. Example: I desire this particular steak because I believe, falsely, that the cow is raised under humane conditions. Or: I desire this insurance product because I believe, falsely, that it covers certain kinds of things that it doesn't. Second, my actual desires may reflect various forms of irrationality. Examples: people desire cigarettes, predatory loans, and fancy watches that they cannot afford.

If we calibrate valuation exclusively to what people desire under conditions of rationality and full information, then we wouldn't want cigarettes and useless medical procedures. But real consumers are irrational and lack full information, and this is precisely the world that marketers are operating in. So long as there is a gap between what people actually value and what they would value under better conditions, we can recognize a clear objective dimension to value, namely counterfactual valuations under optimal (rationality, non-coercion, full information) conditions. Alternative approaches to objective valuation—such as the “objective list” model mentioned above—will approach this differently. But the underlying point is that consumer value is not exclusively in the eye of the beholder and, therefore, the value proposition of marketing depends on an orientation to something other than preferences revealed in the marketplace.

If value has objective dimensions, then what about need? I noted above that the value proposition of marketing is presented by Kotler and Plassmann as a matter of meeting need. Meeting needs will correspond to subjective value when customers believe that some good enables them to fulfill their objectives; that is, when they believe that it fulfills a need. Of course, sometimes their beliefs on such matters are false, which is one way in which the value of a product has objective dimensions. That's what seems to be going on in the case of a useless medical procedure. But some customers also have objectives that are themselves at odds with their own good, as in the example of the status-obsessed Rolex-lover. In these cases, a product may fail to create value even though it satisfies a thin need, because the underlying objective lacks value from an objective point of view. The problem is not the Rolex, as such, but the deeper desire that the Rolex is seen to fulfill.

The idea that there are objective dimensions of value also speaks to the second assumption of marketing stated by Plassmann: “The higher the value to the customer, the better.” If value has objective dimensions, then the assumption that every increase of value “to the customer” (in the sense of subjective valuation) is better is false. Subjectively, customers may value more obsessive social media usage and luxury cars. Objectively, many such customers would be better off buying cheaper cars and spending less time on their phones. If we consider the social implications of consumption, then Plassmann's second stated assumption looks even weaker. Some people get a lot of pleasure out of purchasing poached elephant tusks and mounting them on the wall, or indulging in wasteful consumerism that contributes to climate change and pollutes the oceans. “More” may be better from the standpoint of the customer but worse for everyone else. It is likely to be worse not because the product itself fails to fulfill a thin need but, instead, because the underlying objective that creates the need is itself flawed.

Again, if we think about subjective preferences in terms of what people would prefer under idealized conditions of rationality and full information, then perhaps more value from the customer's point of view really is better. But the gap between subjective reality and subjective ideal—again—is itself reflective of the importance of some objective dimension to value. It

reflects a perspective from which we can evaluate as good, justified, or otherwise defensible, whatever beliefs and preferences we happen to have.

14.4 The Biology of Need

Plassmann’s first stated assumption of marketing is that “most needs are not created by companies but can be tied into higher-order needs rooted in human biology.” Appealing to some of her own research, Plassmann observes that most consumer needs are expressions of more deep-seated biological needs, such as food, shelter, security, friendship, and so on. Thus, the need for a Rolex is an expression of the deeper need to signal one’s status in the social hierarchy. The need for an alarm system in the home is presumably the expression of some need for security. The need for social media products is, presumably, the expression of the need for certain kinds of social connection. All of these things are understood to be biological, I take it, in the sense that they are caused by innate cognitive and affective dispositions rooted in our evolutionary past. Plassmann’s point, of course, is not that I have a biological need for a Rolex or a Big Mac, or Evian, as such. Her point is that these products constitute particular ways of satisfying more general kinds of biological needs.

Let us assume that Plassmann is right that most consumer needs are particular expressions of underlying biological needs. Even in that case, there are clearly many ways in which marketers can affect which particular expression those needs receive in our consumer behavior. Kotler observes that a “brand is an artifact of storytelling,” and good storytelling contributes in powerful ways to how our desires get expressed. I might have wanted Adidas sneakers but, if Nike tells the best story, then my desire for social status will get expressed differently. In that case, the difference between these two preferences seems of little significance; it’s just a question of which product becomes associated with the right kind of fashionable esteem. In other cases, though, the difference matters a lot for value. Thus, a consumer desire for food might have been expressed as a desire for a nice salad. Instead, McDonald’s launched a billion-dollar ad campaign. Now we have a world of burger fiends with high blood pressure and a ballooning public health crisis.

Marketers may also very substantially shape the expression of needs through broader effects on social behavior and expectations. The fact that my desire for status expresses itself as a desire for Nikes is dependent not only on my subjective attraction to Nike design, but also on my beliefs about the esteem that others attach to Nikes. Marketers create that esteem and in that way shape social patterns of behavior. So, while it may be true that, in one sense, marketers do not create needs, there is another clear sense in which they do. That is, marketers create needs by causing them to be expressed in particular forms. Some of the ways in which marketers cause needs to be expressed create value, and some don’t. Again, to draw on the discussion above, the fact that some product fulfills a thin need doesn’t show that the product creates value. And the fact that marketers play such a profound causal role in shaping the expression of needs lends further support to this view. Consumers’ thin needs are subject to all kinds of influences that are independent of what is actually good for them or others. The objective point of view is essential.

The fact that market expressions of need have strong foundations in our biological nature is itself a deeply interesting and important consideration for the way that we think about consumer behavior. But the significance of invoking biology in Plassmann’s discussion is

somewhat ambiguous. She notes at one point that we are equipped with needs “mostly for good reasons.” Her point, I take it, is that our expressions of biological needs have their origins in an evolutionary past where the underlying needy dispositions—toward food, security, status, friendship, sex, and so on—served us well. It is important nonetheless to observe that the fact that some x is caused by biological impulses does not show that x is good or desirable. At best, it shows that x is “natural” in some descriptive sense of the term. But many of our natural instincts are also not good for us or others. Let’s assume that we desire junk food because salt, fat, and sugar were valuable but scarce in our evolutionary environment. Clearly, we shouldn’t draw any inferences about Big Macs on this basis. Likewise, violent sexual desires may be there for good evolutionary reasons—in the sense that they facilitated reproduction under conditions of competition—but no one would argue on this basis that these are desires that it is good to have or fulfill.

The general upshot of these observations is that we should be cautious about inferring that marketers create value because they help customers satisfy the thin needs that they happen to have. Value is created through the satisfaction of needs that reflect objectives that are good for us, and what is good for us often diverges in important ways from the objectives that our consumer behavior expresses. The fact that a particular need, or its expression, has a causal connection to our evolutionary hard-wiring does not itself indicate that this need is good. We must retreat to some perspective from which we can think about well-being.

14.5 Marketing for Well-Being?

If the presumptive goal of marketing is, as Kotler puts it, to “improve customers’ lives,” then marketing should not aim to help customers satisfy thin needs. It should aim to help them satisfy thick needs; that is, those objectives that reflect their well-being. The precise meaning of “well-being” is contested, and any proper exploration of those concerns would go beyond the scope of this comment. Nonetheless, well-being has objective dimensions that are often not reflected in consumer behaviors and preferences if only because, as noted earlier, our behaviors and preferences would be different given better information, less coercion, and more rationality.

One of the premises of market economics is that economic actors are best positioned to know what is best for themselves. Or, as a good salesperson might say: “the customer is always right.” Suggesting that customers don’t always know what is best for themselves introduces the possibility of a certain kind of paternalism that sits uneasily with conventional market values. On the other hand, not all forms of paternalism are created equal. Richard Thaler recently won the Nobel Prize for appreciating the economic value of “nudging” people toward behaviors that are better for them (Thaler and Sunstein, 2008). The idea of economic agency and autonomy is not radically at odds with the idea of marketing for well-being. The key factor, it seems to me, is that marketers should look for ways of improving customer well-being through mechanisms that recruit and enhance, rather than circumvent, their capacities for informed choice. One way of encouraging people to eat well is to brainwash them with subliminal messages. Another possibility is to do marketing that enhances their appreciation of what foods are healthy, why they are healthy, and how to evaluate whether they are healthy.

Whether this suggestion has any practical plausibility in the present business environment is unclear to me. Fundamentally, the challenge lies in the fact that marketers are secondary economic agents; they are contracted to serve the motives of the people who hire them. If those motives are dominated by the goal of selling over value creation, then marketers are obviously in a difficult position if they want to succeed in the business. On the other hand, as Jay Barney argues in his chapter, given improved information about the societal contributions of businesses, there are increasing downside risks to doing things that are socially harmful. Marketers—master storytellers that they are—should be well positioned to help companies reimagine their brand and their value proposition in ways that align much better with what is objectively to the good.

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PART IV
DECISION SCIENCE

Theories of Choice and Value Endogeneity

James G. March

A lifetime ago when I was advising undergraduates, a fairly typical episode involved some smart student asking me what advanced schooling I would advise. The student frequently had a fairly clear picture of vocational objectives, wanting to contribute to society well-being by being involved in an organization dedicated to pursuing some aspect of social welfare. Often, however, they felt ill-equipped for such an endeavor and thought that going to a good business school might provide the knowledge tools that were needed, particularly economic analysis, decision-making, and organizational engineering. It was an entirely rational analysis, seeking the means to accomplish an end; and I collaborated by identifying good business schools where such an objective could be pursued.

Invariably, however, I thought that I should point out a feature of rational action that might be worth considering: the process of pursuing an objective often transforms the values that justify it. In this case, business schools are powerful socializing agents. They change what students believe and what goals they seek. It is an eminently useful phenomenon, often called maturing or building character; but it is also a reminder that a picture of decision-making as simply an instrument of prior preferences is incomplete. Decision-making is also a mechanism for molding or discovering preferences. In particular, participation in business education systematically undermines romantic visions of virtue and is intended to do so.

The point is not that business education is particularly venal. All good education tampers with a student's mind and soul. The point is that the pursuit of rationality as a human project underestimates the extent to which the values we have are affected by our efforts to realize them. Values are persistently endogenous to decision-making; and this endogeneity complicates our understanding of virtue, and thereby complicates our interwoven understandings of intelligence, rationality, decision-making, and leadership.

15.1 Leadership and the Demand for Intelligent Action

Leadership serves numerous, quite different, hopes. In particular, leaders play important roles in the stories that are told about history and are given praise when their behavior fits conventional stereotypes of good leaders. Leaders mobilize support for private agendas or for virtue and secure thereby support from others for whom such projects are valuable. They confer status on others. Leaders symbolize and glorify certain groups and promote particular styles of behavior. They absorb responsibility for the good and bad things that happen during their tenure. Among a long list, one of the more conventional expectations of leadership is that a leader will use intelligent rationality to further the goals of the group.

A core, minimalist component of rationality is the idea that values and consequences are made consistent by intentional intelligence. A rational actor acts intentionally in order to secure outcomes consistent with their own values or the values of the group they lead. In most versions of this conception, values are pictured as *prior* to and exogenous to decision processes on which choices depend and to the outcomes that result. The point is to achieve what you set out to achieve. This has been turned into dogma in much of the literature on evaluating governmental programs where it is assumed that a program should be assessed in terms of the values that motivated it, rather than the possibly obvious alternative—in terms of the values currently held.

The priority of values is a foundation of standard conceptions of rationality. Values are seen as the basis of decision-making, not its consequence. Although it is often easier to change values so they are consistent with actions taken and outcomes observed than it is to make actions and outcomes fit prior values, rationalization and functionalism are viewed as corruptions. Rationalization involves the intentional specification of *posterior* values consistent with realized outcomes; and functionalism involves imputing *prior* values from subsequent outcomes. Both generate consistency between values and outcomes, but primarily through adaptation of the values to outcomes, rather than adaptation of outcomes to values. In most treatments, the latter seems rational, but not the former.

15.2 Values as Shaped by Decision-Making

The difficult truth is that values are the product of decision-making as well as its basis. They can be treated as exogenous to the processes of choice only with caution. They are partly “given” as the result of some independent process but are also elaborated in the course of making choices. As generations of parents have come to appreciate, education may be chosen for its instrumental utility in the service of values; but the values of a student are changed by a good education. This character-building role of education is essential to its quality and a central component of its threat to the forces of evil.

Awareness of the endogenous character of values, however, poses two problems that are not normally considered in explicating decision theory. The first is understanding how values are affected by choosing. What are the behavioral mechanisms by which the processes and outcomes of choice modify the values that choices serve? Some things are fairly clear. For example, approbation tends to track abilities. For the most part and with some obvious exceptions, we come to view what we can accomplish as having virtue.

The second problem is understanding the way a rational, moral person might act to influence future values. What rational sense does it make to resist or pursue current experience in order to produce a set of values different from those currently held?¹ If we choose the actions we take now in order to shape the values we will have in the future, how do we choose among

¹ This precommitment dilemma underlies the myth of Ulysses and the sirens that is dear to the hearts of decision theorists. Returning home from battle, Ulysses needs to sail past an island on which reside some beautiful sirens. He is advised by a friendly goddess that when the sirens broadcast their availability for dalliance, his good intentions will quickly be replaced by his lusts, which will lead him to disaster. In order to avoid developing the wishes for cavorting with the sirens that would otherwise clearly be his fate in the future, Ulysses tells his men to tie him to the masts, thus precommitting himself to subordinate his future values to his present values. It is a precommitment that mirrors the attempts of ordinary people to manage the development and pursuit of their values.

possible future values? How can we use current values to select among alternative courses of action that lead us to embrace different posterior values without necessarily having a clear prior conception of where the process will lead?

The “obvious” answer is that we choose future values by referencing higher-order values, but where do higher-order values originate, and what justifies them? The conventional response identifies a moral code that determines and audits personal values. A moral code comes from outside a choice situation. It is antecedent to personal values and superior to them in the sense that conflicts between a moral code and current individual desires or inclinations are resolved in favor of the code. Any other resolution is seen as corrupt. A moral code typically offers protection against temptations by stigmatizing them, though at the cost of identifying them.

Such a moral code is often taught by religious or civic authorities and inculcated as inherent to a good life. Many of the “choices” in life are thereby at least partly imposed by traditional authority. Whether to attend school. What church to attend. Whether and with whom to engage in sexual intercourse. What kind of clothes to wear. In what neighborhood to live. Being an adherent to a particular religious faith may be to some extent a matter of individual choice, but the intergenerational stability of religion suggests that religion is more “given” than “chosen.” A young man or woman joins the marines for many reasons, but then is shipped to basic training, which is in most respects more a drill in values than training in warfare.

Moral codes are taught by social institutions that are frequently chosen by parents or a child with such indoctrination in mind. An individual also discovers values through experience. Indeed, institutions often use organized experience to reinforce values. Sociologists tend to see experience as organized by society; therapists tend to see experience as chosen; both see experience as shaping values. The distinction between values as chosen and values as imposed may be a tenuous one in practice, however. Life is a mixture of autonomy and conformity in which the primary freedom may be the freedom to travel alternative paths leading to alternative prisons, and moral choice may be less definitive than exploratory.

15.3 Developing Values

Although the charge is a difficult one, decision engineers must accept responsibility not only for the intelligent execution of values but also for the development of morals. The human actor develops values in the course of making decisions. They do so consciously to some degree, entering into activities that shape values in ways that are sought; but the process involves unanticipated discoveries and understandings. The instruments of intended rationality appear to be simply instrumental, but they mold individual values without much deliberate individual choice. As a result, it makes sense to explore the ways in which our technologies of intelligence affect the values we profess. We ask: to what extent does following the dictates of a theory of choice lead to becoming a better person? Does attempting to calculate the expected utility return from an action carry with it a systematic bias with respect to what values are counted? Does being careful to tie action to intentions reduce the likelihood of exploratory discovery of unanticipated desires? And is that good or bad?

The moral codes we observe in humans are notoriously inconsistent and routinely introduce incomparable considerations. These inconsistencies and incomparabilities are a source

of discontent for decision-makers, a basis for much philosophical discussion and great literature, and part of the impetus behind the Savage, von Neumann, and Morgenstern conceptions of preferences and choices that undergird modern conceptions of rationality. In most of those traditions, inconsistency and incomparability are viewed as deficiencies to be eliminated from systems of values, both to preserve individual mental health and to facilitate intelligence.

Alternatively, it can be argued that the torment produced by inconsistency and incomparability may serve virtue as humans negotiate a complicated value terrain. Such an argument invites a more precise specification of the process, but it seems clear that the making of decisions shapes the people we are, and the pursuit of decision theory rationality reinforces only one part of human beauty and virtue. Human torment over unresolvable problems of choice also inhabits human character. Why might we embrace torment along with resolution? Perhaps partly because torment may discourage dogmatism. Perhaps because anguish is an indispensable aspect of human nature; and if you remove anguish, human nature forsakes beauty and becomes cruel. Perhaps because, in a chaotic, changing world, seeing things clearly is a mirage.

15.4 Last Words

No sober student of human intelligence can fail to applaud the contributions of rational theories of choice to human capabilities. They represent some of the principal contributions of the twentieth century. By failing to recognize the endogeneity of preferences, however, they limit some features of their usefulness to students of the twenty-first century. They fail to appreciate the way values are developed in the making of choices, to recognize the character-building aspects of methods of decision-making as well as their utilitarian aspects.

Some Questionable Assumptions in Economic Theory

Itzhak Gilboa

This chapter highlights a few assumptions in economic theory that probably deserve greater attention than they currently get. They vary in terms of explicitness, their degree of acceptability, and the extent to which they have been discussed in the literature. This chapter does not provide a comprehensive survey of the literature on any of these assumptions, and it makes no claim to originality. It is mostly designed to help focus ongoing discussion of the way we teach microeconomic theory at the undergraduate and graduate levels.

16.1 The Bayesian Approach

The Bayesian approach holds that all uncertainty can and should be quantified by probabilities. When probabilities are not given in a manner that can be thought of as objective, one resorts to subjective probabilities. The basic idea is that, even when probabilities cannot have a frequentist interpretation, and even in the absence of objective data, the tools of probability theory can be an aid to rational decision-making. This idea is about as old as probability itself and can be found already in Pascal's Wager ([Pascal, 1670](#)), though the commitment to quantifying all uncertainty is typically attributed to [Bayes \(1763\)](#).

For about three centuries, the Bayesian approach was one possible way of reasoning about uncertainty, and not necessarily the most commonly used or most widely endorsed. In statistics, for example, Bayesian statistics has been developed alongside classical statistics, and while the former has become considerably more popular in recent decades, the latter is still the most basic approach students learn throughout most fields of science. Closer to economics, [Knight \(1921\)](#) and [Keynes \(1921\)](#) argued that not all uncertainty can be quantified probabilistically.

However, as a model of decision-making by rational agents, the Bayesian approach became the dominant tool of analysis in economics, finance, political science, and related disciplines. This development, which happened in the second half of the twentieth century, seems to be due mostly to the axiomatic derivations of subjective expected utility theory, notably by [Savage \(1954\)](#).¹

¹ [Savage \(1954\)](#) was influenced by the works of [Ramsey \(1926a, b\)](#), and [de Finetti \(1931, 1937\)](#), as well as by [von Neumann and Morgenstern \(1944\)](#), though the latter assumed known or given probabilities. [Anscombe and Aumann \(1963\)](#) also suggested a derivation of subjective expected utility maximization that derived the subjective probabilities from objective ones. See [Gilboa \(2009\)](#) and [Wakker \(2010\)](#).

Many developments since the 1960s (such as [Ellsberg, 1961](#)) made economists more open to the idea that agents, fallible as they are, may not be Bayesian in practice. Non-Bayesian theories² are therefore accepted as part of behavioral economics, namely as a description of the way boundedly rational agents behave. For many theorists, the gold standard of rational decision-making remains expected utility maximization relative to a prior probability, even if this prior is only subjective. By contrast, a minority view in decision theory holds that it is not necessarily more rational to be Bayesian than not. This claim naturally depends on one's definition of rationality. Indeed, as most economic theorists would incorporate Savage's axioms into the notion of "rational decision-making," they cannot accept such a claim. [Gilboa, Postlewaite, and Schmeidler \(2009, 2012\)](#) and [Gilboa \(2015\)](#) argue against this view. The main point is that the Bayesian approach does not allow one to capture complete ignorance. One cannot say, "I simply do not know" without quantifying *how much* one does not know. And, it is argued, it is more rational to admit that one does not know than to pretend that one does.

A related point is that the belief that a rational individual has to be Bayesian is naturally reflected in economic modeling: the language that the modeler uses in proving theorems is expected to be Bayesian. That is, even when discussing agents that are not necessarily Bayesian, a result in the paper should take the form of "For any process that satisfies ... it is true that ..."—while "process" refers to a data-generating process that is defined by a probability measure.

Where is this assumption arising from? The modeler of an economic phenomenon is not expected to know all details of the reality. If we discuss a coin toss, for example, or the results of a weekly lottery, statisticians and economists are not assumed to know the outcome, even though we tend to believe that it is knowable in principle (that is, not subject to quantum uncertainty). Rather, there are too many details about the world that make probabilistic prediction the most one can expect science to provide. Moreover, the scientist isn't expected to focus on a given process. On the contrary, we tend to appreciate general, foundational results, that say "for any process in a given family it is true that ..." without specifying the process.³ Why is it the case that scientists are expected to prove their results for any process that can be modeled *probabilistically*?

There are situations in which the answer has to do with what can and what cannot be known in the physical sciences. If we are to toss a coin repeatedly, many would accept that it is practically and theoretically impossible to predict the outcome of each toss, but that there is a parameter p , defined by the physical properties of the coin, which will be the limit of the relative frequencies of the outcomes of future tosses. In this sense, there is a belief that this parameter is really "there," part of objective reality, and if we don't know it, we could expect statistics to uncover it. Importantly, note that the assumption that this parameter really exists depends on what can be known as well as on what *cannot*: if it were possible to figure out not only the parameter p but also the outcome of each toss, this parameter would lose much of its meaning.

² Representation of beliefs in a non-Bayesian way has been suggested by [Dempster \(1967\)](#) and [Shafer \(1976\)](#), among others. Axiomatic derivation of such beliefs in the context of decision-making was pioneered by [Schmeidler \(1989\)](#). Other such models include [Gilboa and Schmeidler \(1989\)](#), [Klibanoff, Marinacci, and Mukerji \(2005\)](#), and [Maccheroni, Marinacci, and Rustichini \(2006\)](#). See [Gilboa and Marinacci \(2013\)](#) for a survey.

³ The Law of Large Numbers would be a prime example.

When we discuss other uncertainties, such as global warming, financial crises, the rise of religion, wars, and revolutions, it is not at all obvious that there exists a knowable probabilistic law as in the example of a repeated coin toss. Had the modeler been omniscient, they would not need to discuss probabilities at all. Given that they aren't, we should ask what can possibly be known. And while in the coin toss example one can point to a parameter p that can be known even if specific outcomes cannot, other examples are more complicated. In such cases, it is not clear that the language of the economic modeler should be that of probability.

16.2 Beliefs and Tastes

A standard course in microeconomic theory would start with agents who have preferences for different goods and would then place these agents in a market to allow them to trade. One agent likes apples better than bananas; another—the other way around; and then they trade and may reach an equilibrium. Importantly, this equilibrium is considered to be desirable in that, under known assumptions, it guarantees a Pareto-optimal allocation. With all known difficulties of the concept of Pareto optimality, and with all known market failures due to failures of some of the assumptions (including, more recently, the “rationality” of the agents), the First Welfare Theorem remains a powerful result, which explains some of economists’ affection for competitive markets.

The standard microeconomic course would then continue to show that the tools developed can be used much more broadly than hitherto discussed. In particular, if multiple time periods are concerned, one need not go back to the drawing board—all that needs to be done is to add the time of consumption as a characteristic of the good, so that “apples today” and “apples tomorrow” be distinct goods, and one can then proceed with the same analysis. Some assumptions about dynamic consistency would be needed to retain the untarnished image of the rational agent, but the mathematics goes through, equilibrium allocations are Pareto optimal, and all goes well. Similarly, if uncertainty is concerned, states of the world are to be introduced into the description of the good, so that “apples in case of rain” and “apples in case of sunshine” become distinct goods, and once again one may proceed as before.

If agents only differ in their tastes (utilities), and not in their beliefs (subjective probabilities), one can indeed introduce states of the world into the model and proceed as in the case of certainty. But if agents’ beliefs vary, this step might be too glib. Can rational economic agents have different beliefs, as the term “*subjective* probabilities” suggests? There is a long and very profound discussion of this question in the literature (see [Aumann, 1976](#); [Kahneman and Tversky, 1979](#); [Morris, 1995](#); [Aumann, 1987](#); [Brandenburger and Dekel, 1987](#); [Gul, 1998](#)). It is probably fair to say that, whereas at the theoretical level there are different views on the question, at the practical one there is no question that different people have different beliefs, often even when they have access to the same information.

The question becomes very pertinent where financial markets are concerned. It seems obvious that the volume of trade in financial markets is partly driven by differences in beliefs (if not by wild speculation). Especially since the crisis of 2008, the question arises: should such markets be regulated? Are these markets really obtaining the “efficient” allocation we love and cherish?

The standard microeconomic course would suggest that the answer is in the affirmative: agents trade these financial markets, which can be embedded in the standard model (as “Arrow securities”). If they reach an equilibrium, we can prove that it is Pareto efficient. However, in the presence of different beliefs, the nature of this efficiency is not as clear as under certainty, or under commonly perceived risk. Consider the “duel example”:⁴ two gentlemen agree to hold a duel tomorrow morning by the river. Each attaches a probability of 90 percent to himself killing his rival and emerging from the duel unscathed. However, each would prefer to flee town had he assigned a probability of 80 percent or less to his favorable outcome. Yet, as both are optimistic, they both wish to hold the duel.

Notice that this agreement between them is of the type that [Mongin \(1995, 1997\)](#) referred to as “spurious unanimity”: the agents seem to agree on the ranking of alternatives not because they agree on utilities and probabilities but because they disagree over both utilities and probabilities in a way that cancels out, as it were. In the case of the duel, each prefers to kill rather than be killed; and each is very certain of his own ability, in a way that is incompatible with the other’s belief. Yet, if we consider their preferences over goods in the expanded, goods-cross-states space, they would both prefer to duel. Similarly, two agents can use the financial market to bet against each other. They have different preferences, as each prefers to be richer at the other’s expense; and they have different beliefs, as each thinks that they know better. These differences cause them both to wish to trade, but at least one of them is in the wrong. As opposed to trading apples for bananas, one of them would regret the trade later on.

There are some economic theorists who argue that both utilities and probabilities are but mathematical artifacts used to represent preferences under uncertainty, and that, for that reason, it is wrong to assign to these concepts any mental meanings, or to draw a distinction between differences in beliefs and differences in tastes. While these seem to be in the minority, many more are still tempted to make the very elegant step of embedding an uncertain world into the classical model, and thereby to accept the taste/belief analogy, if only implicitly. Some attempts to study markets without necessarily accepting this analogy have been made. For example, [Gilboa, Samuelson, and Schmeidler \(2014\)](#) and [Brunnermeier, Simsek, and Xiong \(2015\)](#) offer different notions of Pareto optimality that would treat disagreement of beliefs as a different problem than variety of taste. [Posner and Weyl \(2012\)](#) go a step further and call for regulation of financial assets, partly because of this problem. Whether one accepts these new definitions, or the call for market regulation or not, it appears that more care needs to be given to the desirability of Pareto optimality when it is based on differences in beliefs.

16.3 Repugnant Trade

What are the limits of free trade? When should society step in and disallow voluntary transactions? Some cases seem to be rather obvious. If one of the parties is better informed (as in “inside trading”), such trade is considered unfair, perhaps immoral, and has been declared illegal in many states. There is also little disagreement on the need to regulate or prohibit

⁴ See [Gilboa, Samet, and Schmeidler \(2004\)](#).

trade with children and with sick people who are not in a position to value the transactions they participate in and their impact on their lives. But even if we restrict attention to consensual trade among healthy adults where no asymmetry of information or deception is involved, most people would still think that not all transactions are to be approved. To consider an extreme example, most people feel very uncomfortable about human organs being traded, and this type of trade has been referred to as “repugnant.”

There are economists who do not see why organ trading is considered repugnant. They ask: why should people be robbed of their right to trade; should this be their choice? For example, if a poor person agrees to sell one of their two healthy kidneys, fully aware of the risks involved, saying “This is the only way I can possibly give a chance to my children”—who are we, as a society or a state, to disallow trade and deprive the person of this way out of poverty? If we were running a Communist state in which all services were provided to the person and to their children regardless of trade, and in which private property did not exist, the prohibition of trade would be easily justified, and perhaps unnecessary. But modern economies rarely provide the poor with all their needs, and outlawing organ trading may leave some people without an alternative way of satisfying some of the basic needs of their families. It is therefore not obvious that such prohibition is morally justified. *Importantly, these lines are not supposed to suggest that organ trading should be allowed; they are intended to admit that there is a non-trivial moral issue to discuss here.*

Let us contrast organ trading with “reality shows.” In these, real people undergo real experiences that draw the audience attention to a large degree because they are real. In some of these shows people make marriage proposals, with some candidates becoming exhilarated and others badly disappointed. In others, people undergo extreme experiences over long periods of time, testing their stamina and durability as individuals or as couples, in ways that often feel like experiments with human subjects. It appears obvious that the same shows would not draw nearly as much attention were they commonly known to be staged and played by professional actors. The special interest in extreme experiences of *real* people seems to verge on voyeurism, if not to be a prime example thereof. Thus, participants in reality shows can be viewed as trading their privacy, and sometimes their dignity, for various benefits they obtain from such shows, as fame and future profits. Should this be allowed?

In several ways, there is no comparison between the agony of organ trading and that of reality shows. First, the former are irreversible changes to one’s body, whereas reality shows do not hurt or maim bodies. Second, organs are sold by people who are destitute and would often remain so after the transaction, whereas reality shows select a few individuals out of many aspiring ones, and often make them media stars. Hence, it is obvious that protecting reality show participants may not be a high priority for legislative bodies.

However, there is an aspect in which reality shows are more repugnant than are organ trades: reality shows cannot seriously be justified without assuming other-dependent preferences. For the sake of the argument, assume we were to try to justify organ trading, not only as an equilibrium outcome but also as a utilitarian optimum. We could attempt to make an argument based on a notion of utilitarianism that is consistent not only with [Ben-
tham \(1780\)](#) but also with [Mill \(1861\)](#). That is, we can assume that each person’s utility depends only on their own “consumption” good and argue that voluntary trade of an organ for money, by dint of being voluntary, increases the utility of each. By contrast, claiming that reality shows obtain a utilitarian optimum when each person’s utility depends

only on their own experiences is untenable. It seems obvious that the spectators' enjoyment has to do with the participants' affective reactions.

To belabor this point, imagine that a rich person wishes to buy a kidney from a poor person, and the latter agrees. Repugnant as we might find the deal, it need not rely on the former enjoying the suffering of the latter. The rich person might say, "I really need this kidney to survive. I wish the seller all the best and I honestly would have preferred there to be a different technological solution to my medical problem. I hope the seller will suffer as little as possible, and that their other kidney will never fail." Not only is this a plausible account of the person's feelings, but one may also risk a conjecture that this would be how most people involved in such prospective deals would feel. By contrast, a similar account for reality shows is hardly persuasive. If the people taking part in the show do not truly experience the presumed affect, we would have a non-reality show, or a theater.

There are certainly many practical difficulties with outlawing reality shows, and it may not be easy to draw the line between a reality show and a sport tournament or even a political campaign. More generally, it is relatively simple to define prohibited trade by the object traded—such as human organs—and much harder to define transactions that seem to be driven by other-dependent preferences. And yet, the assumption that trade should be restricted only based on the nature of the goods traded needs to be questioned.⁵

16.4 Is Economics a Predictive Science?

The development of economic theory and, in particular, microeconomic theory over the past few decades raised the question of the role of models in economics. It seems clear that economists use "models" in different ways than do other scientists. Often, these models seem to be so abstract that non-economists wonder how the economists seem to be so excited by, and feel that they learn so much from, "toy models" that don't seem to be good models of anything.

There are a few other curious sociological phenomena relating the modeling in modern economics. As Daniel Kahneman pointed out,⁶ economists are glad to argue that a variety of phenomena are "examples of their models" without any obvious fear of refutation. Indeed, experiments that show refutations of economics models (such as the Ultimatum Game; [Guth, Schmittberger, and Schwarze, 1982](#)) are often dismissed with a shrug by economists—probably much more so than would be the case in other sciences. Moreover, microeconomic theory may be the only scientific field in which one may tell a PhD student, "You have a wonderful model, only not of the application you have in mind."⁷

⁵ In the final analysis, most distinctions have gray areas (including the distinction between black and white). Moral dilemmas abound, and the fact that we cannot always tell good from bad is hardly an excuse not to try, or to dismiss the distinction altogether. The fact that the questions raised by reality shows are about motives adds a layer of complication. We naturally prefer definitions that are easily verifiable, relying on clearly observable terms, to vague ones that require speculations about others' mental phenomena. Still, we distinguish between acts performed with and without intent (as in the case of murder vs. accidental killing), and taking intent into account seems to resonate with our moral intuition. By a similar token, the causes of pleasure can be speculated about and sometimes tested (as in the case of "reality" shows in which real experiences are replaced by theater plays).

⁶ Personal communication, 2001.

⁷ This type of comment is quite common, not only when a PhD student comes up with their very embryonic idea but also in seminars and referee reports, including cases where the authors are senior and experienced.

Much attention has been given to the role of models in economic theory. Gibbard and Varian (1978), McCloskey (1985), Cartwright (1998), Sugden (2000), Maki (2005), Rubinstein (2006), and Grune-Yanoff and Schweinzer (2008) are among the writers who addressed this problem, offering a variety of ways in which models can or should be viewed. Gilboa, Postlewaite, Samuelson, and Schmeidler (2014, 2018) attempt to make two contributions to this debate. The first assumes that economists might be thinking in a case-based as well as in a rule-based way. Thus, economic models are “theoretical cases,” which, alongside experiments and empirical data, are supposed to help one reason about reality by judging its similarity to various cases—real or not, experimental or theoretical. According to this view, models do not suggest any universal claims and therefore cannot be refuted. The second approach holds that one can think of economics as a field of criticism, whose task is to point out problems and mistakes in reasoning suggested—say, by politicians or journalists—but not necessarily to make predictions.

These models of the philosophy of economics are, like models in economics itself, only very idealized images, and one should not take any of them too literally. Clearly, there may be many other such models of economic models and economics at large. It is important, however, that we question the role of field. The standard Popperian view of science doesn’t seem to be a perfect description of the way economists think about their research, or necessarily of how they should be thinking about it.

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Reflections on Gilboa's and March's Chapters

David Schmidt

17.1 What Do We Want from Decision Science?

Itzhak Gilboa observes ([Chapter 16](#) of this volume) that the Bayesian approach holds that all uncertainty can and should be quantified by probabilities.¹ As I understand decision science, Gilboa is correct, and the point of the Bayesian postulate is to render decision theory apt for cranking out theorems. Theoretical tractability comes at a cost, however, in terms of practical realism.

Assigning probabilities, as if probabilities are known, is plausible enough, Gilboa would agree, in games of chance where information on probabilities and monetarily quantified utilities is readily available. It is less plausible to treat unknowns as equiprobable, however, when we can only guess at possible outcomes, when we can only guess at probabilities of such outcomes as we have the imagination to anticipate, and when we have hardly any clue how to gauge their utilities. Indeed, normal people typically do not even dream of trying to make decisions by using a formula to calculate maximum expected utility. We don't do that because we are rational. We know better than to handle real life's sometimes radical uncertainty by plugging pure guesswork into a toy formula.

So, on the one hand, I do not think being moral is closely connected to being a maximizer, as maximizing came to be construed in the twentieth century. On the other hand, I think that morality's departures from maximization do not cause any particular rift between morality and rationality because I also think being *prudent* generally has little to do with being a maximizer. I think then the founding philosophical challenge (as old as Plato's *Republic*) of identifying genuine, substantive connections between being rational and being moral requires working with *humanly* rational choice and humanly moral agency as they really are, not with mathematically tractable idealizations of them.

Here is a further and more positive thought on the prospects and practical limitations of decision science. I have never accepted the instrumentalist idea that the scope of rational choice is the selection of means to given ends, leaving us with nothing substantive to say about the rationality of ends themselves. To me, some ends obviously are better than others. Some ends make for better lives. But common-sense intuition aside, is there a non-question-begging *proof* that ends can be rationally chosen? Could instrumental rationality *all by itself*

¹ I thank the following for great conversations (at the Society for Progress and at the PPE Society) that have influenced me here: Elizabeth Anderson, Ken Arrow, Jay Barney, Josh Cohen, Robert Frank, Michael Fuerstein, Itzhak Gilboa, Charles Holt, Cathleen Johnson, Jim March, Ramon Mendiola, John Meyer, Susan Neiman, Subi Rangan, Al Roth, Amartya Sen, Vernon Smith, and Jean Tirole.

(conjoined to descriptive truisms about human psychology) underwrite the choice of some ends rather than others, or some ends rather than none? In my earlier work, I did not argue that ends as such were rational, because that was never the question. The question is about ends as *chosen*. So, the real question is not whether final ends can be rational so much as whether they can be rationally *chosen*.

One of the exceedingly tricky aspects of the task of rationally choosing ends is that humanly rational choice is choice for beings whose preferences are a moving and evolving target. This is where the philosophical action is, but looking at rationality that way is not apt for cranking out theorems. As James March might have agreed (see his [Chapter 15](#) in this volume), we tend to grow into the choices we make. We are outcomes as well as makers of our choices. That means that *whatever we think is at stake when we make choices, there is more at stake than that*. We tend to become people for whom our major life choices make sense. Sometimes this is a good thing, but it behooves us to make major life choices with one eye on the question of whether we want to give ourselves reason to become *that* kind of person.²

17.2 From Theory of the Good to Theory of the Better

In moral philosophy, we do something called “theory of the good.” Curiously, there is no such topic as “theory of the better.” Yet, consider how abstract the concept of “good” is and consider that we are not trained to notice how much more concrete the concept of “better” is. “Better” is *located*.

Our lack of a theory of the better has, I suspect, held back progress on what we call ideal theory. Prominent scholars such as A. John Simmons, not to mention Rawls, write as if, contra Amartya Sen, we obviously cannot understand *better* except by reference to *perfect*.³ But not so. We rarely have any idea what to regard as perfect. By contrast, almost every decision we make is implicitly a decision about what to count as better. “Better” usually is defined by comparison to a starting point, not an endpoint. “Better” may involve imagining where we *want* to end up, and that will be a future-oriented idea. Yet, even that future thought will not be a conception of something perfect. It will itself be a conception of what to count as worthy of aspiration starting from here.

Perfection, conceived in any substantive way, is itself a moving target. Adult ideals evolve over the course of an examined life. Ideals can grow up. So, although of course we have targets, our targets are not *fixed* in a permanent way. We do not *need* such fixed targets. Thinking we can treat ideals as fixed targets and thinking that without fixed targets we could not make decisions is a way of thinking about ideals that fails to track what we know from experience.

² My first published thoughts on the respective arts of choosing strategies and choosing ends are in, respectively, “Rationality within Reason” (1992) and “Choosing Ends” (1994).

³ Against Sen, Simmons says that, “We can hardly claim to know whether we are on the path to the ideal of justice until we can specify in what that ideal consists.” Sen notes that we do not need to know that we are climbing the highest peak to know that we are climbing. Turning Sen’s peak metaphor against him, Simmons concludes that, “which of the two smaller peaks of justice is the higher (or more just) is a judgment that matters conclusively only if they are both on equally feasible paths to the highest peak of perfect justice.” See Simmons (2010: 34–35). See also [Sen \(2009\)](#). My reflections on this debate can be found in my “Nonideal Theory: What It Is and What It Needs to Be” (2011).

Decision science aims to crank out theorems. We have simple models of rational agency that are close enough to being recognizably human to have interesting implications. Simplification is one of the objectives of theorizing in general, including scientific theorizing. The kind of theory that illuminates is the kind that sticks its neck out and tries to boil the complexity of the human condition down to something simple. Simplifying—trying to understand the simple essence of things—does not really illuminate, however, unless we keep in mind that it exposes us to a certain contingency. Specifically, there is no simplification without risk of over-simplification, when the details we set aside as peripheral turn out to be central in a particular case.

When people spin off and begin to discuss messy complexity, it is not because they don't have the technical skill to crank out theorems. It's because they are trying to transcend the game of clever technicality and say something about the human condition that actually resonates.

17.3 When More Is Better

I noted that “better” is a concrete, located, and comparative idea. What about *more*? Should we assume “more is better”? In fact, “more is better” is a fruitful assumption notwithstanding the risk of it turning out to be an over-simplification in any given case. James March is right that assumptions such as this have put decision science and economics in a position to yield one insight after another into the human condition. Note, however, that “more is better” is not fruitful by virtue of being necessarily true. It is not necessarily true. Neither is “more is better” fruitful because it defines away our need to worry about when it's time to stop. Instead, what makes “more is better” useful is that it serves to remind us to think about when to stop.

It is a personal ideal to stop, think, and genuinely decide. Taking personal responsibility for deciding when we need to stop craving “more” generally will be an art that goes beyond the reach of decision science (including all the “nudging” in which people put such unwarranted faith nowadays). Computations may be part of a rational response to questions about when to stop, but another part of the response will be an existentialist responsibility to decide what to regard as worth wanting.

On one hand, there is a wide swath of human experience in which there is a grain of truth to the idea that more is better. On the other, when we test the assumption that more is better, and find cases that disconfirm, then take the hint that we need to reflect on what life is teaching us about when to stop, those are cases where we learn. Acknowledging grains of contingent truth and getting past tautologies frees us to draw contrasts. It sharpens our intuitive awareness of lines that *should not be crossed* on pain of ruining ourselves by wanting too much.

Obviously, when we assume for argument's sake that more is better, we should always ask, more of what? Strikingly, Adam Smith (1991 [1776]) could see what a terrible thing it can be to want too little. Smith understood that simply wanting “more” can diverge from wanting “better.” That is to say, life is full of situations where unthinkingly wanting more could count as actually wanting too *little*. Smith saw workers laboring to bring services to

market that were good for their customers, but he also saw the dark side of that otherwise excellent social dynamic: namely, workers working overtime for trinkets and thereby failing to be good to themselves.

Smith saw market society as creating a possibility of leisure. Where a Robinson Crusoe living an altogether solitary life would not be able to make a pizza in 10,000 years, a person in favorable circumstances in any of today's commercial hubs can get a pizza for the price of a few minutes of labor. Smith was not, of course, saying citizens have become able to afford pizza, so much as that they have become able to afford leisure. We can afford to make time to think. We make a mistake when we take what could have been leisure time and spend that time commuting from a distant neighborhood where we can afford a larger house or working overtime for baubles. It is trite, yet still true, to say we treat wealth as our way of keeping score. Adam Smith could see that we do this, and he lamented it. Smith lamented that we don't spend our increasingly prodigious wealth stocking up on leisure. He would have agreed with the Society for Progress that the paradigm of business and management has focused overly on performance and not enough on progress.

However, Smith might also have told us that the proper place of business per se is not to actively *drive* a discussion about the value of leisure so much as simply to set the table for it. Commercial society has given us the time to constitute ourselves as a Society for Progress. Centuries ago, such a thing would hardly have been conceivable outside of a monastery. As Alan Krueger and colleagues said, money may be the currency of the economy, but time is the currency of life (Krueger et al., 2009). Commercial society has given us unprecedented latitude for choosing destinations of our own. It is a feature, not a bug, that commercial society cannot choose our destination for us. The mutual expectations that make us a society manage traffic. They help us to navigate. They help us to be advantageously predictable to each other; we learn how to stay out of each other's way. Above all, mutually understood expectations help us to cooperate, putting would-be cooperators in a position of knowing more or less who they can trust. Yet our ultimate destination—how we are going to use such opportunities and potentials as are actually available (however natural or socially constructed)—remains up to us.

17.4 Rationality and Bias

People can have different beliefs even when they have access to the same information. There are forms of confirmation bias that limit how good we can be as philosophers. The order in which we process bits of information affects what it takes for us to be ready to take the next bit at face value. Therefore, you could take two identical clones and give them identical sets of information but feed them the identical bits of information in a different order. By the lights of decision science, that should not make a difference in theory, but in fact it does. The first bit that comes in, if it is plausible, is provisionally accepted, but it has to cohere with the next bit. If it does not cohere with the next bit, and if the next bit is only equally plausible, but not so plausible that it over-rules the first bit, then the second bit is rejected and the first belief, the incumbent belief, is retained. But if the second clone gets the second bit first, then the second clone retains that bit instead, and the two clones end up with different beliefs precisely because they each processed the same information (in a different order) in real

time. The fact that human beings process information one bit at a time will result in the two clones ending up with different beliefs.

A human being is a process, unfolding in real time. Every judgment is temporally located, and our history of accumulated judgment adds up to our path-dependent framework for further judgment. We do not have the option of “all-things-considered” judgment. The fact that information processing is a *process* limits how good we can be at science or philosophy. We don’t have to be biased to end up being skewed. All it takes is needing to process information in a temporal sequence. We can’t do much about that.

Then it gets worse. A recent study of people’s ability to process information about changing trends in global temperatures shows our processing ability being deranged by the most subtle evidence of an ideological orientation. A grayed-out stylized cartoon of an elephant or a donkey in the background of the graph of changing temperature threw subjects off, regardless of which party they identified with. To some, a background image says relax, give this information the benefit of the doubt; the same image leads others to tense up, assume bad motives, and seek reasons to discount the information (Guilbeault et al., 2018).

We process information as if information processing were a team sport. That is a problem. We need to learn to be exceedingly careful about classifying people, especially ourselves. Decisions we make about how to pigeonhole people compromise us as we go, undermining our ability to listen and learn. We imagine we are being responsible when we treat certain sources with skepticism, but often we are kidding ourselves. The uncomfortable truth is that people who see things differently are the ones from whom we have the most to learn.

17.5 Rationality as a Process

We can treat variables as variables. But we have a theoretical reason to treat variables as fixed. It makes our models look more like controlled experiments. But treating our *preferences* as exogenous is a simplifying assumption that can easily mislead.

Jim March observed that the process of pursuing an objective often transforms the values that justify it. Again, this is an idea that is not so amenable to the project of cranking out theorems, but we have over-rated the value of the theorem game. Being able to crank out theorems surely is worth something, but it is no substitute for the messy and humbling project of reflecting on the human condition in such a way that some of our isolated and individual bits of wisdom will rub off on each other and add up to something from which we can all take comfort and inspiration.

Humanly rational choice—rational choice for beings whose preferences are a moving and evolving target—is where the philosophical action is, but looking at rationality that way is not apt for cranking out theorems. We are outcomes as well as makers of our choices. That means that whatever we think is at stake when we make choices, there is more at stake than that.

We are all spending our lives writing a novel, a work of more or less historical fiction. We are characters in that novel. More than anything else, we want our story to be a story about it mattering that we were here. Look at any Facebook page. The iPhone camera is a stunning commercial success in part because it enables us to tell our life story in selfies.⁴

We might be heroes; that’s up to us. There is an existentialist perspective, not easily ignored or discounted, from which it looks like nothing really matters at the end of the day. Yet, if

⁴ I owe the point to Liz Anderson, in conversation, spring 2019.

anything matters to us personally, it is being able to be at peace with people coming after us, reading that novel, hearing our story, and knowing who we were.

Summarizing, and repeating: rationality and morality are not the same. No one should want to spend their lives proving that rationality and morality are tautologically co-extensive, rendered compatible by definition. In fact, bringing the two together is an achievement, not a given. The compatibility, indeed the synergy, between rationality and morality is a hard-won contingency, not a clever philosophical trick. For all that, however, the achievement is there for the taking. It is a robust and frequently realized possibility: an examined life can turn out to be a life worth living.

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PART V
OPERATIONS RESEARCH

The Assumptions of Operations Research

Edward H. Kaplan

18.1 What Is Operations Research?

Born of necessity during the Second World War, operations research is, to paraphrase Philip Morse (1956), the “scientific study of operations.” And what are the “operations” Morse was referring to? Initially the operations in question were military: how to feed an army, how to search for submarines, how to locate radar stations, how to allocate military assets to battlefields. More generally, operations are the fundamental, repetitive processes that organizations employ in pursuit of their fundamental goals. Whether a private business, government agency, or not-for-profit program, organizations are familiar with operational problems such as scheduling, capacity planning, staffing, routing, inventory control, queueing, and other manifestations of uncertainty in manufacturing and services provision, planning and forecasting, and the allocation of financial and physical resources. It is the repetitive nature of operations that has enabled the scientific observation and analysis of data, and the development of new mathematical tools to model these processes. Beyond description and understanding, which are the usual goals of science, operations research is devoted to improving performance in terms of the underlying goals of the organization: maximize profit, minimize cost, or maximize effectiveness (e.g., lives saved, jobs created). Such improvement can be achieved by making better operational decisions; that is, decisions that deal directly with operational processes themselves. Thus, a succinct definition of operations research is the scientific study of operations for the purpose of making better decisions.

18.2 Theory versus Applications

The early days of military operations research were characterized by the identification of new operational problems, data collection, and often simple mathematical models of the processes involved. An excellent review and in-depth discussion of the problems considered can be found in Morse and Kimball (1951). As the field matured after the war, however, operations research projects came to be identified with more complex mathematical models, with newly developed mathematics taking on as central a role as the original real-world problems. Consequently, in current usage, the phrase “operations research” is as likely to refer to a body of mathematical methods (drawn primarily from optimization and stochastic processes) as to operations problems in the real world. For the purposes of discussing the

“assumptions” of operations research, the remainder of this chapter will focus on a small set of implicit assumptions made when conducting applied operations research. What follows is an informal, personal view. To my knowledge, to date there has not been an attempt to surface such assumptions by, for example, surveying operations researchers. [Mingers \(2003\)](#) has published a formal paper that proposes a taxonomy of the philosophical assumptions underpinning the methods used in the closely related field of management science, but no attempt will be made to reconcile his views with my own.

18.3 The (Implicit) Assumptions of (Applied) Operations Research

18.3.1 The “Problem” Is the Unit of Analysis

The first and perhaps most important assumption of applied operations research is that in any application, there exists a “problem” that can be identified (or even constructed) via careful formulation and framing. [Morse and Kimball \(1951\)](#) refer to this as “the problem of finding the problem,” and further state that “[i]t often occurs that the major contribution of the operations research worker is to decide what is the real problem” ([Morse and Kimball, 1951](#): 5). An unstated implication of this problem-driven approach is that operations researcher does not possess a “world view” like, say, economics (with its focus on individual rationality, supply, demand, and the role of markets in efficiently allocating resources), or even physics (as [Richard Feynman \(1963\)](#) put it, “all things are made of atoms”). Rather, operations researchers see the world as a sea of problems in need of solution. This can be seen by how operations researchers label fundamental contributions to the field: “the diet problem, travelling salesman problem, stochastic queue median problem, etc.” ([Kaplan, 2016](#): 9). Complicated but agreed-upon “real-world” problems are themselves often decomposed into a number of related smaller problems, each of which can be formulated, modeled, analyzed, and understood before an overall solution is reached.

18.3.2 Get the “System” Right; Work on the Correct Problem

The next unstated assumption is that in an applied study, the underlying “system” (that is, problem context) is understood, and the correct problem has been identified! This assumption is not unique to operations research—it has often been lamented that sometimes, analysts or scholars produce a precise answer to the wrong question. Nonetheless, this assumption takes on special importance in operations research applications, as most of the time, once a problem has been specified, subsequent thinking stops at the boundaries of the problem. To a serious problem-solver, this is a signal to visit and re-visit one’s understanding of the issue(s) at hand to make sure the analysis has been framed properly. Such questioning remains important throughout any applied analysis: is one working on the right problem? Applied operations researchers generally answer this in the affirmative.

18.3.3 We Believe the Math!

Having identified a problem of interest, the hallmark of an operations research study is the development and analysis of a mathematical model for the situation at hand. Almost always, researchers make simplifying assumptions to enable the application of whatever quantitative techniques are appropriate for the problem, and it is good practice, widely adhered to, to state carefully such assumptions and consider explicitly whether said assumptions hold empirically (often with the aid of data collection and statistical analysis), or whether such assumptions bias the analysis in one direction or another. Sometimes one deliberately bounds a model's possible results by considering best- (or worst-)case scenarios, with the idea that whatever recommendation results from such a model, removing the optimistic (or pessimistic) assumptions makes the underlying recommendation even stronger. But underlying all of these modeling subtleties is an important unstated assumption, which is simply *belief in the model owing to belief in the correctness of the underlying mathematics*. Much of this confidence comes from the nature of mathematical proof. For example, given a set of tasks, each of which requires a (presumed) known amount of time to process, the average pre-processing delay over all tasks is minimized by processing the tasks in order of shortest to longest processing time (SPT scheduling). This is a mathematical fact, easily provable. If in an applied study, it is necessary at some point to produce an average processing-delay-minimizing sequence, SPT would be applied, and the operations researcher would believe that the resulting sequence does in fact provide the correct answer. In the mathematics underlying operations research models, there are countless comparable situations where one can prove a mathematical result about a model that helps answer an operational question. Such results are not simply celebrated as cute or elegant; operations researchers believe that they really work.

18.3.4 Objectives and Constraints

As stated earlier, operations research modeling is not only geared toward scientific understanding; rather, the end goal for an operations research study is to improve decision-making. This implies that there is a fundamental objective (or set of objectives, perhaps competing) that the organization in question seeks to optimize. Examples of fundamental objectives include maximizing profit, minimizing cost, preventing as many infections as possible, and determining a travel route with the shortest travel time. An example of conflicting objectives is: to devise a public health budget allocation that is as efficient as possible (e.g., maximally prevents infections) but also promotes equity across different population subgroups (e.g., by gender, or geographic location, or risk group) (Kaplan and Merson, 2002). Operations researchers presume that the objectives of the organization in question can be identified correctly and quantified (consistent with “working on the right problem” and “we believe the math,” as discussed previously). In the case of competing objectives, it is further assumed that decision-makers’ valuations of the tradeoffs between such goals can be identified properly. Finally, it is assumed that *constraints* on the problem of interest can be recognized and incorporated into the analysis, ensuring that “solutions” (or

recommendations to decision-makers) are feasible: we do not recommend spending more money than can be spent, distributing more vaccines than exist in the vaccine stockpile, or assigning a machine that can process only one job at a time to multiple tasks simultaneously.

18.3.5 Decisions to Make; Let's Do Stuff!

Finally, operations researchers presume that absent their analysis, *decisions will be made anyway*. This means that the ultimate criterion for operations research projects is that whatever decisions result serve to improve matters. Sometimes, studies might find that existing operations and procedures are fine as they are; or, in contrast, that a new highly touted and believed superior approach to conducting operations is anything but. Regardless, operations research is not a spectator sport. Rather, applied operations research is supposed to help improve business, government, military or not-for-profit operations, and operations researchers use their knowledge of mathematical modeling and operational processes to “do stuff” in the real world.

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Reflections on Kaplan's Chapter - I

Philip Kitcher

One of the most chilling exhibits I have ever seen in any museum is a typewritten letter framed on a wall of the House at Wannsee. The house is an opulent villa just outside the south-west corner of Berlin. On 20 January 1942, it served as the venue for a 90-minute conference at which participants planned the "Final Solution." The letter, composed later, comes from an industrialist, who responded to a governmental request to build large ovens. It explains in sober factual detail the dimensions of the ovens to be supplied, their various thermal capacities, and the schedule on which they could be delivered. Efficiency is everything. No reference is made to the purposes underlying the original request.

Operations research (OR) has almost certainly never been guilty of the extraordinary indifference to humanity exhibited in the correspondence between the Nazis and the conscientious industrialists who served them. Nevertheless, its abstractions may suffer from a milder version of the same moral abdication. If the problem is the unit of analysis, and if one should start any analysis by identifying a system and by formulating the correct problem, it's worth asking how investigators ought to decide which systems should be studied and what problems deserve attention. In practice, the system and the problem are often given. The analyst works for a particular enterprise (perhaps as a consultant) and the problem stems from some question posed by leaders of that enterprise who are interested in increasing the efficiency of a specified procedure. Under these circumstances, it's easy for the human impact to disappear from view. The analyst is highly unlikely to be as callous as the industrialist who wrote the letter. How much moral sensitivity ought they to exhibit?

This is a serious question. Much work done under the aegis of OR accepts basic conditions of employment in the relevant sphere and doesn't worry about the social effects of the intended outcomes. Probably most (or all?) practitioners would decline to lend their talents if they were asked to advise a cartel of opioid distributors how best to deploy their "field" agents. Many might balk at designing an assembly line requiring workers to move at the limits of their manual dexterity. Yet if the question concerns streamlining production of some food recognized as nutritionally deficient and contributing to obesity, is there a moral imperative not to take it up? Or if the focus is on redesigning a school system so that it will better serve children from privileged backgrounds, is it so clear that expert advice should be withheld?

OR thrives, of course, on finding attractive problems. Attractive *formal* problems. It's hard for anyone with mathematical training not to feel the pull of the traveling salesman problem. So, I suspect, the tempting prospect of a juicy problem is often an effective lure, whether the venture that would benefit from a solution will do good or increase harm. Mathematical formulations are beautifully neutral. Any results they generate can be applied in alternative contexts. Hence the OR researcher can easily reassure themselves. "I solve the pure problem,"

they declare, “it’s up to others to decide how my results are to be applied.” Can responsibility be so easily shrugged off? If the potential applications include beneficial as well as harmful programs, does that suffice to let the researcher off the hook? “The solution itself has no moral standing. Those who choose how to use it make the morally consequential decisions.” Is that correct?

Famously, many of the scientists who elaborated quantum mechanics in the early twentieth century felt a responsibility to campaign for safeguards to limit the use of atomic and nuclear weapons. Nobody blames them for the research they did years before the destructive potential it unleashed became apparent. Indeed, commentators are inclined to applaud their felt need to be active in the cause of arms limitation. By contrast, investigators who continue to pursue evidence for racial differences in socially significant characteristics—intelligence, aggressive tendencies, and so forth—are often condemned. The moral judgments, *reasonable* judgments in my view, respond to important differences between the cases. It’s one thing to carry out research that *unforeseeably turns out* to have injurious applications. It is quite another to pursue inquiries in domains where convincing evidence is hard to acquire, where hypotheses are likely to impose further burdens on people who have already suffered discrimination, and where a credulous public is likely to accept such hypotheses on insufficient evidence (see [Kitcher, 1997, 2001](#)).

The Wannsee letter provides an extreme example of how human beings and their needs can disappear from view during business transactions. So far, I’ve blurred two ways in which the people vanish. The slogan “Business is business” can rationalize ventures whose harmful effects are known and ignored. The enterprise itself may be socially detrimental. On the other hand, even in projects whose effects are neutral, or even beneficial, the ways in which the goals are achieved may ride rough-shod over people who carry those projects to fruition. The latter concern is particularly pertinent to OR.

Subramanian Rangan has campaigned eloquently for a reorientation of business practices so that they will be directed toward the broader human good. In the assemblies he has organized and the volumes he has edited, he has urged us to reflect on ways to steer business in more societally positive directions. One part of the task he has set us is to worry about the *goals* at which particular business ventures aim. Here, what is needed is a *general* style of critique, one that applies to all the academic domains that frame the ways in which business is pursued at a given historical moment. That form of critique rightly draws from many disciplines, bringing together the thoughts of economists, philosophers, political theorists, sociologists, and business leaders in attempts to understand the circumstances under which socially harmful ventures are pursued. An interdisciplinary effort aims to develop ways of making the people visible.

Our present assignment is more specific. Different disciplines in which business executives are educated court different dangers of allowing human beings to slip out of view. OR aims to design processes for achieving specified goals, so as to make them better than they would otherwise have been. Let’s suppose the goals pass (Subi’s) critical test. The designs OR consistently generates may, nonetheless, consistently ignore the needs of those recruited to implement the “well-designed” processes. These people, the *participants*, to give them a name, are assigned generic human capacities, varying with the problem a particular piece of OR tackles. When they are reduced to abstractions, the result can easily be a milder version of the syndrome with which I’ve been concerned here.

Not all service work is menial and unpleasant. (As David Autor has noted, many kinds of service occupations provide satisfying forms of employment.) Yet some undoubtedly is. People who serve in fast-food restaurants, and those charged with the grubby tasks of cleaning up the messes as quickly as possible, experience considerable stress and few rewarding moments. The rollerblading denizens of Amazon's delivery centers and the "associates" at Walmart are subjected to rigid constraints, laid down in the name of efficiency. It's easy to envisage an OR analysis that would vindicate the arrangements under which they labor. That style of OR, one in which the participants are abstractly characterized human beings—ciphers whose maximal speed at task T is s , and who need to be released to visit a toilet after time t (a visit that should last no longer than n seconds)—probably delivers an optimal specification of how to deploy some (minimal) number of participants so as to generate some (maximal) output in some (minimal) time. Is it the kind of OR that should be used in public life (and not merely in business) and taught in business schools?

What's the alternative? Presumably to bring the participants back into view as people. But how? By recognizing some of their needs and interests as further constraints on the optimization problem. Of course, that's already present to a limited extent. Biological limitations are recognized. The maximal sustainable speed of the rollerblader is determined, and there's some attention to properties of bladders and bowels (you don't want blood, or worse, on the floor). Yet these are hardly responses to the humanity of the participants. They simply acknowledge that an organism of a particular species can only go so fast, and that various of its organs require periodic evacuation. OR typically doesn't consider any psychological needs of these participants, how hostile interactions or how repetitive tasks might affect them. Business is business, and the food must be served, the packages retrieved, and the shelves stocked as quickly as possible.

So how could OR amend its people-ignoring practices? By treating its designs as provisional, subject to revision and modification in light of the experiences of the participants. *Multi-stage* OR starts with the skeletal design of a process, achieved perhaps by solving a formal optimization problem. It then tries it out with participants, whose task is not only to live up to the design, but also to reflect on their experiences and report what they found unpleasant. Their responses serve as input to the second stage of analysis, serving as constraints on a solution. After that problem has been analyzed, the new design is implemented, and the new participants (should they include some of those involved at the first stage?) offer their judgments. If there are no complaints (or only minor complaints, easily fixed), the OR venture is done. If not, it proceeds further until an equilibrium between design and participant-response is achieved.

Multi-stage OR would, of course, be economically inefficient. It's likely (although, I suggest, not certain) that the ultimate design wouldn't deliver the theoretical optimum cost-benefit ratio. Moreover, the proliferation of stages wastes time and effort. Experiments cost. These inefficiencies can only be sustained if some regulatory framework distorts the workings of the market—and that, a critic will suggest, is problematic, even potentially disastrous.

Because business is business, our critic claims, you can't allow yourself to pander to human inclinations. Imagine if a society mandates designing processes of production, service, distribution, or whatever by using multi-stage OR. What will happen? That society will generate outcomes at higher costs than those incurred by its rivals. Either prices will rise or profits

will fall. In the latter case, capital will migrate to rival societies that trim the frills and return to basic (good old-fashioned) OR. To protect itself, then, the society had better not regulate.

Maybe multi-stage OR survives. It continues to be developed by researchers in some business schools and to be absorbed into the thinking of the executives and consultants those institutions train. Let's imagine, then, that some enterprises within the society voluntarily engage in multi-stage OR. To the extent that these ventures have rivals whose efforts accord with basic OR, they will find themselves in the same position as the regulated society. Their prices will rise or their profits will fall. Once again, falling profits will prompt the flow of capital to competitors. Voluntary policies of taking participants seriously are unsustainable.

Finally, of course, multi-stage OR drops out of the business school curriculum. Those who pursue higher degrees in business administration don't want their time wasted. They see no point in learning about a process that none of the enterprises they will join or advise will ever implement.

This dismal story strikes many people as highly plausible. I want to note, however, that it's far from rigorous. Assumptions are hidden all over the place. Who knows whether, under social environments dedicated to emphasizing the public good, capital would always flow in the ways the critic suggests? Who knows if the apparent losses resulting from the allegedly suboptimal multi-stage designs would be compensated in other ways—by greater participant dedication or reduced turnover, perhaps? The story itself is shot through and through with an old dogma, the myth of *homo economicus*. (For exposure of the myth from different angles, see the classical article of Amartya Sen (1977) and the experimental results of Ernst Fehr and his associates (e.g., Fehr and Fischbacher, 2002)).

It would be presumptuous and foolish to call for reform of OR, so as to make the people visible. Yet the danger to which I have pointed ought to be acknowledged. Perhaps the answer is to *experiment* with alternatives to standard OR. One obvious alternative would be multi-stage OR. I've argued elsewhere that areas of inquiry often benefit from the "division of cognitive labor," from the pursuit (and comparison) of rival research programs (Kitcher, 1990, 1993: chapter 8; see also Elgin, 2017). OR seems ripe for proliferation. With respect to particular OR problems, one might explore the effects of implementing designs generated from basic OR and from its more participant-oriented rivals. That would permit a more informed future comparison of the alternatives about which my imagined critic makes confident pronouncements.

I began with an extreme example of what can happen when the people vanish. Any reflective citizen ought to be worried about the general phenomenon, even when it occurs in milder forms. It isn't enough to gesture at supposed impossibility arguments, based on dubious dogma. A serious problem demands serious empirical investigation.

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Reflections on Kaplan's Chapter - II

Mathias Risse

20.1 The Problem

Presumably the availability of massive amounts of data as well as the increasing sophistication of machine learning will enormously increase the reach of the tools provided by operations research (OR). It is therefore of the greatest importance that the ethical dimensions of their use are not neglected, either in teaching or in applications (see [O'Neil, 2017](#)). What I mean by "ethical dimensions" is consideration of how the use of these tools affects society as a whole, and how it engages with prevailing values. Addressing these dimensions would involve asking a range of questions that one would hope are raised where these methods are taught or applied (see, for instance, [Zuboff, 2019](#)).

I suppose generally OR tools will be taught with little attention being paid to these matters—presumably these tools will be taught as morally neutral, to be used for better or worse aims, but then little time will be spent on preparing students for distinguishing one from the other. Presumably the rationale will be "we are just teaching certain tools and methods; what's done with them is no more our responsibility than it is the fault of a car dealer that one of their customers used a car from their lot to rob a bank." But again, this is increasingly problematic in light of what mathematical tools can do in the age of big data.

20.2 General Questions about OR

- (1) Is an analysis conducted to determine the exact range of people affected by the tools deployed or measures taken? Are their interests properly considered? As appropriate, are they being given a voice? How about non-human animals, environmental concerns, and other matters not reducible to how humans are faring?
- (2) Are OR tools used in ways that could at least in principle be made transparent in appropriate ways to all relevant agents?
- (3) Is there a critical attitude toward how uncertainty and risk are captured? If epistemic input is guesswork, models will merely create an illusion of precision.
- (4) What is the impact on society as a whole if the relevant tools are used broadly? For instance, parts of human behavior are presumably sensibly described as rational in the simple sense of people wanting more rather than less and being concerned about risk. But such an understanding of rationality falls short of a much broader sense of purposeful behavior—individuals and also firms might engage with the world by pursuing all sorts of reasonable purposes that would be ill-captured in terms of this narrow understanding of rationality. But if business and perhaps also

government are dominated by people trained in methods organized around the narrow understanding of rationality, then in due course society as a whole might be negatively affected because too many other concerns fall by the wayside.

20.3 Questions Specifically about OR

- (1) Mathematization of problems (obviously) comes with many benefits since the relationship among various formalized quantities can be traced for great personal and collective benefit. But it only produces overall positive results if the quantification and formalization involved does not create problems of its own. Just what, and how much, is lost through mathematization? Precision is helpful in many contexts, but it may also come at the expense of losing sight of part of what is at issue in the first place.
- (2) Is the kind of maximization that tools in OR deploy acceptable when used broadly over time? Measures not taken or goals neglected because they are not conducive to the relevant exercise of optimization might eventually lead to deficits that are impossible to fix. And precisely what is being optimized? Most readily, it will be money or other things that are already quantified. But what else is neglected through the particular optimization decisions? Is optimization the right approach in the first place, or is a kind of maximin approach more appropriate where the concern is to keep harm/worst outcomes limited?
- (3) Do the models or tools deployed assume that everything can be traded off against everything else? Is that a warranted assumption in the given context? Should precautionary thinking enter as well (where certain goals are not treated as standing in tradeoff relations with others)?

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PART VI
ORGANIZATION THEORY AND SOCIOLOGY

Fundamental Assumptions in Organization Theory

Julie Battilana

The field of organization theory is broad and diverse. Its common denominator is the study of organizations, understood as “social structures created by individuals to support the collaborative pursuit of specified goals” (Scott and Davis, 2015: 11). These social structures span from formal organizations—be they corporations, not-for-profits, public organizations, or social enterprises—to less formal organizational forms—such as collectives of individuals and/or organizations participating in social movements. The field of organization theory thus studies a wide range of organizational forms across sectors of society and across geographies. While some organizational scholars study contemporary organizations, others adopt a historical perspective to understand the evolution of organizations over time. Moreover, the study of organizations encompasses multiple levels of analysis—the individual, the organizational, and the inter-organizational—as well as diverse research methodologies—observational and experimental, qualitative and quantitative (Edmondson and McManus, 2007). While the study of organizations in the mid-1970s centered on large corporations trying to concentrate, diversify, and bureaucratize, subsequent study has increasingly theorized about the changing boundaries of organizations, the use of alliances and network forms, and the effects of financial markets (see Davis and Marquis, 2005). The appropriate metaphor for understanding organization theory’s history thus seems to be building the Tower of Babel (Reed, 1992), as researchers with different backgrounds and interests have examined different types of organizations and focused on different levels of analysis, while using slightly different assumptions in particular periods.

As a result, any exercise in examining the field as a whole runs the risk of providing a reductionist view of it. Nonetheless, with that caveat in mind, in this chapter I try to trace fundamental assumptions of the mosaic of organization theory and discuss how these assumptions play out at schools of business today. Assumptions are the beliefs that people accept as true without requiring proof. They are accordingly critical to unpack in order to uncover what we take for granted, not only in order to sharpen our analytical thinking but also in order to grapple with how such assumptions shape our reality (Ferraro, Pfeffer, and Sutton, 2005). Because of the way that organizational theory has historically developed, I argue that its essence is about the questioning of assumptions about the drivers of human and organizational behaviors in society and the study of the manifestations and consequences of these behaviors. Specifically, organizational theory initially developed in reaction to the dominance of the rational actor model that was at the heart of neoclassical economics and that heavily influenced the content taught in business schools (Fourcade and Khurana, 2013; Khurana, 2007).

I further argue that although organization theory is now institutionalized and recognized as a field of research, it is still underrepresented in the content taught in business schools. Business schools certainly offer courses that build on organizational theory, such as courses on leadership, change management, human capital management, and organizational design. Yet, the questioning of the assumptions about the drivers of human and organizational behaviors, which is at the core of organization theory, applies beyond these courses. Every course—be it in finance, accounting, marketing, or operations—directly or indirectly deals with human beings in organizations and/or organizations in their broader environment. As such, the questioning of the assumptions about the drivers of human and organizational behaviors and their implications—central to organizational theory—also applies to these courses. Yet, the premise of many courses taught in business schools today is still that individuals and organizations are rational actors seeking to maximize their utility or profit. In doing so, business schools contribute to strengthening a society in which recognition comes mostly from financial achievements. Such a unidimensional view of recognition is problematic, as it reinforces the race to wealth accumulation, of which many are left out, and risks exacerbating material inequalities as well as recognition gaps (Lamont, 2018).

In summary, the purpose of this chapter is to examine the core assumptions that are at the heart of the mosaic of organizational theory and discuss the extent to which they shape the content taught in business schools today. To start the conversation, I consider how core assumptions within organization theory refute core tenets of the dominant economic paradigm encompassed in the model of classical economic man, or *homo economicus*, who embodies rational action. Specifically, I contrast assumptions from the perspectives of *homo economicus* and organization theory regarding how (1) people in organizations think, (2) what motivates individual and organizational behaviors, (3) the degree of agency of people in organizations and society, and (4) how power operates in organizations. In conclusion, I discuss how the core assumptions of organization theory on each of these four dimensions play out in contemporary teaching in business schools.

21.1 Assumptions about Human and Organizational Behaviors in Organization Theory

Assumptions around cognition, motivation, agency, and power are interrelated, with agency affecting power, motivation affecting cognition, and so on. Yet, cognition, motivation, agency, and power each delineates lenses of human and organizational behaviors with specific drivers, manifestations, and consequences. In organization theory, I argue that the assumptions in these core areas are closely tied to efforts to counter the rational actor model.

The field of organization theory finds its roots in the work of social scientists such as Weber, Durkheim, and Marx, whose theory-building and empirical investigations opened the door to studying organizations systematically. Yet, the study of organizations did not become a distinct site of academic inquiry until the late 1940s (Scott and Davis, 2015). Around that time, organization theory began to coalesce, in part, in reaction to prevailing assumptions around rationality—against engineers emphasizing instrumental aspects of technical and administrative systems (Shenhav, 1999; Scott, 2004) and against economists emphasizing all-knowing actors making optimal decisions to maximize individual utility and corporate profit (March and Simon, 1958; Scott and Davis, 2015).

The point of departure of rational action is no less salient today than in the 1940s, given that laypeople as well as academics often now still interpret the world through this lens by default (Ferraro, Pfeffer, and Sutton, 2005). Assuming rationality implies, besides purposefulness, the additional characteristic of consistency; that is, “consistent, value-maximizing choice within specified constraints” (Allison and Zelikow, 1999: 18). In this rational view, actors are able to rank their preferences comprehensively among the given set of choices, and they make decisions that optimize their payoffs in the face of particular alternatives that carry specific consequences when selected (Allison and Zelikow, 1999; Baumol, 1961). The rational actor model pervading neoclassical economics holds the assumption that actors (consumers, entrepreneurs, employees, and employers) are perfectly rational; that is, that they always choose the alternative that allows them to maximize their utility or profit taking into account their constraints; individuals always exploit an opportunity to improve their situations. Indeed, those who adopt the *homo economicus* model assume, for a given choice, that individuals can know all possible alternatives, that individuals can assess the probability of consequences from particular alternatives occurring, and that individuals can evaluate these different consequences based on objective selection criteria.

I now turn to how organization theory, in contrast, deals differently from the rational actor model regarding the premises of how people in organizations think, what motivates individual and organizational behaviors, the degree of agency of people in organizations, and how power operates in organizations.

21.1.1 Cognition

Under the premise of rational choice, human beings make decisions that optimize the utility of individuals and the profit of firms, maximizing benefits or minimizing costs given the defined set of inputs and constraints. This perfectly rational kind of decision-making presupposes distinct cognitive capacities and habits of thinking among people in organizations.

The Carnegie School, which provides a foundation for the modern study of organizations, directly aimed to challenge the formulation of perfect rationality in economics. Simon (1955, 1956) deliberately used analytical concepts from rational choice and turned them on their head. A crux of the criticism centered on human cognition. Simon proposed a model of satisficing, whereby individuals make decisions when they can find an alternative that satisfies their criteria, as opposed to searching comprehensively across all prespecified possible alternatives (see Gavetti, Levinthal, and Ocasio, 2007).

Bounded rationality has been a core tenet of much of organization theory. Through the lens of bounded rationality, scholars have interpreted not only idiosyncrasies but also standardization. For example, recognizing individuals’ cognitive limits to logical decision-making (March, 1978) also provided a basis for understanding organizations’ standardized decision rules. March and Simon described standardized decision rules as a widespread facet of organization behaviors, delineating prevalent “programs” whereby “an environmental stimulus may evoke immediately from the organization a highly complex and organized set of responses” (March and Simon, 1958: 141). They observed that these kinds of standardized practices were important to help overcome the bounded rationality of organizational

members. According to [Simon \(1947\)](#), hierarchical authority enables organizations to surpass such individual limitations, as results from top decision-makers become the basis for decisions across the organizational ladder. As such, according to the Carnegie School, even organizational attributes such as standardization and hierarchy, which may seem logical and formulaic in accordance with rationality, actually exist to overcome the bounded nature of individuals' and groups' abilities to think rationally ([Gavetti, Levinthal, and Ocasio, 2007](#)).

21.1.2 Motivation

Another key facet of the mainstream rational actor model is the assumption that self-interest motivates people. In perfectly rational decision-making, people evaluate options according to the potential to enhance their own utility or corporate profit ([Allison and Zelikow, 1999](#)).

Some organization theories also have presupposed opportunism, or “self-interest seeking with guile” ([Williamson, 1993](#): 97). However, the mosaic of organization theory additionally accounts for a plethora of other drivers of individual behaviors. To begin, many recognize the human need for belonging ([Maslow, 1943](#)), which, in organizations, manifests in needs for affiliation and identification ([Ashforth and Mael, 1989](#)). More broadly, many organization theories also take the view that actors are not only motivated by economic considerations but also by social ones. The implication is that organization theories account for the effects of values such as altruism and expectations like reciprocity, for instance. The introjection of values can also govern economic action in part or in full. These values, be they consciously or unconsciously embraced, shape the content of individual motivations, as well as decisions about how to achieve them ([Portes, 2010](#)). As [Podolny, Khurana, and Hill-Popper \(2004\)](#) point out, early organization scholars saw leadership in organizations as important not due to its implications for financial performance but rather for its ability to imbue individuals in organizations with a greater sense of purpose and meaning ([Barnard, 1938](#); [Selznick, 1984](#); [Weber, 1946, 1978](#)).

Such diversity of individual motivations in organizations also implies a diversity of goals pursued in organizations. The foundations of the Carnegie School conceived organizational members as harboring conflicting interests ([Barnard, 1938](#); [Cyert and March, 1963](#); [March and Simon, 1958](#); [Simon, 1947](#)). As such, in organization theory, a central challenge for organizations is to facilitate agreement in the face of multiple goals. Accordingly, in addition to individuals pursuing multiple goals at the intraorganizational level, organization theory also accounts for the pursuit of multiple goals at the organizational level. Besides companies seeking profit, the motivation to improve the lives of individuals and communities is another realm for which organization theories are increasingly accounting. New research on hybrid organizations that simultaneously pursue social and financial goals is growing (for reviews, see [Battilana and Lee, 2014](#); [Battilana, Besharov, and Mitzinneck, 2017](#); [Saebi, Foss, and Linder, 2019](#); [Smith, Gonin, and Besharov, 2013](#)). Such hybrid organizations are not unusual because they pursue multiple goals. Instead, they are unusual because the extent to which economic and social goals are still perceived as different is so wide. The economic/social divide has deep roots not only in academia ([Friedman, 1970](#); [Jensen, 2002](#)) but also in institutional, organizational, and individual life day to day. Better understanding how organizations

can overcome tensions between social and financial goals has become a more central theme in organization theory as more corporations aim to fulfill external and internal demands to expand their accountabilities beyond shareholders and consider social impact (Battilana, 2015b, 2018).

21.1.3 Agency

Besides thinking rationally to fulfill their self-interest, the rational actor model also implies a great deal of agency for individuals. In the longstanding social science debate between agency and social structure, the rational actor model is firmly rooted in the extreme of voluntarism. From this view, individual actors are the primary drivers of behaviors and changes in social contexts, and their unchecked agency is exemplified not only in their autonomy but also in their proactivity and self-direction (Burrell and Morgan, 1979).

At the other end of the spectrum, in the realm of determinism, individuals exhibit less creativity, and the social structures of the external world are the primary forces constraining and driving behavior and change (Astley and Van de Ven, 1983). While organization theories are not entirely deterministic, they account to a greater extent for the effects of social structure and ways in which individuals have limited agency. That being said, the level of human agency assumed varies across organizational theories. From the late 1960s to early 1980s, several organization theories, such as those of strategic choice, emphasized agency over structure (see Astley and Van de Ven, 1983). Yet, other strands of organization theory at their core situate individuals and organizations as imbued with embedded agency, circumscribed by their environments (see Battilana and D'Aunno, 2009).

In parallel to these different streams of research, the field of research on leadership has become an important one, attracting attention among organizational scholars. In their review of the field, Glynn and Raffaelli report that more than three-quarters of organization studies articles and nearly two-thirds in the mainstay journal *Leadership Quarterly* modeled leaders as agentic actors who are oriented “towards taking action of some kind” (Glynn and Raffaelli, 2010: 369). Many of these studies examined how leadership affects organizational performance. Yet, some have also challenged the assumption that leadership plays a strong role in improving the effectiveness of organizations (Kaiser, Hogan, and Craig, 2008), emphasizing more the role of historical, organizational, and environmental dimensions in promoting organizational effectiveness (Lieberson and O'Connor, 1972; Pfeffer, 1977; Salancik and Pfeffer, 1977).

In addition to human agency and its limits, organizational theories furthermore account for organizational agency and its limits. The basis of institutional theory, in particular, is that organizations need others to perceive them as legitimate in order to survive (Meyer and Rowan, 1977). Organizations face pressure to appear to conform to the norms prevailing in their institutional environment. The study of social networks and organizational inter-relationships also brings out the influence of the environment on organizations. For example, Granovetter highlighted how organizations and markets are actually embedded within the social relationships that shape them. Even seemingly rational hierarchies thus have to contend with considerations of informal social status in order to understand behaviors inside and across organizations (Granovetter, 1985, 1990; Portes, 2010).

21.1.4 Power

Power is closely linked to motivation and agency. Under the premise of *homo economicus*, power is not in the foreground. The power of the invisible hand is invisible. In the mainstream discourse of neoclassic economics, individual decisions are often abstracted away from politics, as are firm decisions in markets equilibrating supply and demand.

In contrast, in organization theories, power is more center stage. Scholars have conceived power in various ways—for example, as the capacity to achieve individual goals regardless of resistance (Weber, 1968), to coerce particular behavior from others (Dahl, 1957), to delineate the boundaries of discussion and/or decision-making (Bachrach and Baratz, 1963), and to convince others to hold a particular belief (Lukes, 1974). All of these conceptions imply that power is a function of an actor's dependence on another. In organization theories, power is accordingly inherently relational, always depending on the interaction with others. All social interactions involve power, if only because an exchange, in an interaction or transaction, takes place. A given social actor has more power in relation to some social actors than others. Power is thus a situational concept rather than a dispositional one. People are not “powerful” or “powerless” in general. They are only so in relation to other social actors in a specific social relationship (Pfeffer, 1981) and their power depends on the extent to which they control access to resources that the other party values.

At the intraorganizational level, accounting for the omnipresence of power in organizations and building on Cyert and March's (1963) foundational work, many organization theories have viewed and continue to view organizations as comprised of political coalitions. At the interorganizational level, in turn, organizational theories also account for power in relationships across firms and between firms and their environments. Following resource dependence theory (Pfeffer and Salancik, 1978), organizational theorists now widely accept that environments constrain organizations, and organizations take actions to manage their resource dependencies (for a review, see Hillman, Withers, and Collins, 2009). Power is a key component for understanding such actions, whereby organizations try to decrease the power that others wield over time and increase the power that they wield over others.

Research in organization theory also accounts for the fact that the distribution of power in a particular environment also affects how it functions both at the intra- and inter-organizational levels. People begin to take power hierarchies for granted in the course of time, as they create and share accounts that take for granted existing asymmetries (Sidanius and Pratto, 2001). As a result, not only those at the top but also those at the bottom of the hierarchy tend to reproduce the distribution of power (Martorana, Galinsky, and Rao, 2005), such that it is often surprisingly stable.

21.2 Where Is Organizational Theory in Business Schools Today?

In my experience as a professor of business administration for more than a decade, I see that the conversations at the heart of organization theory about the drivers of human and organizational behaviors and their implications for society remain underrepresented in business

schools today. While research in the field of organization theory diverges from some of the trappings of *homo economicus*, our teaching does not entirely do so.

21.2.1 Cognition

To help students think more effectively and creatively, business schools provide tools to deal with bounded rationality. Yet, what are the assumptions underlying these tools, and are they fit for the future? The 2008 financial crisis was like a lightning rod, with some blaming schools of business for the crisis (McDonald, 2017) and making the need to question the assumptions that form the basis of financial models clear and acute. If business schools are not adequately preparing students to understand and question these assumptions, others will rightly blame them again during the next financial crisis when it arrives.

The rise of new technologies also presents new opportunities as well as challenges for how business schools help students think in organizations. In particular, we need to consider further not only the advantages but also the dangers from the algorithms underlying new technologies. As intelligence becomes increasingly decoupled from moral consciousness (Harari, 2017), such technologies can have intended as well as unintended negative implications for various groups of people, and we need to be better able to anticipate and discuss the positive and negative. For example, the “internet of things” may increase productivity to the extent that producing additional goods and services may no longer be subject to the laws of supply and demand (Rifkin, 2015). Yet, some change may favor those who already have more resources, such that rising productivity may sharpen economic disparities (Brynjolfsson and McAfee, 2014). At the same time, artificial intelligence can lower the price of prediction, which may enable more informed strategy formation and decision-making in organizations (Agrawal, Gans, and Goldfarb, 2018). Yet, the rise of big data and the increasing reliance on algorithms that are not well understood or regulated may have perverse effects, such as exacerbating existing discrimination (O’Neil, 2016). Moreover, automation may complement labor, especially if we invest in human capital to help ensure that individuals can adapt to technological change (Autor, 2015). Yet, some predictions of job losses, with “synthetic intellects” and “forged laborers” replacing people, are also sweeping (Frey and Osborne, 2017; Kaplan, 2015), reminding us of the need to carefully think about the human, organizational, and societal implications of technological change.

21.2.2 Motivation

To better account for a range of motivations, business schools are increasingly trying to meet the growing demand for courses geared toward social entrepreneurs and social innovators (Lawrence, Phillips, and Tracey, 2012). Yet, are such initiatives to understand value creation more holistically penetrating the core of business school curricula? Indeed, the need to account for value creation for society and the environment alongside value creation for shareholders is not limited to the world of social enterprises. Instead, it is a critical challenge facing every corporation in response not only to external demands from consumers and even

investors (Wang et al., 2016) but also internal demands from employees as they search for meaning at work (Rosso, Dekas, and Wrzesniewski, 2010).

Today many business schools appear to have retreated from their original social mission. Those who invented business schools (first the Wharton School at the University of Pennsylvania in 1881 and then others) intended these institutions to fulfill the social aim of imbuing the arena of management with the moral legitimacy and authority to serve the interests of society. As such, providing professional training to managers would require developing not only the corresponding body of knowledge of the profession but also its moral standards of conduct. However, today such a social mission seems eroded, replaced first by an emphasis on professional knowledge as opposed to professional ideals (Khurana, 2007). Now, while many business schools offer courses that deal with business ethics, these courses too often remain isolated from the rest of the curriculum. Yet, moral considerations apply to every aspect of life in organizations.

In this context, it is up to faculty members to decide how much emphasis they want to put on moral issues and values in their teaching. While such discretion may enable adaptation to evolving concerns and useful innovation, it also risks systematically neglecting moral issues and values, if instructors are not themselves trained to deal with them in the classroom (Anteby, 2013). It would be a mistake to believe that use of the *homo economicus* model is the solution to such issues as it supposedly puts values aside and focuses on efficiency. Far from being value-free, the *homo economicus* model is articulated around a core set of values that place profit and utility maximization above other goals. The conversation about values can thus, and should, not be avoided.

21.2.3 Agency

In the realm of agency, the notion of individual heroes often percolates in the popular imagination, including at schools of business. We tend to uphold the promise of a lone hero who will be able to change an organization, an industry, or even the world alone. In the face of this dominant narrative, are we equipping students to understand not only how they can have an impact on their environment, but also how their behaviors are shaped and constrained by their environment? We tend to overestimate the amount of control that we have in a given situation (Ross, 1977) and underestimate the influence that society, other individuals and institutions, and taken-for-granted patterns of acting and organizing have on our decisions. This tendency is particularly true among those in individualistic societies, which inculcate the prized importance of personal choice (Iyengar, 2010).

Yet, living in a social world, while we may try to influence others, others also influence us. In practice, individual leaders rarely succeed alone in implementing change in society. Instead, they often need to participate in collective action to bring about change, especially when such change diverges from taken-for-granted norms (Battilana, 2015a). The challenge is thus to help students understand how complicated it is to bring about change in an industry or, more broadly, in society, and better equip them with tools to be able to contribute to collective action.

In this context, what is at stake is the shift from thinking about leadership as a purely individual construct meant to capture the impact of a single individual on an organization

or in society to thinking about leadership as a relational and collective concept. Adopting such an approach, Ganz defines leadership as “accepting responsibility to create conditions that enable others to achieve shared purpose in the face of uncertainty” (Ganz, 2010: 527). Building on this definition, teaching on leadership in business schools could better account for its relational nature and for the importance of collective action.

21.2.4 Power

Finally, as an instructor for a course on power and influence in society for MBA students, I have seen fallacies about power surface again and again among students over the years. They often assume that power is a possession, which some people have inherited or developed while others do not have it; that power is only for the few who are ambitious enough to use it, not the majority; that power requires immoral manipulation and devious coercion to wield, which necessarily would dirty their hands and hearts; and that new digital technologies have transformed power dynamics, such that now everyone is already empowered.

Yet, none of these assumptions hold up in reality. In fact, power is situational and relational by nature, varying across time and space. Knowledge about power dynamics is for everyone who cares about making a difference, and history shows over and over again that power can serve both nefarious and noble purposes. At the same time, while new technologies present some exciting opportunities for enhancing economic and social value for organizations and society, they have not changed the underlying workings of power structures and relationships, and they have even exacerbated existing inequalities in some instances. At business schools, we should account for and discuss power dynamics and the critical moral question of what to use one's power for across courses in our curricula. We have the opportunity to support students in the developmental process of self-discovery and moral reasoning that will enable them to anchor their actions in a strong moral compass. By doing so, we can help equip them with ways of thinking and behaving to deploy power as a force for good.

21.3 Conclusion

Although the founding of business schools aimed to establish management as a profession with a corresponding body of knowledge and moral standards, business schools have failed to live up to that promise (Khurana, 2007). The rational actor model that was at the heart of neoclassical economics had an imprinting effect on the content taught in business schools, where it continues to have a lasting influence. Since the 1970s, business schools have largely reflected and reproduced the dominant market logic, responding to pressures from student-customers and external raters to focus on skillset development, particularly in finance, accounting, and marketing, without serious consideration of the public good (Khurana, 2007). What is at stake today is a paradigm shift for business schools.

The question remains whether we are yet on the brink of such a shift, from capitalism as we know it today, on the backs of business schools and other institutions that generally internalize the assumptions of rational economic man, toward an alternative that places social and environmental concerns at its heart, besides financial ones. In the seminal book

The Structure of Scientific Revolutions, Kuhn (1970) traced distinct phases in the development of scientific fields, from normal science, where researchers generally find what they expect to find and make incremental advances; to crisis, where researchers question the given paradigm and become willing to rethink what they take for granted and try alternatives; to revolutionary change, where researchers replace the unsatisfactory paradigm with another. The questioning of some of the assumptions on which many models taught in business schools are based is not yet widespread, yet some shifts are already underway. In this context, organization theory provides some entry points to recasting the assumptions underlying *homo economicus*. But such upturning of our habits will require collective action in a broader movement for change.

There are some signals of change in the ecosystem. For example, social impact investing that integrates social and environmental value creation considerations alongside financial ones is on the rise, and an increasing number of young entrepreneurs are creating social businesses that aim to produce not only financial but also social and environmental value. Yet, financial and social goals remain the premises of separate spheres of activity, where institutional arrangements continue to reinforce separate sets of values. In this context, transforming capitalism will require the joint effort of companies, governments, unions, shareholders, consumers, investors, and business schools that train tomorrow's business leaders (Battilana and Pache, 2018).

Organizational theorists, like all of the social scientists teaching in business schools, have the potential to be part of this movement for change, but they do not hold all the answers. While organization theory may complement other disciplines and provide some antidotes to gaps and fallacies in some of the taken-for-granted assumptions about human and organizational behaviors, organization theorists too require humility in the face of complex problems and multilevel phenomena that require cross-disciplinary initiatives to understand better. Revising the curricula of business schools is a good place to start, but it is also a challenging one as it will require all of the disciplines of social sciences represented in business schools to work together. Deeply rooted disciplinary silos are major obstacles to such collaboration. Yet, we must find a way to collaborate if we want to contribute to the paradigm shift that is at stake.

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Organization and Management Theory

Our Assumptions and the Quest for a Better World

James P. Walsh

The “domain statement” of the organization and management theory (OMT) division of the Academy of Management (AOM) reads as follows:

[OMT] involves building and testing theory about organizations, their members and their management, organization-environment relations, and organizing processes. The area has a rich intellectual heritage. Theoretical advances in organization theory have included strategic choice, resource dependence theory, organizational ecology and institutional theory. More recently, we have provided a home for critical, feminist, cognitive, and post-modern theorists. We encourage new theory development and the application of our existing theory base to such emerging and continuing management challenges as quality improvement, strategic alliances, new technology implementation, organizational restructuring, governance and control, and strategic global diversity. The division celebrates theoretical activity, methodological pluralism and linkages between theory and practice.

At last count, over 4,000 members of the AOM affiliate themselves with the work described in the OMT domain statement.¹ Another 4,000 scholars from previous generations likely embraced these ambitions as well. As the division officers noted, there is a “rich intellectual heritage” here. Walking a fine line between self-confidence and hubris, I will attempt to identify a few assumptions that orient this enormous body of work. Identifying three, I will step back, consider why I may have this wrong, and, in doing so, identify a fourth.

Here are the three. I believe that most organization theory and leadership scholars believe that individuals matter. Assuming that individuals, leaders and managers, create the processes, systems, and structures that produce the individual, group, and organization outcomes they seek, they believe in agency. Moreover, these scholars believe that their theories, models, and methods will help to make the world a better place. Finally, they believe that science is their friend. Positive science orients a great deal of the work in this field. Let me say a few words about each before taking stock of this stocktaking.

¹ I would like to thank John Meyer, Subi Rangan, and Sandra Waddock for their feedback on an earlier draft and Corey Seeman for his expert help with the citation analyses.

22.1 Agency Matters

Notwithstanding storied evidence of conformity (Asch, 1956; Milgram, 1974) and psychologists' understanding that the effect of personality on behavior varies across situations (Mischel, 2004), many organization theorists believe that people (or at least some people²) can impose their will on the world.³ For years, scholars helped managers design tasks (Roberts and Glick, 1981), jobs (Hackman and Oldham, 1980), and organizations (Galbraith, 1973). For nearly forty years, Nadler and Tushman's (1980) "congruence model" has served as a foundation for our required "Human Behavior in Organizations" undergraduate and graduate courses. This model shows leaders-to-be how to take a series of inputs (environment, resources, and history) and transform them into a set of desired performance outcomes (at the individual, group, and organization levels of analysis), by managing a transformation process, one where individuals interact with the tasks, formal organizational arrangements, and informal organization that these leaders worked so hard to create. Of course, those individuals will have power. They deploy it in different ways to different effect. Some time ago, Etzioni (1961) identified three kinds of power (coercive, utilitarian, and normative) and noted that when deployed in organizations, each yields a different kind of involvement: coercion produces compliance, utilitarian exchange yields a calculative response, and normative influence breeds moral engagement. If managed well, the resulting corporate culture (Schein, 2017) can be a source of competitive advantage (Barney, 1986). Of course, scholars do not just assert that such leaders matter; they persistently investigate the effects of leadership on firm performance. Indeed, the accumulated evidence suggests that they are indeed influential (Lieberson and O'Connor, 1972; Day and Lord, 1988; Hambrick and Quigley, 2014).⁴ Many scholars believe that strategic choice matters (Child, 1972, 1997).

To be sure, we also have theories of organization that do not privilege human agency. Hannan and Freeman (1977: 930), for example, introduced their groundbreaking paper, "The Population Ecology of Organizations," with these words:

Clearly, leaders of organizations do formulate strategies and organizations do adapt to environmental contingencies. As a result, at least some of the relationship between structure and environment must reflect adaptive behavior and learning but there is no reason to presume that the great structural variety among organizations reflects only or even primarily adaptation.

They closed their paper with these words, "Until we see evidence to the contrary, we will continue to doubt that the major features of the world of organizations arise through learning or adaptation" (p. 957). They are much more interested in environmental selection than they are in heroic conceptions of determined leadership.

² See Uhl-Bien, Riggio, Lowe, and Carsten (2014) for a review of the followership literature.

³ While theorists typically attend to those with formal organization authority, the field does recognize that anyone in an organization can lead (DeRue and Ashford, 2010).

⁴ In what was to be an influential paper in the economics literature, Bertrand and Schoar (2003: 1170) recognized our field's abiding focus: "While the role of managers in shaping corporate practices has been virtually ignored in the economics and finance literature, there is a large body of work in the management science literature analyzing the determinants of decision making among CEOs."

Institutional theory, another major organization theory, also came to life in 1977. In a seminal paper, [Meyer and Rowan \(1977: 340\)](#) argued:

Organizations are driven to incorporate the practices and procedures defined by prevailing rationalized concepts of organizational work and institutionalized in society. Organizations that do so increase their legitimacy and their survival prospects, independent of the immediate efficacy of the acquired practices and procedures.

They too argued that forces beyond the reach of organization's leaders shaped the organization's prospects. Having said that, [Christine Oliver \(1991: 145–146\)](#) later introduced agency to a theory that was more deterministic than not:

The institutional perspective also has been increasingly criticized for its lack of attention to the role of organizational self-interests and active agency in organizational responses to institutional pressures and expectations ... It is proposed here that institutional theory can accommodate interest-seeking, active organizational behavior when organizations' responses to institutional pressures and expectations are not assumed to be invariably passive and conforming across all institutional conditions.

The fact of this article's popularity and its role in drawing more adherents to institutional theory (and, in the end, many more than those who embrace population ecology theory) suggest that agency matters to organization theorists. [Figure 22.1](#) displays the Google citation counts for all three papers from their date of publication through 2017. The pattern of interest in Oliver's work mirrors the pattern of interest in Meyer and Rowan's very popular work. The correlation between the two annual citations is .99.

While the comparative interest in population ecology and institutional theory is important to note, we can explore the institution theory's emerging agency dynamics in

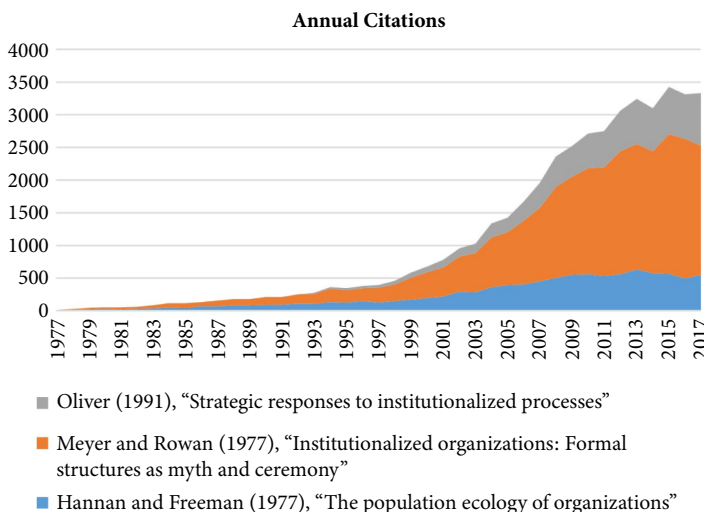


Figure 22.1 Annual Google citation counts for [Hannan and Freeman \(1977\)](#), [Meyer and Rowan \(1977\)](#), and [Oliver \(1991\)](#) from publication to 2017.

Source: Author's analysis.

greater detail. If agency matters to organization theorists, then we would expect to see institutional theory's agency-infused work to gather more scholarly attention than work without such an orientation. I decided to examine this idea.

To begin, I collected all of the work that cited [Meyer and Rowan \(1977\)](#), [Oliver \(1991\)](#), and both [Meyer and Rowan \(1977\)](#) and [Oliver \(1991\)](#) in 2008. I then looked at the citations to those articles over the next ten years (between 2008 and 2017 inclusive). If agency matters to organization theorists as I think it does, I expect those who cite [Meyer and Rowan \(1977\)](#) and [Oliver \(1991\)](#) together will gather more attention in the following years than those who cited just [Meyer and Rowan \(1977\)](#). (I had no prediction about the attention that "Oliver-only" work would receive.)

[Figure 22.1](#) (using Google Scholar data) tells us that 1,390 authors or teams of authors cited [Meyer and Rowan \(1977\)](#) in 2008, and that 473 authors cited [Oliver \(1991\)](#) in that same year. Using Web of Science data to do this follow-on analysis, we know that these citation numbers will drop dramatically ([Amara and Landry, 2012](#)). Sure enough, the Web of Science lists only 170 references to [Meyer and Rowan \(1977\)](#) and 49 references to [Oliver \(1991\)](#) in 2008. While [Amara and Landry \(2012\)](#) talk about some important differences between the Google Scholar and the Web of Science technology, we need to recognize that the correlation between the two is 82. This strong correlation suggests that we can use the Web of Science data for our purposes here.

The average number of citations to all of the papers that cited [Meyer and Rowan \(1977\)](#) in 2008 is 76.89 (with a standard deviation of 51.97); 3,183 papers cited those 170 papers in the 2008–2017 time period. The average number of citations to all of the papers that cited [Oliver \(1991\)](#) in 2008 is 81.36 (with a standard deviation of 67.18); 1,055 papers cited those 49 papers in those 10 years. And as expected, the papers that cited both [Meyer and Rowan \(1977\)](#) and [Oliver \(1991\)](#) together in 2008 received the most attention. Six hundred and fifty-nine papers cited those thirty-one papers between 2008 and 2017; on average, they each received 86.52 citations (with a standard deviation of 61.71).⁵ A one-way analysis of variance tells us that these means differ at the .001 level ($F(2, 4894) = 8.81, p < .001$). A post hoc Bonferroni corrected t-test analysis tells us that this difference is driven solely by the mean difference between the citations to the papers that referenced both [Meyer and Rowan \(1977\)](#) and [Oliver \(1991\)](#) and those that just referenced [Meyer and Rowan \(1977\)](#). That 86.52 versus 76.89 mean difference is significant at the .001 level ($t(1, 3840) = 4.18, p < .001$). The tests for difference in the other two comparisons are non-significant. Clearly, OMT scholars are drawn to questions of agency.

22.2 Making a Better World

To the extent that organization scholars think about business per se (some do and some, solely interested in organizational dynamics, do not), I suspect that most are pleased to be a

⁵ Of course, this is a very broad look at these citation patterns. For example, I am not controlling for the year of subsequent citation here. That is, a 2009 paper that references a paper citing Meyer and Rowan in 2008 has more years to gather citations in this ten-year window than a paper published in 2014, 2015, or 2016. Assuming that these three broad types of papers gather citations in the same fashion in that ten-year period, I am not exploring any temporal dynamics here. In addition, John Meyer suggested that it would be a good idea to examine the authors of the 4,897 papers that cited those 250 papers published in 2008. Those with business school affiliations may be more likely to embrace agency-inspired institutional theory work than not. That kind of analysis is beyond the scope of this project. I am just interested in an omnibus assessment right now.

part of an endeavor that helps people imagine, create, and sell a product or service in a competitive marketplace for customer benefit and firm profit. They care about value creation. I think it is also fair to say that they care especially about the lives of those who in Freeman's (1984: 46) words "affect or [are] affected by the achievement of the activities of an organization." Indeed, "the human relations movement" flourished in the 1970s (Wren and Bedeian, 2017). Walsh, Weber, and Margolis (2003) read and coded every empirical paper published by the *Journal of the Academy of Management*, soon renamed the *Academy of Management Journal*, from its inception in 1958 to 2000. They tracked the extent to which human welfare figured prominently in this work, comparing this interest to a focus on performance. Looking at each paper's focus of inquiry, they defined human welfare as "such constructs as health, satisfaction, justice, social responsibility, and environmental stewardship" (p. 861). They reported attention to these constructs at three levels of analysis: individuals, organizations, and society. They captured their results on p. 863.

As we can see in Figure 22.2a, the five-year moving average clearly reveals our field's abiding interest in human welfare (and, of course, it pictures the influence of the human relations movement in the 1970s). It may surprise some to learn that the field of organization and management was once more interested in human welfare than it was performance. The rise of globalization in the 1980s changed that. The exacting competition in factor and product markets shifted our attention to performance. Soon, this focus eclipsed our interest in human welfare. Still, the uptick in attention to welfare at the end of the century left us wondering if a focus on well-being returned in the following years. After all, many people now investigate B Corps and benefit corporations (Hiller, 2013), the base of the pyramid phenomenon (London, 2016), collective value (Kania and Kramer, 2011), shared value

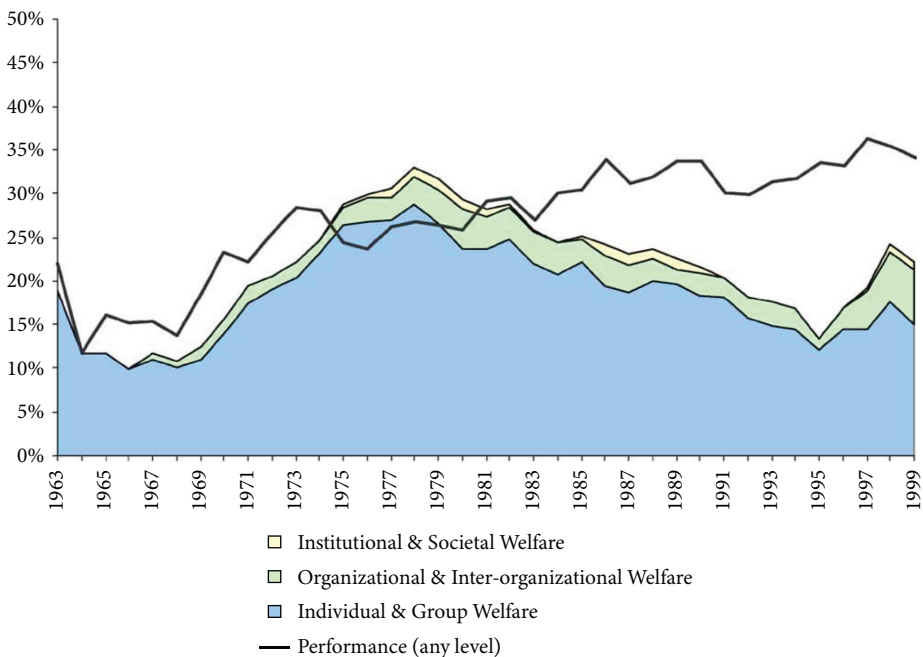


Figure 22.2a An indicator of management scholars' interest in performance and human welfare: 1963–1999.

Source: Reprinted with permission from Walsh, Weber, and Margolis (2003).

(Porter and Kramer, 2011), social enterprise (Battilana and Lee, 2014), and the like. Returning to this project with Klaus Weber and now Kartik Bajpai, Figure 22.2b shows the results of a smart algorithm that coded every empirical article in this same way, this time through 2015.

The gray lines show our ability to replicate our previous hand-coded work. Looking ahead sixteen years, we see that this focus on human welfare continued, with about 25 percent of all the articles in the field of organization and management focusing on well-being; the interest in performance continues to capture our attention but curiously, this attention has waned in recent years.

I can offer one other piece of evidence to support my intuition that organization scholars are interested in a better world. In 2009, I surveyed a group of first-year PhD students, AOM junior faculty consortium attendees, and retired members of the AOM, asking them why they are scholars. The content-analyzed results are pictured in Figure 22.3 (from Walsh, 2011: 223).

No matter their career stage, our colleagues are scholars because of the dual draw of living the life of the mind and making the world a better place. Three quotes capture the essence of our “make a better world” orientation:

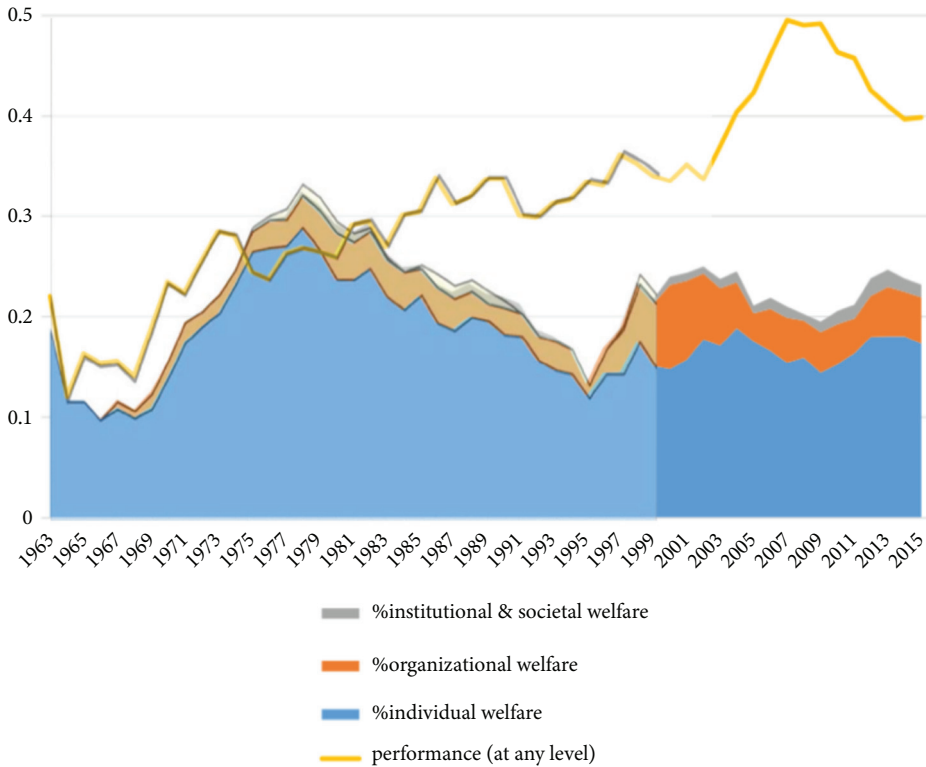


Figure 22.2b An indicator of management scholars’ interest in performance and human welfare: 1963–2015.

Source: Author’s unpublished update, 2018.

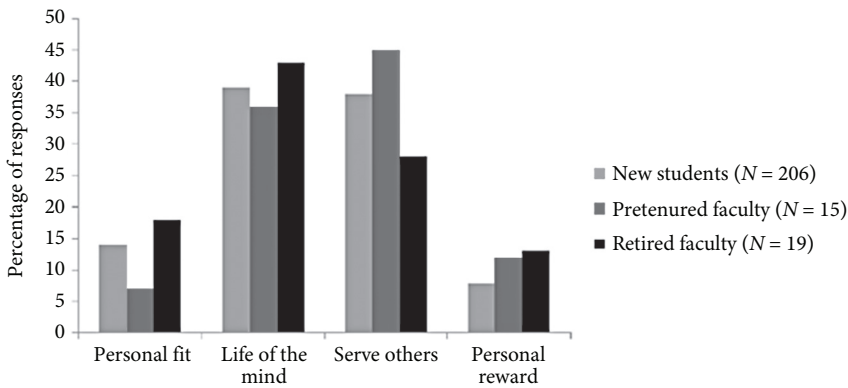


Figure 22.3 Student and faculty responses to “Why are you a scholar?”.

Source: Reprinted with permission from Walsh (2011).

- “I want to improve the lives of people, whether it is by making organizations more effective, markets more efficient, or employees more satisfied.”
- “I want to help/inspire younger students to be successful at whatever they choose to do in life.”
- “I want to leave the world better than I found it.”

22.3 The “Agency X Make a Better World” Interaction in Business Schools

Recall Subi’s question: “What in your view are the three, five, or seven fundamental assumptions that underlie the models and methods in the field of leadership/org theory *as studied and taught in schools of business*?” Sharing two assumptions so far, I have not yet said a word about our business school context. Spending almost forty years in schools of business, I do believe that these two assumptions orient much of what we do. While my intuition says something, it would be far better if I could offer some evidence to support this claim. To that end, I collected the mission and vision statements for a group of select business schools. The Addendum at the end of this chapter captures the current aspiration statements (current as of June 2018) from the “Top Ten” business schools identified by the *US News and World Report* and the *Financial Times*. They all focus on betterment.

Nine of the ten business schools in the *US News*’ appraisal specifically focus on leaders as agents for world betterment, change, and improvement. Michigan Ross is the exception; it focuses on business as a change agent for the world, a view that appeals to some these days (Donaldson and Walsh, 2015). Unlike *US News and World Report*, the *Financial Times* appraises business schools the world over. Their list comprises five US business schools from the *US News* list and five others from Europe. Eight of this group of ten single out leaders as their force for change. The other two offer variations on the theme—London Business School (LBS) focuses on how the world and business itself does business; IE University looks

to affect the people who shape the world. These schools' mission statements unambiguously reveal assumptions about individual agency in service of a better world.⁶

With evidence for these assumptions so firmly in hand, it is tempting to think these two define our world. But there is a third. So much a part of the air we breathe in university life, it is easy to miss the fact that the intuitions and practice of science shape much of what we think, say, and write.

22.4 Science Matters

While we have been organizing our productive activity for thousands of years (Diamond, 1997), formal schools of business have only recently helped us do so. The University of Pennsylvania's Wharton School, founded in 1881, was the first undergraduate school of business; Dartmouth College's Tuck School, founded in 1900, was the first graduate school of business. Augier and March (2011) provide a succinct history of these early years. Inspired by Abraham Flexner's (1910) report to the Carnegie Foundation, one that urged science to serve as the foundation for modern medicine, Augier and March chronicled how business schools tried to follow that same path. A few stylized facts might serve to make that point. Frederick Taylor published his iconic book, *The Principles of Scientific Management*, in 1911. Quite aware of that work and its potential, the Tuck School asked him to join its faculty in the early years (D'Aveni, 2003); moreover, the University of Pennsylvania granted him an honorary Doctor of Science degree in 1906 (<https://secure.www.upenn.edu/secretary/hondegchron.html#1906>). Notwithstanding the allure of science, the curriculum in our early years was marked more by storytelling and anecdote than it was science. Augier and March (2011: 28) colorfully observed that business schools in the first half of the twentieth century "were seen by many academics as using poorly trained faculty to provide intellectually undemanding vocational training for students of limited talent." Things changed after the Second World War.

Reports by the Carnegie Foundation (Pierson, 1959) and the Ford Foundation (Gordon and Howell, 1959) transformed business education in the same way that Flexner's report transformed medicine. Both reports asked business schools to embrace scientific thinking (and, indeed, systematic research). Gordon and Howell (1959: 164) were quite clear: "It is becoming increasingly important that the businessman have some background in science and technology. It is equally important that he obtain an appreciation of the scientific method and of the spirit of inquiry that motivates science."

Change was certainly in the air. *Administrative Science Quarterly*, a flagship journal in our field, was founded in 1956. The very first page in its inaugural issue speaks to its ambitions: "The name of this journal ... was not lightly chosen. It expresses a belief in the possibility of developing an administrative science and a conviction that progress is being made and will continue."

⁶ We also hear voices inside business schools asking them to step up and solve the world's problems. In a recent essay entitled "Management Education for Sustainable Development," my Michigan colleague and associate Dean Jerry Davis (2018) argued, "Management's broad purpose today is the achievement of the UN's Sustainable Development Goals [SDGs]." He believes that the SDGs "provide a solid framework for how we educate future managers." Interestingly, John Hailey (1998) wrote a paper twenty years ago with that exact title and the same broad aspiration. Business schools have been interested in making a better world for some time.

Writing in that first issue, [Litchfield \(1956: 7\)](#) longed for a general theory of administration:

Indeed, so far are we from broad generalizations about administration that we appear to maintain that there is not a generic administrative process but only a series of isolated types of administration. We seem to be saying that there is business administration and hospital administration and public administration; that there is military administration, hotel administration, and school administration. But there is no administration.

James D. Thompson, one of the “founding fathers” of modern organization theory, also wrote a paper in that first issue. Entitled “On Building an Administrative Science,” he too longed for an embrace of scientific reasoning. Doing so, he lamented the problem of looking to “best practice” for insight:

Much of our literature is lore, spelling out how a procedure or technique is carried out in current practice or proclaiming that “this is the way” to do it. This material contains rather bold and often implicit assumptions about the relationships between the procedure or technique under consideration and other things which take place within the organization. This type of literature frequently asserts that a certain device is proper, i.e., gets desired results, on the grounds that “General Motors has it” or that the one hundred “best-managed” companies use it. But a particular budgeting procedure, for example, may be appropriate for General Motors and not for Company X, and it may be appropriate for General Motors in 1956 but less appropriate in 1960. (p. 105)

Alert to what would be an enduring attraction to these best practices, [Thompson \(1956: 111\)](#) asked us to beware the inferences we draw from descriptive research: “Surveys showing ‘how things are done’ have their place in an administrative science, but much more needs to be done along the lines of ‘what happens if.’”

The American Assembly of Collegiate Schools of Business (renamed the Association to Advance Collegiate Schools of Business (AACSB) in 2001) commissioned another look at management education in the late 1980s. In their report, [Porter and McGibbon \(1988\)](#) noted a host of contemporary challenges and opportunities but they did not dispute the model of education endorsed thirty years prior. Indeed, a few years later, Jeffrey [Pfeffer \(1993\)](#), a very influential organization theorist, argued strongly that we needed to stay our science course. Observing what he called our “particularistic advancement of separate agendas, often with explicitly political undertones” (p. 616), [Pfeffer \(1993: 599\)](#) worried about our scientific fortunes:

The study of organizations is arguably paradigmatically not well developed, in part because of values that emphasize representativeness, inclusiveness, and theoretical and methodological diversity. Although these values are attractive ideals, there are consequences for the field’s ability to make scientific progress, which almost always requires some level of consensus, as well as for its likely ability to compete successfully with adjacent social sciences such as economics in the contest for resources.

To be sure, these words generated a fair bit of controversy (Van Maanen, 1995; Pfeffer, 1995) but just the same, our embrace of science continues.

The allure of and quest for evidence-based management probably best represents our current embrace of scientific reasoning. Denise Rousseau (2006: 56), the sixtieth president of the AOM, articulated its promise in her 2005 presidential address:

Evidence-based management means translating principles based on best evidence into organizational practices. Through evidence-based management, practicing managers develop into experts who make organizational decisions informed by social science and organizational research—part of the zeitgeist moving professional decisions away from personal preference and unsystematic experience toward those based on the best available scientific evidence.

Noting again that we should look to medicine for inspiration, Rynes and Bartunek (2017) recently took stock of the past, present, and future of this quest. Noting the importance of high-quality, systematic reviews and the need for better research, they ended their review with the word hope: “We hope this review fosters EBMgt’s [evidence-based management’s] ability to respond to those challenges” (p. 256). A faith in science is still very much a part of our world.⁷

22.5 Taking Stock of My Stocktaking ... and a Fourth Assumption

I began this chapter with a worry about crossing the line between self-confidence and hubris. It may be a fool’s errand to rise to Subi’s question. After all, organization theory is a broad field with a deep history. Nevertheless, I gave it a shot. Having done so, I want to conclude by taking stock. I want to examine my own assumptions. Doing so, I think I see that agency matters more than we know, but for a different reason. And while it is hard to argue with our aspirations for a better world and an embrace of science, I believe that each conception can be enhanced.

To begin, we must recognize that to embrace agency is to bring us foursquare into the age-old contest between sociology and psychology (and yes, economics). Murray Davis (1971) used this tension to describe research he deemed “interesting.” Focused on what he called the “sociology of the interesting,” he said that scholars looking to make a name for themselves should consider turning an established paradigm on its head. By way of example, he created a twelve-fold typology, one he called “the index of the interesting” (p. 313). One of his twelve moves is relevant here, “abstraction” (p. 316). It reflects the tension we see in the following polar-opposite views:

- (1) “What seems to be an individual phenomenon is in reality a holistic phenomenon” (for example, Durkheim argued that suicide is a mark of society and not an individual);

⁷ To be sure, some worry that we privilege science over storytelling at our peril (Corbett, Cornelissen, Delios, and Harley, 2014).

- (2) “What seems to be a holistic phenomenon is in reality, an individual phenomenon” (for example, Freud’s assertion that war was not a social phenomenon but in reality a psychological one).

The former reflects standard situational assumptions in sociology, the latter standard dispositional assumptions in psychology and economics.

At this point, we could dive into the nuanced debate. I do not want to do that but it is important to note its contours. Thirty years ago, [Baron and Hannan \(1994\)](#) nicely crystalized the tension. Sociologists react in one of two ways to the idea in economics that rational choice undergirds much of social behavior (think *homo economicus*).⁸ Those who embrace Durkheim’s 1895 idea of “social facts” argue that many social phenomena simply do not reduce to individual agency ([Durkheim, 2014](#)). Others recognize agency but see individual preference as derived from the person’s social environment, not a cause of it. [Baron and Hannan \(1994: 1117\)](#) said it well: “Many sociologists view preferences as *result* of enduring exchanges and social contract, not as the rationales for initiating them.” And from that basic distinction, the work explodes. Psychologists explore the person-centric cognitive ([Weber and Johnson, 2009](#)), emotional ([Lerner, Ye, Valdesolo, and Kassam, 2015](#)), and even unconscious ([Newell and Shanks, 2014](#)) nature of decision-making. Years ago, [Allison \(1971\)](#) (and later, [Allison and Zelikow, 1999](#)) explored how individual notions of agency (in their “Rational Actor” Model I) commingled with contextual forces (in their “Organizational Behavior” Model II and their “Government Politics” Model III) to explain co-determined decision-making. Relatedly, the turn to agency in institutional theory leaves us with a situationalist theory that more and more accommodates notions of individual initiative ([Battilana, Leca, and Boxenbaum, 2009](#)). Indeed, the idea of “institutional work” encompasses “the purposive actions of individuals and organizations aimed at creating, maintaining, and disrupting institutions” ([Lawrence and Suddaby, 2006: 216](#)). In their view, individuals shape the world that so shapes them. Beyond that, the recent notion of “institutional actorhood” tells us that individuals actively accommodate themselves to those institutional forces. [Voronov and Weber \(2016: 469\)](#) talk of how a person “actively fus[es] her or his sense of self with the demand of the institutional actor role ascribed to her/him.” It is fair to say that scholars today are much more interested in understanding co-determination than fighting paradigm wars (see [Bandura, 2018](#); [Foy, Schleifer, and Tiryakian, 2018](#); and [Thaler, 2016](#) for a look at how psychologists, sociologists, and economists see such work unfolding).

Every organizational theorist is quite aware of the distinctions and tensions that define the debates. That said, organization theorists in business schools generally reject [Durkheim’s \(2014\)](#) strong-form situationalist thinking. Instead, they embrace some kind of agency notion, if not the rational actor model itself.⁹ It may be that another well-known organization theory, resource dependence ([Pfeffer and Salancik, 1978](#)), explains why.

⁸ [Thaler \(2016: 1578\)](#) reviewed the assumptions about human behavior that define *homo economicus*: “(i) Agents have well-defined preferences and unbiased beliefs and expectations. (ii) They make optimal choices based on these beliefs and preferences. This in turn implies that agents have infinite cognitive abilities (or, put another way, are as smart as the smartest economist) and infinite willpower since they choose what is best, not what is momentarily tempting. (iii) Although they may act altruistically, especially toward close friends and family, their primary motivation is self-interest.”

⁹ To be sure, many believe that it is folly to embrace the rational actor model. [Ferraro, Pfeffer, and Sutton \(2005\)](#), for example, showed us how prescriptive ideas, grounded not in the reality of human behavior but in the stylized imagination of such behavior, can, by affecting our language, norms, and institutional designs, actually shape behavior to conform to those ideas. In that same year, [Ghoshal \(2005\)](#) famously warned business school professors

Looking to learn the secrets of effective organization and management, individuals and organizations pay top dollar to enroll in business schools' many degree and executive programs; very successful alumni in turn donate large sums of money to their schools in an effort to help others learn to lead as they once did. While the data may fit the theory, it may be too cynical by half to assert that organization theorists embrace an agency perspective because the rewards for promulgating such a perspective are so lucrative. If so, it would be quite ironic to discover that those who proffer an agency perspective are themselves captive of strong incentives.¹⁰ Of course, those with a clear mind and deep integrity can embrace an agency perspective as well. We can debate the debate and no doubt learn something new, but the really interesting—and important—work will unfold when we realize that in the broadest sense, the agency scholars are correct. We live in an unprecedented time—in what some have referred to as the Anthropocene. Today's consensus view is that humans have dominion over all life on the planet.

We assert our dominion over others in both a direct “psychological fashion” and in an indirect “sociological fashion,” one where the systems and structures we create control others. As such, we humans impose our will on the world. Doing so at scale since the Industrial Revolution, the results are in—“humans are now a primary operating element in the Earth's ecosystems” (Hoffman and Jennings, 2015: 10). This may not be good news.

Examining existential risk, the risk “that threatens the premature extinction of Earth-originating intelligent life,” Bostrom (2013: 15, 16) argued that the “great bulk of existential risk in the foreseeable future consists of anthropogenic existential risks—that is, those arising from human activity.” We seem to be destroying ourselves. Raising the specter of “biological annihilation,” Ceballos, Ehrlich, and Dirzo (2017: EW6089, E6096) recently observed, “the window for effective action is very short, probably two or three decades at most.” If business is the most powerful institution on the world's stage today and business leaders have any agency at all, then it is imperative that they use that agency to better the world. In fact, “bettering” the world may not be good enough—they may need to help save it.¹¹

to beware the rational actor (*homo economicus*) model of human behavior (in a paper entitled “Bad Management Theories Are Destroying Good Management Practices”). Nevertheless, after chronicling the evolution of business schools, Fourcade and Khurana (2013) argued that economic thinking still holds a firm grip on them. To that point, James March observed that American management education is “deeply embedded in a rational mystique” (Coutu, 2006). Explaining why, he argued earlier, “a sense of human control over human destiny and a belief in the importance of leadership are fundamental articles of faith” in a world of ambiguity (March, 1984: 61).

¹⁰ Our understanding of attribution processes (Nisbett and Ross, 1980) tells us that individuals routinely make person attributions for their success (and blame their decision environment for their failures). Therefore, senior business leaders (i.e., potential business school donors) are eager to read about successful leadership practices (see Meindl, Ehrlich, and Dukerich, 1985 and Hayward, Rindova, and Pollock, 2004). They may also be pleased to fund research that investigates astute and courageous business leadership.

¹¹ Of course, this is not to say that business leaders and business scholars should ignore other problems. Consider Burawoy (2015). In his 2014 presidential address to the International Sociological Association, he argued that while we certainly need to worry about ecological catastrophe (p. 25), we also need to be alert to the problems of marketization (p. 18) and both the commodification and, interestingly, ex-commodification of labor, money, nature, and knowledge—leading to increasing inequality based on precarity (labor), indebtedness (money), and dispossession (nature and knowledge) (p. 28). Relatedly, Wilmott (2011) wondered and worried about the ambitions of those who engage in institutional work. He begged institutional workers to right the world's wrongs:

A connection might be forged by appreciating how processes of emancipation—whether conceived in relation to class, race, gender, disability, or a broader hegemonic ideology of anthropocentrism, consumerism, or whatever—involve institutional work ... in the process of struggling to mitigate, and ultimately overcome, socially unnecessary deprivations (e.g., slavery, chauvinism, and neo-liberalism). (p. 70)

Twenty years ago, Margolis and Walsh (2003: 268) began their paper entitled “Misery Loves Companies” with the observation, “The world cries out for repair.” Those words ring as true today as they did then.

My own belief is that we scholars need to say (aloud, of course) exactly what kind of world we want to inhabit and then work to bring it to life. We might do well to turn to moral philosophy for ideas about “the good” and ideas about how that “good” can inform an objective science. Some organizational theorists are eager to take up the challenge. Consider [Burrell, Reed, Calàs, Smircich, and Alvesson's \(1994: 10\)](#) biting and aspirational words as they launched their new journal, *Organization*. They were prescient:

The ethical and political relevance of “organization”—at the end of the century in which any remaining faith in the inherent justice and goodness of the latter has been irreparably shattered by the reality of world war, genocide and ecological destruction—requires further clarification and evaluation ... In the post-Holocaust world of which we are an integral part, it can no longer be assumed that organization is an automatic guarantee of collective material well-being and moral responsibility ... Indeed, the story of the organization of the Holocaust could be made into a textbook of scientific management.

We now recognize that the problems of our times may be unlike any we have seen before. Struggling to capture their essence, we call them “super wicked problems” ([Levin, Cashore, Bernstein, and Auld, 2012](#)) or “grand challenges” ([Ferraro, Etzion, and Gehman, 2015](#)).¹² We may need to embrace a different kind of science to solve these problems and address these challenges. For example, Anne [Tsui \(2016\)](#), the sixty-seventh president of the AOM and a past editor of the *Academy of Management Journal*, recently advocated for a “responsible science.” Quite aware of society’s problems, she argued that we should do research that honors both our epistemic and social values. Leading an effort to transform research in business schools, she and others generated a list of “world-saving” topics that they think should command our research attention ([Tsui, 2017](#)).¹³ [George, Howard-Grenville, Joshi, and Tohany \(2016: 2016–2017\)](#) developed a “Grand Challenge Framework” to help guide just this kind of work.

Looking ahead, I suspect that we will see our science become more forward-looking than it is now. That is, working with people from business, government, and civil society (likely in an inductive fashion—see [Eisenhardt, Graebner, and Sonenshein, 2016](#)), scholars will help to imagine social betterment initiatives and then, crucially, evaluate their efficacy as they unfold. Doing so, we will honor [Levin, Cashore, Bernstein, and Auld's \(2012\)](#) call for “applied forward reasoning” and [Ferraro, Etzion, and Gehman's \(2015\)](#) call for “action experimentation.” Indeed, I believe we will see much more action research ([Coughlan, 2011](#)) and field experimentation ([Grant and Wall, 2009](#); [Eden, 2017](#); [Hauser, Linos, and Rogers, 2017](#)) in the field of organization and management. Embracing agency, our normative

¹² [Levin, Cashore, Bernstein, and Auld \(2012: 124\)](#) argue that “super wicked problems” are marked by four attributes: (a) time is running out; (b) those who cause the problem also seek to provide a solution; (c) the central authority needed to address them is weak or non-existent; and (d) irrational discounting occurs that pushes responses into the future. [Ferraro, Etzion, and Gehman \(2015: 364\)](#) define “grand challenges” by three attributes: (a) they are complex (i.e., marked by many interactions and associations, emergent understandings, and nonlinear dynamics); (b) they confront organizations with radical uncertainty (i.e., actors cannot define the possible future states of the world and therefore cannot forecast the consequences of their present actions, or whether future others will appreciate them); and (c) they are evaluative (i.e., they cut across jurisdictional boundaries, implicating multiple criteria of worth, and revealing new concerns even as they are being tackled).

¹³ The names of the twenty-three colleagues who helped her with this effort can be found here: www.rrbm.network/supporters/founding-members.

aspirations and science, these kinds of methods will allow us to help shape the world as we impartially investigate it.¹⁴

This talk of agency, well-being, and science points to a fourth assumption that undergirds our scholarship. We are reflective. As drawn to the life of the mind as we are to making a better world, we continually reflect upon our efforts. Indeed, we talk endlessly among ourselves about our work's assumptions, boundary conditions, limitations, interest value, and intended, as well as unintended, consequences.¹⁵ Subi Rangan's exercise here is a case in point. If we are to make the progress we envision, we need to be fully aware of our assumptions. [Rynes and Bartunek \(2017\)](#) ended their review talking about hope. I would like to do the same. I sincerely hope that our Society for Progress's effort to make a better world bears fruit.

Addendum

Mission Statements of Top Ten MBA Programs

(Source: US News and World Report and Financial Times)

Harvard University—USNWP 1/FT

- We educate leaders who make a difference in the world.

University of Chicago (Booth)—USNWP 1/FT 9

- Since 1898, we have produced ideas and leaders that shape the world of business. Today, we empower bold thinkers and inquisitive minds to dig deeper, discover more, and shape the future.

University of Pennsylvania (Wharton)—USNWP 3/FT 3

- Wharton's pioneering vision was to produce graduates who would become "pillars of the state, whether in private or in public life." The Wharton School maintains a long tradition of educating visionary leaders in academia, business, government, and not-for-profit organizations. Today Wharton has expanded the scope of this vision to become the most comprehensive source of business knowledge in the world ...

¹⁴ I am grateful to Sandra Waddock for introducing me to the work of Fritjof Chopra, alone (1996) and with Pier Luigi Luisi (2014), and for alerting me to our need to address the systemic problems of the Anthropocene holistically and with deep scholarly imagination.

¹⁵ Note that medicine does the same. As many in business schools embrace the medical school's embrace of science, many in medicine question this practice: "Did the Flexner Report overlook the ethos of medicine in its blind passion for science and education? What was the cost of our success, and who has borne that burden? Review of medical care in the last century documents that the trust and respect that were extended to the profession 50 years ago have been substantially eroded. There has been a fall from grace of our vaunted profession (Rothman, 2000). Physicians have lost their authenticity as trusted healers ... The profession's infatuation with the hyper-rational world of German medicine created an excellence in science that was not balanced by a comparable excellence in clinical caring. Flexner's corpus was all nerves without the life blood of caring" (Duffy, 2011: 273–274, 275). (See also Cooke, Irby, Sullivan, and Ludmerer, 2006.)

Stanford University—USNWP 4/FT 2

- To engage and serve Stanford GSB alumni throughout their lives and to advance Stanford GSB in its mission to develop innovative, principled, and insightful leaders who change the world.

Massachusetts Institute of Technology (Sloan)—USNWP 5

- The mission of the MIT Sloan School of Management is to develop principled, innovative leaders who improve the world and to generate ideas that advance management practice.

Northwestern University (Kellogg)—USNWP 6

- Our purpose is to educate, equip, and inspire leaders who build strong organizations and wisely leverage the power of market to create lasting value.

University of California, Berkeley (Haas)—USNWP 7

- To develop leaders who redefine how we do business.

University of Michigan (Ross)—USNWP 7

- At Michigan Ross, we believe the ultimate goal of our research and teaching is to use business to create a better world. This is our purpose and our passion.

Columbia University—USNWP 9/FT 7

- Our mission is twofold: we are committed to educating and developing leaders and builders of enterprises who create value for their stakeholders and society at large; we accomplish this through our MBA, PhD, and Executive Education programs. We are equally committed to developing new scholars and teachers, and to creating and disseminating pathbreaking knowledge, concepts, and tools which advance the understanding and practice of management; we accomplish this through our faculty research and PhD programs.

Dartmouth College (Tuck)—10

- Tuck educates wise leaders to better the world of business.

The Financial Times Additions

INSEAD—FT 1

- As a global educational institution with a pioneering multi-campus model, our mission is to create an open-minded learning environment that brings together people,

cultures and ideas from around the world, in order to transform individuals and organisations through business education. Through teaching, we develop responsible, thoughtful leaders and entrepreneurs who create value for their organisations and their communities. Through research, we expand the frontiers of knowledge and influence business practice.

University of Cambridge (Judge)—FT 5

- We aim to foster the next generation of women leaders and expand the pool of women with the requisite leadership skills. We conduct cutting edge research to generate insights on creating the cultures, institutions and organisations that will enable more women to become successful leaders. By bringing students, corporations and policy makers more closely together we disseminate our findings and create the forums to translate ideas into practical solutions ... Our goal is to achieve an impact across a wide range of corporate sectors, both profit and non-profit, and to take the initiative to a number of different countries.

London Business School—FT 6

- At London Business School, we strive to have a profound impact on the way the world does business, and the way business impacts the world.

IE University—FT 8

- IE University is committed to its students, faculty and wider academic community. We offer a dynamic, transformational learning environment that shapes the people who will go on to shape the world.

University of Navarra (IESE)—FT 10

- ESE, the Graduate Business School of the University of Navarra, is committed to the development of leaders who aspire to have a deep, positive and lasting impact on people, firms and society; to inspiring leaders to work with a spirit of service and integrity, basing their actions on the highest standards of professionalism and accountability; and to educating leaders to whom we can confidently entrust the future of business and society.

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Assumptions Rational and Not

Reflections on Battilana's and Walsh's Chapters

Kwame Anthony Appiah

One way to understand the presuppositions of a scholarly discipline is historical: we can explore how its current framing of the central questions of the field grew in reaction to earlier such frames. Battilana's and Walsh's fascinating chapters (in this volume) on organizational theory essentially share a narrative in which modern organizational theory, especially as it relates to the organization of business enterprises, arises in reaction to earlier ways of thinking about business using rational choice models. I'll use that framing of the issue in what I have to say. My conclusion will urge a theoretical pluralism that is somewhat in evidence in their contributions.

23.1 The Rational Actor Model: Formal Structure

It's worth distinguishing, first, two different aspects of these earlier rational choice models.

One is what you might call the "formal" dimensions of those models; the other is the informal baggage that often traveled with them.

On the formal side, the basic aim of the rational choice approach is to understand the behavior of people and institutions as arising from the interactions of agents with a very idealized psychology. That psychology essentially assumes, first, that people have *beliefs* and what I'll call "*tastes*." Together these determine their *preferences* among actions: where an agent has a preference for an action A over an action B if, faced with just these two options, they'll choose A. The model therefore assumes that people also have the ability to represent a set of options for action and assign them a place in a ranking.

Beliefs represent the world as being a certain way. Tastes, on the other hand, affect agents' preferences among options by way of their beliefs. Roughly, the tastes identify what the agent is aiming at and the beliefs tell the agent how to get those things. Tastes are taken as given in the model, and they are represented by assigning values called utilities to states of the world. There's no general theory as to how utilities are formed. So there's not much constraint on their content. But there *are* strong formal constraints on the structure of preferences. For any set of options for action the agent represents, their ranking of them must place each of them equal to, above or below, every other option. As Walsh rightly points out, citing Baron and Hannan, sociologists have offered rich accounts of the origins of preferences; and rational choice models that aim to be predictive might profit from building in such approaches.

Beliefs are supposed to be generated by logic and empirical evidence and the model assumes little about the content of this process either but, once more, a great deal about its form. So, in particular, it represents beliefs by assigning probabilities to propositions, where

strongly believing that P is represented as P's having a probability close to 1, and strongly disbelieving it is having a probability close to 0. The general theory says very little about the starting assignments of these probability values, the initial or prior probabilities. It assumes that the process of belief-formation maintains consistency (or, more precisely, probabilistic consistency).¹ The rational belief model assumes, in effect, that the agent never makes logical errors.²

This very small number of elements is taken to describe the relevant features of the psychology of individual agents, thus ignoring, for example, the role of the emotions in shaping behavior and cognition, as well as the actual inconsistency and incompleteness of actual agents' degrees of belief and their preferences. It is, in some respects, an extreme idealization.

But it's not reasonable to object to such an idealizing model just on the grounds that it assumes things that aren't true. As Hans Vaihinger (2009: 15) put it in *The Philosophy of As If*, an idealization just *is* a useful untruth. Idealizations involve "errors—but fruitful errors." And there's no doubt that those parts of modern social science that work with this model have proved fruitful.

23.2 The Rational Actor Model: Informal Baggage

Along with this formal apparatus travel various informal assumptions, also idealizing, which no one would defend as true to actual human psychology either. Sometimes, for example, it's assumed that people are not just rational in this technical sense, but also profit-maximizing, which is equivalent to supposing that every outcome has a money value and their only taste is for more money for themselves over less. That makes them not just implausibly self-interested but also unattractively mercenary.³ On other occasions, it is granted that not everything has a money value, but it's still assumed that tastes are always self-interested; that is, they are always for things for oneself. Again, that's both false of most people—who care about what happens to those they love, for example—and unattractive. But, once more, that doesn't mean it can't be fruitful.

None of these idealizing informal assumptions is a commitment of the basic picture of rationality. None of them, I think, is a completely absurd in every context. If the options for an agent we are considering are choices for a business, it is not absurd to suppose that a manager will be able to assign them probabilities and money values, and that all that they need to know is the expected value of each option. We should not be surprised if they pick the option with the highest expected value.⁴

¹ An assignment of probabilities to propositions is probabilistically consistent if it meets certain basic conditions, such as that

$$\begin{aligned} p(A) &= 1 - p(\text{not-}A), \\ p(A \& C) &\leq p(A), p(C), \end{aligned}$$

and so on.

² Formally, in one simple and familiar version of the model, belief acquisition is the move from one p-function, p , to a later one, p' , by Bayesian conditionalization, where the new p-function is the result of some proposition, P , coming to have probability 1, and every other proposition, Q , comes to have the conditional probability on P that it had in the earlier probability function, where the conditional probability of Q on P is $p(Q \& P)/p(P)$.

³ Usually, if we are thinking of people as profit-maximizers, we assume that money has diminishing marginal utility, so that each additional dollar we get has less utility than the last.

⁴ But notice that this assumes that they are neither risk-averse nor risk-seeking. We'll be assuming, that is, that they will value an option that has a 10 percent chance of giving a million dollars equally to a sure 100,000. Even if we

The version of the theory I've sketched here is meant as a model for explaining the behavior of agents. It's not an account of how they should behave, but an idealized picture of how they do. But one further traveling assumption of the rational choice picture deserves notice: it's the thought that if people were able to behave in this way and did so, that would be rational in a normative sense. They would be doing what they had the best reasons to do.

23.3 Organizational Behavior: Objections

Battilana identifies many features of this family of models that led the students of organizations to reject them descriptively. Human cognitive limitations mean that the demands of consistency that the rational actor model imposed are not going to be met for any actual person. We have cognitive limitations. We leave out relevant facts because we have limited memories. There are usually too many relevant factors for us to keep them all in mind. And, even if we could, we'd be unable to do all the necessary calculations or get them all right, if we *did* do them. On many topics we don't know how to assign a probability to an outcome at all, which we need to do to assess its relevance to our options. And we have limitations of time and capacity to acquire information we know to be relevant.

Once we recognize our rationality is thus bounded, we'll see that there are good reasons why people actually use other strategies than the ones the rational actor model commends. Given our limitations, it might be better to look for options with certain desirable features, satisficing—picking options that are good enough by certain criteria—rather than seeking to maximize anything, let alone money.

And there are also considerations that should constrain our choices in ways other than by imposing costs. Some legal and moral considerations require us to do certain things—report earnings accurately—and not to do others—breach environmental regulations—even if to do so would increase profits (or reputation, or something else we care about). The right way to take an environmental regulation into account isn't to estimate what you'd be charged if you broke it and see if that's less than the gain in profits you could attain. Normative requirements may need to be taken into account in ways that a maximizing approach cannot model.

Then there are factors specific to organizations. Actually, for business managers, money is, as a matter of fact, almost never the only thing that matters. So the informal assumption of profit-maximization goes out the door, whether you use it to explain the behavior of individuals within the organization, as seeking to maximize what they can get from the firm, say, or in defining the overall aims of the organization. The informal assumption that the main motivator for members of business organizations is money ignores things like the need for belonging that Battilana mentions, or the fact that people care, as she also points out, about being assigned tasks that connect with a wider significance. Here the point is not that the rational agency picture is wrong, but that we can explain things about the behavior or organizations that don't rely on that picture. If leadership inspires by connecting work tasks with significance, that is worth knowing.

take account of the diminishing marginal utility of money—so it's \$1,100,000, say—it's not obvious that a reasonable person couldn't prefer the bird in the hand. That's also an assumption that travels with the classical theory, though it's possible to modify the theory to avoid this feature. See [Buchak \(2013\)](#).

Organizational behavior theory thus exhibits the pull we find in social science more generally. On the one hand is the impulse, found in social psychology and sociology, to think of people's behavior and tastes as shaped by their situations—so we identify people's options as the interaction of their institutional role, as a package of dispositions, and the causally relevant features of their situation. Rational choice theorists—in economics and political science and philosophy—tend to think of people's behavior as the result of their individual tastes and beliefs, which shape preferences. It is, perhaps, worth saying that there is more to be learned from taking the best of both approaches than from insisting that only one of them is correct.

23.4 Organization and Business, in Particular

Both chapters assume that organizational theory will spend a lot of time trying to understand the behavior of individual agents. There are at least two pressures to do this. One, which Walsh stresses, is that much of the theory in question, especially in business schools, aims to guide individual managers. It's addressed to them *as* agents. (He also suggests a less charitable motive for the much more substantial assumption that the success of businesses is strongly determined by the agency of their leaders; namely, that successful leaders are underwriting business schools.) This can pose a problem because the explanatory models treat agents as deterministic systems: this is not uniquely a feature of the rational choice picture, which, in effect, predicts that agents will do what the theory says is the rational thing. Even if we accept that the rationality of agents is bounded, we will be trying to develop theories of what they will do. Coming out of a class that teaches this lesson, you may find yourself reacting like the proverbial young man in the Maurice Hare limerick whose illusion of free will has been disturbed.⁵

And that raises the very general philosophical problem that faces all theories of agency; namely, that from the point of view of the theorist, we are natural beings, governed by causal laws. From this standpoint, we belong to what Kant (1964) called the world of the senses, the *Sinnenwelt*. But it's not a standpoint we can adopt when we ourselves act as agents: "All men think of themselves as having a free will," Kant (p. 118) noted. You can't think of your own actions as things that just happen.

Accordingly, he wrote, "for *purposes of action* the footpath of freedom is the only one on which we can make use of reason in our conduct" (ibid.). Here we situate ourselves in what he dubbed the world of the understanding, the *Verstandeswelt*. Faced with an actual decision, you cannot adopt the standpoint of the *Sinnenwelt* and wait and see what you will do. What these theories do, in fact, is treat the actor they are advising as free—living in the world of the understanding—while encouraging them to treat everyone else as a deterministic system—adopting the standpoint of the senses.

But there's a second, very different pressure to adopt agency as a central idea. And that is the following natural line of thought. Organizations consist of individuals interacting with one another. Every truth about them is made true by individual people doing things. The product produced by the business, the service it provides, exists because people make and do things. And what they make and do determines what the organization produces,

⁵ See Hare (1959).

what services it provides. So there *must*, in some sense, be a story about individual agents underlying every truth about organizations.

To see that this fact establishes less than we might hope (or fear), we need the useful distinction between ontological individualism—the claim that *organizational facts are made up of facts about individuals*, so that, in particular, if all the individual facts are the same, the organizational facts can't be different—and methodological individualism, which is the claim that *we must always give explanations of social facts in terms of facts about the individuals composing them*. Notice that methodological individualism doesn't follow from ontological individualism, any more than the fact that every organism is made up of atoms interacting according to natural laws means that we cannot give biological explanations—in population biology, say—that don't mention atoms at all.

So, in particular, suppose that institutional theory, as Walsh describes it, is right to claim that legitimacy comes from using “the practices and procedures defined by prevailing rationalized concepts of organizational work and institutionalized in society.” Practices and procedures that meet these conditions can then be expected to be successfully taken up in organizations: when they are, we can appeal to this theoretical claim. And we can do so without knowing what it is about individual agents and their interactions that makes this true. That is a separable question.

The general point is that there are social facts, stable generalizations that we don't know—and don't need to know—how to derive from the aggregation of individual behaviors. Social facts about organizations can be useful in managing them, even if they aren't couched in terms of the behavior of individual agents.

23.5 What Theory Does

Battilana and Walsh identify some important directions for organizational research, drawing, in Battilana's case, on their parsing of the issues as involving cognition, motivation, agency, and power. It may be interesting to try to connect some of these conclusions with the broader issues I have just laid out. So, take first Battilana's conclusions about cognition. The central thought of the reaction against the rational choice picture was that it ignored our cognitive limitations. The observation that increased computing power and the availability of big data reduce some of the cognitive limitations of businesses means, in effect, that some of the arguments for the use of heuristics in decision-making are weakened. The more we know and the more we can take into account, the larger the fields over which we are able to maximize rather than satisficing. Of course, the cognitive perfection assumed in the most general rational choice model is still infinitely beyond reach. But, as Battilana points out, if we defer the task of decision-making in situations with complex and large-scale data to algorithms, we risk reproducing one of the problems earlier identified with earlier rational choice approaches, namely that they fail to take normative considerations into account in the right way. As I said above, one objection to those earlier approaches was that normative requirements may need to be taken into account in ways that a maximizing approach cannot model. (This is only a *risk*, of course: no doubt the right algorithms will take the appropriate considerations into account in the right way.)

This problem is connected with some of her observations about organizational behavior's treatment of motivation, namely that the field does not currently insist to a sufficient degree on the role not just of motives other than profit—as it has to, in her own special area, the study

of social entrepreneurship—but of moral considerations in particular. This is particularly puzzling, given the central role that Walsh argues of the presupposition that the task of the science of organizations is to help businesses make the world a better place. I share their sense that careful attention to the detailed content and structure of normative considerations should be a central element of organizational theory in business schools.

But if it is your aim to assist those you teach in making the world better, you'll want theory that provides practical help looking forward. And here it is worth underlining that the disciplinary interest in the *explanation* of organizational behavior will not always prove useful. That is because, as the literature on scientific explanation makes clear, explanation and prediction are not always tightly connected. In particular, attempts to understand the behavior of organizations in terms of the interactions of individual agents may not always provide much help in predicting what an organization will actually do. That's in part because the information explanatory theories advert to may not be very easy to get at. This is an underappreciated difficulty of the basic rational choice approach, which requires assumptions about agents' preferences to make its predictions; and these may be extremely hard to uncover. But this is a problem for many theories that assume a richer picture of human agency as well.

Here it may be worth stressing one of Walsh's observations about agency. People in our culture tend to underestimate the role of organizational structure and overestimate the role of individual agency. Stories of heroic leadership can be misleading: if almost anybody in role X would do Y in circumstance C, it doesn't much matter what the internal structure of the agent is. That, I take it, is a major theoretical lesson of the population ecology approach, whose salience in recent organizational theory Walsh stresses.

I have already pointed out that the thought that agency matters, which plays so large a role in both these accounts of the field of organizational behavior, is obviously correct as a claim about ontological individualism. But, as I also said, that does not entail methodological individualism. And as Walsh construes it, it seems to me that claim is in fact not a methodological one but a more substantial empirical claim: there are people whose behavior is causally central to the outcomes for organizations, including large ones, and their behavior is worth studying precisely for that reason.

One way of putting this would be to say that there are individuals whose behavior is worth focusing on if you want to know what an organization will do. It's an empirical question whether those people are only at the top of the administrative hierarchy. Agenda-setting seems like a good example here: the fact that someone is in a position to set the agenda for a decision process gives them a great deal of control over the outcome, especially if they also have influence over other procedures; and that capacity is not always fully in the hands of the CEO.

23.6 Conclusion

Battilana lists in her summary discussion of power a number of things that her students "often assume." Let me quote the passage in full:

that power is a possession, which some people have inherited or developed while others do not have it; that power is only for the few who are ambitious enough to use it, not

the majority; that power requires immoral manipulation and devious coercion to wield, which necessarily would dirty their hands and hearts; and that new digital technologies have transformed power dynamics, such that now everyone is already empowered.

Her point is that these claims constitute a little contribution to organizational theory ... and that they are all mistaken. That is something that aspiring managers need to know. It seems to me that this is an important instance of the general point that useful knowledge about organizations is often going to be stated in terms that do not need to draw on the sort of high-level theory to be found in the debates about the limitations and advantages of rational choice models. In the study of organizations, it will be true, as I have argued elsewhere (Appiah, 2017: x) it is true generally, that the “best chance of understanding the world must be to have a plurality of ways of thinking about it.”

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The Orientation of Economic Sociology

Assumptions and Limits

John W. Meyer

I review in this chapter the empowering and limiting assumptions underlying the emergent academic field of economic sociology.¹ It has expanded rapidly, not only in the curricula of traditional academic departments but also in business and other professional schools. A main focus of this field is on the social consumption side of expanded modern economy: the social status system, now rooted heavily in educational credentials, and its inequalities. I discuss that topic here. How does the organized modern “economy” (including financialized public and non-profit structures) employ, produce, and impact variations in social value among individuals, groups, and societies?

24.1 Background

The contemporary period has seen a great expansion in intellectual attention to the world of for-profit business, but also related issues of proper management, efficiency, accountability, and sustainability in non-profit and governmental structures. Prominently, there is the worldwide expansion of business schools and their degrees—growth far exceeds the very rapid growth of higher education in general, and curricula have greatly expanded to include fields like sociology. Of course, the academic field of economics has grown even more in size and standing.

This overall growth is part of the general expansion of the social sciences at the academic heart of the university and especially in professional schools in business, education, public administration, engineering, and medicine. The expansion is clearly linked to the much-discussed relative decline in the humanities ([Frank and Gabler, 2006](#); Dori and Moon, 2006). In a period of rapid globalization, the sweeping universalistic claims of the social sciences come to take precedence over analyses of history and culture. A good social science student can now discuss and prescribe policy for times and places about which they are entirely ignorant in substance. Of course, the social scientization of traditional cultural arrangements undercuts older notions of ethics and responsibility. It may or may not help construct new notions—a main concern of the larger project of which this chapter is a part.

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Sociology has experienced this special growth. The field is now organized on a worldwide basis, moving especially rapidly into the vacuum created by the decline of Communism. Sociology expands as a purely academic enterprise at the core of the university, but also in the more applied contexts. Its expansion has particularly focused on issues directly related to the economy, now broadly conceived. The study of formal organization is one focus, examining what might be seen as the apparatus of production. This field is dealt with elsewhere in this book (by Profs. Battilana and Walsh).

The other focus of the emergent economic sociology is on the social consumption side of expanded modern economy: the stratification system and its inequalities. I here discuss work in this area.

Economic sociology has not developed around models of its own—efforts to do this have not been very successful. So the field has developed as a sort of “yes, but ...” commentary on economic analyses, noting social forces—especially those linked to social status and its variations—that limit or alter economic processes. Economic sociologists study how labor market outcomes—seen as the choices of people and those who hire and promote them—are affected by social status, identity, group membership, social relationships, and institutionalized patterns of culture and power. They similarly analyze investment opportunities as functions of social or cultural “capital.” And they study the social factors affecting credit and consumer opportunities: for example, institutionalized segregation, discriminatory credit systems, and the like. In all these areas, the field is practically obsessed with analyzing how economic participants are affected by their social status, over and above strictly economic interests and capacities. Dimensions of social status—race, class, gender, education, and organizational position—are shown to have independent effects on economic investment, labor market, consumption, managerial, and technical outcomes.

The baseline for analysis—shared with economics, and with modern liberal ideology in general—is that (1) society is built on individual persons and their behavior (seen as purposive “action”); (2) these persons are to be seen as primordially equal; (3) inequalities in resultant condition should reflect differences in education and organizational position rather than background conditions; and (4) individual status variations can be seen as occurring within national societies. These underlying assumptions limit the field, especially as it appears in business school research and education. They tend to make it more commentary on the limitations of economic analysis than independent models: modern economic sociology lacks much of a picture of modern society, economic or not. Normative dimensions come into the field, but mainly concerned with ways economic justice is seen as distorted by variations in social status and power—gender, race, class, and so on. A broader picture of human society—including global society—is marginalized, along with many of the normative issues involved. And no positive models of corrective structures for the injustices perceived and analyzed are set forward.

24.2 The Starting Point: The Individual

The liberal economy and society, models of which have been dominant for the past seventy years, are built on strong notions of empowered individuals, seen as actors rather than more passive entrants. Indeed, the term actor—as foundational purposive font of

society, not as enactor of a script—has come into common use in the social sciences (Hwang and Colyvas, 2011). Purposive “decisions” produced by individuals and the organizations they create are central to established models of organized society (Luhmann, 2005; March, 1994; Ahrne and Brunsson, 2008). They are clearly very central to dominant models in the academic field of economics—and also in economic sociology.

Older sociologies took another view, seeing individuals and group structures as built on culture, custom, and habit, and thus embedded in institutionalized social life. Individuals themselves tended to be analyzed as derivative on institutional arrangements. Classic social theory was about institutions and was not what would now be called action theory.

Such lines of thought remain in sociology (sometimes, in analyses of social organization, called the “old institutionalism”) but they are not central. Current ideas envision society as produced and changed by individual actors, often assembled into organized structures that are themselves actors (Bromley and Meyer, 2015). In rather extreme analyses, individual actors are *all* that exist in society. All social causation occurs through them, and any analysis must depict this if it is to be properly scientific (famously, Coleman, 1986). The scientism involved leads to the incorporation of normative elements supporting dimensions of cultural individualism. So naturally, this perspective is especially strong in American sociology. But given the dominant position of American social science in the world, it has penetrated everywhere, and it is certainly a feature of sociology as it appears in business schools. Individualism, of course, has left, right, and centrist dimensions: the more conservative elements are little stressed in contemporary sociology, which focuses on human equality more than on social order or progress.

Methodological individualism is a scientistic creed in that it captures both an analytic perspective and a normative frame. Analytically, it sees social change as occurring through the choices of individuals (commonly rational ones, though generally seen as reflecting supra-economic considerations). Normatively, it assesses social desiderata around benefits for individual people. Economic growth is measured per capita, political development as the democratic expression of the will of the people, and socio-cultural freedom as expanded individual choice in matters of family, religion, and culture. Criticisms of narrowly economic versions of this tend to broaden conceptions of individual choice to include wider ranges of empowerment, as in the work of Amartya Sen (2001), but retain the focus on the individual as the bottom-line entity in society. Models that depict highly collective goods like the environment, or the overall health of the world economy and society, are weakly developed.

The institutionalization of all this in world-level normative doctrine has been extreme. Elliott (2007, 2011, 2014) tracks assertions of human rights in global-level treaties and other instruments over the past decades, finding an extraordinary expansion in numbers of such assertions. There is also a dramatic expansion in the types of people explicitly included as “individuals” (varying by age, gender, disability, indigeneity, minority status, immigration status, and so on). The rights asserted expand far beyond basic civil, social, and political ones, to include sweeping cultural and personal ones: the contemporary individual is greatly empowered and can properly opine on the Ultimate. And as the recognized rights of humans are elaborated in national and global discourse, they tend to enter the purview of economic sociology. The disadvantages experienced by gay people, for example, come to be studied by economic sociologists mainly after the gay rights movement makes headway in broader normative discourses.

It should be emphasized that the human rights Elliott recounts are almost always the rights of humans as individuals. Gender rights, for instance, mean that individual women have the rights, not that women as a corporate group have them. Around the world, there are exceptions—sometimes standing inheres in women as collective, for instance in the assignment of public offices. But this is less common, and sometimes controversial (as with affirmative action arrangements). In the treaties Elliott studies, the only consistent exception lies with “indigenous people,” who are sometimes seen as having collective standing. (Of course, a really important exception, which I consider below, is the membership in the sovereign national state.)

The ideal society, thus, seems to be one in which individuals are unconstrained. Their choices are not social constructions but are rooted in something essentialized. This is obviously unrealistic but lies behind both sociological models and normative orders.

Comment: Of course, people live in foundational social entities other than their identity as individuals. Modern sociologies, especially economic ones, tend to treat these broader identities as derivative (unlike anthropologists). But it would be valuable to have analyses starting with social structures not rooted in individualism as foundational: families seen as corporate groups, communities, nations, and indeed the world, with human society seen in toto (Meyer and Risse, 2018). We have, for instance, lost the notion of the welfare of the family over and above that of its individual members, though people commonly act on such considerations. Clearly, the disasters of the first half of the twentieth century helped kill off alternative sociological imageries—statisms and corporatisms have been in ill repute through the whole post-war period. This may have been all to the good as a normative matter, but it certainly has created some impoverishment in sociology as an analytic discipline—and especially in economic sociology. In short, it would be useful to have more models and measures of progress that are not reducible to per capita benefits. Our present individualisms, however virtuous normatively, have intellectual costs.

- (1) Broadening the perspective would enable improved analyses of the constructed character of the identity of the modern individual and the agency attributed to, and often incorporated by, this individual. People who imagine that they are empowered individuals, and who live in institutions (e.g., democracy) built on such assumptions, are obviously different from those living under other assumptions. This becomes especially important because the imagined properties of the modern individual actor change rapidly during recent periods (e.g., individuals are now understood to choose and change gender and sexuality, religious identities, and all sorts of family relationships). A sociology taking individualism for granted has had little capacity to interpret major social changes in the capacities and properties of the “individual.” These have involved the great expansion of matters seen as economic—a concept that now includes all sorts of behavior formerly seen as structured under other institutional arrangements, from family to community. For instance, the comforts provided by the old priests are now often given by professionalized therapists, whose efforts are counted as part of the economy and contribute to the gross domestic product.
- (2) Seeing the social construction of modern individualism would also permit better analyses of economic society as rooted in other structures than the individual, corresponding to much modern anti-liberal ideology: families, communities, nations, ethnic groups, and so on. All these baseline entities are now treated as derivative—choices of or reactions to modern economic individualism. Thus, a

common and mistaken historical interpretation of welfare democracy has it as a reaction to economic forces, rather than a construction of cultural individualism. It is a current mistake to see contemporary anti-liberalism as principally economic in character, rather than a reaction to the rise of other dimensions of the status system (e.g., education, professionalism, organizational power).

24.3 Individuals Are Ultimately Equal

If the individuals, rather than, for instance, families, are the foundational elements of social and economic life, how are we to assess their condition? Here, the sociological perspective, along with the normative ideals dominating the world, gives a definite and resolute answer. The individuals are equal, in ultimate religious and legal conceptions. The global human rights system that Elliott reports asserts the rights of proliferating groups, practically always in terms of equality. Special protections may be specified—for children, the elderly, women, disabled people, and so on—but these are generally formulated as defenses of equality. [Berkovitch \(1999\)](#), for instance, notes that older global assertions of special protections for women in their capacities as mothers give way in the post-war decades to assertions of equality.

The contemporary depiction of the ideal of human equality—extreme and sweeping across the globe—is dramatic, and surprisingly uncontested, perhaps because of the stigmatization of common alternatives. It is a normative assertion, but also provides a base against which to assess ongoing practice. And it occurs decoupled to a now global social world filled with extreme inequalities of all sorts: these are seen as leftovers of the past, or constructions of present power imbalances to be attenuated by corrective policy. And they are seen as improperly decoupled from normative ideals—and thus the focus of much effort at corrective action. Economic sociologists attend to inequalities less in analyses of their roots than in descriptions of the decoupling involved, and thus in their failure to conform to ideals.

The most visible and most measurable inequalities occur in economic arenas, perhaps especially with monetarization of values. These are the core foci of economic sociology. Common research agendas look for inequalities built around gender: perhaps distorted socialization has limited the capacities or aspirations of women. Parents, teachers, and school arrangements may discriminate. Access to professional training may be restricted, or women may be channeled into dead-end roles. Hiring and promotion discrimination may occur. And with almost everything else held constant, women may be paid less than men. Cautious analyses see much of this as built into the socialized (and potentially correctable) choices of the women, who may prefer the social benefits of family more than economic gains: more commonly, analysts see discriminatory activities as built into the perceptions and experiences of the people making the real decisions, and/or the social pressures of family life.

Very similar lines of research focus on general inequalities based on ethnicity and race; or social class background. Other studies focus on more specialized inequalities—disability, for instance, or the status of people as immigrants. Extensions of this perspective focus on inequalities within the organized economy itself: the unfair advantages of people of particular status, in special network settings and structures, or in advantageously located organizations. Thus, a range of social assets is envisioned: to make analyses seem more

scientific or economic, the term “capital” is often employed—so we get terms like social, cultural, or relational capital to depict unequal assets producing unequal outcomes.

The search for, and explanation of, inequality is the main business of contemporary economic sociology. Inequality in the world is extreme, and there is much to study. But the situation is odd, and much is left out. It is strange that all of organized social structure is seen as a sort of gigantic social problem assessed against a normative model of human equality. The baseline perspective is one in which there is perfect equality, or at least perfect equality of opportunity (and resultant social mobility). Against this past or future Eden, actual society is seen as Fallen, and as requiring reform.

Comment: The fields of economic sociology and social stratification are often seen as a bit boring (though often high in technical quality). They might be more analytically creative if they contained more models treating inequalities as baselines. This might involve more attention to the goods of other structures than the individual person. In actual societies, inequalities are legitimated in terms of a range of models. These may be normatively unacceptable, but ignoring their existence has intellectual costs in understanding. Much anti-liberal mobilization has roots in them: the current resistance to immigration may reflect attachment to community more than defense of economic positions.

Analyses that started with assumptions of human inequality, in deference to goods of families and communities and the whole world, would then treat the modern and post-modern production of equalities as problematic and requiring explanation: the striking recent reconceptions of the status of women in the workplace, or of gay and lesbian people in society generally, represent huge equalitarian social changes by no means obvious in origin. It is a major failing of economic sociology that it is filled with analyses of human inequality but has few models accounting for the production of equalities, and claims to equality. A most important social status in contemporary stratification systems is human personhood—a symbolic classification on which all are equal, and against which other inequalities are assessed as requiring correction.

- (1) Thus, a shift in assumptions would permit analyses of the rise and expansion of norms of equality, and their consequences for social mobilization and change: The economic sociologists now seem to assume equality is a natural past and future condition, marred only by the evils of the present. There are dozens of analyses of why women are infrequently in engineering: and almost no analyses of why they increasingly *are* there (Ramirez and Wotipka, 2001).
- (2) Models assuming inequality would also be useful in helping to explain and understand the impact of non-individualistic ontologies—as these are quite central to the development of human society. It would be useful to activate older ideas in sociology—like classic conflict theories—that tended to assume inequality as a very natural condition, and movements to equality as requiring explanation.

24.4 Education, Formal Organization, and the Production and Legitimation of Individual Inequality

The modern sense that social development and progress result from the choices and actions of individuals has produced an extraordinary commitment to the improvement of the persons thought to comprise society. Extreme educational expansion has resulted, on a

worldwide scale. Mass education, universal in aspiration and usually in reality, is found everywhere (Meyer et al., 1992). And especially since the Second World War, higher education has exploded in scale—reaching to something like 40 percent of a cohort of young people (Schofer and Meyer, 2005).

The education involved is conceived in individualist terms: the student is not simply trained to conform as member of a group but is to increasingly choose and act as an individual actor in local, national, and even an imagined global society (Meyer et al., 2010).

Education is not simply a competence-producing resource provided for young persons. It is itself a central social status—indicated by degrees that have meaning everywhere and that retain this meaning through the life course. Education and its certificates are counted up in national statistics measuring progress and are now counted in the statements of central world institutions (e.g., UNESCO, the World Bank, and the Organisation for Economic Cooperation and Development (OECD)). And educational improvement is a main goal of the collective institutions of world society.

The expansion of education reflects a picture of society as rooted in individual persons. It also reflects a notion that the individuals are normatively equal—and that education itself may correct the injustices of old inequalities (e.g., of class or race). But further, education is conceived as a legitimate basis on which to allocate new functional inequalities in organized society and economy. The centrality of education supports the rise of rationalized formal organization in state and society as an appropriate and equitable form (Bromley and Meyer, 2015). If the differentiated modern system inevitably produces and organizes some inequalities in position, they should in this system be properly structured in formalized and rationalized roles, and merit should allocate these roles. Education becomes the main legitimating criterion for sorting people out everywhere in the modern world. Indeed, in all the world's stratification systems, education (and the educational component of occupational roles in the formal organizations that populate the world) increasingly becomes the main component of measures of individual stratificational position. Its role far exceeds straightforward economic measures like individual income. In the organized modern society, education (and the organizations that value it) tends to determine economic success, far more than more direct market assessments of work.

Sociologists, then, prominently assess objectionable inequalities among individuals by tracing them back to inequalities in access to educational success. Higher-status children get better schools and/or higher-status familial cultures equip them to perform better on educational outcomes (themselves often seen as riddled with bias).

The sociologists, however, do not much question the role of education in the assignment of social positions. It is unjust that the boss's son has unequal access to the MBA, but not that the MBA becomes a requirement for high administrative positions. In this sense, the sociologists subscribe to the functional logics of the modern system rather than standing back to analyze these. The proposal of Ivan Illich (1971) to prohibit the listing of educational achievements in applications for positions—in the same way that we would see the listing of familial background successes as illicit—has fallen on deaf sociological ears.

As business has become increasingly organized in globalizing society, educational credentials have become more and more central as legitimating structures. The astonishing expansion of business schools and the worldwide elaboration of the MBA are important consequences: economic sociologists tend to take this for granted and have very limited analyses of why it occurs. They tend to imagine that the MBA is functionally valuable as human capital, despite much skeptical empirical evidence of any functional value.

Comment: The world society of equal individuals is filled with inequalities: the decoupling between equalitarian ideals and extraordinarily unequal practices is extreme. So there are many movements for correction—the implementation of the ideals. But there are massive institutions legitimizing the inequalities involved. In practice in the world, inequalities are best legitimated with reference to individual education, which expands and becomes central to the global stratification system in a world economy filled with large-scale rationalized organizations. Sociological models take for granted this whole system rather than analyzing its development, and are oriented to the analysis of unjust biases within its order.

It would be good to have more sociological models that treated the rise of large-scale rationalized organizations built on enormously expanded (and highly stratified) education as a problematic reflection of dominant ideologies (rather than functional necessities for progress). In this way, we could better explain the rise of oppositions to the modern order on every front—they are better conceived as oppositions to an organized and schooled and now global stratification system than as a set of inequalities in income or access to income. Some of these oppositions attack the whole edifice of modernity (e.g., Boko Haram). More often, they organize “populist” reactions within the established models. Conflict in the contemporary world is built around political, social, and cultural status more than economic class conflict. Models that treated organizational and educational inequality as themselves problematic would help explain matters.

- (1) Overall, sociological analyses (like economic ones) of the extraordinary rise of the service sector as the central feature of the economy are impoverished. This sector is in good part constructed by the educational system, rather than by more natural developments. Giving up the assumption that education means merit, and that a stratification system built on education makes functional sense, would permit a much-improved analysis of the culture of contemporary modern (and post-modern) liberal society.
- (2) Education is seen by the economic sociologists as economically functional for the modern economy. This produces misdirected analyses of where education expands (now worldwide), and its central substantive character (focused more on “human development” than on “human capital”). And it takes for granted rather than analyzing the core ideologies underlying modern education: so it is poorly equipped to analyze contemporary anti-liberal and anti-education movements.

24.5 The Globalization of the Society of Nominally Equal Individuals

Sociological theory and research have developed over the past two centuries around notions of society as the object of analysis. Society was conceived in national terms, though one could analyze more local structures, as the anthropologists did. Society was increasingly conceived as made up of individual persons—and these persons were increasingly seen as central actors in social construction and change. The individuals involved were the citizens of a national

society—commonly thought organized around a national state. Individual standing, and inequalities in this standing, were thus analyzed within nation-state contexts. The realities of a global economy have rendered this whole perspective more and more problematic. But the economic sociologists—and sociologists in general—have not caught up to the changes in social realities. Expanded educational and organizational arrangements have created global systems, but the economic sociologists focus principally on national dimensions: this limits analyses of potentially interesting and important phenomena.

Post-war globalization—economic, military, political, social, and cultural—created in popular awareness more than academic analysis something of a vision of society as global. The effect was intensified in the neoliberal period that followed on the collapse of Communism. So citizen rights became human rights. And membership in national society became a dimension—and a very unequal one—in the newly imagined world society (Meyer and Risse, 2018).

In an older world, national boundaries defined distinct national worlds within which equality and inequality could be critically analyzed. Comparisons between countries were more weakly developed, and much less intense as a basis of normative assessment. Globalization changes that and makes it possible and necessary to have data and analyses showing the enormous differences among national societies seen in terms of the welfare of individuals. For example, differences among countries in the educational access of women were once matters of non-comparable cultural variation. In the new globalized world, they are injustices and can in principle be the objects of detailed sociological inquiry.

All this is intensified with the educational (and organizational) globalization of world society. Two teachers with the same educational background in two different countries playing the same role will have radically different situations in terms of economic status. And there is no legitimating justification: their educations are equal or similar.

Naturally, this situation generates a good deal of social mobilization in the world. The situation is made more extreme because the more educated classes of people around the world—schooled in institutions that are and claim to be quite similar—have a unified culture not available to the lower educational classes. They thus make up what is, and is seen to be, a dominant elite class in a potentially exploitive relationship with their domestic social inferiors. The situation invites conflict built more around educational status than economic power, though the two are obviously closely related.

Comment: The comparison sets around which people and groups in world society organize their assessments of self and others have been radically globalized and universalized in the current period. As people think where they might best live and work, much broader comparisons arise than in the past. Conceptions of justice and injustice are thus transformed. The expansion of education, and of the formally organized society, defines social status in rather universalistic terms, permitting and encouraging global comparisons and perspectives on matters of justice and power.

It would be useful to have models of social stratification that cut across national boundaries and recognize the transnational character of much educational and organizational status. Such models could help us better explain the forms of social mobilization that arise in response to global social changes: these models are only secondarily economic in character, and the reactions they produce are economic to a very limited extent. The expansion

of shared social status at elite levels produced by globalized educational and organizational systems permits shared elite identities and also facilitates both elite and popular reactions. Thus:

- (1) It would be useful to see local and national and global notions of “society” as variable constructions, rather dramatically shifting over time. This would permit a better understanding of the rapid and worldwide rise of liberal and economic orientations since the Second World War, especially in the recent neoliberal period. People and social groups everywhere have enhanced inclinations to assess their condition against global reference points. They change ideas and practices rapidly in bursts of modernization. But they also change their standards of justice and injustice against expanding global norms. So modernizations calm some conflicts, but generate new ones—sometimes, as with religious conflicts, on a global scale.
- (2) Models focusing on a more global society would thus also permit better analyses of the current reactions to these orientations, sometimes taking place at the global level. Contemporary anti-liberalisms are not simply local reactions to supra-national forces—they can be themselves global in character and organized on global levels.

24.6 Conclusions

Economic sociology has tended to be cautious and conservative in character, taking for granted the nominally economic features of contemporary global social life. It is a “yes, but ...” take-off from modern economic thought. It shares the limited ideological conception of society as made up of discrete acting individuals, but proposes these people are embedded in empowering and constraining networks of cognitive and social relationship. This produces research of high technical quality, working with available data collected by the economic system itself, and with forms of conventional analysis. One would be hard pressed, however, to describe the field as intellectually interesting: it derives its passions from the normative analysis of deviations from imagined human equality more than from explanations of complex societal structures.

The field would benefit by stepping back analytically from its normative commitment to individualist conceptions of society, and by seeing these commitments as indeed central to modern culture. Thus:

- (1) Economy and society are made up of other foundational entities than individuals: individualism is a culture, not a baseline in reality.
- (2) Human equality is a highly constructed element, not a natural baseline with which to start analysis. It would be useful to have more models and analyses starting with inequalities as baselines. This would permit attention to the peculiar modern focus on equality as a consequence rather than an initial condition.
- (3) Education is not merit by definition, though modern society is constructed, organized, and legitimated as if it were. The constructed and constructing character of education in the building of the massively organized society should be the focus of

analysis, as it is the basis of much social resistance and reaction. In particular, sociology in business schools ought to attend to explanations of why business schools exist and prosper.

- (4) The societal context of action is decreasingly the nation-state. Membership in a global human society is an increasing reference point in the assessments on which people, groups, and nations behave. In the stratification of this society, education, organization, and *national membership* can be contested and conflictful elements. One effect of globalization is the rise of a worldwide credentialing system built around business schools and their MBAs, which critics see as an unaccountable dominating class structure.

I suggest, thus, a liberation of economic sociology from its prison in economic reasoning. This would permit better analyses of the sweeping social changes themselves generated by institutionalized liberalism. And it would permit better analyses of current reactions to them.

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Assumptions Underlying Sociological Models in Business Schools

Gerald F. Davis

The social sciences as we know them arose roughly contemporaneously with the rise of the large corporation and the advent of pragmatism in the United States. As such, making sense of the corporation, as one of the central institutions of twentieth-century capitalism, has been a key concern of sociology, particularly since the advent of organization theory in the 1950s. Yet sociologists rarely set foot in business schools until the 1970s; subsequently, however, there has been a large-scale migration of organization theorists and economic sociologists from sociology to business, so much so that most of the research on these topics published in top sociology journals originates within business schools—for better and for worse.

This chapter summarizes the conjoined histories of sociology and the corporation over the past 130 years and then shares what I see as the five most important assumptions underlying sociological work within business schools. I note at the start that the assumptions that made sense for much of the twentieth century may no longer hold in the twenty-first.

25.1 Sociology and the Corporation

The modern corporation and the academic discipline of sociology in the US emerged simultaneously around the turn of the twentieth century, and their development has been intertwined ever since. Corporations set in play many of the social processes that are central themes in the field of sociology. Mergers consolidated regional competitors into corporate oligopolies on a national scale, and the emergence of mass production encouraged urbanization. Corporate industrialization, urbanization, and mass migration thus defined some of the central topics of the field of sociology, which was being formalized as an academic discipline through the works of Emile Durkheim and Max Weber.

The growing dominance of large corporations early in the century led to a populist backlash over concerns about their economic and political power. In the US, Progressives sought to limit the power of these corporations and the banks that financed them. Future Supreme Court justice Louis Brandeis (1914) warned of the dangers of concentrated financial control and described an “endless chain” of interlocking directors controlling the economy, centered around a few New York banks. Lenin (1937) observed similar trends in Germany, suggesting that concentrated industry controlled by concentrated finance was an inevitable feature of industrial capitalism. However, while banks continued to play a central role in the German economy, their dominance in the US was short-lived.

A second merger wave during the 1920s resulted in the 200 largest corporations controlling half of the nation's business assets. Berle and Means (1932) described the resulting corporate-centered economy as a new economic system, akin to feudalism, where executives wielded immense power with little constraint from their dispersed shareholders. This shift made corporations central economic and social institutions for generations to come. Government regulation during the Second World War led to the development of modern human resource management, with firms creating benefits like health insurance that persist to this day. Corporations became responsible for the health, welfare, and retirement security of employees and their dependents, becoming ever more enveloping social institutions.

Post-war sociologists built on the idea that corporations were organizing principles of modern society. Ralf Dahrendorf (1959) argued that the separation of corporate ownership and control described by Berle and Means disrupted traditional class relations. Society was no longer divided into owners and workers but into management and labor based on authority. C. Wright Mills (1956) identified a new power elite, consisting of corporate executives, government, and military leaders, shaping societal outcomes.

25.2 Rise of Organization Theory

In a society dominated by large corporations, organization theory became a central sub-field within sociology (Perrow, 1991). Emerging in the late 1950s as a separate domain, organization theory sought to create a new understanding of society centered on corporations and other organizations. James D. Thompson (1967) synthesized early insights into a more or less coherent statement, explaining the placement of organizational boundaries, sources of power, and the impact of societal movements on organizational structures. The theory suggested that understanding corporations was key to understanding society.

Researchers examined how corporate structures influenced societal outcomes such as the sources and uses of political power and the origins of economic inequality. Studies showed that overlapping board memberships led to cohesive corporate behavior, contrary to the expected competitive environment. Research on economic mobility and inequality highlighted how organizational processes determined career pathways and compensation.

In summary, the emergence and evolution of modern corporations and sociology have been intertwined since the turn of the twentieth century. The rise of large corporations led to significant economic and political changes, prompting regulatory efforts and shaping societal structures. Sociological studies have provided valuable insights into the role of corporations as central actors in modern society, influencing class relations, power dynamics, and economic mobility.

25.3 Social Sciences in the Business School

Although sociology and the corporation grew up together in the United States, the discipline of sociology had at most limited representation within business schools until the 1960s and 1970s. To a large degree, business schools' first decades were decidedly more oriented toward practice rather than theory, and faculty often consisted of grizzled veterans from

the world of commerce. Business schools were essentially vocational schools. This began to change in 1959 after the simultaneous publication of two books lamenting the state of business education: *Higher Education for Business*, written by Robert Gordon and James Howell and funded by the Ford Foundation, and *The Education of American Business Men*, funded by the Carnegie Corporation and authored by Frank Pierson. The studies found that business administration was less a true profession than a “vague, shifting, formless subject” (Hutchins, 1960). Pierson found that “students in business schools have predominantly pragmatic attitudes, come from families of low income and weak educational background, and have relatively low test scores on entrance,” and typically graduate into standard corporate jobs (Hutchins, 1960). Faculty were not much more inspiring: according to Gordon and Howell, “Much if not most research in the business schools attempts merely to describe current practice or, going a short step further, to develop normative rules which summarize what is considered to be the best of prevailing practice. The business literature is not, in general, characterized by challenging hypotheses, well developed conceptual frameworks, the use of sophisticated research techniques, penetrating analysis, the use of evidence drawn from the relevant underlying disciplines—or very significant conclusions” (1959: 379). They urged that business schools should educate students in the social and behavioral sciences, and that these subjects—psychology, sociology, anthropology—should be taught by people trained in their disciplines.

In subsequent years, elite business schools began recruiting social scientists from core disciplines such as economics, psychology, and sociology in bulk. Few were more aggressive in this approach than Stanford’s Graduate School of Business, where faculty recruiting, evaluation, and promotion practices came to valorize publication in core social science disciplines over publication in business-specific outlets. This approach came to dominate top-ranked business schools, to such an extent that the vast majority of organization theorists migrated from sociology departments to schools of business. Indeed, most articles on organizations in any given volume of the *American Journal of Sociology* or the *American Sociological Review* are likely to originate from business schools. (At my own university, the sociology department—long revered for its research on organizations and economic sociology—has at most a handful of doctoral students focused on organizations, while the business school is well populated with organizational scholars.)

25.4 Five Sociological Assumptions and Their Implications

Sociological theory and research are distinctive from the other social sciences in several ways. As a field, sociology tends to venerate its elders, particularly Marx, Weber, and Durkheim (only one of whom would have self-identified as a sociologist). The oft-cited quip in sociology is that you can’t publish a finding in sociology unless you can locate a dead German who said it first. Many other fields, in contrast, have a continually receding horizon of knowledge in which anything published more than five years ago is probably now irrelevant. Associated with venerating the elders is a belief that books (rather than articles) are often the best vessel for conveying arguments. Some ideas take more than thirty-five double-spaced pages to develop and convey; a really nice regression table may not be sufficient to do the trick. Last, with the exception of some sub-fields, sociologists tend to eschew methodological individualism and to believe in the existence of “social facts.”

Below are five assumptions that will be familiar to sociologically inclined scholars housed in business schools.

Aggregates such as “organization,” “class,” and “society” are meaningful units with distinctive collective properties. Sociological analysis in business schools generally assumes that organizations have a meaningful “entitativity” and are not simply a convenient shorthand for individual actions. In the book that founded organization theory as a discipline, [March and Simon \(1958: 4\)](#) stated that “the high specificity of structure and coordination within organizations ... marks off the individual organization as a sociological unit comparable in significance to the individual organism in biology.”

This is not uncontroversial: there is a strong current of methodological individualism in the social sciences that argues that any explanation must ultimately be in terms of individuals:

- “The laws of the phenomena of society are, and can be, nothing but the actions and passions of human beings,” namely “the laws of individual human nature.” (John Stuart Mill)
- “There is no other way toward an understanding of social phenomena but through our understanding of individual actions directed toward other people and guided by their expected behavior.” (Friedrich Hayek)
- “We should never be satisfied by an explanation in terms of so-called ‘collectives.’” (Karl Popper)
- “Those who prefer to conduct inquiry into the relationships among classes, states, and other organizations as such, and without attempts to reduce analysis to the individuals who participate, do not, in my view, pass muster as social scientists in any useful sense of the term.” (James Buchanan)
- “... most organizations are simply *legal fictions* which serve as a nexus for a set of contracting relationships between individuals ... We seldom fall into the trap of characterizing the wheat or stock market as an individual, but we often make this error by thinking about organizations as if they were persons with motivations and intentions.” (Michael Jensen and William Meckling)

Organizational sociologists, in contrast, see organizations as fundamental, meaningful ontological units in society with their own tangible reality and rules of motion. You can count them, classify them, compare them. They have boundaries, motivations, purpose. This is an ontological commitment, but it also implies an ethical commitment: organizations can be held accountable for things.

This kind of claim was uncontroversial for most of the twentieth century, when corporations like General Motors and AT&T were expected to last indefinitely, and to provide lifetime employment, career ladders, health insurance, retirement pensions, and good works for their surrounding communities ([Davis, 2016](#)). When Ford Motor Company was vertically integrated all the way into the earth (from which it wrested coal, iron, oak lumber, and rubber from plantations in Brazil), it was clear enough who or what should be held responsible for the corporation’s actions. Today, however, most products purchased in the US are untouched by employees of the company whose name is on the label, from Nike sneakers to the heparin one is injected with en route to surgery. Only about one in 100 US corporations whose products contained electronic components could say with any certainty that their

goods were not funding armed conflict in the Democratic Republic of the Congo. It took most of a year for Nestle to verify that, as activists had claimed, its Purina seafood-flavored cat chow included shrimp caught by slave labor off the coast of Thailand. American capitalism today is so disaggregated that it faces a “responsibility paradox”: outside constituencies hold corporations increasingly accountable even as their supply chains become increasingly dispersed and inscrutable. (But I can tell you from personal experience that consumers do not appreciate being told that their purchases are funding atrocities.)

Membership in an organization is a crucial source of identity and social connection for people. Jim March has contrasted a utilitarian model of human action, in which actors have interests and make choices in pursuit of those interests, with an alternative identity-based approach in which individuals ask: what kind of person am I? What is this situation? What does a person like me do in a situation like this? In this context, figuring out “What kind of person am I?” (that is, one’s *identity*) is central to one’s choice behavior. Organizations and professions can provide compelling sources of identity.

People in industrial economies spend a large part of their lives enveloped within organizations. When they join an organization, they are socialized into its culture, which serves as a kind of operating system providing (usually implicit) answers to questions such as (hat tip to Ed Schein):

- The nature of *reality and truth*: how are “facts” determined? How do we make decisions?
- The nature of *human nature*: are people fundamentally good or bad, fixed, or changeable?
- The nature of *human activity*: what are the “right” things for people to do? What is the best way to influence or control human action?
- The nature of *human relationships*: how should people relate to each other—cooperation or competition, individualism or collaboration?

Moreover, the organization confers an identity on participants: where we work provides a sense of who we are and shapes the kinds of interactions we have with others. Writing in the 1950s, economist Carl Kaysen (1957) stated that “The whole labor force of the modern corporation is, insofar as possible, turned into a corps of lifetime employees, with great emphasis on stability of employment.” Through its enveloping labor practices, “membership in the modern corporation becomes the single strongest social force shaping its career members.” They became, in effect, organization men, and their experiences at work carry over into other aspects of their lives (including, for instance, their values around childrearing).

The enduring personality imprints from one’s place of work seemed evident during the days of career employment and organization men. Increasingly, however, the identity-bestowing effects of organizations are ephemeral, because even the people who clock in and out each day may work *at* a particular organization, but not *for* it. In 2019 Google has 102,000 employees around the world, but an even larger number of “temps, vendors, and contractors” (TVCs), recognizable by their red name badges. TVCs at Google (and similar firms) are comparable to the 1,000,000+ Filipino laborers in Saudi Arabia, who may work for years but never attain citizenship. The catchment area for the “imagined community” is increasingly problematic in our contemporary world of fissured workplaces. There is reason to expect that this format will become even more prevalent into the future.

An actor's position in a network—the configuration of their connections with other actors—can be as important as their individual attributes in shaping perceptions, decisions, and actions. Herbert Simon proposed that, in contrast to simple models of choice in intro economics, individuals are boundedly rational and that they typically “satisfice” rather than maximize (see [Simon, 1979](#)). Bounded rationality is consistent with our knowledge of actual human choice behavior, and it assumes that decision makers have incomplete and inaccurate information about alternatives and consequences, and they opt for actions that are expected to lead to outcomes deemed satisfactory. For boundedly rational individuals, the people around us—our networks—are consequential sources of information and evaluation.

We might imagine that people and organizations process information and make decisions on the basis of individualized cost–benefit analyses rooted in their own preferences. But sociologists reflexively look to social networks as a powerful influence on what people perceive, what they value, and how they act. Networks are pervasive channels for the flow of information (e.g., the spread of rumors) and can convey normative influences (e.g., how many of your friends are wearing MAGA hats). An implication of this is that the shape of networks can be an important influence on social dynamics: just as a virus might spread much more quickly in a dense urban area than in a sparse rural place, rumors or fads are prone to spread faster in dense networks than sparse ones, and some people are much more contagious than others due to the profile of their contact networks. (There is a very large literature on mapping social networks, with lots of fun terms like “geodesic” and “eigenvector centrality.”) And some kinds of network positions provide advantages for those who occupy them.

Networks have gone from being a peripheral area of research, to a fetching metaphor, to a central way of understanding contemporary social life. At my school we teach social network analysis to all of our undergraduates, complete with software and nerd terminology. One sign that this way of thinking has made the big time is the arrival of China's “social credit” system in which individuals' credit scores hold them responsible for the actions and social media activities of their network contacts. If your friends on social media are identified at an anti-government rally, or say something snarky online, it might bring down your credit score and raise your mortgage rate.

Organizations are especially consequential sources of economic stratification and mobility. Income inequality in society is largely the result of processes that happen in organizations, and economic mobility—how people move up or down the socio-economic ladder—depends heavily on the structure of organizations ([Baron, 1984](#)). I wrote elsewhere ([Davis, 2017](#): 658),

The distribution of income in industrialized societies happens primarily through organizational processes. Who gets hired, how they are evaluated, how they are paid and how they are promoted or fired all happen in organizations through the employment relation. Organizational structures are therefore the fulcrum for the distribution of individual rewards. To understand who gets what, we need to know how employing organizations are structured.

For much of the post-war era, compensation rates for jobs came from bureaucratic processes that were more or less protected from external markets; these bureaucratic processes in turn

gave people a legible map for how to move up in the world (from the proverbial mailroom to the executive suite). In the US, the availability of well-paid employment in the industrial North was largely responsible for the “great migration” and helped create a large and (relatively) diverse middle class. Conversely, the changing “demography” of corporations (how big they are, how long they last, how they are structured, how they hire and pay) can have a substantial effect on patterns of inequality and mobility.

Around the world, there is a shockingly large connection between the size of a country’s largest business employers and its level of income equality. The most equal economies on earth (Denmark, Sweden, Switzerland, the Netherlands) are home to some of the world’s largest employers, particularly relative to their populations. (Denmark’s biggest domestic firm has a half-million employees, about the same as China’s biggest domestic firm.) In contrast, the most unequal countries (Brazil, Colombia, South Africa, Bangladesh) can’t manage to grow a firm with even 100,000 employees. We can imagine some different causal pathways, but it is clear that there is a strong relation between the types of organizations an economy has and its level of inequality.

“Evolution” and “contagion” are useful metaphors for social stability and change, particularly when thinking about organization and other institutions. Those who write and teach about organizations and industry seem to find biological metaphors almost utterly inescapable. Two that are especially influential are evolution and contagion. Strategists describe industry ecosystems, niches, symbiosis, and other dynamics using terms borrowed from evolutionary thinking (even though some of the essential elements of natural selection, such as reproduction and inheritance, are absent or problematic). A core insight, however, is that for many reasons organizations and other institutions tend toward inertia, looking and acting much the same over time in spite of substantial changes in their surrounding environments; as a result, changes in the kinds of organizations we see often results from the death of inert incumbent organizations and their replacement by challengers bearing new ways of doing things, rather than by flexible change among incumbents. Organizations become “institutionalized” (valued in themselves, above and beyond their usefulness as tools) and thus resistant to fundamental change.

When it does occur, change among existing organizations often happens via contagion, in which organizations emulate what their contacts, competitors, or role models do, sometimes in the absence of compelling evidence that the practice actually works. (“Contacts” can be neighbors, alliance partners, firms sharing directors, fellow members of associations, and so on.) Thus, populations of organizations are often subject to faddish behavior; some of these fads can stick long enough to become part of the standard repertoire routinely adopted by organizations (DiMaggio and Powell, 1983). Going viral isn’t just for memes and K-pop bands.

“Power” is a controversial construct that students love. The term “power” is used routinely in business, but it is a problematic construct; as Jim March might have said, we allude to power when we don’t have anything better to explain things. Goldman Sachs, Google, and Walmart all seem powerful, but finding a commensurable metric for these three would be tricky. In spite of this, courses on power and politics are highly popular among business students (most of whom want to be powerful). In this context, sociologists typically rely on a relational or exchange-based view of power, in which power comes from having exclusive and discretionary control over resources that are valued by individuals or organizations. That is, power is not an attribute of an individual in isolation (such as how much

you can bench-press) but is a property of a relationship: you are powerful to the extent that others depend on you for resources you control that are critical to them, especially when there are few alternatives. (“Resources” in this context are purposely vague and can include information, talent, capital, networks, tangible goods, and more.)

Related to “power” is the concept of “size.” We often hear bad things about giant corporations and nod as if we know what “giant” means. But as Wittgenstein once asked, “How do you know when it’s noon on the sun?” During the formative years of organization theory, different measures of size were highly correlated: companies with large revenues tended to have many employees, large asset bases, and big market capitalizations. “Bigness” on any of these measures was highly correlated with bigness on all the rest, and scholars could therefore use the measures more or less interchangeably. But the correlations among these measures have gone down continuously over recent decades, particularly in the US, as asset-lite models have spread in both manufacturing and services. The corporations with the largest market capitalizations today are primarily tech conglomerates with relatively modest employment (Alphabet, Meta, Microsoft, Apple). For instance, at this writing chipmaker Nvidia has a market cap of \$2.7 trillion, yet fewer than 30,000 employees globally. Companies with the biggest revenues might have few employees and modest market caps—drug distributors McKesson and Cencora (formerly Amerisource Bergen) are routinely among the ten largest Fortune 500 companies, but Cencora has 40,000 employees and a market cap of \$10 billion. Giant employers like retailers Kroger or Home Depot may have modest market caps and comparatively moderate revenues. And Zoom, with 300 million daily users, rents server space from Amazon and Oracle and has fewer than 8,000 employees—about 2 percent of the number at Home Depot.

In short, some of the most basic constructs in organization theory, such as “size” and “power,” often elude ready measurement today, in light of the growing diversity of business models. Many of the stylized facts we have relied on for much of the twentieth century in sociology no longer fit the facts of the case on the ground.

25.5 Conclusion

Sociology brings a distinctive theoretical sensibility to business and the studies of organizations and has created a large body of theory to make sense of our society of organizations. But the organization of the economy is changing in ways that make many of the most central assumptions of sociology problematic. I hope this discussion has laid these out clearly enough to encourage a productive dialogue.

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Social Science Assumptions

Reflections on Meyer's Chapter

David Schmidt

26.1 Is It Science?

There is a model of scholastic and Cartesian philosophy, still current, that aims to specify axioms from which necessary truths can be deduced. Viewed this way, philosophy is a game of showing that other people's arguments are invalid or unsound. The game drives us to pour our creative energies into imagining counterexamples to each other's axioms.

Descartes treated this game as the required intellectual foundation for disciplined scientific inquiry. The aspiration of science was to begin with what could validly be derived from premises that were not only true but indubitable. This assumption was huge, incorrect, and costly. Perhaps the assumption seemed like common sense at the time. It would have been what Descartes's scholastic readers were expecting and what they would have found familiar and reassuring. In any case, although the assumption was unmotivated, it stuck. For centuries, epistemologists who followed Descartes struggled to articulate an analysis of the concept of knowledge: the set of necessary and sufficient conditions for it to be true that "S knows that p." Has that quest been fruitless? Surely not, but neither has it been a great success, and that is a mystery worth pondering. What else could philosophy be?

A few decades ago, Alvin Goldman gave up on the Cartesian project. He did something resembling epistemology, but Goldman's epistemology was a game with a different objective. Goldman gave up on trying to offer a geometry-style proof that we cannot possibly be dreaming, and instead examined empirical evidence regarding which ways of gathering and processing information are more reliable than others—more reliable (very roughly) at leaving subjects with true beliefs. Goldman's approach is an alternative to starting with axioms. Goldman started with observations pertaining to human psychology, and with a question. We might wonder how exactly to pigeonhole Goldman's project. We might ask, is it really epistemology? Is it philosophy? Is it science? Today, I might say Goldman was doing moral science. He was studying the human condition in general, and more specifically, where we get our information and how reliable our information is. He was doing philosophy as it once was done, and as it could again be done today (see, for example, [Goldman 1999](#)).

At the height of the Scottish Enlightenment, [David Hume's *Treatise of Human Nature* \(1888; originally published in 1739\)](#) likewise started with what could be observed. Hume taught us that correlation is not causation. We can observe correlation. We cannot observe causation. We infer causation, but that inference is a leap.

What an arresting, disturbing idea! It is hard for modern eyes not to read Hume as taking a radically skeptical position on the subject of causation. What else could he have

been doing? There is an answer. Hume was not being skeptical about causation. He was being skeptical about deduction. Hume was observing something crucial about the nature of science: science is not deductive. Science is about what is true, including what is not *necessarily* true. Science is about leaping to the best explanation of observed data. Science leaps. Leaps are fallible. So be it.

Another of Hume's profoundly disturbing observations is that there is a gap between "is" and "ought." Here, too, it is hard for us not to read Hume as a skeptic about morality, but here, too, there is another way to read him. Hume in fact was a skeptic about deduction. We can read him as pointing out the limits of deduction as a way of framing the objective of the emerging scientific enterprise. We can read Hume as saying, "You find science dubious for gathering data and then leaping to a conclusion not entailed by the evidence? But that can't be an insuperable problem. Even ethics is like that!" A four-year-old budding scientist who experiments with touching the red-hot plate on top of the stove learns fast that they ought to move their hand. How do they learn this? Their inference that they ought to move their hand is not valid, but neither is it a mistake. The child is learning something real, and they are learning from experience, not from deduction.

The idea was that jumping from observed correlation to conclusions about causation—in full awareness that one is jumping to conclusions that could be wrong—is a scientific *ideal* rather than an admission of guilt. This ideal does not explicitly guide philosophical practice. The urge to prove things—and to dismiss as *unproven* whatever we do not want to believe—is Cartesian. But we can get past it.

26.2 Theories Are Testable

Theory identifies robust, law-like correlations between independent and dependent variables. A *theory* is an attempt to cut through an ocean of potentially relevant variables to isolate a particular relationship. It has to be understood, however, especially in social science, that all those other potentially relevant variables remain potentially relevant. Thus, for example, we see a robust, law-like logical correlation between raising minimum wages and raising unemployment rates among teenagers whose labor isn't yet worth that higher wage. Robust, law-like relationships license predictions. That does not entail that rising minimum wage is always followed by rising teenage unemployment. Even licensed predictions are not confirmed in every case.

When warranted predictions are disconfirmed, something good is happening. When your theory is disconfirmed, your theory is telling you that your world is poised to teach you something. It is telling you: something in that ocean of *potentially* relevant variables has manifested its potential, and it is pulling the system in something other than the predicted direction.

Adam Smith evaluated trade barriers by asking whether they correlate in robust, law-like, intelligible ways to changes in price and employment rates. I can imagine Smith wrapping up discussions of fairness not with deductions from fundamental principles but with something like science. I imagine Smith saying, "I've seen how trade barriers and monopoly licenses correlate to rising domestic prices and rising unemployment. Given what I have seen, I would not want to be remembered as defending trade barriers. You want me to call them fair? I will

say this much: observable correlations may not disprove the idea that trade barriers are just, but they sure do embarrass it.”

I see Hume and Smith as aspiring to practice moral science. I see them as having succeeded. Following Galileo and Francis Bacon, then Newton, they were on a quest to “introduce the experimental methods of reasoning into moral subjects” (to borrow the subtitle of Hume’s *Treatise*). Among philosophers, the Scottish observation-based approach was called *empiricism*.

By the mid-1800s, John Stuart Mill had taken empiricism to the limit, arguing that everything we know comes to us by experience and experiment. We draw inferences from observed empirical regularities. Even propositions like “ $2 + 2 = 4$ ” are learned by generalizing from observed results. In his day, Mill was visible and influential as an expositor of the new moral sciences. Accordingly, he was taken seriously when, in a series of works culminating in 1848 with *Principles of Political Economy*, Mill separated the study of how goods are produced from the study of how goods are distributed. That is what you do for the sake of analytical rigor and tough-minded science: if two things can be separated, you separate them.¹

Today, we hardly remember John Stuart Mill pressing that distinction, or that we took Mill’s authority for granted and went along with him. Today, we cannot see how spurious that distinction was, for we can hardly imagine not seeing production and distribution as separate topics. Sometimes what looks like two things is actually one, along the lines of the morning star and evening star. If we presume to treat them as separate simply because they appear to be so, we make mistakes.

Ironically, in the aftermath of Mill’s distinction, philosophy retreated from what empiricism had been, and was cut off from the scientific study of what makes some societies more productive than others. Production became the province of some other department. Since Philosophy came apart from Political Economy and Sociology, we have portrayed what society produces as a pie. We have portrayed fairness as a question about distributing opportunities to consume the pie. Questions about what possesses people to devote their lives to getting pie to the table were left to the social sciences. What Philosophy in isolation was equipped to study was intuitions regarding what to count as a fair way of dividing the pie among consumers.

26.2.1 To Be Ideal Is to Be an Ideal Response

Amartya Sen has been working for a long time on an idea that I might describe as the idea that ideals can be endogenous. In other words, responses to a problem can be realistically ideal in the sense of being best responses to evolving problems as those problems take shape. But ideals so conceived are *testable*.

Some of those who call themselves ideal theorists sometimes seem to assume an ideal is not a solution to a problem but is instead a call to imagine what it would be like to not

¹ Mill thought humanity might someday, perhaps soon, reach an economic steady state. See [Mill \(1848\)](#). For commentary, see Vallier (2010: 109). To be sure, the telegraph was invented in 1837, and by 1848, many thinkers suspected that electricity’s potential, especially in the realm of distance communication, was far from exhausted. Yet, for whatever reason, Mill thought that someday there would be relatively little news on the production side; human progress and human welfare would have more to do with better distribution than with rising productivity.

have a problem. Ideals so conceived may be untestable and to that extent indefensible, but one theorist's "indefensible" is another theorist's "irrefutable." Itzhak Gilboa (in this volume) questions how economics works as a predictive science. For what it is worth, it does not bother me to see the predictions of economics often turning out to be false. The bigger problem would be if economics were like astrology, with postulates too ambiguous ever to be genuinely testable. If nothing could ever disprove your predictions, then whatever else you may be, your work is not scientific.

26.3 More Is Better

Suffice it to say, it's a big assumption that justice is about how to treat the pie. Elizabeth Anderson's work, Iris Marion Young's work, and Robert Nozick's work too point in the direction of a different approach, almost a different subject (See [Anderson 2010](#), [Young 1990](#), and [Nozick 1974](#)). Namely, we can see justice, including egalitarian justice, as pertaining more to a process than to an outcome. Questions about justice are questions about treatment.

Justice, analytically, concerns what people are due. It concerns what we expect from each other. More narrowly, it concerns what we have good reason to expect from each other, which is pretty close to speaking of what it is *right* for us to expect. To speak of what it is right to expect is pretty close to speaking of what we have a right to expect. But if we speak of what we have a right to expect, then we are speaking about what we are due, which is to say that we are squarely on the topic of justice. The Young/Nozick/Anderson question, then, is a question not always and not typically about shares. Sometimes, indeed typically, it is a question about how we ought to treat each other. Because we now think about the outcome more than the process, we have fallen into seeing justice as a question of how to treat the pie, but there was a time when we understood that justice is about how to treat bakers. Anderson and Young gave us egalitarianism for adults: their egalitarianism is not about slices; it's about dignity.

Hume and Smith likewise saw economic justice as pertaining to an ongoing process, not an outcome. To Hume, we assess patterns of mutual expectation. To be sure, not all patterns command respect. On Hume's theory, the expectations that command respect are useful or agreeable to self or others. For starters, converging on expectations can help people to understand each other, and understand what to expect from each other. To Smith, the question is even more pointedly empirical. We assess expectations in terms of how they affect the wealth of nations. How do wealthier societies manage commercial traffic? What are the documented consequences of alternative trade policies? Their questions mattered. Their questions did not beg the question. And their questions had testable answers.

So, today, we have John Meyer's well-taken admonitions about economic reasoning on one side, but on the other hand we have Weber's (and then Woodrow Wilson's) jaw-dropping assumption that the experts who would run the administrative state would have no agenda other than to deploy their expertise for the common good. ([Weber's *Economy and Society* \[1978\]](#) was originally published, posthumously, in 1921.) From that perspective, democratic checks and balances would in effect be a mere hindrance on the efficient operation of said administrative state.

When it comes to specialization, it is not always true that more is better. Our reasons to endorse specialization depend on specialization having enough content for us to be able to draw a line between specialization and overspecialization. A company that produces buggy

whips or key punch cards or movies stored on DVD media will turn out someday to be overspecialized and face extinction accordingly. A species of woodpecker can be overspecialized if it feeds on only one kind of tree that is liable to disappear from the ecosystem. However, we don't confirm that the woodpecker or the business is overspecialized, and that it will not adapt to a changing niche, until it disappears.

Can an academic be overspecialized? Can a whole field be overspecialized? Yes, if work in the field has no potential to translate into results with external application. Yes, if the question of what an ideal ruler would do is oblivious to the discipline that studies abuse of power. Yes, if the academic's work is only readable to half a dozen other specialists. Yes, if a theorist is respected when they retreat from saying socialism is the most efficient economic system to saying socialism's fundamental principle cannot be disproven merely by observing what happens when people are forced to live by it. Recall the tobacco industry's claim that correlations between smoking and cancer do not constitute *proof*. We cannot retreat so far from the realm of observable correlation that we end up claiming that the only way to disprove a fundamental principle is to validly deduce from indubitable axioms that it is necessarily false. We cannot retreat so far from the realm of the testable that we end up saying that once we designate a principle "fundamental," then the principle's contingent correlation with misery, no matter how robust, is not relevant.

The feedback that we call creative destruction, which blows away overspecialized businesses, cannot operate in the academy so long as an academic can safely assume that the work will be refereed by two or three of the half-dozen writers who write the same sort of stuff. I like specialization in general, but we should trust specialization (or specialists) only when success in a specialty has enough empirical content and external validity to give us a way of recognizing overspecialization. Maybe to the extent that business can incorporate ethics (so that we can conceive of things like "triple bottom lines"), and ethics can incorporate social science (so that we can talk about conditions under which people find it fulfilling to bring the pie to the table), we are moving in the direction of an antidote to overspecialization—an antidote to being untestable.²

26.4 We Assume a Lot about What Needs Justifying

To John Meyer, the premise for sociological analysis—shared with economics and with modern liberal ideology in general—is that (1) society is built of individual persons and their behavior; (2) these persons are to be seen as primordially equal; (3) inequalities in resultant condition should reflect differences in education rather than background condition; and (4) individual status variations can be seen as occurring within national societies. Meyer observes that these assumptions limit the field.

Meyer might agree that "limited" and "specialized" are two sides of the same coin. While "specialized" is not a bad thing per se, there is a line, however blurry, between specialized and overspecialized, and academics tend to cross that line. We are trained to work on half-problems; that is, "tractable" problems. (As I've said, we work on justice as a half-question about how to divide an already-produced pie rather than as a whole question

² Jay Barney (see his chapter in this volume) compares and contrasts positioning theory and resource-based theory as an example of two frameworks that make sense on their own terms, but where each represents a fair challenge to the other.

about how to respect bakers.) Meyer also says equality is a highly constructed element, not a natural baseline. It would be useful to have models and analyses starting with observable inequalities as points of departure.³

A simple conjecture: if we treat equality as an achievement rather than a natural default, we would be in a better position to understand and appreciate what counts as realistically feasible progress toward an equality worth wanting. We could, with Hume, ask which equalities are *demonstrably* worth achieving, by virtue of furthering other values we also embrace (such as usefulness to self and others). Such empirical tests could reveal that achieving equality along that dimension has robust instrumental value *even if* we make no assumption about its intrinsic value. (As per Sen [1992], the opportunity cost of achieving equality along one dimension is that we sacrifice equality along some other.)

To be sure, some inequalities are caused, indeed *engineered*, by tribal structures of class, sex, race, religion, and so on. But if we assume that it is a necessary truth that inequalities are deliberately engineered, as if that were a tautology, that will blind us to how profoundly offensive it is when the engineering of an inequality is an observable empirical fact rather than an empty tautology. It will blind us to the difference between inequalities that are no one's fault versus inequalities deliberately chosen or upheld by particular agents who deserve to be held accountable.

In any case, following Meyer, a point worth registering is that treating any particular equality as an ideal worth wanting may or may not be justified. We are trained to regard our identities, our membership in a particular tribe, as a matter of the questions we learn not to ask, especially questions about equality. (See the chapter in this volume by Jerry Davis.) The point is neither hostile to nor even skeptical about equal treatment being an ideal; the point is simply that it's worth thinking about how we ever actually know that a given equality is something we have genuine reason to want.

What makes us assume that inequalities need justifying? To assume inequalities are what need justifying is dangerously close to assuming justice pertains to the outcome, not the process, which is dangerously close to assuming that the "right" outcome justifies whatever horrors we perpetrate in service of it, where "right" can mean conforming to intuitions about a fundamental principle that we bend over backwards to insulate from testability, thereby revealing how little faith we have in its ability to withstand scrutiny.

26.5 Are Ideals an Alternative to Tradeoffs?

Suppose we entertain equality of income as an alleged ideal. Then we reflect on the fact that some workers are older than others. Older workers have lifetimes of acquired skill and knowledge that younger workers will not have for another generation. We might think that bit of information is telling us that if we want to equalize income, we had better think about equalizing lifetime income, since equalizing the incomes of people of all ages at any frozen

³ Theorists talk about our responsibility for deciding how to handle undeserved inequalities, as if there were no comparable questions about undeserved equalities. But what if we stop assuming that equality is not beyond examination? Consider an analogy. In medieval times, the phenomenon of motion was thought to need explanation. (Why do objects remain in motion, absent any obvious force to keep them in motion?) The Enlightenment view that supplanted this perspective is that objects in motion have inertia. Objects go on unless something (friction, for example) stops them. Change, not motion, is what needs explanation. We assumed that motion needs explaining, but that is a big and unmotivated assumption. Indeed, it turned out, switching to a different assumption was fruitful. We now see change, not continuation, as what needs explaining.

moment would seem preposterous to the kind of egalitarian who believes in equal pay for equal work but does not believe in pretending that all work is equal. To think like this is to see a particular egalitarian ideal—equality of income—as testable, and as a hypothesis that could evolve in response to emerging information. But if we accept equal lifetime income as less antithetical to human flourishing than equalizing all incomes in a frozen moment, then our ideal will appear to be a massive compromise at any frozen moment. We can look all day at any particular time-slice of income distributions, and we will not be able to tell whether we are looking at a picture of equality. (Analogy: if we look at a traffic management system, do we believe that everyone should get a green light eventually, or that everyone should get a green light at the same time? The latter stifles progress, but the former will look like a grossly unequal distribution of green and red lights at any given moment. And it will encourage us to believe a falsehood—namely, position is everything, while being able to move is not relevant. Even if the ideal were achieved, any particular snapshot would still appear to be a picture of great inequality simply by virtue of our not having been born on the same day. In hands of egalitarians like Liz Anderson, ideals of equal treatment are once again leading us back to the kind of egalitarianism that in the nineteenth century was a genuinely liberal ideal.⁴)

One takeaway of Amartya Sen's work on equality is that we can ask: are serious ideals *alternatives* to messy tradeoffs? Do serious ideals preclude tradeoffs? Another way to look at it would be to suppose that true ideals are themselves tradeoffs. A true ideal might emerge from asking when we have reason to believe that insisting on equality along one dimension contributes more to human flourishing than insisting on equality along some other dimension. If one equality has to be sacrificed for the sake of another, couldn't there be an ideal place to stop? A realistic egalitarianism avoids assuming too much. A realistic egalitarianism will reflect changing experience and accumulating historical observation regarding contexts where one way of equalizing makes people worse off while some other way makes people better off. Or, if we create more and more power in a vain quest to crush all the social forces that make equality of outcome impossible, what could make us dream that such power will be equally distributed?

So, what would count as a reason to see one equality rather than another as a worthy ideal? What would make a hypothesis that it's ideal *testable*? Can we learn what the various dimensions of equality measurably contribute to human flourishing? Can we learn what various ways of creating the power to enforce equality contribute? (Do they affect life expectancy? Do they affect whether poor people want to move to where an alleged ideal is put into practice? Do they affect whether people see their community as a zero-sum game?) What would take an intuition about equality out of the realm of untestable intuition that analytic philosophy became when the scientific method disappeared into silos of emerging departments of social science over the course of the 1800s? (See Robert Frank's and Jerry Davis's chapters in this volume.)

⁴ In passing, a conjecture about the nineteenth-century assumption that bargaining power is a key ingredient in any recipe for equal treatment. The Marxist model of the labor market assumes the labor market is a monopsony, with no competition of the buyer side, and assumes the seller side of the market is a reserve army of desperate unskilled workers driven to accept any offer that beats starving. On this model, there are three remedies: (a) unionize, so that there is a corresponding monopoly on the seller side, and therefore a symmetry of power; (b) have a minimum wage to put a floor under the monopsony buyer that is above the natural floor of the starvation wage but not above a worker's marginal productivity; (c) legislate in an attempt to force employers not to collude. See Anderson's chapter in this volume.

26.6 We Assume Methods of Ethics Are for Deciding What to Do

Consequentialism as a moral science was once a response to questions about what works. There was a time when a philosopher like Adam Smith would have asked: where is life expectancy rising? Where is quality of life changing in ways that make those places the ones where poor people want their kids to grow up? (Why would people who profess to care about the poor reject such seemingly decisive information?) What works is still what economists study to some extent. But philosophers after Sidgwick and culminating in Singer came to treat consequentialism as something other than a question of what works to improve the human condition. They came to treat it as a method of deciding what to do.⁵ Eventually, scholars like Peter Singer came to treat it as a question of how much we have to give in order to count as morally innocent. In conjunction, in the case of consequentialism in particular, the question was how much we have to give in order to count as taking the principle to its logical conclusion. The point is not that Singer's question is a bad question, but that it is a different question. Somewhere along the line, in our Sidgwickian quest to make moral philosophy more methodical, we unwittingly changed the topic.⁶

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⁵ Sidgwick (1874). See also Singer (1972).

⁶ But see my "After Solipsism" (2016). See also the book to which this essay ultimately led, namely Schmidtz (2023).

Methodological Individualism—Lessons (?) from Biology

Reflections on Davis's and Meyer's Chapters

Philip Kitcher

Academic sociologists frequently invoke “higher-level” social entities—social classes, communities, organizations—in their attempts to explain. Many other scholars, inside and outside the social sciences, regard such references with suspicion, often viewing the exercises as verging on mysticism. Economists, particularly “economic imperialists” like Gary Becker, are forthright in their rejection. Taking the alleged social agents to be constituted out of genuine actors—individual human beings—they opt for methodological individualism. All social phenomena, they claim, are to be explained by appealing to properties of individual people and to the relations in which people stand to one another. When economics and sociology come together, as in “economic sociology” or in the business school classroom, there is bound to be a struggle. Given the relative clout of the two parent disciplines, it's not hard to predict which side will usually win.

To my mind, this debate is usually conducted in too wholesale a manner, without respect for the varying features of different research problems. Attention to developments in the biological sciences during the past half-century can (I believe) open the way to more flexible and promising discussions. What follows, then, is a review of three theoretical controversies in biology, and some potential morals for social science.

“Higher-level” social entities are composed of lower-level units: individual human beings. The biological hierarchy is more extensive. Linnean taxonomy makes a sequence of nested distinctions. Phyla, for example, are constituted by classes, orders, families, genera, and species. Species are made up of individual organisms. Organisms, in turn, are composed of organs and systems, cells, genes, and a host of other molecules. Just as economists might take social phenomena to result (“ultimately”) from the interactions among individual people, biologists have sometimes been tempted to conceive “higher-level” phenomena as consequences of the real causal agents that inhabit lower levels. The most well-known version of the view supposes those agents to be segments of DNA: “we, and all other animals, are machines created by our genes” (Dawkins, 1976: 3).

Decades of discussion have generated far more subtle versions of the positions advanced in the three controversies I shall review. I'll begin with a different question about the role of genes, this time as it affects molecular biology.

After the discovery (in 1953) of the molecular structure of DNA, it became popular in many quarters to suppose that biology is “ultimately” an extension of chemistry. In our attempts to understand living things, we cognitively limited human beings will probably

always have to talk about cells and organs and organisms and species. “Fundamentally,” however, a truly penetrating intelligence (Laplace’s demon reborn) could explain all biological phenomena simply by tracing them from physico-chemical interactions among molecules. People should emulate that intelligence, insofar as we can. At a conference I attended in the 1980s, a distinguished molecular biologist quipped that he had entered biology to study organisms, and, by the time of his senior year at MIT, he was finally ready to tackle organelles (intra-cellular structures).

On closer inspection, however, the genesis of biology from chemistry turned out to be far from simple. Consider a regularity recognized since the early twentieth century: genes on nonhomologous chromosomes (chromosomes that don’t pair with one another in the cellular division, meiosis, that gives rise to the sex cells) typically assort independently. How would you derive that from chemical principles? You’d first need some structural specification of genes—and that’s notoriously impossible to provide. All genes are segments of nucleic acids (DNA in most organisms, RNA in retroviruses), but *which* segments count as genes defies structural characterization. (If a structural characterization were available, the identification of genes in sequenced genomes would be enormously simplified. Parts of genomics would go much faster.)

But even supposing you had a structural specification, how would you deploy it to reveal the regularity? Would you frenetically have to examine all the diverse individual instances, delineating the reactions underlying segregation in every actual (and possible) event of meiosis? Even if you arrived at that gargantuan derivation, it would still not prove explanatory. You’d have described all the individual trees, but the contours of the forest would be beyond your view. Moreover, there’s a far simpler and more illuminating explanation. Prior to meiotic division, the chromosomes align in pairs. At this point some recombination between paired chromosomes can occur. After that, one member of each reconstituted chromosome pair is transmitted to the gamete formed. The transmissions from different chromosome pairs are probabilistically independent. That’s why genes at loci on different chromosome pairs assort independently (for more details, see [Kitcher, 2003](#): chapter 1).

Aspects of gamete production can be illuminated by recognizing the process as one in which the bearers of genes (the chromosomes) are paired and segregated. Every particular process (token process) proceeds through a series of chemical reactions. But the reactions are extraordinarily diverse. The class of production processes isn’t homogeneous: there’s no chemical unity to the process type. Explanation in genetics has to acknowledge entities at different levels in the biological hierarchy.

The point can be reinforced by considering a centerpiece of molecular biology. Phenotypic traits typically result from complicated processes involving interactions among many molecules. At early stages in many of these developmental processes, genes—segments of DNA—are transcribed to produce RNA. Transcription occurs when a molecule “associates” with a stretch of DNA, unwinding the double helix and allowing a complementary RNA to form: the bases exposed provide the template for the sequence of bases in the growing strand of RNA. The molecules that initiate the process are the RNA polymerases. Across the full range of living things, they are chemically very diverse.

How is the (fundamental) process of transcription to be explained? Not by consistently plumbing the molecular details. To be sure, there are important general molecular features of these processes: in DNA molecules, cytosine pairs with guanine, adenine with

thymine—although in the RNA formed, uracil replaces thymine. But the standard explanation, found in every textbook, mixes functional and structural aspects. Chemistry yields no *structural* account of what RNA polymerases are and what “association” with DNA molecules amounts to. The concept of an RNA polymerase is functional: the polymerases are those molecules that “get close enough” to chromosomes to “unwind” the DNA allowing for the “reading” of a segment and the formation of a complementary messenger RNA. It’s not just classical (non-molecular) genetics that resists reduction to biochemistry. You can’t even get molecular biology out of biochemistry. Further, important biological explanations sometimes appeal to entities acting at different biological levels.

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This point is reinforced by considering the debate Dawkins initiated. In his immensely popular first book (Dawkins, 1976), he proposed a revisionary way of thinking about natural selection by appealing to a commonplace of Neo-Darwinism. Evolutionary change had been viewed, since the synthesis of the 1930s and 1940s, as change in gene frequencies within a population. Natural selection, the principal agent of evolutionary change,¹ modifies the distribution of alleles. Dawkins concluded that the units of selection are genes, and that evolutionary events and processes would be most perspicuously represented by revealing the competition among alleles for representation in future generations. *The Selfish Gene* offered an eloquent development of that theme.

It also extended an important theoretical debate within evolutionary biology. From 1859 on, Darwin and his successors struggled to explain traits, particularly forms of behavior, that seemed to impose reproductive costs on their bearers and to contribute to the reproductive success of rival organisms. An organism behaves altruistically *in the biological sense*² when its action increases the expected reproduction of another organism at expected reproductive cost to itself. How can altruistic behavior originate (become present in a population) and be maintained (survive within that population) under natural selection? During the early part of the twentieth century, the question was often answered by appealing to “the good of the species.” Thus, to cite one especially fanciful example, animals were supposed sometimes to restrict their reproduction by responding to situations in which their environments could only support a particular population size: the familiar observation of birds “assembling” on power lines was interpreted as their “taking a census” of current population size—after which their reproductive “decisions” would presumably be made.

During the 1960s, G. C. Williams and John Maynard Smith offered apparently decisive arguments against so-called “group selection.” They pointed out that, within any population, variants disposed to increase their own reproductive success will always be favored, and that, typically, selection for traits beneficial to individual organisms will be considerably faster than selection for properties of groups. Moreover, in the same decade, William Hamilton provided a rigorous elaboration of an intuitive strategy for tackling questions of

¹ The Neo-Darwinian synthesis of the 1930s, which gave rise to today’s orthodoxy, maintains the primary role of natural selection in evolution. Prior to the synthesis, the power of selection was often challenged. In recent decades, there have been recurrent attempts to dethrone selection, and to view other processes as important factors in evolutionary change.

² Much confusion has been generated from the appropriation of an everyday term (“altruism”) for technical biological uses. The biological sense should be clearly demarcated from ordinary usage—even though Dawkins and others often blur the boundaries.

biological altruism. Noting that “altruistic alleles” would be shared with relatives, he showed how actions that increased the reproductive success of kin can spread in a population, even if they decrease the reproductive success of the agent. Further joint work between Hamilton and the political scientist Robert Axelrod showed how regimes of cooperation among non-relatives can be sustained under natural selection.³

Dawkins’s heralding of the gene as the unit of selection can be seen as a further development of this theoretical trend. In effect, he argued that the standard view according to which traits of individuals are selected and group selection is highly suspect had failed to pursue its guiding idea to the logical conclusion. Moreover, from a pragmatic perspective, Dawkins offered useful advice. Evolutionary biologists less mathematically adept than Hamilton made mistakes when they tried to apply the complex accounting involved in kin selection. Thinking in terms of a competition among altruistic and non-altruistic alleles was heuristically helpful.

Yet, as several scholars quickly pointed out, Dawkins had conflated two importantly different ideas. Evolutionary change under natural selection typically involves the selection of genes. It doesn’t follow that it always proceeds by selecting *for* properties of genes. To think of the history of life as dominated by competition among alleles supposes not only that the alleles are the winners and the losers but also that their characteristics dictate which ones win and which ones lose. By the early 1980s, the differences had been forcefully presented, using central examples of natural selection in action (particularly heterozygote superiority, where the trait selected appears to be a property of the *genotype* and not of the individual alleles that compose it; see [Sober and Lewontin, 1982](#)). From that time on, philosophers and biologists have collaborated to elaborate the current orthodoxy, the theory of *multi-level selection* ([Sober, 1984](#); [Lloyd, 1988](#); [Wilson and Sober, 1994](#); [Sober and Wilson, 1999](#); [Okasha, 2007](#); [Nowak, Tarnita, and Wilson, 2010](#)).

Multi-level selection theory distinguishes among types of evolutionary episodes in which natural selection plays a major role. In any given episode, it’s important to separate the entities selected (usually genes) from the causal factors that affect the selection. Causal analyses reveal that, in different instances, properties of entities at different levels play crucial roles. Moreover, within a single episode there can be processes of selection in which the causal interactions occur at distinct levels. Sometimes there is selection for traits of genes, sometimes for characteristics of genotypes, sometimes for properties of cells, or tissues, or organisms, or populations or species. Finally, some selection processes are mixtures, cases in which selection at one level is reinforced by or opposed to selection at another.

Today this is orthodoxy in large parts of theoretical evolutionary biology and in the philosophy of biology. It doesn’t go entirely unopposed. Although Martin Nowak and his collaborators have done much to rehabilitate group selection—including downgrading Hamilton’s work on kin selection—their conclusions face important objections (see [Birch, 2014, 2017](#)). Moreover, several authors have queried the assumption of some uniquely privileged level at which natural selection acts.

³ For these developments, see [Williams \(1966\)](#), [Maynard Smith \(1964, 1982\)](#), [Hamilton \(1964\)](#), and [Axelrod and Hamilton \(1981\)](#). Although Axelrod and Hamilton explained how cooperation among non-kin can be sustained in a population, once it has become prevalent, they left open the question of how it can increase when it is rare. Since 1981, several extensions of their analysis to resolve that problem have been offered. See, for one version, [Kitcher \(2003: chapter 9\)](#). There, John Batali and I develop an approach to optional games (games in which individuals can choose not to play with a particular partner) to show that the absence of cooperation in indefinitely repeated optional Prisoner’s Dilemma is evolutionarily unstable.

The first to do so was Richard Dawkins. His second book (Dawkins, 1982)⁴ softened the stance he had taken in 1976. Instead of proposing that natural selection processes are *correctly* seen in terms of competition among alleles, he suggested that they *could* be viewed in these terms and that doing so offered advantageous new perspectives. If that is correct, then some of the supposed examples of higher-level selection must lend themselves to reinterpretation. During the next decade, Kim Sterelny, Kenneth Waters, and I explored this possibility, arguing that the selection processes invoked in the (then-embryonic) development of multi-selection theory, particularly the example of heterozygote superiority, lend themselves to causally adequate modeling in genic terms (Kitcher, 2003: chapter 4 (co-authored with Sterelny); Waters, 1991; Kitcher, Sterelny, and Waters, 1993). Later, in response to Stephen Jay Gould's attempt to argue for species selection, I attempted to indicate how models at the level of the individual organism (or even at the genic level) could not only do the "evolutionary accounting" but also display the causal structure of the situation (Kitcher, 2004).

An ambitious version of pluralism would contend that for any supposed instance of higher-level selection there are rival, causally adequate, models of the process that identify selection at lower levels, including one that takes selection to occur at the genic level. It might go on to claim that the genic representation is always maximally illuminating—or allow that different perspectives supply different insights. I am no longer an ambitious pluralist. To my mind, what seems beyond dispute is that, for a significant range of evolutionary episodes, representations of them as involving selection at different levels are available.⁵ It seems dubious to think of natural selection as a causal force that always points to some determinate level in a biological hierarchy. In particular, many cases of individual selection can be analyzed, as Dawkins (1982) proposed, in genic terms. Sometimes these rival representations expose the causal relations in an illuminating way. Sometimes they are simply easier to employ. Choices among alternative analyses are best made on pragmatic grounds.

My third, and final, example concerns the ways in which appeals to biological ideas have figured in efforts to explain human psychology, human behavior, and aspects of human societies. Many ventures of this kind have been inspired by the advances in evolutionary theory of the 1960s and 1970s (the work of Williams, Hamilton, and Maynard Smith) together with an array of richly detailed studies of particular species. E. O. Wilson's investigations of the social insects were brilliant examples of the latter genre. Reflecting on his own conclusions, on the contributions of the theorists, and on the emerging pictures of many animal societies, he offered a comprehensive overview (Wilson, 1975).

Wilson proposed to found a new scientific field, sociobiology, whose goal would be to understand psychological, behavioral, and social phenomena in biological terms. For *all* animals, including our own species. As a few (uncharacteristically incautious) remarks indicated, the full development of this field would make the social sciences (and the humanities) obsolete. Various phenomena traditionally treated by these fledgling enterprises would be "removed from the hands" of the practitioners and "biologized." Predictably, scholars who scented prospects of their own redundancy rose up to challenge Wilson's vision. So too did many of his biological colleagues who feared the political implications of some of his claims.

⁴ Of all his (rightly influential) books, this one is Dawkins's most creative theoretical work. It is also probably his least read. That is a pity.

⁵ More pedantically: for a significant class of evolutionary episodes, viewed by multi-level selection theory as occurring at a single level above the genic, there are representations that identify selection at the genic level alone.

In its original form, sociobiology lasted little more than a decade. By the mid-1980s, it had been extensively criticized (Lewontin, Rose, and Kamin, 1984; [Kitcher, 1985](#)), and those sympathetic to Wilson's general approach began a process of transmutation. Today, two more moderate (or apparently moderate) descendants survive. Evolutionary anthropology, especially as pursued by Sarah Hrdy, Monique Borgerhoff Mulder, and Eric Alden Smith, has absorbed the principal points made in critiques of Wilson's ambitious venture, and has offered illuminating and rigorous accounts of human social groups. Far better known is evolutionary psychology, which has tended to catch the attention of media pundits. Its more sensational form—the so-called “Santa Barbara paradigm”⁶—offers provocative conclusions about supposed psychological adaptations to a hypothetical ancestral environment. Often the headline-catching researchers seem to have forgotten (or deliberately rejected?) the lessons of the sociobiology debate.

One particular aspect of the controversies in this area is relevant to debates about methodological individualism. Wilson attempted to forestall an obvious objection to his program by addressing directly the charge that, in the human past, the role of natural selection has been overwhelmed by cultural transmission and cultural selection. Famously, he hypothesized that “the genes hold culture on a leash” ([Wilson, 1978](#): 167). To his credit, he then collaborated with the mathematical biologist Charles Lumsden to articulate an account of gene–culture coevolution that would test this hypothesis. Their book-length treatment ([Lumsden and Wilson, 1981](#)) announced a positive result: the claim of genetic control on culture had been upheld. Investigations of the complex mathematics revealed, however, that this supposed finding depended on particular choices of the values of crucial parameters ([Maynard Smith and Warren, 1982](#); [Kitcher, 1985](#): chapter 10).⁷

The issue was settled within a decade of Wilson's bold conjecture. In 1985 Robert Boyd and Peter Richardson articulated a theory of gene–culture coevolution that delivered two major theorems ([Boyd and Richardson, 1985](#)).⁸ First: a population under both natural selection and cultural selection can reach states different from those it would have attained under natural selection alone. Second: that state is sustainable under natural selection. When gene–culture coevolution is carefully analyzed, it appears that the genes *do not* hold culture on a leash.

The work I have cursorily reviewed is not well known outside an academic sub-specialty. Understanding gene–culture coevolution is not easy, and testing hypotheses about human behavior when the role of cultural transmission is acknowledged is extremely

⁶ Named for the home of two highly influential evolutionary psychologists, Leda Cosmides and John Tooby. Their work has been heavily criticized, as has that of Martin Daly, David Buss, and (in some modes) Stephen Pinker. The nadir of the movement may be [Thornhill and Palmer \(2000\)](#); see [Kitcher \(2003\)](#), co-authored with A. Leah Vickers for a diagnosis. There is a clear contrast between the Santa Barbara-inspired ventures and a far more cautious and scientifically grounded approach developed in the UK (particularly in the work of Daniel Nettle). The transatlantic difference may reflect the continuing influence of two outstanding British scientists engaged with animal behavior: John Maynard Smith and Patrick Bateson.

⁷ One point deserves emphasis. Lumsden and Wilson were not guilty of anything ethically dubious—they made an honest mistake (becoming lost in the complexities of their own mathematical account). Since some readers have interpreted my critique as charging them with fudging the numbers, I want to make it clear that that is a misreading. For all my disagreements with Wilson, I have the highest respect both for his academic integrity and for his extraordinary accomplishments in the study of social insects.

⁸ Boyd and Richardson's work developed further the rigorous style of analysis offered in [Cavalli-Sforza and Feldman \(1991\)](#), the style Lumsden and Wilson had tried to emulate. Later, [Boyd and Richardson \(1992\)](#) argued that when “sizable groups” have a practice of punishment, just about anything can evolve.

demanding.⁹ By contrast, journalism and the popular press are pervaded by much looser talk. A Dawkinsian coinage has caught on. “Meme” is, apparently, a highly successful meme.

It is also a disaster from the perspective of rigorously studying patterns of cultural transmission and cultural change. As large numbers of critics have pointed out, most cultural process cannot be broken into discrete units, and complex mixtures of intra- and inter-generational transfer require breaking with simple models of transmission. Furthermore, many discussions of memes mix two dominant metaphors, sometimes seeing cultural change in evolutionary terms, sometimes favoring an approach in terms of contagion (see Jerry Davis, Assumption 5, in this volume). Even before you try to work out any causal account (some type of cultural dynamics), the *kinematics* of the two models are strikingly different (Kitcher, 2003: chapter 10).

Wilson appreciated the importance of understanding in detail how biological and cultural evolution interact. His hypothesis turned out to be incorrect. Boyd and Richardson have provided the tools for investigating cultural transmission. Vague appeals to memes are worse than the clichéd attempt to find the keys under the lamppost. For the light isn’t on, and that place is somewhere you should know you’ve never been. You can’t avoid the hard work of searching.

So much biology! I apologize. But these debates have implications for sociology and how it might be applied to business.

1. Methodological individualism is too restrictive. Despite the fact that living organisms are composed of molecules, many facets of life resist explanation in molecular terms. Even though an entity Y is made up of Xs, and the processes in which Y participates are decomposable into interactions among Xs, understanding those processes may require a taxonomy that cuts across the classification of the Xs.
2. The debate between individualists and holists isn’t one to be settled by abstract (“philosophical”) arguments. It should focus on specific instances, in which practitioners attempt to provide rigorous analyses at different levels. The units of selection controversy and the attempts to understand human behavior in bio-cultural terms both show the importance of developing careful models and responding to empirical data.
3. Sometimes, a specific debate between individualists and holists may end in a victory for both sides. If my (weak) pluralism about units of selection is correct, some phenomena may be fully explained at either of two levels. When that occurs, pragmatic considerations may favor adopting one or the other analysis. Or, if each provides a different advantage, employing both.
4. Metaphors are no substitute for mathematical analysis informed by precise findings about the processes under study. If sociologists want to understand socio-cultural transmission, they should try to deploy the best available theories of cultural evolution. If those theories are too complex to deliver results in the intended context, they should attempt to find ways of simplifying them.
5. It is probably good to encourage diversity within the academic business community. Both the units of selection debate and the discussions of gene–culture coevolution

⁹ Robert Boyd once told me that only one of his PhD students in anthropology had been able to apply the theory. I don’t know if the situation has changed since.

benefited from the presence of committed reductionists and committed holists. Fostering a “division of cognitive labor” (Kitcher, 1990) made for progress in biological inquiries, and it might do so for business sociology too.

I’ll close with an anecdote (possibly apocryphal), relating to this last point. Supposedly, during the Second World War, engineers at Oxford and Cambridge who were not on active duty aided the war effort by engaging in periodic competitions. One of the universities aimed to develop the most damaging shells; the other tried to improve the armor used in tanks and other vehicles. When they met, the best shells were launched against the best materials. Because of the traditional rivalry, each university hoped to win. The real goal, however, was to raise the chances of military victory.

I have approached the controversy about individualism as if it were a purely methodological debate, concerned with the most accurate ways of representing social dynamics. Yet, in the spirit of the enterprise in which we are (collectively) engaged, you might wonder if one of the rival positions is more favorable from the perspective of advancing the broader social good.¹⁰ People often suppose that individualism is antithetical to progressive political causes, and they are moved to defend holism on these grounds. Indeed, that assumption has figured in at least one of my three biological examples (the sociobiology controversy).

As far as I can see, the assumption is false. Trouble (or liberation) doesn’t arise from the *level* assigned to the actors, but from the *specific features* attributed to them. Everything depends on the character of the models elaborated. To be sure, if economists articulate their individualism by supposing that the people whose preferences they consider are solely concerned with monetary advantages for themselves, their analyses will often deliver conclusions that can be interpreted as dooming the prospects for promoting the public good. If, on the other hand, the structural relations they favor among those actors offer incentives to pro-social behavior—or if they assume that people have altruistic inclinations—very different outcomes may be predicted.

Moreover, the myth of the rapacious, competitive individual can be replicated at the group level. The firm or the transnational corporation can be characterized as concerned only with its own financial profits. Individualist analyses are not doomed to re-enact Adam’s original sin. Nor does methodological holism guarantee salvation. God—or the devil—is always in the details.

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¹⁰ I am grateful to Subi for pressing me to address this question.

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Philosophical Concepts in Organization and Leadership

Valerie Tiberius

Both Julie Battilana and Jim Walsh mention that the field of organization theory in business research is broad and diverse, and this certainly comes through in their chapters in this volume. This scope is made even wider when you add Ramón Mendiola's provocative thoughts about leadership. Coming to this rich set of ideas as a real outsider, as I do, it seems unwise to try to summarize or distill the different perspectives. Instead, I'll make some comments about four themes that struck me as interesting and not worry if my comments don't form a narrative. It might very well be that the field is too diverse for a single narrative to make sense.

28.1 Homo Economicus

The first thing that struck me is that Battilana's discussion of the ways in which organization theory attempts to question, revise, and replace the assumptions of neoclassical economics and its starring actor, *homo economicus*, could have been written by a political philosopher. Many of the criticisms she mentions are the same ones that philosophers such as Elizabeth Anderson would press against economists' assumptions about rational agency. If organizational theory rejects the dominant model of perfect rationality, it has more common ground with philosophy than other areas of business or economics.

But does organizational theory reject the dominant model? It's less clear from Walsh's chapter that this is the case. According to Walsh, "organization theorists in business schools generally reject Durkheim's (2014) strong form situationalist thinking. Instead, they embrace some kind of agency notion, if not the rational actor model itself." He then adds in a footnote that there is a good deal of skepticism about the model of rational economic man in organizational theory, but in the end, his view about the conception of rational agency in organization theory isn't as radical as Battilana's.

In a field this large, it could be that there is no received view about this matter. Or, it could be the difference is due to the differences in the ages and experiences of the two authors. I don't know. But I would warn against creating a false dichotomy between agency and determination by social forces. I think Battilana and Walsh both recognize the distinction, but both sometimes talk about the distinction between the individualist economic perspective and the deterministic sociological perspective in ways that make them seem like two dichotomously opposed alternatives. I suppose some of the players in the debate may think of them this way, but it seems to me that the real debate is about the *extent to which* individual agency is (1) aptly characterized as governed by norms of economic rationality and (2) moved

unknowingly by social forces. Social structures exert influence *on individual agents* who make decisions and act. That influence might be overwhelming, but this isn't to say there are no individual agents; it's to say that individual agency is rarely (if ever) autonomous. One might think this is a distinction without a difference, but I think it's important to realize that when we talk about social influence, we are talking about influence *on* particular people and their psychological mechanisms. One needn't accept radical views about collective agency in order to acknowledge the profound and ubiquitous influence of external forces on agents.

Relatedly, the degree to which individual human agents are caused to act by exogenous forces is a separate matter from the degree to which human beings are dominant or in control. On the agency/social determinism debate, Walsh says, "We can debate the debate and no doubt learn something new, but the really interesting—and important—work will unfold when we realize that in the broadest sense, the agency scholars are correct. We live in an unprecedented time—in the Anthropocene. Today's consensus view is that humans have dominion over all life on the planet." If the agency theorists are just saying that there is such a thing as individual agency, then I agree that they are correct, but our dominion (or domination) over life on the planet is, I would suggest, irrelevant. Our planetary domination could be the result of individual human agents acting badly on their own steam, or it could be the result of human agents acting badly due to powerful social forces.

The debate discussed by Battilana and Walsh reminds me of an analogous debate in virtue ethics (a subfield of philosophical ethics that identifies virtues as central to morality) about the extent to which human action is explained by reference to character traits as opposed to situational factors. Some philosophers (Doris, 2002; Harman, 1999) have argued that the fact that situational factors influence human behavior in dramatic and unacknowledged ways is evidence that we do not have the kinds of stable traits of character that virtue ethics (starting with Aristotle) presumes we have. The point of the critique is not that there isn't individual agency; rather, the point is that individual agency is strongly influenced by situation and that, therefore, the best ways to improve individual human agency are probably not to think about cultivating good character but rather to think about how to change the situations in which individual agents tend to find themselves.

28.2 Power

One of the things that political philosophers (among others) complain about in neoclassical economics is the lack of attention to power. I was glad to read that power, according to Battilana, is a central topic in organization theory. (Power doesn't come up in Walsh's chapter, which led me to wonder, as I did above, whether there is a generational gap here, or just a personal difference of emphasis.) I think Battilana is right to notice that power is a social or relational phenomenon rather than a free-floating trait. As she puts it, "Power is thus a situational concept rather than a dispositional one. People are not 'powerful' or 'powerless' in general. They are only so in relation to other social actors in a specific social relationship ... and their power depends on the extent to which they control access to resources that the other party values." Certainly, this is true of the relevant kind of power: it is power *over* someone else and, therefore, inherently relational.

Although I agree that power is contingent on social relations in this way, it is also true that power sometimes looks all the world to be a fixed disposition of certain people or groups

of people. We shouldn't let the situational nature of power obscure the fact that situations are often rigidly constructed to keep power in the hands of certain kinds of people. I would put this point in terms of social oppression and the way in which it works to confine some groups of people for the benefit of others. Marilyn Frye's (1983) well-known (in philosophy anyway!) analysis of oppression might be helpful here. Frye uses the analogy of a birdcage to explain the nature of oppression. An oppressive system is like a birdcage in the sense that it is composed of many small barriers (the bars of the cage) that function together to limit the options for a group of people. Just as if you only focus on one bar in the cage, you can't see why the bird doesn't fly around it, so too if you only focus on one seemingly trivial discriminatory practice, one biased cultural norm, or one small difference in how some are treated, you can't see how anyone could be oppressed by these things. As Frye (1983: 4) puts it,

The experience of oppressed people is that the living of one's life is confined and shaped by forces and barriers which are not accidental or occasional and hence avoidable but are systematically related to each other in such a way as to catch one between and among them and restrict or penalize motion in any direction. It is the experience of being caged in.

People in socially oppressed groups, then, have less power over others in virtue of longstanding historical barriers that are beyond their individual control. Importantly, these barriers are constructed in such a way as to benefit those who are not caged in, and one of the benefits of not being oppressed is having power over those who are. This does not mean that power is dispositional rather than relational, but it does mean that power will tend to be focused in the hands of members of groups that have historically had power. Power may be relational and social, but this does not make it any less fixed and real. It would be dangerous to assume (and I'm not accusing Battilana of doing so!) that because power is not a fixed trait of certain individuals it is just a contingent and changeable happenstance that it is located where it is.

28.3 Motivation

In her discussion of the assumptions about human motives in the neoclassical economic paradigm, Battilana says that "[t]he introjection of values can also govern economic action in part or in full. These values, be they consciously or unconsciously embraced, shape the content of individual motivations, as well as decisions about how to achieve them." In the context, she is drawing a distinction between "values" and self-interest, the main motivation for rational economic man. But self-interest is itself a value and purely self-interested people pursue many values that they see as contributing to their own welfare. Again, one might say that to insist that we call self-interest and self-interested values "values" is to draw a distinction without a difference. But I think insisting in this way helps us to see that self-interest is not the default motive, any deviation from which demands justification.

Walsh argues that the field of organization and management theory is characterized by certain altruistic motivations. He refers to the field's "abiding interest in human welfare" and provides survey evidence to show that "No matter their career stage, our colleagues are scholars because of the dual draw of living the life of the mind and making the world a better place." I'm really glad to hear this, but it did remind me of something Lily Tomlin once said:

“I always *wanted to be* somebody, but now I realize I *should have been more specific*.” Wanting to make the world a better place is an admirable goal, but it is one that has been shared by some people with horrific ideas about the means to it. I would feel more comforted by the list of pro-social business school mission statements if there were some content to such feel-good phrases as “creating value,” “improving the world,” and “positive, lasting impact.”

One problem with being more specific, as Lily Tomlin’s quip makes clear, is that it’s just really hard to get more specific about big questions like “What is a successful person?” or “How can we improve the world?”. Philosophers have been proposing competing answers to these questions for millennia and we haven’t arrived at definitive answers. It’s a particularly daunting task when we need to say something uncontroversial that more or less everyone could agree to, as is the case with mission statements. Even with these difficulties in mind, however, it might be worth fleshing out “improvement” and other such notions both in mission statements and in business school curricula. Perhaps useful lessons could be drawn from arguments used in ethics classes against naïve forms of moral relativism. One of the things that ethics textbooks tend to point out is that while there are some ethical controversies, there is also a lot of agreement about, for instance, basic values such as human health, happiness, and the free exercise of our rational faculties (e.g., [Shafer-Landau, 2009](#)). I like to hope that we are also getting to the point where making progress on global coordination problems like climate change might also be a widely enough shared value.

28.4 Leadership

In his remarks on leadership, Mendiola shifts between talking about leaders and talking about “true leaders.” *True* leaders, Mendiola says, “know better, choose better, and act better.” They are forward-thinking, inspiring, collaborative, determined, pragmatic, and they take responsibility not only for the success of their business but also for society. True leaders have integrity and purpose. “True leader” seems a much more appropriate term for someone who has all these features than simply “leader,” because we all know that there are leaders who do not have many of these characteristics. You don’t have to be a keen observer of history to know that there are and have been leaders without integrity who lead capriciously, leaders who cannot collaborate who rule as depots, and leaders who take no responsibility for much of anything besides lining their own pockets.

The term “true leader” is what philosophers would call a “thick ethical concept.” Bernard Williams (1985) first defined “thick concepts” as those that are both action-guiding and world-guided. In other words, a thick concept is one that has both descriptive meaning and prescriptive or evaluative meaning. This is true of many virtue concepts: however you define kindness, for example, it has to have something to do with our regard for others and how we treat them, but it also (typically) serves to recommend or express admiration of the kind person. Similarly, for a “true leader”: a true leader must be leading some people, but they must also be the kind of leader who deserves our approbation and respect.

Is this just a bit of useless philosophical jargon? To see why it might be important, it will be helpful to explain why Williams introduces the idea of thick concepts in the first place. For Williams, thick ethical concepts justify the claims to ethical knowledge by the people who use them. To see what this means, let’s grant for a moment that Mendiola’s characterization of a true leader is widely shared among a certain group of people, say the group of business

school professors and corporate leaders. These folks apply the concept of “true leader” to some businesspeople and withhold it from others with fairly broad agreement: “Ramon is a true leader, Donald is not,” for example. Williams’s idea is that the people who use the term “true leader” in this way share some common ethical knowledge: they know what a true leader is (they can pick them out of a line-up), which means (because of the component of evaluative meaning) they know whom to admire, praise, and emulate.

The thing about the kind of ethical knowledge that comes with using thick concepts—and this is why I think there might be more than a lesson in philosophical jargon here—is that it is fragile. As Williams famously said, “reflection might destroy knowledge, because thick ethical concepts that were used in a less reflective state might be driven from use by reflection” (1985: 167). In other words, as soon as enough members in our hypothetical community of business professors and leaders begin to question what counts as a true leader, the concept loses its force and (Williams would say) ethical knowledge is lost. Although I would be happy to be proved wrong, I worry that this destruction has already begun with the notion of “true leader.” Mendiola’s picture of a true leader is heart-warming, but would it receive broad assent from the relevant community? I hope so, but I fear not.

Whether it’s hope or fear that turns out to be the right response, I think it is worth recognizing the fragility of the concepts that are held together by shared values; perhaps recognizing their fragility, we will be more careful to nurture and protect them. At the same time, we also must acknowledge that thick concepts can be shaped by shared *bad* values. If “true leaders” are thought by the community to be men and never women, that’s part of the concept that needs to change. This last point introduces the possibility that shared thick concepts can be modified in response to new ideas. And this opens the door to the thought that even if my fear is warranted, we may gain new thick concepts that help to reify reasonable norms. If that’s the case, we can all agree that an aspirational concept of the true leader in business, such as the one Mendiola presents, is needed now more than ever. What is really needed, to be sure, is for the concept to catch on (or catch on *once again*, as the case may be), for it to become the thing that everyone has in mind when the true leaders are discussed.

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PART VII
LEADERSHIP AND CORPORATE
GOVERNANCE

Fundamental Assumptions about True Leaders

Ramón Mendiola

When facing the question: “What are the fundamental assumptions that underlie the models and methods in the field of leadership?”, it is critical to consider behavioral and moral issues in addition to technical and rational arguments. At the end of the day, leaders are human beings that will act based on their beliefs and moral compass and in addition, they will act based on what they learned in school and through their professional experience; what has been useful to make good decisions and climb the enterprise ladder.

Based on my personal experience and the analysis of business colleagues and academic leaders I have had the privilege to work with in the past decades, I believe there are eight fundamental assumptions about leadership:

1. **Leaders have integrity.** Leaders have strong principles and moral uprightness. We must assume that in order for leaders to inspire others, they need to be credible. In general this occurs in the presence of moral integrity. Leadership requires an ethical approach both in processes and outcomes (Komives, Lucas, & McMahon, 2007). Honesty forms the foundation of trust and credibility. Leadership also has to be purpose- and values-driven.

According to philosophers and great thinkers in history, people are naturally good and their integrity has the power to inspire others to act. For example, Mencius (2004: 150-151) in 371/390 BC wrote, “When left to follow its natural feelings, human nature will do good. For wherever there are things and affairs, there must be their principles. The sense of mercy is found in all men; the sense of shame is found in all men; the sense of respect is found in all men; the sense of right and wrong is found in all men. The sense of mercy constitutes humanity; the sense of shame constitutes righteousness; the sense of respect constitutes decorum, the sense of right and wrong constitutes wisdom. Humanity, righteousness, decorum and wisdom are not something instilled into us from without; they are inherent in our nature.”

2. **Leaders have a long-term view, a forward thinking that allows them to be authors of vision.** Great leaders are gifted with many exceptional qualities that give them the ability to lead their teams in the right direction and to successfully grow their businesses regardless of all challenges and setbacks. However, research into significant attributes of leaders has demonstrated that “forward thinking is one of the most desired attributes of leaders, second only to honesty and integrity” (Kouzes and Posner, 2002: 105).

Leaders have the ability to see ten years from now, read trends in a more sophisticated way, read complex patterns, and consider more alternative solutions to one specific challenge. They are very good at creating clusters of knowledge that help them

to have a long-term perspective not only of their organization but the world as a whole. This ability allows leaders to design a vision that is holistic and has transformational power.

3. **Leaders inspire others.** Leadership is not about a title, positional authority, the number of people who report to this person, or where they sit in the organization. Leadership is about inspiring others to act. Having a clear vision and a pragmatic appreciation of what needs to be done counts for nothing if the leader has no capacity to inspire and encourage people into action. A leader is not a person who takes care of the transformation themselves, but rather is someone who inspires others to achieve greater heights. Great leaders in human history such as Gandhi and Martin Luther King, Jr. had the capacity to inspire multitudes to act upon a shared vision.
4. **True leaders are not dictatorial but collaborative decision-makers.** In the past, a paradigm existed around leadership that stated: “leaders should be decisive and make decisions by themselves in order to be respected and show strength.” Nowadays, organizational development (political, social, and business) has demonstrated that hierarchical decision-making is not necessarily the most appropriate way to make decisions in the complex business environment we are experiencing today. When tackling major initiatives/decisions, the breadth of knowledge and perspectives is mandatory to have a holistic solution. Diverse views and backgrounds (gender, age, nationality, educational background, etc.) create cross-fertilization and allow leap-frogging that sparks powerful insights and innovation. Diverse teams are stronger teams, and that should include diversity in thinking styles.

Leaders need to form collaborative, diverse teams that can tackle the most critical challenges in an organization. The collaborative teams then form ecosystems that nurture innovation, socialization of ideas, and the sustainable growth of an enterprise.

Modeling a collaborative behavior is critical for the success of the organization. The perceived behavior of the leader and their team plays a significant role in determining how cooperative teams are prepared to be. In a recent lecture by former President Barack Obama, he mentioned that when facing the most critical challenges for the United States during his presidency, he trusted a highly diverse team to help him make decisions. It is impossible for a lone human being to make better decisions than a highly skilled, committed team of ethical men and women.

5. **Leaders are determined.** When analyzing true transformational leaders in history, there is one characteristic that is always highlighted: if leaders decide that something is worth doing, then they will put their heart and soul into it. Even if many people think differently, if they believe it is the right thing to do, they will do it and will mobilize as many people as possible to commit to this endeavor.

As Lee Kuan Yew said in *The Man and His Ideas* (1998): “I am very determined. If I decide that something is worth doing, then I’ll put my heart and soul to it. The whole ground can be against me, but if I know it is right, I’ll do it. That’s the business of a leader.”

6. **Leaders are pragmatic.** A theory is an attractive proposition, at least intellectually. However, when facing a real problem, challenge or threat, leaders will act according to their beliefs and practical experience. Based on their strategic thinking patterns, leaders are pragmatic. They act and learn quickly in order to adjust course. The pragmatic

leader acts, learns, and adjusts. They possess a bias toward action and continuous improvement; they are not conformists; they are always searching for better ways to do things.

Leaders are first movers and adapt quickly to changes in their environment. As John C. Maxwell shares in his book *Sometimes You Win, Sometimes You Learn* (2013: 7), a true leader is a humble person that learns from their mistakes through reflection. As he says: “Experience isn’t the best teacher, evaluated experience is.”

7. **True leaders are accountable not only for the success of the enterprise but also for society.** In his book *Equality and Efficiency* (1975: 91-92), Arthur M. Okun wrote, “John Stuart once said that ‘he will be a communist if he believed that economic misery and deprivation were inherent in a capitalistic economy’ and he was right, they are not inherent and they can be eliminated. Indeed, in democratic capitalism, they must be eliminated.” Companies as well as governments and civil society organizations have the shared responsibility to improve quality of life, foster performance, and pursue social progress.

We live in countries and societies with so many challenges that it is impossible for governments or non-governmental organizations to have all the ideas, the resources, and the competencies to tackle all these social and environmental challenges. Business leaders have the opportunity and responsibility to be part of the solution and be held accountable not only for the success of the organization they lead, but also for the improvement of the environmental and social conditions around them. Today, more than ever, business leaders need to step forward and take action toward the global most critical challenges.

Companies should become positive agents within an interconnected sustainable ecosystem and create social and environmental value at the same time they produce economic value, and these three dimensions of value creation have to be linked not only to shareholders but to all the business stakeholders (clients, consumers, suppliers, regulators, government, media, academia, communities, etc.).

A true leader does not have a business strategy and an additional corporate social responsibility strategy next to it. On the contrary, there is a merging between the two and the business leader measures the success of the company in three dimensions simultaneously: social, environmental, and economic.

The most successful business leaders of the next decades will be those who understand the three dimensions of the “triple bottom line” (Elkington and Knight, 1991). Our world, capitalism, and companies are and have always been three-dimensional. Our mistake has been to oversimplify them to understand them better and to grasp and manage them easier.

As John Mackey and Raj Sisodia wrote in their book *Conscious Capitalism* (2013: 273-274), “Businesses need to look at their performance with a broad set of criteria. They should not be judged purely on financial results ... A business that generates financial wealth but destroys other forms of wealth (which can have greater impacts on people’s well-being) adds far less value to the world.”

Considering the challenges ahead (poverty, inequality, global warming, pollution), the role of a true leader must be broadened; a holistic approach is not only desirable but an imperative and a choice that cannot wait much longer.

The challenge lies in convincing CEOs to become true leaders that reconcile performance with progress and accept that there is a better way of doing business, a better way of working and a better way of living, one with no tradeoffs and where success is defined holistically.

8. **Leaders have purpose.** A true leader believes that they came to this world with a “calling.” One of the most profound definitions of purpose was created by Frederick Buechner (1973: 95): “The place where your deep gladness and the world’s deep hunger meet.” Leaders need to discover their own purpose in life and find their enterprise’s purpose.

At a personal level, the purpose describes who a leader really is and it is the compass that guides their life to commit to transformational actions. The search for purpose is not a single moment of truth but a journey. In the words of Guy Hatcher (2013: 12): “it is a journey of understanding who we are and then finding the courage to do what we need to do in order to follow your passion and purpose.”

In fact, continuous learning and improvement are essential to the development of a leader. Leadership development is a process. Through experiences, interaction with others, and self-reflection, it is possible for a leader to develop their leadership style throughout their lifetime.

The second goal of a leader deals with finding the enterprise’s purpose and it is as important as discovering their own purpose. The search for a company’s purpose must be based on introspective analysis of the business, its people, and compound insight from the entire organization. The company must ask itself: why do we exist? How do we add value and for whom?

It is important to mention that a company’s purpose must be a sincere and true reflection of its essence and how it does business. It must be ambitious enough to drive the interest of stakeholders yet grounded enough to compel employees to deliver results. The purpose will resonate among employees and stakeholders if it is clearly aligned to its core business. Employees must understand how their business activities interact with the company’s purpose. The stronger the connection between the core business and the purpose, the more easily employees will identify with the purpose and start acting upon it. In fact, employees’ hearts (and not only their minds) must connect with the company’s higher purpose. When employees identify with their company’s greater sense of purpose, they improve their engagement, motivation, and commitment to the company. If you win the hearts of your employees, you will have their minds forever.

These eight fundamental assumptions on leadership allow us to conclude that true leaders *know better, choose better, and act better*. They know better what are the trends and future conditions that will lead an enterprise to success, they anticipate challenges and threats, and they pursue opportunities faster than others. They choose better because they surround themselves with the best talent and create the best collaborative teams to accomplish ambitious goals—not only economic ones and not only for their own organization but for society as a whole. They sort better between short-term and long-term performance or between different expectations by shareholders and other stakeholders.

Finally, they act better. They show visible actions and set new standards toward more sustainable performance and progress in society based on a holistic approach. They are already

taking action; they are reinventing themselves and inspiring others to experience a rebirth of their enterprises from its core purpose.

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A Discussion on Corporate Governance

Ravi Kailas

What theorists and practitioners commonly refer to as “corporate governance” did not emerge from any proactive framework delineating corporate purpose or responsibility, but from a series of reactive measures against misbehavior and misaligned incentives in modern firms.¹ In 1974, just four decades ago, the United States’ Securities and Exchange Commission took legal action against three directors of Penn Central after a series of executive misconduct came to light during the railway company’s bankruptcy proceedings. Two years later, the term “corporate governance” appeared for the first time in an official journal of the US federal government, and in the same year, Ralph Nader, Mark Green, and Joel Seligman collectively penned *Taming the Giant Corporation*, cataloging a litany of abuses by mega-corporations (including Penn Central). The public unveiling of these abuses motivated both a significant overhaul of corporate law and an emerging theoretical framework for checks and balances against managerial domination over corporate structure and decisions (Nader, Green, and Seligman, 1976)

History is littered with such examples of bad actors and ethical *failures* in corporations prompting public outcry and, subsequently, the crystallization of “governance” in theoretical, normative, and regulatory terms. In 1992, after the financial collapse of a few major companies, the scandal of the Bank of Credit and Commerce International collapse, and the discovery that Robert Maxwell of Maxwell Communications had siphoned £440 million from company pension funds, the UK government issued the Cadbury Report, outlining a series of principles that could mitigate autocratic managerial control (Cadbury, 1992). The provisions of the Cadbury Report were given statutory authority through a “comply or explain” model; companies were required to comply with the report’s postulates (independent directors, compensation committees, and audit committees) or explain the exact reasons for noncompliance. The Anglo-Saxon model, the dominant model of corporate governance referred to by policymakers and entrepreneurs, has been framed by this reactive double movement throughout history, this continual tension between executive-led corporate laxity or abuse on one hand, and defensive regulatory oversight on the other. Reactive regulatory measures often focused on the zones of board structure, executive compensation, auditing, and (more recently) shareholder activism (Cernat, 2004). It seemed widely assumed that this was how markets worked—profit maximization of individual actors would toe (and eventually break) the lines of good conduct, after which regulation would right the due course.

¹ For a general overview on the principles of corporate governance, see Nordberg (2010) and Larcker and Tayan (2015). For a history of corporate governance, see Coffee Jr. (1998), Morck (2005, 2007), and Shleifer (1997). While Clark (2004) provides a survey of different theories of corporate governance, Ravenscraft and Scherer (1996) focus on corporate governance in the twenty-first century.

In the academic sphere, the defining texts of Anglo-Saxon corporate governance (namely, Jensen and Meckling's (1976) "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" and Fama's (1980) "Agency Problems and the Theory of the Firm") centered specifically on the principal-agent problem between beneficial owners (shareholders) and agents/controllers (upper management). The motivating question at hand was the following: in the case of a firm, where owners/principals (shareholders) delegate decision-making power to agents (upper management), assuming all actors are seeking to maximize individual utility (i.e., financial returns), how, and to what extent, can various inputs such as the managerial labor market, capital markets, and corporate ownership structures align the incentives of agents with that of principals? Over time, the principal-agent problem has evolved in complexity, most prominently with the rise of institutional shareholding, adding yet another dimension of agency problems between beneficial owners (shareholders), institutional agents (pension fund managers), and corporate managers.

The principal-agent problem is chiefly an informational and incentive problem. Beneficial shareholders cannot monitor the actions of manager agents, and thus nominate representatives (in the form of a board) to obtain information and act as a punitive authority against bad actors. There are two underlying assumptions that should be stressed here: one, that a board structure ensures the orderly and useful disclosure of information, and two, that the auditing (we watch what you do) and punitive (we can fire you) powers of the board are sufficient to align management to shareholder and other interests. The information *and* incentive assumption have a further underlying assumption, what I will call the "good faith assumption"; that is, "guards" in a corporate governance structure, such as independent board members and auditors, are objective, competent actors who try, to the best of their ability, to carry out their fiduciary duties.

Yet corporate governance has for too long relied on reputation-based signaling to power the good-faith assumption. Board members who have previously headed large companies and name-brand auditing firms are implicitly trusted. Ironically, the most prominent governance scandals in corporate history have often had both. That age-old question, "who guards the guards?" has not been answered, to the detriment of governance across the world. If the good-faith assumption rests on shaky ground, then the informational assumption and incentive assumption are categorically more difficult to uphold. If boards themselves are elected through non-transparent means, or serve purely as decorative, rubber-stamp committees (a reality that remains quite widespread), or if auditors collude with bad corporate actors, then the function of those guards—namely, informational disclosure and incentive alignment—is significantly subverted.

As an entrepreneur who has been actively building businesses in India for over twenty-five years, I can only cogently speak to the lessons and assumptions I have gleaned about corporate governance as a practitioner, not a theorist. I speak from the broad public sentiment that reactive measures against corporate governance failures have been unsuccessful in reining in managerial-led corporate misbehavior, especially when regulatory bodies themselves are subject to legally permissible capture. I speak from the perspective of someone who has seen the most *prima facie* sound structures fall prey to individual greed. Lastly, I speak from the perspective of someone who has lived through and been responsible for governance failures, even though governance has always been of prime importance to me, due to personal oversight as well as structural constraints.

It is a strong assumption within my practice as an entrepreneur that *corporate governance must consider corporate purpose as its point of departure*. This is in direct opposition with Jenkins and Fama-inspired theorists, who view the firm as a nexus of contractual relationships wherein the “personalization” of the firm is a legal fiction and hence devoid of substantive content. To Jenkins and Fama, questions such as “what should be the objective function of the firm?” or “does the firm have social responsibility?”—indeed, any attempt to speak to corporate purpose more broadly—are seriously misleading. However, I take the opposite view, namely that governance *must* consider the purpose of the corporation itself.

For one, the “corporate purpose” view of governance is the one supported by the social and historical account of corporations. Indeed, the genesis of the corporation as a legal and formal structure originated *expressly* from a defined social purpose; the “incorporated” entities in fifteenth- and sixteenth-century England were given royal charters granting privileges and capital injections by the Crown for the sake of furthering public interest. Corporations were entities that built and operated public infrastructure such as canals and facilitated global trade to local markets (that such trade essentially constituted the deliberate pillage of other states is a conversation for another time).²

What is to be stressed is that corporate status was a *privilege* that existed for *public* purposes. Furthermore, this privilege was granted by the sovereign, which in turn generated its claim to power from the public. In this way, corporations are an idiosyncratic creation of capitalism—a structure or “legal fiction” granted privilege *by* state intervention, *for* supporting capital expansion in the free market. In this way, corporations were not invented to serve their shareholders but owed their existence to the public, who brought the corporation into existence to deploy capital for the sake of furthering public interest. Shareholders owned a claim on a corporation’s assets and cash flows, but the legal construct that allowed the shareholder to emerge had, as its aim, the enrichment of the general public.

If corporate governance should be situated in the broader understanding of corporate purpose, then corporate governance is essentially a set of rules pointing to normative ends—shareholders ought to be protected, employees ought to be protected, management ought to be subject to checks and balances, *for the sake of* enabling the corporation to better create some good. The necessity of thinking about and debating this corporate purpose is becoming increasingly apparent. For corporations today enjoy unprecedented financial, social, and political power; on the other hand, negative externalities of corporate behavior now impact global communities at unprecedented scale. Indeed, I often find this to be the most urgent question that faces me as an entrepreneur: what are the purposes, and therefore responsibilities, of a corporation? There is no objective answer to this; rather, there seems to be a range of answers to defining the “good” that corporations provide—a mix of stakeholder rewards, community enrichment, technological innovation, gainful and happy employment, production of goods and services, and so on. Different corporations give different weights to each good, often as defined by the entrepreneur—to this day, the first item on many incorporation documents is to state the mission or purpose of the corporation. Governance, in this case, looks much more like a philosophy of corporate purpose, as defined then executed by incorporators, than an optimization solution to the principal–agent problem or simply compliance with reactive legal mandates.

² For a general history of the corporation, see [Micklethwait and Wooldridge \(2005\)](#) and [Robins \(2012\)](#).

If corporate governance must consider corporate purpose as its point of departure, then my second assumption is that *governance theories that do not take a broader set of public goods and stakeholder benefits into account (such as shareholder primacy/maximizing shareholder value) are flawed*. Yet shareholder primacy has been one of the most influential philosophies of corporate governance. The movement was inspired by Fama and Jenkins's agency theories, which were based on the assumption that *shareholders are the owners of corporations* and thus should be the final authority on corporate action. This, in itself, was a severely flawed assumption. For shareholders are not "owners" or controllers of corporations—shareholders own a claim on assets and cash flow, not on the corporation itself. This is for good reason, as shareholders are protected by limited liability and conditional identity disclosure, and are often increasingly physically and psychologically distant from corporate activity. How can such shareholders enjoy protected downside, anonymity, and rights to passive ownership and still demand to be the controlling owners of the underlying business?

Despite these flawed foundations, throughout the 1980s and 1990s, influential business schools turned the philosophy of maximizing shareholder value into a global messianic practice, not least by propagating the theory to its impressionable, management-bound student bodies. Thankfully, this singular focus on maximizing shareholder value has taken a not insignificant blow in recent years. Indeed, academics and entrepreneurs alike have now argued against shareholder primacy. In theory, maximizing shareholder value rests on the confused assumption of shareholder ownership. In practice, it has and continues to promote unwise short-termism, putting undue pressure on corporate actors to deliver on short-term share returns versus long-term value creation for shareholders, stakeholders, and society at large. Even Harvard Business School has changed its decades-long tune, with a recent article claiming how maximizing shareholder value is "flawed in its assumptions, confused as a matter of law and damaging in practice" (Bower and Paine, 2017).

In my entrepreneurial career, I have often balked at the framing of corporate governance through the narrow lenses of agency theories and shareholder value primacy. I have also felt unconvinced by the narrow, legal definition of good governance or compliance. I recall uncomfortable moments with investment bankers and investors who assume that the "Indian" businesses we were building were automatically inferior in governance to advanced-economy counterparts. It seemed ironic to me that a Morgan Stanley banker could sit across from me and make sweeping statements about "third-world governance" while the corporation of which he was an employee recently paid billions of dollars in fines for perpetrating a negligent profit-seeking scheme that sent the entire world economy into a recession. That, to me, was evidence enough that the reactive regulatory view of governance, and its practice in the most sophisticated advanced economies, was an endless cat-and-mouse game, which did not prove the integrity of the mice.

That being said, there remain many systemic issues with corporate governance in Indian businesses, not least the rates of bribery, embezzlement, and tax evasion and lack of governance standards that plague Indian enterprise. Yet if there is one thing I will give credit to India for, it is that it has a history of viewing corporate governance and corporate existence through the lens of corporate purpose. Indeed, India has a long history of corporate philanthropy, largely due to the symbiotic relationship between family, business, and philanthropy within its society, a relationship that dates back to the nineteenth century, when

major industrial houses such as the Birla's, the Bajaj's, the Godrej's, and so on undertook "corporate responsibility" through charitable contributions (Dasra, 2017: 3). These efforts were never enough—family businesses hoarded assets and transferred power to next-of-kin, creating enormous discrepancies in wealth creation and releasing only a small margin of their wealth to public aims. Yet India, through this imperfect evolution, proved a certain positive tenet—that by *humanizing* the corporation (through its strong ties to a family name)—the holistic nature of a corporation, and the need to define corporate purpose (much like the intense human need to define personal purpose), became pronounced.

This kind of thinking laid the seed for theories of the firm driven by the concept of corporate purpose. Jamsetji Tata eloquently expressed this philosophy, stating that "in a free enterprise, the community is not just another stakeholder in business, but is in fact the very purpose of its existence."³ Since Jamsetji Tata's passing, the Tatas have continued to build their corporate empire on Gandhi's philosophy of trusteeship—the idea that wealth (especially corporate wealth) should be held in trust and directed toward social good, with entrepreneurs as the "stewards" as opposed to "owners" of wealth. To Gandhi, trusteeship was a means of transforming the capitalist order into a humane and equitable society, a transition where the self-reform of wealth creators could supplant the need for violent revolution. In this conception of the corporation, community was central and served as a primary motivating factor as opposed to a secondary consideration.⁴

Family business philanthropy and Gandhian trusteeship has continued to shape corporate social responsibility (CSR) in the Indian context. CSR is based on the idea that corporations do not exist in isolation—thus their success should be defined *both* by returns to the stockholder and by the development of the surrounding social, environmental, and communal ecosystem that houses and nurtures the corporation. The theory, much like Gandhian trusteeship, makes an argument of self-preservation; CSR purports that paradigms based on maximizing economic growth or stockholder wealth alone are self-destructive and unsustainable for the corporation itself. Indeed, neglecting stakeholders and benefiting only stockholders can result in myriad consequences, such as disruptive backlash from the local community, a deteriorating environment/climate, and hostile political reform. The 2013 Companies Act created a legal provision for CSR, taking a "comply or explain" policy where Indian companies of a certain size should donate 2 percent of average net profits over the past three years to CSR activities, or publicly disclose their reasons for falling short of the threshold. This 2 percent mandate is an unfortunately small margin in terms of actual wealth redistribution, but it does send a strong social signal that no corporation beyond a certain size should ignore its responsibilities to the wider public.

In this chapter, I have attempted to convey how there is a direct opposition between agency-inspired theories of maximizing shareholder value and India's imprecise, lived philosophy of CSR. To me, the latter is the socially and historically accurate, legally sound, and practically beneficial framing of corporate governance. Yet while India has circulated these beliefs, this by no means indicates that it is a stalwart in corporate governance; in fact, Indian companies have also strayed far from the aspiration of good governance and corporate purpose in reality—even the Tatas, the great pioneers and practitioners of trusteeship, have recently fallen short of their own standards of legal and extra-legal governance.

³ Quoted in Cossin and Hwee (2016: 73).

⁴ See Gopinath (2005), Kapoor (1993), and Rolnick (1962) for more on Gandhi's concept of trusteeship.

The question that faces those who adhere to this framework of corporate purpose is: how do we bring reality closer to theoretical or philosophical aspirations? How can entrepreneurs build sound, sustainable corporate governance on the basis of corporate purpose? My belief is that *if corporate purpose is determined by an interlocking set of responsibilities to various stakeholders, then governance should be separated into two categories—hard governance and soft governance*. Hard governance denotes a system of laws and rules that balance the interests of direct stakeholders, namely shareholders, managers, employees, lenders, suppliers, and all entities that have entered a contractual relationship with the firm. Provisions that we usually think of as “corporate governance”—such as the makeup of the board of directors, executive compensation committees, auditing processes, shareholder rights, lending rights, banking and accounting standards, and internal controls—all fall under the purview of “hard governance.”

Soft governance, on the other hand, is a system of provisions as well as *cultural* elements that enforce CSR and transparency to stakeholders that are *not* in direct contractual relationship with the corporation—such as the environment, the surrounding community, and society at large. Soft governance can be shaped by mandated provisions (such as India’s CSR requirement), but is most often a voluntary undertaking that combines management-led culture setting, employee participation, corporate mission, and value formulation. Soft governance’s impacts are more intangible and distant and thus more difficult to discern, but it plays an enormous role in the overall mandate of corporate governance. That being said, soft governance is not always good—founder or management-set culture can also be toxic and extremely deleterious, as we have seen in the case of Uber, Theranos, and the like.

The models that I admire are corporate structures that remain competitive while institutionalizing (organically or inorganically) ethically sound aspects of soft governance into hard governance. Corporations like the Tatas instantiate soft governance into hard governance through its corporate structure: a charitable trust is the majority shareholder of the underlying business. With such an entity majority voter, it is unlikely for the Tatas to engage in business lines or take decisions that violate certain ethical principles. This trusteeship structure also further reinforces soft governance, as the Tata culture is built on the loyalty of its employees and partners, who take the corporation’s larger purpose as a point of motivation and pride.

Another example is the Mondragon Corporation, a manufacturing conglomerate nestled in the Basque mountains; it is also the largest worker-owned and worker-managed enterprise in the world. Hard governance measures ensure stability, such as a clear and transparent voting processes for electing workers’ representatives of the co-op, who take turns acting as management for Mondragon Group companies (often, these managers return to their employee roles as technical staff promptly and happily after their term is served). Soft governance measures are reinforced by the fact that the employees constitute a majority of the surrounding community, as most of those who live in Mondragon are co-op workers. In a globalized world, the Mondragon co-op is a unique example of a model that has remained competitive while truly serving the interests of multiple stakeholders. While the scale of such a structure is likely constrained, I wonder if the rest of the world could learn more from the localism that has been preserved in its midst.

The Society of Progress was formed in part due to the understanding that capitalism is under critique—and for good reason. Trust in corporate actors and entities has been diminishing in the public eye for some time, and the very ability for capitalism to deliver value

or “progress” in an equitable way over a long-term horizon has been shaken by the various developments of the past few decades. To that end, understanding and redefining corporate governance, with an aim to first understand and bring to the fore the question of *corporate purpose* as a point of departure, is key in instating a broader paradigm of value creation. The corporation as an entity has been endowed with the characteristic of perpetuity; this power means that its correspondent responsibilities to society should also be held to the same longevity and rigor.

Governance in itself need not be only a negative framework of constraints and legally mandated responsibilities in reaction to gross corporate misbehavior. Instead, corporate governance should be debated and practiced as a proactive philosophy of corporate purpose, determining how corporations could better deliver value to a broad base of stakeholders, including, and most importantly, to society at large.

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Incorrect Assumptions That Have Guided Our Economic System

Bertrand Collomb

I believe that the main incorrect assumptions on which our free market society has been based are related to the definition and the use of “rationality.” Although they seem technical in nature, they have had very profound societal consequences. And they all come from the desire to represent reality by models simple enough to yield clear and simple solutions. Paraphrasing Pascal, we could say: *Not being able to make simple what is true, one has decided to hold for true what was simple.*

31.1 The Market as Defining Optimal Prices and Resource Allocations

The very basic market theory is founded on the assumptions of decreasing return for each player, and independent behavior of players. In practice, most firms work in areas of increasing return (hence the drive for size) and mimicry is an important aspect of many players’ behavior.

Under those circumstances, the theory would predict a monopoly as the optimal solution. In practice, the control of dominant positions (not only their abuses) is essential and has been toned down since the Reagan era. It is more difficult in the global digital era where significant innovations can change the whole picture. However, whether for financial institutions or for the major technology firms (such as Google, Amazon, Meta, Apple), it is clear that our system often leads to excessive size and market power.

And we have found no way to decrease the “herd” phenomenon on the markets, except stopping market operations to let things calm down when there is a crisis!

31.2 The Assumption That Each Player Wants to Optimize One “Utility Function”

Simon showed in 1955 that a “rational” person was not looking for optimizing a single criterion, but rather trying to find a “satisfactory” situation relating to a set of different and often non-commensurate goals. But modeling such a behavior is too complicated! Also of interest is the fact that a multi-goal problem often leads to “non-convex” models, where, from a given starting position, a superior outcome cannot be achieved by “trial and error” small changes. Hence the need for crises and structural changes.

31.3 The Impracticality of a Statistical Approach in Real Life and the Falsehood of the Risk Control Strategies

The so-called “Allais paradox” has shown that the expected value of an outcome is not the choice criterion of “rational” people in practice. It was further shown that events with low assumed probability (black swans) needed to have a much bigger weight, and that the automatic and unconscious use of Gauss distributions imbedded in many theories was misleading. Therefore, most of the analysis of uncertainty (notably in the financial analysis) has a false appearance of being scientific.

31.4 Accountants Want to Have “One” Certain Solution, and Hate Any Kind of Judgment in Their Numbers (Investors as Well, Because They Never Trust Companies)

Measurement is therefore often biased and leads to assessments that are biased (as any assessment necessarily is) but presented under the disguise of one and only one truth. And measurement leads, consciously or not, to certain types of decisions.

31.5 The Assumption That, If Situation B Is Preferable to A, Then It Is Preferable to Move from A to B, without Even Considering the Dynamic Transition Impact

The speed of change is essential in the cost of changing, and many societal reactions against globalization are in fact directed to a speed of change that is socially not bearable. But there is very little work that combines the static and the dynamic valuation. Ideally, we should try to reach an optimum state under a constraint limiting the pace of change to a socially acceptable level. But the instability of political will or the difficulty to maintain a consensus over time make people suspicious of any staged process, and lead them to prefer abrupt change. Recognizing and, if possible, measuring the cost of speedy change should be a concern for economists.

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Corporate Governance and Leadership

Reflections on Kailas's and Mendiola's Chapters

Kwame Anthony Appiah

The two chapters by Kailas and Mendiola in this volume on corporate governance and leadership, while very different in their focus, share a central thought: namely, that a strong sense of moral responsibility is an essential element in the successful leadership of corporations. It is not surprising that our two authors are convinced of this. They were invited to join the Society for Progress because they were thoughtful and successful business leaders who share our conviction that morality and the moral sciences need to be integrated into the training of business leaders, the study of business, and the development of the business school curriculum.

But it will come as a surprise both to some of those who are critical of the current practice of capitalism and to some of capitalism's defenders. The former see corporations as driven entirely by the financial interests of managers and the shareholders they supposedly serve. The latter are often convinced that a Smithian invisible hand guarantees that business will do its best for all of us by aiming only at the bottom line. We are all aware that ascribing this view to Smith is a great injustice; even his invisible hand operated in a world of respect for rules and a legal framework that enforced them when they were broken, and many of today's critics of capitalism believe that the rules have now been twisted to serve the interests of corporations, their owners and managers, in ways that undermine the proper working of markets.

Although both the chapters are highly ethically driven, they do have different foci. Kailas is interested in the reality of corporate life, which is that the challenge of effective governance—which involves leadership both by senior managers and by boards—is developing a shared “philosophy of corporate purpose.” Corporations are agents: they have aims, they act on plans and beliefs, they make choices for which they can be held morally and legally responsible. The task of leadership, then, is to carry out the deliberations that determine (a) what the aims of the corporation are, (b) how it gathers the information necessary for planning, and then, in the end, (c) which plans it develops and carry out. From this perspective it is obvious that the role of shareholders is not to have their wishes carried out by the corporation—they are not in a position to do the deliberation necessary to carry out these tasks. Rather, they are to select the boards, who in turn employ the management that will carry out this deliberation with them. The sense in which this governance entails developing a philosophy is not that it makes the corporation's every decision: it is rather that it sets the broad framework by which decisions are made and exercises broad oversight over their implementation.

But it is a difficult challenge to balance the many permissible aims of the corporation set by the leadership. Corporations generally are created to provide goods and services at a profit; a profit that, once workers and management are paid, must either be reinvested or paid to shareholders. But like all moral agents they must balance their aims—making goods, providing services, making profits, paying and developing the skills of employees, investing in factors of production, paying shareholders—and there will be many ways to do this; and they may have subsidiary aims, such as responsible citizenship in the communities where they work, which are subsidiary in the sense that they are either (a) purposes they could abandon without losing their defining corporate aims or (b) often in the service of their principal aims, so that, for example, responsible citizenship again may help secure the capacity to pursue them. In balancing these many aims, the board may think of itself as building a corporation, an entity that can pursue such primary and subsidiary purposes over the long haul, so that, for example, immediate profit may seem less important than building capacity at some moments, while at others, it may seem that, in the absence of projects that fit with the corporation's existing aims and capacities, the obvious thing is to return money to shareholders by one of the many available means of doing so.

That is the task, though, of those concerned to develop a philosophy of corporate purpose. In pursuing it, ethical considerations will come in many ways. There are virtues—honesty, diligence, courtesy—that have to do with the conduct of personal relationships within the business context. But there are also moral constraints on what the corporation may do, on how it may pursue its aims, that have to do with the ethical evaluation of *its* aims and plans. It is important to the *personal* ethical life of corporate leaders whether they pay bribes in private life: but they need to set the corporation against bribery, too. I can be honest with my fellow board members while urging the corporation to do something dishonest. I can be a diligent member of the board while allowing the corporation to be sloppy in its environmental impact planning.

It is in thinking about these questions, of the role of moral considerations in governance, that Mendiola's chapter raises important issues. His focus is on the CEO: and his basic thrust is that there are many qualities that will help the CEO be effective. Some of these qualities are moral virtues: personal integrity, attentiveness to the general good of society, respectfulness in your dealings with your colleagues and employees. Others are matters of temperament: long-term vision and pragmatism, an identification with the corporation as a vocation. And then there are skills, like the capacity to inspire those who work for the corporation, which are presumably only virtues when used in an ethically reputable cause.

The role of the personal integrity of the corporate leader is presumably twofold. On the one hand, it is an intrinsic good to be a person of integrity. But this is not why your integrity matters for the corporation you lead. There it matters because, both in your dealings on behalf of the corporation with people outside it, and in your dealings with employees, a belief in your integrity will build trust and enable you to get more effectively to agreement within and without the corporation and to elicit compliance from employees. Integrity also serves to inspire. There is scope for gaming the system here. Trust is built by being *thought to be* a person of integrity. Sometimes it will be possible to appear honorable without being so. And there is something self-undermining about an attempt to acquire integrity for its instrumental advantages: honesty may be the best policy, but someone who does the honest thing because it is good policy isn't honest; they're faking honesty.

And, in any case, in the case of all the moral and intellectual virtues, as we saw a little while ago, the values that underlie them need to be present not just in the leader, not even just in each individual employee, but in the corporation. These are not the same thing. Take honesty, once more. A dishonest person can insist on honest dealings in the corporation they lead just because it is the best policy. Or consider the intellectual virtue of thoroughness. Employees, including the CEO, can each be thorough in what they do at work without the corporation's being thorough in its working through of the options. The latter will only occur if the thoroughness of each of them means that the full range of options has been carefully studied. And even a thorough CEO—one who was careful and scrupulous in all the intellectual dimensions of their work—could miss options for the corporation if they didn't make sure that the whole team was given the right tasks. And doing that might require the rather different intellectual virtue of imaginativeness.

There is a natural worry about the very many moral and intellectual demands built into this understanding of leadership and governance. These capacities are not often found in large measure in a single person. And we are asking for boards and CEOs who ideally exemplify them all. And the worry is, if this is what is needed, will we be able to find it? So, let me point out that properly constructed corporations can exhibit some of the virtues *they* need, even if their employees often fall short, provided there are proper procedures in place. Maybe it's best if the leader is the sort of corporate superman that Mendiola describes, but surely this is not necessary for the whole world of employees? People in properly functioning institutions will mostly do the right thing even if they are only averagely good.

Let me give some simple examples: if the cashiers in my supermarket are not diligent, they may overcharge customers. If that happens often, the supermarket is cheating its customers, even though the only individual vice here is a (common) intellectual one of not paying proper attention. But once I use electronic price tagging, that risk is substantially reduced. Here is another, completely different kind of example: if my airline requires its pilots to go through checklists every time they begin a flight or a landing, and requires pilots to confirm with copilots that they have done so, the individual attention to detail of my pilots, their scrupulousness, won't matter.

Once you see the general point here, it is natural to turn it back to consideration of the CEO. The thought will be that a board of ordinary mortals, expert in business, perhaps, but not in ethics, can make sure the CEO keeps the corporation within moral bounds without insisting that they be a saint or a superman. That might even be thought to be the point of our institutions of governance—auditors, securities and exchange commissions, bank regulators, annual meetings—and of the boards themselves, whose personal liability for wrongs is limited only when they exercise reasonably good judgment: their joint purpose is to identify standards and create institutions to check and enforce compliance.

The norms that they will be enforcing will not just be legal ones. Business in any society itself has an ethos and people who work in businesses will want to be regarded with respect by all those with whom they interact as businesspeople and with the wider social worlds of people informed about business with whom they interact. When people are held to deserve respect, we say we honor them; if they deserve disrespect, we say they are shamed.

So here's my central message in this chapter: the management of honor can be an important resource in shaping the behavior of the officers and other employees of corporations. When it comes to sustaining and disciplining corporate behavior, a particular kind of

respect—peer esteem for those who achieve excellence—plays a critical role. It helps maintain demanding norms of behavior. As Geoffrey Brennan and Philip Pettit (2005) have pointed out, esteem, as a way of shaping our behavior, is, in effect, policed by all who share a code. The reason is simple: people automatically regard those who meet their codes with respect and those who breach them with contempt. Because these responses are automatic, the system is, in effect, extremely cheap to maintain. It only requires us to respond in ways we are naturally inclined to respond anyway.

Suppose, instead, you wanted to achieve the same effects through the formal mechanism of the law. Then you'd have to give new police and sentencing powers to particular people, which would produce new worries. You'd face the old Latin question: *Quis custodiet ipsos custodes?* Who will guard the guards? One attractive feature of the economy of esteem is that all of us are its guards. No individual has the focused power to apply the incentives of esteem that a police officer has when they arrest you, or a judge does in deciding a sentence (Brennan and Pettit, 2005: 260).

Consider the code of military honor. It calls on people as soldiers (or as marines, or officers, etc.) and, of course, as Americans or Pakistanis; and while soldiers may feel shame or pride when their regiment or their platoon does badly or well, fundamentally it matters to them that they themselves should follow the military's codes of honor.

It is worth asking why it is that honor is needed here. We could, after all, use the law all by itself to guide our armies; military discipline makes easy use of all sorts of punishments. And mercenaries can be motivated by money. So, why aren't these other ordinary forms of social regulation—the market and the law—enough to manage military men and women?

Well, first of all, both these other forms of regulation require surveillance. If we are to be able to pay you your bonus or punish you for your offenses, someone has to be able to find out what you have done. But when the battle is hardest, the fog of war obscures everything. If the aim of a soldier were just to get their bonus or escape the brig, they would have no incentive to behave well at the very moment when we most require it. By contrast, honor, which is grounded in the individual soldier's own sense of honor (and that of their peers), can be effective without extensive surveillance; and anyone who is around will be an effective enforcer of it, so that the cost of enforcement of honor is actually quite low, and we won't have to worry about guarding its guardians.

There's another reason for favoring honor over law as a mechanism for motivating soldiers. The sorts of sacrifice that are most useful in warfare require people to take risks that require them to do things that are, in the jargon, *supererogatory*: they are acts that are morally good but that ask too much of us to be morally required. To punish someone for failing to do something that they have no duty to do is morally wrong.

Analogous arguments can be made for other professions. Bankers and other corporate officers, too, do many things it is very hard or expensive for outsiders to keep an eye on. We have every reason to hope that they will do more than can be required of them by their contracts of employment. And, as we saw in the crises in the American economy in the first decade of this millennium, the behavior of individual bankers seeking to make profits can, in the aggregate, impose large costs on all of us.

The key point here is that a sense of honor—and the correlative need to avoid shame—when it works does a better job than regulation and the threat of sanctions on their own, or the market and the promise of profit alone, in shaping the behavior of businesspeople to reduce these costs on us all. We need regulation and monetary penalties and rewards. But if

people don't care about whether they are worthy of respect, we can be pretty confident that they will find ways, some of them dishonest, around regulation. And the major disincentives to dishonesty are two: first that, once you're caught at it, you will cease to have the trust essential to do business; and second that you cannot live with the sense of yourself as *that* kind of person. And, as I say, that means that in a business culture of honorable men and women, the costs of this system of regulation of behavior are pretty low.

To understand how we should shape professional norms requires the sorts of reflection on the design of institutions that economists have made their professional study and the sort of knowledge of social psychology that also goes into that design. And it is a noticeable fact of recent history that in many professional domains the consolations of money have, to some extent, shouldered aside those of esteem. Sometimes the two currencies have reached an unappealing compact. The surgeon Atul Gawande has argued, in reviewing the evidence about the rising costs of healthcare in the United States, that there are medical communities in which the values of entrepreneurship—hard work and innovation in the service of expanding profits—have overtaken the traditional guild values of the Hippocratic Oath. When this happens, esteem grows aligned with money, to the detriment, as he argues, of health (Gawande, 2009). So in the business of healthcare a purely market psychology is less effective than one that combines markets with structures of professional honor in producing progress. So, as I argue in my book *The Honor Code*, honor is a hugely important social resource (Appiah, 2010).

The task, then, in each corporation—whether or not they are aimed at profit—is both to draw on existing standards of professional ethics and to develop organization-specific norms. When we speak of professional ethics, what we're talking about are norms of conduct specific to the members of a profession. These norms work, in part, because they are internalized by members of the profession, so that they care about keeping to them, they respect those who do so, and they have contempt for those who flagrantly disregard them. They meet my definition of an honor code.

Now, to be clear, codes of honor can lead people to do bad things as well as great or simply good ones. The development in the financial world of a code in which profit was almost the only norm is part of what led us into the financial crises of the first decade of this millennium. As leaders, you need to make sure that your codes are better than that. You need norms and the people with a sense of honor to sustain them; but they must, of course, be the right norms.

How do people learn the right norms? Well, first of all, they are articulated and defended by the professions' leaders, of course; by people like CEOs. But mostly people learn them by seeing them working every day in the lives of others further along in the profession. I said that the economy of esteem was cheap to run because it depends on responses that are automatic in those who care about honor. But that doesn't mean it's cheap or easy to set up. Young residents see established doctors caring for their patients. They see their seniors seeking to reassure patients, inform them, respect their concerns, and balance what they need to know with what they can understand. They see the respect in the eyes of the doctors, nurses, and other health professionals who work with them, and learn about the poor reputations of those who don't get it right. And, importantly, in medical schools they also get explicit instruction in medical ethics, in professional norms, and in thinking about the many choices they will face that are specific to the practice of medicine.

Similar things, of course, could be said about how lawyers learn what is and is not honored in the law. It is taught by those who live up to the standards and by those who show their

respect for those who live up to the standards. It is learned when professional awards are doled out. And the point about professional ethics is that in order to understand what is at stake, you have to understand the profession. You have no sense of what it is to be both a servant of your client and an officer of the court until you face the dilemmas raised by a client who admits a crime and proposes to go on the stand and lie. To know what a lawyer ought to do in such circumstances, you have to know some law, you have to understand what the point is of the right to counsel, you have to have lived through some trials. And so outsiders will often be in a very poor situation to evaluate what you have done.

Which is why what should matter to you is the judgment of your informed professional peers. Only they really understand what you are doing, and only they are in a good position to look at what you have done and see whether you could or should have done better.

Professional ethics will often depart from the ethics of everyday life: legal ethics requires you to offer good service to some pretty awful people; likewise for medical ethics. If it were just a matter of advancing the good, perhaps you could deliberately undermine the case of your wicked client, or let the crime-boss die. But it is your job, however bad they are, to get them a fair trial, the best treatment.

It's really important that learning these norms isn't just a matter of figuring out what will get and lose you respect. It's a matter of caring, as I said earlier, about being *worthy* of respect, of knowing not just what will get you respect but what will actually entitle you to it. You need to buy into, engage with, absorb, and then care about meeting the norms.

One reason professional norms need to be internalized is analogous to the fog of war. There is a fog of law because it is very hard to figure out whether people are actually keeping some of the most important legal professional norms. The norms about when you can and can't ignore what you know about what your client, a criminal defendant, has done are often easy to evade. After all, as a matter of law, no one is supposed to overhear your conversations with your client, and they will often have no idea what you are supposed to do. Only someone who carries the norms with them in their heart—so that it matters to them whether they have lived up to the standards that earn respect, whether or not anyone knows it—can be trusted to live up to the highest standards when no one is looking. The same ought to be true of bankers, managers, and other professionals.

Internalizing these concerns depends on the fact that honor and identity interact. It is *as a lawyer* that you are bound by the professional ethics of the law, *as a doctor* that you are bound by the Hippocratic norms. And you have to think of yourself as a lawyer or a doctor to buy into them. So building a sense of professional identity is part of the task of law school and medical school and of internships and residencies in the profession. It's part of the job of established figures in the profession to bind you into it as they bind you into the norms that go with membership.

Now, I said just now that we needed to draw both on professional ethics and on organization-specific codes. Your business, your organization, should seek to build a sense of identity as a member of the corporation, to develop loyalties to each other, to the organization and to its goals. These will include its chartered purposes—defending gun rights, advancing civil liberties, offering services and goods for profit—but will also include the company's stated code of conduct in relation to consumers, employees, investors, local communities, or other stakeholders; as well as its explicit and implicit commitments to various local, national, local, and industry-wide norms.

There is no need to be explicit about the obvious: the people who work for you may think it condescending to be told that they should treat customers with respect. But in general, I think, the articulation and discussion of these norms, properly carried through, can help to build a sense of corporate identity and corporate commitments. Of course, the embodiment of these norms in the practice of corporate leaders, and the explicit recognition of those who advance corporate goals “above and beyond the call of duty,” is also going to be important in inducting employees into a corporate culture with commitments beyond a central chartered goal, whether it be profit or some other aim.

Precisely because these organization-specific codes are connected with your identification with a specific job, they can’t just be taken wholesale “off the rack,” as it were. They have to be worked through by the corporation’s leaders, in consultation with the wider class of employees, so that they can become theirs. This is part of the truth in the claim that leadership involves developing “a philosophy of corporate purpose.”

I said earlier I think these general ideas apply to not-for-profit as well as for-profit corporations. So I think that the leaders of the National Rifle Association (NRA) and American Civil Liberties Union (ACLU), too, have reason to ask whether, in pursuing their central goals, they don’t also need at least to develop codes of behavior that limit the means they can use to pursue their legitimate aims. I myself would be unhappy to be an NRA member, if I learned that the organization defended gun rights in ways that, though legal, were morally unsavory: lying advertisements, dishonest claims, sleazy campaigns. If I’m to be a proud card-carrying member of one of these organizations, it’s going to be because I know they pursue aims I value, but only in ways that deserve my respect.

Some of you will think talk of honor sounds portentous or old-fashioned or pretentious. So notice that I am not talking about using the *word* “honor” all the time. What matters is articulating the norms and getting people to care about living up to them and to care about being worthy of the respect of their fellow professionals. And when you have an organization of people who have those feelings, they will have them, by the way, not just about the norms I have been talking about but about the work of the organization itself: they will respect those who excel at their jobs and take pride in their own achievements at work and pleasure in the respect of others. Due respect—the respect that is owed to you—is another, perhaps less portentous, name for honor.

Notice, finally, that what is at work here is not just the individual honor and shame that come from living up to and falling down on our commitments at work. Collective honor matters, too. A decent corporation will be one whose members take pleasure in working for an organization that deserves respect. And when someone fails to live up to the organization’s norms, they are not just letting themselves down, they are dishonoring the firm and all who work for it. Each of us has a reason not only to live up to the standards of our profession and our company but also to make sure that others in the business do, too. For they can bring shame and glory to us all.

Some years ago, I had dinner with the CEO of a well-known German company based in Hamburg. He discovered I was an academic and we started talking about the Hamburg School of Business Administration, with which he was associated. The school, it turns out, has a degree that it calls the MA in Business Administration and Honorable Leadership, a program sponsored by the *Versammlung Eines Ehrbaren Kaufmanns zu Hamburg* (Hamburg Association of Honorable Merchants), whose history goes back to the early sixteenth century. Its members are committed, as you can learn from their website, both to operating

honorably themselves and to “maintaining the conditions for honorable dealing in their enterprises.” They think that corporations will contribute the most to human progress when they are run by honorable men and women who seek to lead those who work for them to behave honorably too. I think they are right.¹

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¹ “Wir sind ein Zusammenschluss von Hamburger Kaufleuten, die sich den Werten des Ehrbaren Kaufmanns verpflichtet fühlen und in ihren Unternehmen die Bedingungen für ehrbares Handeln pflegen” (www.veek-hamburg.de).

On Corporate Governance

Reflections on Kailas's Chapter

Philip Pettit

Ravi Kailas's reflections on corporate governance are compelling, not just for their genesis in his personal experience in corporate management but also for the intellectual quality of his observations and arguments. I am happy to be able to write a short commentary on his piece.¹ I offer comments in three categories, historical, philosophical, and institutional. All are meant to flesh out Kailas's point of view and, where relevant, to point to some problems it raises.

33.1 Historical Comments

Kailas reminds us of the history of incorporation and I would like simply to expand a little on the lesson he seeks to underline: that the right to incorporate is a legal privilege that was traditionally granted under the assumption that corporations would serve the public good, widely considered. There is truth in this but it is wrapped in complexity.²

We may begin with the situation about the beginning of the seventeenth century when corporations first came into existence in the Netherlands and England. Those trading nations had been involved for decades in long-term trade that required different investors to put their funds together as partners. But partnerships were vulnerable on a number of fronts, in particular because any partner could withdraw their funds from the enterprise, exposing others to serious loss.

That put pressure on partners to agree to lock their funds in for an extended period and the upshot within a decade or two was a practice, licensed in law, whereby asset lock-in could be indefinite. That measure became acceptable to would-be investors once it became clear, again with legal licensing, that the members could sell their rights to a share in the profits of the enterprise. With such asset lock-in, the joint stock company was born and at the same time, of course, the stock market.

¹ For a recent discussion of the nature of the corporation and an outline history, see [Pettit \(2023: chapter 6\)](#).

² For an overview of the history and character of the joint stock company, see [Walker \(1931\)](#); [Schmitthoff \(1939\)](#); [Ireland \(1996\)](#); [Hansmann, Kraakman, and Squire \(2013\)](#); and [Ireland \(2018\)](#). For a useful history of joint stock companies in the United States, see [Horowitz \(1992\)](#). For an accessible discussion of the overall properties of the joint stock company, see [Blair \(2003\)](#) and [Ciepley \(2013\)](#). And for a good introduction to the standing of the company in current law, see [Orts \(2013\)](#).

With asset lock-in two other measures became established as a matter of practice, if not always of law. One was the recognition that a joint stock company, unlike a traditional partnership, should be shielded from the losses of any shareholder; the other, although this was not always assured, that individual shareholders should be shielded as private property owners from the losses of the company. One amounted to entity-shielding, as it has been called, the other to what came to be known as limited liability: in effect, shareholder-shielding.

The formally established joint stock companies that dominated in the early period had to be publicly formed at a parliamentary or royal level and they were given explicit charters, usually for trading in specific, distant territories; indeed, they were often militarily supported in those enterprises by the state. But side by side with such chartered corporations, as we may call them, a much larger raft of unchartered companies also appeared in the seventeenth century and their shares too were often traded on the stock market. These mainly operated in local manufacture, in short-haul trade, and in various forms of banking, and were often established as family enterprises.

Political concerns about the rise of the stock market, and the proliferating number of unchartered companies, drove Parliament in 1720 to pass the Bubble Act, as it came to be called: it was passed shortly before the South Sea Bubble. This stipulated that chartered companies had to stick rigidly to the purpose, associated with a form of public utility, for which the company was established by Parliament or the king. And it also denied shareholders in unchartered companies the right to trade their shares on the stock market. It is not clear that the Act had much impact, but in any case it was lifted early in the nineteenth century, as the corporation came into its own.

Developments in Britain and the United States in that century exemplify what happened sooner or later in most developed economies. Perhaps the most important was that joint stock companies were enabled to form just by registering appropriately; no law or royal assent was required. This may have been motivated by a recognition that joint stock companies with many investors or shareholders were the best means of advancing nationally important projects such as creating canals and, later, building railroads. That idea, echoing the lesson emphasized by Kailas, makes for a connection with the earlier idea of chartering a company for a specific purpose.

Among the developments in the nineteenth century, one established the limited liability of shareholders: a formal stipulation that shielded them in the event of the enterprise's collapse. Another enabled such bodies to move at ease between different jurisdictions: for example, between different states of the United States in the nineteenth century. And a third, reversing a provision of the Bubble Act, enabled companies to alter their sphere of activity, moving from banking into industry or from industry into agriculture, or maintaining a presence in range of fields at once.

Despite these changes, most companies in nineteenth-century Britain were still unchartered, operating often as family businesses. But all of that changed as a result of an 1897 judicial decision by the House of Lords in 1897, *Salomon v Salomon & Co.* Mr. Salomon had transferred his personal enterprise of boot-making to a company constituted by himself and other family members; he was paid for the transfer by shares in the new company and by a privileged status as a claimant, in the event of bankruptcy, on the company's assets. The company did indeed fail and his claim on its assets meant that unsecured creditors were left with nothing. They brought a case against him, arguing that the company was merely a device of obfuscation but the House of Lords, the final appeal court in UK law, found in his

favor. The company, it said, had a legal personality distinct from his and the claim he made on its assets was comparable to—and, of course, weightier than—the claims of the creditors.

That finding led many unchartered companies and partnerships in England to seek a legally chartered status, recognizing that doing so made a variety of initiatives possible and attractive. And a wave of legislation in various states in the US had a similar effect. It made it possible for corporations to avoid the risk of liability under a variety of laws—bankruptcy law but also contract law, tort law, and even criminal law—by creating subsidiary companies whose management they could control.³

Ensuing legislation and jurisprudence has enabled companies to form themselves into networks or groups, perhaps operating under the control of a single holding company, that can command connected ranges of commercial activity and establish dominance in one or another market. And, of course, it has enabled them to avoid paying taxes in higher-taxing jurisdictions by creating shell companies in lower-taxing countries and assigning the bulk of their profits to those companies.⁴

33.2 Philosophical Comments

One of Ravi Kailas's main themes is that the corporation should not be seen as “a nexus of contractual relationships wherein the ‘personalization’ of the firm is a legal fiction and hence devoid of substantive content.” I absolutely agree with him in rejecting the eliminativist view, which was inspired by writers like Jenkins and Fama, that the players in a firm are a microcosm of the players in any market, the only difference being that their contracts with one another are often longer-lasting and more detailed.⁵

Why hold that the corporation is an agent in its own right? Assume that those in a corporation, like those in any organization, each endorse common purposes, and act for those purposes in their different roles, according to judgments that are shared by all: this as distinct from each acting, for example, according to their own potentially idiosyncratic and conflicting judgments. There can be no organization without a set of agreed goals, albeit goals that may be revisable over time. And no organization could expect to realize those goals if members each acted in their allotted part as they individually thought best, not under protocols or procedures established centrally.

³ While solidly supported in the law of joint stock companies, this development has an absurd aspect to which we have become accustomed. It would suggest that one and the same individual can act under one hat—that of a company—in order to benefit himself under another: that of the individual. It calls up the figure of Pooh-bah, The Lord High Everything Else, in Gilbert and Sullivan's operetta, *The Mikado*. He too operates under many hats but takes seriously the separateness he enjoys in each persona. Thus, he advises another official, Ko-Ko, who asks him to be deceptive, that “as Paymaster-General, I could so cook the accounts that, as Lord High Auditor, I should never discover the fraud. But then, as Archbishop of Titipu, it would be my duty to denounce my dishonesty.” It is worth recalling in this context that the common sense displayed by Aristotle (1996: 3.3) in arguing that when a people come to constitute a new *polis* in virtue of adopting a new constitution, it does not follow that they escape the debts that they might have run up under the older one.

⁴ Another more recent development, in some ways involving a very different direction, is the shrinking of certain companies and the outsourcing of functions, including manufacturing and wholesaling functions, that would traditionally have been kept in-house. This has enabled companies to avoid traditional, sometimes legally enforced obligations to their employees: those who do the work they commission have the status of independent contractors. See Davis (2016).

⁵ The material that follows draws on my work with Christian List on the nature of group agency (List and Pettit, 2011) and on other work related more directly to commercial corporations: Pettit (2014, 2015, 2016).

Any corporation is an agent in its own right, insofar as its members have to construct in a creative way the set of purposes and judgments on which they act as a body; this will have to be creative insofar as many must go against the position of a majority, even a unanimity, amongst them. The point is illustrated readily by what I have called the discursive dilemma.

Suppose that you, Smith, and I form a corporation, or any sort of group agent, and agree on certain purposes to follow. Will we be able to agree readily on what judgments should guide us in pursuing those purposes? Will we be able to do so by majority voting, as suggested, for example, by Hobbes, Locke, and Rousseau? It turns out, not.

Suppose we have to make judgments on whether it is the case that p , whether it is the case that q , and whether it is the case that $p \& q$: this in the way a court of three members might have to judge in a tort case on whether the plaintiff suffered harm (p), on whether the defendant had a duty of care (q), and on whether the defendant is liable to pay tort costs ($p \& q$). You and I might vote that p , Smith that not p ; Smith and I might vote that q , you that not q . Thus, a majority will support “ p ” and a majority “ q .” Will the majority support “ $p \& q$,” then? No: I will be the only one to vote for this result.

The discursive dilemma consists in the fact that if we vote according to our own views in group like this, then the body we form will not be able to act as an agent, being incapable of guaranteeing minimal consistency; whereas if we act so as to allow the group to function as an agent, then on some issue we have to endorse corporately a proposition that a majority amongst us individually reject. The problem generalizes, as various impossibility theorems have now shown: there is no systematic way of generating a group set of judgments out of the independent judgments of the members. In order to let the group assume the status of an agent that can be relied upon to be consistent, or at least to be sensitive to charges of inconsistency, the members must submit to a mode of organization that overcomes these aggregation problems.⁶

The simplest mode possible—although possible only with a small group like ours—would be a straw-vote procedure, under which we vote on issue after issue but check on whether any vote (such as a vote that not $p \& q$) would introduce inconsistency, and if it would, then work at agreeing a compromise about what the group view should be: whether, for example, we should accept as a group that $p \& q$ (or reject “ p ” or reject “ q ”). In following such a procedure, we would be constructing a set of attitudes for the group agent we constitute—and a mode of revising these in light of further evidence; in effect, we would be making it into an agent in its own right.

Wittingly or unwittingly, every corporate agent is organized in a way that gives it an identity in its own right as an agent. It is entirely made up of individuals, to be sure, but the individuals put their personal identity offline when, as members or officials, they internalize and enact whatever is required of them in their corporate role; they give life to the group entity as to an agent distinct from them individually and distinct from any n -tuple—say, any majority—they happen to form. That entity is an agent in the basic decision-theoretic sense that it is organized so as to reliably pursue designated purposes according to reliably formed judgments or representations about the world it occupies: about the obstacles the world puts

⁶ I introduced the idea of the discursive dilemma in Pettit (2001b, 2001a), building on work in law and economics (Kornhauser and Sager, 1993). For an initial impossibility theorem generalizing this, see List and Pettit (2002) and for an overview of later, related theorems see List and Polak (2010). For a comparison between these results in judgment aggregation and more familiar social choice impossibility theorems, especially Arrow’s, see Dietrich and List (2007).

in its way, about the relative feasibility and urgency of its purposes in any context, and about the best means of realizing them.

This is all to support Kailas's opposition to the familiar claim that a corporation is just a nexus of contracts, like any market, not an agent in its own right. The only argument I know for that claim is outrageously fallacious. It might go like this: corporations and markets are both composed of contracting individuals; but markets are not agents; so, corporations cannot be agents. Consider a parallel: trees and people are both composed of cells; but trees are not agents; so, people cannot be agents.

Once it is granted that corporations are agents, it follows that it makes sense, as Kailas insists, that they should be ascribed purposes and, I would add, that they can and should be held responsible, say by stakeholders, for how far they enact those purposes. It is their standing as agents that enables them also to be held responsible in the law, even in criminal law: that is, held responsible in their own right, and independently of whether certain officials are also held responsible for the voluntary actions they took in allowing the body to violate the law.

33.3 Institutional Comments

My remarks so far all evade the central question raised by Kailas, which bears on the purpose or purposes that ought to be assigned to the corporation. He says that corporations ought to pursue goals that include "normative ends" or "public goods." The goals, he suggests, should comprise "a mix of stakeholder rewards, community enrichment, technological innovation, gainful and happy employment, production of goods and services, and so on."

I agree that it would be excellent if corporations pursued goals of this kind. But I have two concerns. One bears on whether it is feasible to expect corporations in general, in particular larger corporations, to be spontaneously faithful to the standards associated with such a rich, social set of goals. But even if there was ground to expect such corporate virtue, a second concern is whether we could ever hope to make their fidelity to relevant standards robust over changes in the opportunities and incentives of boards or management or shareholders: robust, in effect, over the appearance of temptations to defect.

It would be an improvement on the status quo, to be sure, if suitable standards were established and if corporations spontaneously abided by them. But the improvement would not be a great cause for celebration if they retained the power of breaching them with more or less impunity, should the temptations be strong enough. In that case, they would resemble benevolent dictators: bodies on whose continuing goodwill ordinary people and communities would depend.

How to encourage spontaneous compliance with accepted standards among corporations? And how to entrench it to the point of being robustly or reliably present: to the point where corporations have little choice but to comply?

There is some reason to think that even we individuals, however virtuous we may be, depend for retaining our virtue on being exposed to one another's disesteem in the event of breaching accepted standards. That is the lesson of the ring of Gyges. Who among us can be sure, no matter how virtuous they are, that they would remain virtuous in the event of being able to behave badly without any fear of being detected, let alone punished?

Applied to the corporate case, this observation suggests strongly that if companies are to develop and maintain a disposition to abide by the sorts of standards at which Kailas gestures, then those standards would not only need to be established in public law and consciousness: itself a real challenge. They would have to be subjected to a bracing discipline of visibility and an economy of esteem in which it made little sense to play fast and loose with the standards.⁷

Would that be enough, assuming it was feasible? I don't think so. There would also have to be changes in corporate structure that reduced or removed opposing incentives: for example, the incentives of managers to boost the current share price, thereby increasing their own bonuses. And, of course, there would have to be a strengthening of the regime of constraints that Kailas himself thinks has been weakened. This would require safeguards against excessively deferential boards, against the capture of regulatory agencies, and against the connivance of auditing bodies.

These, as I am painfully aware, are rather abstract and glib observations about a massively important problem. But let me conclude with one further thought in the same vein. This is that it is of the greatest importance that regulators should become willing not just to fine corporations for malfeasance—the pattern in the wake of the GFC (global financial crisis of 2008)—but to take them to court as criminal defendants. True, corporations are enormously well equipped to deal with court challenges, having deep pockets and nerves of steel: this because they have no nerves at all. But the thing they most fear may be the bad, indeed the toxic, publicity they would suffer if they had to defend themselves in court. Like the gallows in the life of individual offenders, the prospect of exposure in criminal court would concentrate the corporate mind wonderfully.

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PART VIII
TECHNOLOGY

Assumptions Regarding Technology

S. D. Shibulal

The word “technology” has very complex connotations. When we think of the word “technology,” we think of scientific know-how or complicated applications. In the most basic sense, technology refers to tools and methods that enhance protection, pleasure, and productivity. In prehistoric times, the discovery of fire enhanced protection from wild animals; provided pleasure in the form of warmth and cooked food; and improved productivity by giving us light at night. The invention of the wheel made transportation of people and goods more efficient, thus enhancing productivity. Modern medical technologies protect us from life-threatening diseases. In the past few decades, technology has advanced by leaps and bounds. From skyscrapers to seedless watermelons, stem cell derivatives to smartphones, digital cameras to driverless cars, our lives have been changed in many ways due to these advances.

In business, technology helps to increase efficiency and streamlines processes. For the administrator, it improves governance and oversight, thus driving more accountability and discipline. Each person or sector views technology differently. There are a few fundamental assumptions that underlie the models and methods in the field of technology, both in practice and as studied and taught in schools of business.

We assume that it is good to overcome human limitations. Machines can do what humans can't do or do it with less effort. The invention of tools like the hammer and, later, the power drill helped empower humans. Technologists also assume humans prefer accuracy and consistency so that there is predictability. Both the calculator and the computer are more accurate and reliable than manual calculations. Excel sheets have made accounting, calculation, and tabulation of results less cumbersome.

The field of technology also assumes that time, effort, and risk in any activity should be reduced, if not eliminated. Mixer-grinders, washing machines, and later ATMs and mobile banking were innovations in this category. Moreover, the field of technology assumes that scientific knowledge is a fundamental precursor to technology as applied knowledge. This hypothesis supports the expenditure on science. In the field of electronics, the invention of the transistor was a precursor to chips and computers and computing technology.

In the field of medicine, the technology of sterilization ensured that the spread of infection during a surgery could be contained. The discovery of penicillin in the 1940s heralded the dawn of the antibiotic age. It has been recognized as one of the greatest advances in therapeutic medicine. Before its introduction, there was no effective treatment for infections such as pneumonia, gonorrhea, or rheumatic fever. Similarly, although insulin doesn't cure diabetes, it is one of the biggest discoveries in the field of medicine. It came as a boon for people with severe diabetes. Some people who were on the deathbed were saved. As long as they kept getting their insulin, they could live an almost normal life.

Also, the basic discovery of changing sound waves to electric waves and back to sound waves led to the invention of the telephone. The latest models of smartphones are capable of doing many of the tasks that a computer does. In fact, smartphones have made many electronic gadgets redundant.

Although R&D is the backbone of the field of technology, it is an expensive proposition, therefore we move on a premise that concerted effort in R&D activity should be limited relative to the total expenditure of time, money, and effort. On average, the world R&D-to-GDP ratio is estimated to be about 2 percent. However, in some sub-sectors such as pharmaceuticals it may be as high as 20 percent.

Inventors are driven primarily by curiosity and a love of science. It is the entrepreneur who takes the invention to the market and makes the profit. The one who invents gets rewards in the form of royalties. The airplane was invented by the Wright brothers but it was Tony Jannus who conducted the United States' first scheduled commercial airline flight in January 1914 for the St. Petersburg–Tampa Airboat Line. Later it was Boeing that first emerged as a manufacturing company and made it a marketable product. It is expected that inventors will seek patents and other protections of their intellectual property. Discoveries that are regarded as useful, novel, and non-obvious are considered good candidates for intellectual property rights. Economists have found that patents foster innovation. A study by Arora, Ceccagnoli, and Cowen (2008: 1169) found that “the patent premium for innovations that were patented is substantial. Firms earn on an average a 50% premium over the no patenting case, ranging from 60% in the health-related industries to about 40% in electronics.”

Today innovators assume that they should and will be able to exploit their discoveries for gain. Indeed, most big companies have R&D departments. Technology is commercialized either through sale of products and services or through licensing. Indeed, it is common for technology producers to have extensive marketing departments that are often larger than their R&D departments. A corollary to the above is that technologists assume that wider adoption is better than narrower adoption as revenues are expected to rise faster than costs.

Another corollary is that commercial interests may dominate other interests and lead to incomplete disclosure about the downsides of the technology. Recently, drilling companies suggested trillions of cubic feet of shale gas may be recoverable from underneath through a process known as “fracking.” Fracking is the process of drilling down into the earth before a high-pressure water mixture is directed at the rock to release the gas inside. However, many people have called for a moratorium on fracking until we can be sure it is safe, or until further research is completed to assess its environmental impact. Dissenters feel that fracking uses excessive water and is reducing investment in renewable sources of energy and encouraging continued reliance on fossil fuels. The case of genetically modified crops (GMCs) is similar. From the first generation of GMCs, two main areas of concern have emerged: risk to the environment and risk to human health.

Advancement of technology assumes that the consumer will be willing to pay a premium for the relative benefits of the technology. A current example of this is Apple products. The iPhone is a product that a great majority could not afford to buy. Its superior features and operating system are its advantages. Customers' budget constraints are not a concern. However, competition reduces willingness to pay on the part of the consumer, and actual prices may come down. Innovation may keep prices higher than they would otherwise be.

The field of technology assumes that obsolescence is inevitable. New technology will make earlier ones redundant or less desirable. In 1965, Intel co-founder Gordon Moore proposed

what has come to be known as Moore's Law: the number of transistors in an integrated circuit will double about every two years. Moore's projection has held up for several decades and has been used in the industry to guide long-term planning and to set targets for R&D. Constant innovation is imperative to survive in the world of business. Diminishing returns notwithstanding, products should be smarter, faster, safer, more comfortable, more powerful, and not necessarily less expensive. More features are generally preferable to fewer.

Since the danger from violence is very real, the field of technology assumes that there is concern amongst the public about their protection. There will be a significant investment and effort dedicated to the defense and weapons industry. Superior weapons war-making capabilities will shift the balance of power in favor of the one with the superior technology. This can set off "arms races" in technology fields, as witnessed during the Cold War between the USA and the USSR.

Now we witness the race in AI among major powers. This constant pressure to keep up creates a contagion of obsolescence, especially in the private sector. If a firm's competitor has adopted AI, it may have little choice but to follow suit. In this way, technologies can be "contagious" when competition and rivalry are involved.

The field of technology assumes spillovers are a good thing. Technology invented for one purpose is adopted for another, sometimes unrelated, field. For example, gaming software and hardware have been adopted for virtual reality, the internet of things, and now AI. Technology also trickles down; for example, satellites developed for military purposes eventually enabled the creation of mapping apps common on every smartphone. GPS only gives the coordinates of the location. It is affordable and accessible and there are a million things you can do with GPS as seen today. It is a simple technology that is enormously scalable and affordable.

Similarly, the network effect ensures that after a point, the cost of not being on a network, such as WhatsApp, may be more than being in it. The simplest network effects are direct: increases in usage lead to direct increases in value. Network effects can also be indirect, where increase in the use of a product causes the production of complementary goods, and this leads to an increase in the value of the original product. For instance, while there are some direct network effects associated with Windows, the indirect network effects that arise from the increase in quality and availability of complementary applications software are also important.

The field of technology assumes that science, markets, and the law define its limits. Decency and morality are not first-order factors in the consideration to develop or diffuse new technologies.

In the past decade, the US defense department launched Project Maven to develop and integrate computer-vision algorithms needed to help military in counterinsurgency and counterterrorism operations. Several Google employees signed a petition in protest against the company's involvement with this project that studies imagery that could be used to improve the accuracy of drone strikes. The employees believed that Google should not be in the business of war and asked that Project Maven be canceled and that Google draft, publicize, and enforce a clear policy stating that neither Google nor its contractors will ever build warfare technology. They were concerned that the US military could weaponize AI.

Similarly, when Craigslist was used for the sex trade, concerns were voiced. Many believe that technology needs a "true north" or a moral compass as to how technology should be used. Although innovations are made with good intent, how the black sheep of society use

it may not be within our control. Craigslist is a classified advertisements website set up to facilitate buyers and sellers but it is being misused by those in the “flesh trade.” Nuclear power is another example. Whether we use it for bombs or nuclear energy is a choice we need to make.

The field of technology assumes that pioneers should be agnostic about whether the technology they are developing will be a complement or a substitute to humans. In other words, human adjustment to radical technologies is beyond the scope of the technologist. This assumption will receive greater scrutiny with the acceleration and adoption of generative AI.

When I reflect on my journey of thirty years with Infosys, we started out with a unique global delivery model of IT services. Infosys shifted labor according to the requirements of the clients. At that time, it was not our concern that other people might lose their jobs because of us. We created a model and made a profit. Infosys had an extensive marketing department.

Advanced robotics is introducing a new generation of machines capable of executing dexterous and delicate tasks: recognizing, computing, and acting on information, and even collaborating and learning from humans. As technology progresses, manufacturers are looking to adopt robotics. However, the high costs and technical obstacles involved in remodeling manufacturing processes are prohibitive. There is concern that robots may replace human labor. Soon a good proportion of many manufacturing and office tasks are likely to be taken over by hardware and software robots.

The spread of Uber also supports this assumption. Uber considers itself a technology platform and not a taxi company. It merely provides the branding and platform for drivers to create a small business using the technology. This does not require Uber to pay salaries as each individual cab driver earns their own wages. The growth of Uber has been aggressive and they have also faced a number of legal actions. Existing taxi companies fear Uber, noting that their wages create an unfair advantage for them and steal the existing workforce.

The field of technology also assumes that humans will adapt to powerful new technologies. They will abandon prior social relations and habits if science and modernity are sufficiently emphasized and brought to the foreground.

In my opinion, technology should be accessible to most sections of society. A good example here would be the Aadhaar card in India. It needs a two-point verification—the Aadhaar number and biometric verification. It is simple, cheap, and easy to use. It has also enabled a unique identification system that has helped the government to track finances, subsidies, and even criminal records.

In the future, there is a possibility of leveraging technology to set up cooperative business platforms that are democratic in nature. The way we do business in the future will change. Corporate houses may give way to Ubers and Amazons. There will be a new set of rules. Democratic and public software platforms may be the new way of conducting business in the future.

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A Compass for Technology

Jim Hagemann Snabe

Through the introduction of new technology, industrialization has created opportunities and increased wealth for more than 200 years. With the exponential development of digital technologies in the fourth Industrial Revolution, the world is at a crossroads. Businesses and societies will go through radical changes at an unprecedented speed. Digital technologies are disrupting traditional value chains and creating new opportunities for more sustainable economic growth and inclusion. At the same time, the use of digital technology will challenge fundamental pillars of society like privacy, security, education, job markets, human interaction, and trust.

The opportunities are significant, but so are the potential unintended uses and consequences of digital technology. The companies developing the new digital technologies benefit from digital network effects through the deployment of platforms and extensive use of data. At the same time inadequate regulation, concentration of innovation, and uneven adoption of technology could undermine the opportunities that digitalization presents. The digital revolution provides a once-in-a-generation chance to drive radical change and progress across the global economy. However, this transformation should not only be driven by the technological opportunities. Its negative, unintended consequences must be managed. We urgently need to define a “Compass for Technology” to bend the curve of digital transformation toward a more prosperous tomorrow. An important choice must be made between a more open, inclusive, and interconnected world and one that is closed, siloed, and unequal.

The fundamental assumption is that the companies developing the new technologies can focus on the benefits and let society deal with the unintended consequences. However, given the impact on society that the digital technologies will have, the speed of technological advancements, and the slowness of the development of political frameworks, the question is whether it is time to challenge this fundamental assumption. How can we develop a compass for the use of technology that forces business leaders to steer the digital transformation toward progress in society and take responsibility for avoiding the unintended consequences of digital technology?

35.1 The Industrial Revolution

For 200 years, humankind has benefited from technological advancements. The Industrial Revolution improved our standard of living radically and moved billions of people out of extreme poverty. Notwithstanding the two World Wars and the many local conflagrations still ongoing, we’ve seen positive development on all populated continents, albeit at different

speeds. The Industrial Revolution is often characterized by the advent of mass production. Small, expensive, and slow handcraft production methods transitioned into standard products produced in large numbers in factories with the lowest marginal costs. The introduction of global standards has particularly contributed to boosting productivity. It has made it possible to sell to consumers globally and ship goods far at almost zero costs, and created a global market competing on price.

Most business leaders have learned to lead based on the assumption that competitive advantage is created by producing goods on a mass scale as efficiently as possible and that any unintended consequences of technology are managed by society through regulation.

The improvements in efficiency and productivity in the first three Industrial Revolutions were driven by a series of trends enabled largely by mechanical technologies:

- *Specialization.* Production and supply chains were divided into specific elements, which increased the possibilities for specialization and reduced costs. Individual companies and employees primarily focused on maximizing efficiency in their part of the value chain.
- *Automation using machines.* The introduction of machines made specialized workforces even more efficient; production costs fell while real wages rose in the middle class, resulting in increased demand for mass products.
- *Globalization and standardization* created a wave of offshoring and outsourcing to countries where labor was cheap, especially China and India. Business models were developed based on producing at the lowest possible marginal cost.

Throughout the Industrial Revolution, the fundamental assumption was economies of scale. This logic has created global giants, with size and scale as their competitive advantage. It has been an advantage to be big, and the winning strategy has been to maximize the size and the scalability of the company and its market while minimizing costs.

At the same time, the focus on optimization of scale and cost combined with a high degree of specialization has created linear value chains with a high consumption of resources and high degrees of waste and significant costs of externalities like pollution. The assumption is that businesses can take full advantage of the new technologies, and let society deal with the unintended consequences. Policymakers define regulatory frameworks in order to limit the unintended consequences, and businesses optimize within the frameworks.

35.2 The Digital Revolution

So, what has changed? Globalization continues, as does consumption and the opportunity to maximize scale using new technology. Based on that logic, business as well as management models should still be viable. In the meantime, a fourth Industrial Revolution has gained momentum and changed the logic. Where the other Industrial Revolutions have been mechanical, this revolution is digital. Digitalization, in many cases, changes the linear curve to an exponential one, because the technologies are connected, thus constantly gaining new connection points and data, while continually doubling speed, reducing costs, and doubling the capacity. With our mobile devices, we have the internet in our pocket, so we can be connected everywhere to devices all over the world and take advantage of the technological opportunities of digital networks and platforms quickly and cheaply.

Until a few years ago, digital technologies mainly disrupted industries where the physical products could be replaced by digital versions, such as music, film, media, money, and advertising. The winners were digital companies like Google, Meta, Netflix, and Spotify, that did not have the disadvantage of a physical supply chain but could reinvent the industry based on digital assumptions. The traditional assumption that a company needs to own its assets in order to sell its value is also being challenged by the digital business model. Uber, Airbnb, and a number of other digital platforms do not own assets. Uber and Lyft do not own cars, Airbnb does not own hotels or properties, and the new banking platforms do not have cash or branches. They just connect supply and demand and have changed the conditions for established companies.

Digital platforms transform business models, so the old players that previously benefited from size and scale are overtaken by small but fast digital companies, who know the individual customer better because of their access to customer data and utilization of online technologies to connect supply with demand without an intermediary.

The exceptional feature of digital technology is that it challenges the traditional assumption of economies of scale. Instead, the competitive advantage is moved to digital platforms and the value of data. Marginal costs and distribution costs of the platform are virtually zero. This means that the earlier industrial-age logic, where competition focuses on scale to reduce marginal costs, is no longer sufficient. Digitalization allows companies to understand consumer preferences more accurately and deliver on individual needs and preferences.

The digital disruption is not new but has now gained momentum and speed. With the addition of AI and interconnected devices, the speed of disruption is likely to accelerate even further. Through the “internet of things,” most physical products become digitized and connected. Through the addition of AI, physical products begin to learn, update, and maintain themselves, accelerating technological opportunities beyond anything we have ever seen before.

Chairman and CEO of Softbank, Masayoshi Son, compares this with the biological phenomenon called the Cambrian explosion more than 500 million years ago, where visual abilities changed our evolution. His thirty-year-vision is a world where the artificial computer brain will have an intelligence quotient (IQ) of 10,000, compared with 100 for the average human. The Japanese businessman also predicted that by 2040 there would be an army of 10 billion intelligent robots making human lives easier. A prediction of incredible opportunities—but also many challenges that are currently unsolved.

When these technologies are combined in new ways, many of our current assumptions and business models are challenged. As an example, the car of the future will most likely be a self-driving electric vehicle, closely connected to other vehicles, traffic systems, energy systems, and sensors.

35.3 The New Challenges

The example of the self-driving car illustrates the possible benefits of digital technology. A system of self-driving vehicles is in many ways the ultimate public transportation system with significant benefits to society. First of all, it is convenient as it transports people from door to door and not from bus stop to bus stop. The cost of transportation will be dramatically

reduced due to the fact that the assets are utilized much more. At the same time, we will convert transportation time to productive time. More importantly, we will reduce the number of accidents in traffic to near zero and as a consequence save human lives and healthcare costs. And we will be able to dramatically reduce the carbon footprint of transportation, which today is responsible for up to 22 percent of total CO₂ emissions (Lefevre and Enriquez, 2019). In other words, a system of self-driving vehicles unlocks huge benefits for society.

At the same time, digitizing value chains and industries introduces new challenges. Self-learning robots like autonomous vehicles eliminate a significant number of jobs. Current estimates of global job losses due to digitalization range widely, from 2 million to as high as 2 billion by 2030 (World Economic Forum, 2016). The analysis suggests that digitalization can be a net job creator in some industries. But the transformation of value chains will create winners and losers depending on the ability of businesses and education systems to re-skill people. Currently, our education system is not designed for life-long learning, but assumes education takes place during the first seventeen to twenty-five years of our lives.

Another challenge is that the network effect of the digital economy tends to create platform monopolies with the risk of concentrating power and value in few hands and thus increasing inequality. Digital platforms typically require a certain scale to deliver transformative innovation networks and unlock new value. Significant scale, however, brings concerns about anti-competitive behavior and a risk of abuse of power. In the context of platforms, notions of how dominance and power are expressed differ from traditional concepts of industrial monopolies. For example, platform orchestrators leveraging the predictive power of advanced analytics raise concerns that one commercial actor can systemically generate insights that other participants cannot. The combination of dramatic shifts in job markets and the centralization of power and economic value to a few global platforms may cause significant winners and losers and, in the process, increase inequality and social unrest (see [Brynjolfsson and McAfee, 2014](#)).

Another consequence of the digital economy is its impact on privacy. While the system of autonomous vehicles delivers convenient transportation services, it also generates information about where people are, where they are going, what they are doing—and potentially what they are thinking. The misuse of information at Facebook to manipulate opinions is evidence of the current limited understanding we have when it comes to the use and misuse of digital tools and data. At the same time, it is evidence of irresponsible leadership, which ultimately can lead to a breakdown of trust in institutions and society at large. Add to this the risk of misuse of data and control of connected devices through cyber-attacks from criminal organizations or terrorists and the risk of breakdown of trust and society is even higher.

35.4 Challenging Technology Assumptions

The impact of digital technologies on jobs and skills, the risks of platform monopolies, and the potential loss of privacy are just three examples of the new challenges we need to understand and overcome before we can maximize the benefits of the digital revolution for society. The use of technology has always had flip sides. With the introduction of machines in manufacturing for mass production, we accepted externalities like pollution in order to increase

efficiency. With a linear adoption of technology, policymakers could understand the unintended consequences and react by introducing regulation and taxation to limit the negative impact. With the exponential introduction of digital technology in business and society, this is no longer possible. It is unlikely that policymakers will be able to understand and manage the unintended use and consequences of digital technology in time.

In order to balance the benefits and risks associated with the use of technology, we need to understand the possible unintended consequences up front and require business leaders to take responsibility not only for the benefits of new technology but also for the avoidance of unintended consequences. The balancing of benefits and unintended consequences should be managed on various levels—including:

- Human: enhancement of human capability versus replacement of workforce.

AI algorithms combined with advanced robotics and sensors offer opportunities to leverage technology in job categories that previously were assumed to require human efforts and intelligence. One example is healthcare, where technology is able to deliver accurate diagnostics with higher accuracy than many experts. A common assumption is that replacing human effort with technology is good for business. However, if taken to the extreme, this could cause significant levels of unemployment, which could lead to increased inequality and social unrest. How do we challenge the assumption that technology should be used to replace the role of humans? How do we create incentives for business to use technology to enhance human effort and potential? How could we reinvent the tax system to refocus business on leveraging technology to reduce resource consumption and externalities and enhance human workforce?

- Platform: digital inclusion versus platform monopolies.

Digital platforms deliver network effects that significantly increase the value of technology, reduce costs for all participants, and enhance opportunities for innovation and re-use. Some platforms, like open-source software development platforms, deliver decentral innovation capacity and access. A common assumption is that in order to create the network effects, platforms need to be concentrated in few but very powerful global digital platforms. However, if taken to the extreme, the platform tends to centralize power and value in few hands with limited opportunities for others to benefit. How do we create network effects via few global platforms while preserving decentral power, and fair distribution of opportunities and value? What role does governments play in order to regulate platforms, create incentives for openness, and provide access to innovation? How do we create transparency on the use of data and allow people to regain control of their own data? How do we measure the openness of platforms?

- Intelligence: enhanced intelligence versus loss of control.

The combination of advanced machine learning algorithms, the emergence of massive parallel processing computers, and the access to large data sets enable computer systems to learn without being explicitly programmed. This “self-learning” capability offers huge opportunities to convert complex data sets into intelligence, enhance human understanding of complex

systems, and improve human decision-making. Historically, AI applications have been relatively narrow, focused on solving specific problems with known rules and structured data, such as learning to play rule-based games, speech recognition, and image analysis. However, AI is a rapidly developing field and machine learning algorithms are already starting to be deployed in areas where more serious ethical and security concerns arise. A common assumption is that the more powerful the AI algorithms are, the more valuable AI will be. However, if taken to the extreme, advanced algorithms will ultimately reduce our understanding of how AI-based systems arrive at certain conclusions. In addition, there are increasing concerns that humans could ultimately lose control of AI-based systems when the self-learning algorithms become more advanced than humans. How do we leverage AI systems to find better solutions for fundamental issues in society? How do we ensure that humans stay in control of AI-based systems? Do we need to apply ethical rules for the use of AI—and if so, how do we best define and implement such ethical rules?

- Information: democratization of information versus loss of trust.

Through the distribution of affordable smartphones and access to low-cost mobile broadband, billions of people are able to share information, ideas, and opinions and gain instant access to information and knowledge. The power and ownership of knowledge is no more for an exclusive few, but available for everyone. A common assumption is that this instant access to and sharing of information is the ultimate democratization of information. Democratization of information offers the free flow of ideas, opinions, and knowledge that inform public debate and dialogue in society and hold the promise of social and democratic inclusion. However, the unfiltered creation of information and the development of advanced algorithms to help search and navigate the information on the internet tend to sort information according to individual preferences and create “islands of common opinions.” Combined with the ability to track data on individual behaviors and preferences on mobile devices, social media is currently being misused to manipulate opinions and spread fake news in very targeted ways. Taken to the extreme, the consequence could be that the promise of democratization of information is converted to a loss of trust in society, which would undermine the fundamentals of democracy. How do we ensure the quality of information shared on the internet? How do we reduce the risk of loss of privacy and avoid manipulation? How do we find the balance between sorting information for relevance and creating opportunities for manipulation? How do we create the needed transparency?

35.5 The Compass for Progress

In each of the examples above, it is clear that digital technologies offer significant opportunities to create value and progress. At the same time, it seems like an extreme use of technology can lead to the exact opposite. Technology will not define the limitations of what is possible. In fact, the exponential development of digital technology will only increase the risk of unintended use and consequences. Limitations to avoid extreme use of technology should be defined by humans. As a consequence, it is important that we challenge our current assumptions around technology and begin to steer the technological development in a direction that is in line with our ambitions for progress in society.

In order for us to leverage digital technologies to solve fundamental challenges in society, we need to define a Compass for Technology that sets the direction of what is desired when it comes to the use of digital technology. It is time to challenge the assumption that businesses can focus on the benefits of technology and let society handle any unintended consequences. Instead, business leaders should commit to balancing the opportunities to accelerate innovation and commercial growth with critical societal impacts and concerns, in order for us to drive economic value *and* progress from technological advancements. We need a Compass for Technology and responsible leaders committed to using the compass when navigating the fourth Industrial Revolution.

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Situating the Assumptions of Technology in Broader Normative Frameworks

Reflections on Shibulal's and Snabe's Chapters

Elizabeth Anderson

Neoclassical welfare economics is founded on certain key economic structures like private property, markets, and for-profit firms. It posits that individuals are rational actors who maximize utility, with voluntary choices reflecting their preferences, thereby advancing their welfare ([Friedman, 1970](#)). It gauges the success of the entire economic system based on Pareto efficiency, assuming a context where private firms primarily aim to maximize profits under a regulatory environment that ensures optimal economic outcomes through effective fiscal and monetary policies ([Debreu, 1959](#)). It presupposes compliance with laws by most agents without attempts to bypass or undermine them.

Critiques of neoclassical welfare economics often highlight its neglect of distributive justice, where vast wealth disparities can still be Pareto efficient. In defense, proponents suggest that redistributive responsibilities fall to the state. However, historical economic figures like Adam [Smith \(1776\)](#) and Karl [Marx \(1964\)](#) proposed a broader evaluative lens, focusing not just on efficiency or wealth distribution but also on the impact of economic systems on ourselves. What do we make of ourselves, and of our relationships to others, in arranging production, commerce, and distribution through different institutions?¹ Do our economic arrangements enhance or diminish our skills and other capabilities? Do they promote antagonistic, domineering, and contemptuous or sympathetic, cooperative, and respectful relations with other people? They argued that economic structures shape individual capabilities, social interactions, our moral dispositions, and our preferences, influencing whether societies foster competitive, cooperative, or antagonistic relationships among individuals. This broader perspective emphasizes the profound influence of economic arrangements beyond mere consumer satisfaction, particularly in labor markets, which critically affect the quality of social relations.

The following discussion will examine the assumptions of technology from the normative perspectives of both neoclassical and classical economics.

36.1 Assumptions of Commercial High Technology

S. D. Shibulal and Jim Snabe in their chapters in this volume articulate numerous assumptions underlying commercial technology, along with several challenges posed by technology

¹ See [Frank, 2000](#); and [Schwartz, 2005](#).

that call for institutional innovation. I shall consider, in turn, the potential of neoclassical and classical normative frameworks to recognize and cope with these challenges.

Software designed to predict and deliver information and entertainment precisely tailored to users' past consumption patterns and similarity to other users appears to fulfill to the maximum possible degree the aim of consumer preference satisfaction. Hence, on neo-classical assumptions, it appears to maximize consumer welfare. Yet the assumption that people are better off when their revealed online preferences are satisfied is questionable. Although Facebook users spend almost an hour per day on this site, greater engagement with Facebook appears to make people worse off: it reduces users' own sense of physical health, mental health, and life satisfaction, their face-to-face social engagement, their involvement in meaningful activities, and their self-esteem. Viewing the carefully curated positive self-images others have posted on their Facebook pages makes people feel bad about themselves and induces them to waste their time on similar competitive and misleading representations of self to others ([Christakis and Shakya, 2017](#)).

The internet promises free access to vast amounts of information held by others. This would seem to be an unalloyed good. Yet asymmetrical information is also a source of market failure, if those with greater information exploit those with less ([Akerlof, 1970](#)). Algorithms designed to maximize viewers' attention have been gamed to drive them to videos and websites pitching extremist propaganda, conspiracy theories, and medical scams. While individuals may "prefer" sites they find fascinating, algorithms selecting for fascination alone might frustrate other user preferences—for example, to gain accurate information, and to avoid being misled, manipulated, or defrauded.

Network effects have led to monopolistic or oligopolistic conditions on several technology platforms, including for web search, online retail, social media, and ride-sharing. In the neoclassical theory of monopoly, this should result in higher prices, lower quality, and lower supply. Some monopolistic platforms defy these predictions. Google, YouTube, Facebook, and many other sites are free to users. Google and Amazon deliver unrivaled and continuously improving quality in web search and online retail, respectively. Both are continuously expanding the supply of services they offer to more and more users. The costs of these tech monopolies often lie elsewhere. Users have yielded vast, detailed personal data to these platforms, losing their privacy to tech companies in the process of using their services. Facebook has repeatedly violated users' expectations of privacy, and systematically misled the public about how much they know about users, how their data are used, and how much control users have over their data. Users have little recourse because they lack both exit and voice, the two means by which stakeholders can influence a dysfunctional organization ([Hirschman, 1970](#)). Many can't exit Facebook because they need to interact with others who use it. But they also lack effective voice, as Facebook's corporate governance structure is weak, unable to hold its CEO to account.

The most important challenges high technology poses today concern its effects on the fate of workers, the quality of human relationships, and democracy and governance. The normative framework of classical economics offers richer insight into these effects than the spare ideas of preference satisfaction, efficiency, and profit-maximization that dominate neoclassical economics.

Shibulal notes the common assumption of technology firms that humans must adapt to technology, and not the other way around. This assumption has had a profound impact on workers, for both good and ill. Technological improvements raise productivity, and often

reduce workplace injuries and drudgery by taking over repetitive operations. However, automation also causes technological unemployment and reduces the labor share of value-added, leading to stagnant wages relative to productivity growth (Acemoglu and Restrepo, 2019). Scheduling software and platforms for gig work have increased workers' precarity by replacing steady full-time jobs with unpredictable hours or even mere minutes of work from day to day. Adam Smith and Karl Marx worried about the ways industrial technology deskilled workers and consigned them to stultifying jobs.² To the extent that AI replaces skilled work such as medical diagnosis and reviewing legal materials, we have reason to share these worries today. Will the remaining work to be done after AI is fully developed and deployed be challenging and interesting, or tedious and menial? Even some kinds of work for technology companies that requires skilled human judgment can combine extreme tedium at a relentless pace with emotional distress: consider the moderators hired to remove content that violates Facebook's complex community standards, including videos of murder, suicide, and rape (Solon, 2017).

Shibulal notes that technology firms assume that wider adoption of technology is better than narrower, while Snabe highlights the assumption that a more interconnected world is better. The notorious internal memo circulated by Facebook vice-president Andrew Bosworth endorses these assumptions even while recognizing some of their costs:

We connect people ... That can be bad if they make it negative. Maybe it costs a life by exposing someone to bullies. Maybe someone dies in a terrorist attack coordinated on our tools ... The ugly truth is that we believe in connecting people so deeply that anything that allows us to connect more people more often is **de facto** good ... That's why all the work we do in growth is justified. All the questionable contact importing practices. All the subtle language that helps people stay searchable by friends. All of the work we do to bring more communication in. The work we will likely have to do in China some day. All of it.

Connecting people regardless of the malevolent intent of some has spread toxic relationships through social media by such means as trolling, cyberstalking, cyberbullying, swatting, doxxing, revenge porn, fake news, and much more. The vast scale and viral tendencies of social media, which connect distant strangers to obscure individuals who have engaged in offensive or embarrassing conduct, have inflated the magnitude of the social shaming that attends public exposure of such conduct, often beyond any just standard of proportionality. We are far past the point where it is credible to claim that connecting people is good in itself. Yet social media such as Facebook and Twitter (now rebranded as X) have repeatedly failed to police bad actors or deliver the tools users need to protect themselves from toxic relationships.

Snabe observes that tech companies assume that they can focus on the benefits of their technology and leave management of the unintended consequences to society. In practice, this usually means state regulation. Yet he notes that technology develops much more rapidly than the state is able to respond with appropriate public policy. I would add that the problem is not simply that the state cannot move quickly enough. It is that technology may

² See Satz, 2010 for other related concerns.

undermine the very tools society needs to manage technology's negative externalities. Digital technology has undermined democracy itself, and not only by malevolent actors such as Russia, which interfered in the 2016 US presidential election. Algorithms used by social media isolate partisan and identity groups into distinct media and communication networks, exposing them to echo-chamber reinforcement of false and extreme beliefs (Sunstein, 2009). Such technologies foster division and distrust, and undermine the cross-group communication needed to create the shared reality needed for societies to engage in constructive problem-solving.

These phenomena raise important governance challenges, not only for the state but also for the internal management of technology firms. It is possible that the sheer scale of some platforms, the speed with which information is uploaded and shared, and the opacity of the algorithms used to distribute it render them ungovernable by any means, even as their negative consequences spread. If so, this could supply an argument from classical economic normative concerns for antitrust action, to break up certain platforms to governable size, even if platform monopolies defy the negative predictions made about them in neoclassical theory.

Preference satisfaction, efficiency, and profitability supply significant normative standards for evaluating economic institutions and practices, including high technology. Further normative insights into technology can be gained by drawing on traditions in classical economics, which focus on the impact of economic arrangements on the capacities of human beings, the quality of social relationships, and the responsiveness of the state to broad human interests.

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Concerns about Technology

Reflections on Shibulal's and Snabe's Chapters

Susan Neiman

While in their chapters in this volume both Shibulal and Snabe allow that technological progress is not always benign, their language does not reflect the depth of the crises technology has produced. Even leaving aside the dangers that technological advances may produce in the future—for example, intelligent and weaponized robots—we know enough about technology's effects in the present to find words like “flipside” or “challenge” optimistic evasions of foundational problems. The largest and most immediate is the environmental crisis, brought on both by the assumptions about rationality mentioned above and by the belief that technological advances always equal progress.

Who would argue against growth? Its opposite is decline. Like responsibility, whose antonym is carelessness or recklessness, the assumption that economic growth is a good conceals a set of prior assumptions that are couched in benign language. First among them is the idea that people are (only? mostly?) made happy by the accumulation of stuff. Even were this true, the long-term consequences of an economy bent on producing ever more stuff will clearly make most of us miserable in the future, as reckless consumption changes the face of the planet. But there is plenty of evidence that acquiring more stuff is not the key to human happiness, and there are many philosophical traditions, going back at least to the Stoics, that question it. What Rousseau saw in the eighteenth century—that after a brief moment at acquisition, we are much less likely to feel pleasure in gaining an object than we are to feel discomfort in losing it—was confirmed by social psychologists in the twentieth. Once our basic needs are satisfied, we get more pleasure from experiences than from things. Of course, as Robert Frank's work has shown, we can be made quite unhappy if we live in an environment where we are constantly subject to the message that more, and bigger, is better. If all my neighbors build McMansions, my ordinary home will seem small. Even worse, if they all throw lavish parties for their children, I will worry that a modest celebration will deprive my own. That message, and my neighbors' priorities, are fueled by \$200 billion worth of annual advertising in the US alone. Those who are less susceptible to such influences have begun to acknowledge that more stuff is not equivalent to more happiness. Millions of Americans following Marie Kondo's injunction to rid themselves of excess objects suggest this is not a phenomenon confined to inhabitants of small rural communes, or dour ascetics.

Decent defenders of the current consumption-driven market acknowledge that something must be done about the plastic in the seas. Faced with the suggestion that not everything they own, or produce, might be necessary for a good life, they are nonetheless likely to respond with a barrage of questions. Who's to say what's necessary? What's wrong with creating new needs? Are you proposing government regulation? Stalinism? Such questions demand hard thinking, but they are often designed to prevent it by making us feel that the answers are so

elusive that political or cultural answers are impossible. If political answers are not sought, however, everything will be left as it is, which is to say: in the hands of the market, and according to market logic: more + faster = better.

But supposing you're not convinced by this logic. Whether or not you're susceptible to the charms of minimalist Japanese aesthetics, you know that endless accumulation is not the road to heaven, in this life or any other. Unless you actually choose to live off the grid, you cannot opt out of accumulation as often as you please. This is thanks to the assumption, nicely stated by S. D. Shibulal, that "the field of technology assumes that obsolescence is inevitable." What's missing in this assumption isn't philosophy but history. Obsolescence was invented, and historians have even pinpointed a date. In 1924 the Phoebus Cartel, an association of manufacturers including General Electric, Osram, and Philips, held a meeting in Switzerland. They agreed to reduce the life of lightbulbs—at the time proudly averaging 2,500 hours—to 1,000 hours, thereby more than doubling the number of lightbulbs that would be sold. Members of the cartel controlled their subsidiaries firmly, and those who did not reduce the quality of their lightbulbs were fined. The cartel was successful, within a decade, of making the thousand-hour lightbulb the standard. But it probably required no conspiracy; the idea was in the air. In 1928 the young advertising journal *Printers Ink* proclaimed, "an article that refuses to wear out is a tragedy for business." The manufacture of goods designed to decay was hardly limited to lightbulbs. The auto industry discovered it early, allowing General Motors to dominate the market by 1931, edging out Henry Ford, who clung to the obsolete idea that goods should be built to last.

The phrase "planned obsolescence" was first used in a pamphlet written in 1932 by American entrepreneur Bernard London, who argued that in order to reduce unemployment during the Great Depression, the government should make planned obsolescence compulsory. In an age that had yet to develop environmental concerns, the solution looked simple: the more often a product decays, the more products need to be made, the more workers needed to make them. There was no need to mention the more profit created for corporations. London's proposal for compulsory planned obsolescence proved unnecessary, for the advertising industry was learning that seduction was more effective than legal force. Convincing consumers that their things were unfashionable even before they actually broke down began in the 1950s in earnest. Occasionally a product still needed tinkering: after Dupont invented nylon stockings strong enough to tow a truck, it sent the chemists back to the laboratory to design nylons that run when snagged by a fingernail. Today's products often hide computer chips that ensure their demise, and we expect to replace most of the things we depend on every few years. Nor does the maintenance of this system of production require cartels or fines. In 1981, the East German lightbulb manufacturer whose products lit up half Beijing tried to peddle its longer-lasting wares at a West German trade fair. No company was interested in stocking them. The factory was closed shortly after the fall of the Berlin Wall ended travel restrictions for eastern Europeans, and business restrictions for Western companies.

Critics as different as Goodman, Vance Packard, and David Riesman deplored the introduction of planned obsolescence, and other features of the burgeoning consumer culture of the early 1960s. That's probably the reason the term went out of use and was replaced by the woolier "product life cycle." Life cycles sound normal, part of the organic process of birth and decay. We now find it natural that most of the objects we use will need to be replaced before we have finished paying for them.

Planned obsolescence stimulates the economy. (Once again, who has anything against stimulation?) In doing so, however, it not only produces more stuff than the planet can sustain, even if we succeed in turning more of the developing world into dumping sites. Perhaps even worse, though less obvious, than its effects on the planet are the effects of planned obsolescence on human beings. Since the eighteenth century at the latest, philosophers from Rousseau to Arendt have argued that work is far less a means to earning money than a crucial element of being human.

Without taking things out of nature's hands and consuming them, and without defending himself against the natural processes of growth and decay, the laboring animal could not survive. But without being at home in the midst of things whose durability makes them fit for use and for erecting a world whose very permanence stands in direct contrast to life, this life would never be human. (Arendt, 1998: 135)

This is only true if the work is meaningful, producing things whose value partly consists in their durability. Shoddy objects designed to self-destruct cannot fulfill this need.

Finally, planned obsolescence plays a role in undermining even those who don't care about owning the latest iteration of a technological device that has become a necessity in a world in which everyone else has one. You may have no interest in keeping up with your neighbors (or their children), but your cellphone and computer can be relied on to collapse every few years. The market has made it impossible to simply buy another, for your old model has been replaced by a plethora of new ones. (Once more: who dares complain about choice?) Not only must you sort between them; all the operations you have learned to perform without reflection have now been altered, and you must decipher another instruction manual to recover your earlier level of proficiency. If all the hours human beings waste every year on what are cheerfully called upgrades were devoted to solving real problems, any number of them could be solved.

Solving real problems would entail questioning the basic structure(s) of contemporary society, and that task is so enormous that we prefer to be distracted. While both authors acknowledge that digital technologies have some drawbacks, both start from a set of assumptions that dramatically understate those drawbacks. "Through the distribution of affordable smartphones and access to low-cost mobile broadband, billions of people are able to share information, ideas, and opinions, and gain instant access to information and knowledge." An advertisement for Apple? This cheerful description ignores the well-known fact that the web is used to gain instant access to more pornography than anything else. But even were a majority of people using the web to read Plato, this assumption ignores the growing body of research about what the internet is doing to our brains. There is a wide debate about many aspects, but Nicolas Carr's book *The Shallows* describes some incontestable conclusions:

One thing is very clear: if, knowing what we know today about the brain's plasticity, you were to set out to invent a medium that would rewire our mental circuits as quickly and thoroughly as possible, you would probably end up designing something that looks and works a lot like the Internet. It's not just that we tend to use the Net regularly, even obsessively. It's that the Net delivers precisely the kind of sensory and cognitive

stimuli—repetitive, intensive, interactive, addictive—that have been shown to result in strong and rapid alterations in brain circuits and functions. With the exception of alphabets and number systems, the Net may well be the single most powerful mind-altering technology that has ever come into general use. At the very least, it's the most powerful that has come along since the book. (Carr, 2010: 116)

Carr explains the profound and extensive brain changes that our own experience leads us to suspect; he argues that “The Net is, by design, an interruption system, a machine geared for dividing attention” (ibid.: 131). Grabbing our attention only in order to scatter it, the net exercises the brain as much, and as little, as crossword puzzles do. But attention is the key to consolidating memories—and to the sort of rich, engaged thinking that requires long-term memory. “Psychological research long ago proved what most of us know from experience: frequent interruptions scatter our thoughts, weaken our memory, and make us tense and anxious. The more complex the train of thought we're involved in, the greater the impairment the distractions cause” (ibid.: 132).

Matters are even worse when we consider social media. It is telling that many of its pioneers have now become, in the words of Sean Parker, the founding president of Facebook, “conscientious objectors” to social media, and even more telling that they severely limit their own children's use of it. As Parker (2017) said,

The thought process that went into building these applications, Facebook being the first of them ... was all about: “How do we consume as much of your time and conscious attention as possible?” That means that we need to sort of give you a little dopamine hit every once in a while, because someone liked or commented on a photo or a post or whatever. And that's going to get you to contribute more content and that's going to get you ... more likes and comments.

Another Facebook objector, former vice-president for user growth Chamath Palihapitiya (2017), wrote as follows:

The short-term, dopamine-driven feedback loops that we have created are destroying how society works. No civil discourse, no cooperation; misinformation, mistruth. This is not about Russian ads. This is a global problem. It is eroding the core foundations of how people behave by and between each other. I can control my decision, which is that I don't use that shit. I can control my kids' decisions, which is that they're not allowed to use that shit.

Focusing on the damage done to civil society through the proliferation of fake news, Snabe proposes that “business leaders should commit to balancing the opportunities to accelerate innovation and commercial growth with critical societal impacts and concerns, in order for us to drive economic value and progress from technological advancements.” This proposal underestimates the depth of the problem. What would happen if, instead of seeking balance between accelerating innovation and social concerns, we declared a moratorium on technological innovation until we determine the impact that innovation has already had on our lives, and what can be done about the damage?

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PART IX
FINANCE

Taking Stock of Some Core Assumptions in Finance

Raghuram Rajan

I aim to take stock of some core assumptions in finance. This is by no means to suggest that the finance profession is a prisoner of these assumptions, and that people haven't challenged them. People have gone way beyond to explore what happens in the real world. In some sense, these assumptions are primarily put down so that one can see what would happen in a "perfect world," and then focus on what might be real-world differences that need to be explained. It is a kind of framework for thinking rigorously. I will highlight some assumptions that are rather well known, and then offer some additional related observations.

The first assumption is that markets are generally quite efficient. What does that mean? Essentially, that it's hard to make money in markets, especially financial markets. If in fact I knew that a stock price was going to rise tomorrow and everybody else knew that, well, it would go up today anticipating that movement, so it would be hard for people to make money. More generally, the argument is that any kind of pattern that exists in stock prices, patterns that you can reliably make money off, will sooner rather than later be discovered by market participants and it will become harder to make money off it. There have been many anomalies discovered in financial markets in recent years: the January effect, the small stock effect, the value effect, and so on.

All of these imply that investing in a class of securities at a particular time can allow you to make higher returns than normal. It turns out that once any particular anomaly is discovered, generally the ability to make money off it disappears fairly quickly. In other words, once market participants recognize that it's a true anomaly, they trade in such a way as to try to take advantage of it. If enough people trade and buy that particular anomaly to exploit it, they essentially get rid of the ways of making profit.

The second assumption, perhaps I might say axiom, is what is called shareholder value maximization, which is a source of much controversy in the broader population. The belief is that the job of corporate managers is to maximize value for shareholders. In Milton Friedman's stronger rendering, it is in fact the one and only job of corporate CEOs, to maximize profits. Avarice, which used to be a problem in medieval times, now becomes the "duty" of CEOs.

This assertion springs from the belief that in a corporation most of the claimants, in fact all the claimants *except* the shareholders, are fixed claimants. Think of short-term debt holders, think of workers who are on daily wages. In that kind of environment, the only claim on the firm that is variable is really the shareholders' claim. It's the residual claim that comes after everybody else is paid off. In that sense, if you maximize the value of the shareholders' claim, you are maximizing the value of the firm, the value that the firm creates for society

because everything else is going to fixed-claim holders, such as the workers and the debt holders. Therefore, management is doing the right thing by society. It's obviously dependent on the assumption that everybody else is a fixed-claim holder—that, for example, daily wage workers cannot be exploited unduly in a competitive market. Over the years, this has been strongly disputed.

Again, this serves as a starting point with which to understand what matters. It has, of course, got corporate CEOs in trouble, especially as they started being able to compensate themselves in shares because then it was, look, I'm getting more shares and higher compensation, but that's because I did wonders for the stock price. There certainly have been big aberrations based on that kind of compensation structure, a culture of pay for non-performance. Also, the theory assumes the legal and regulatory system takes care of all the negative side effects of corporate actions, such as pollution. Again, that need not be true.

A third big axiom in finance is the Modigliani–Miller theorem. The idea behind Modigliani–Miller is quite simply that the kind of liabilities that a firm issues, regardless of whether it's debt or equity, does not affect the value of the firm. Put differently, you can lever up however much you want since the value of the firm is really the value of the cash flow generated by the firm, which is assumed unchanged by the firm's liability structure in the Modigliani–Miller theorem. Then all you're doing is partitioning the two cash flows into different kinds of securities, such as equity or debt. It then doesn't matter how you partition it. The overall value must remain the same.

If we want to reduce risk while holding large financial claims across the economy, we diversify. So, finance, as a result of all this, does a fourth thing, which is to focus on spreading risk through diversification. Of course, what this means is nobody really sees the whole. Everybody sees parts because things have been cut up in such a way as to spread the risk through the economy.

Zooming out more broadly, people may agree that there is a good side to finance, but they may rightly ask, "What about all the bad sides?" Indeed, there are bad sides. I think the profession, regulators, everybody tries to mitigate some of the bad sides. Are they entirely successful? No. Is eliminating finance therefore a good thing? No. Do we have some hope of moving in the right direction? Yes.

Now to additional comments. First, about the use of euphemisms when it comes to corporations and their finances. Instead of firing workers, corporations "downsize," or "rationalize," or "right-size." I think the broader question is: is there a method for firms that works better than shareholder value maximization? The answer is probably yes, but that should not lead us to the extreme "corporate social responsibility" position that some argue for. That position risks making a firm no different from a government. The question of course becomes: who imposes these values on the firm? Do we all together as the citizenry vote on what individual firms should do? In what sense is a corporation then a private entity?

Indeed, is there any value to it being a private entity? I think, yes. When you look at the performance difference between private firms and public-sector firms, public-sector firms are often driven by some of these notions of corporate social responsibility. Along with many political and perhaps not so desirable aims, they typically tend to do much worse than private-sector firms on narrow notions of efficiency without necessarily delivering on the broader social responsibility.

By implication, I think we have to be a little careful about demanding, let alone mandating, too much of private firms. Firms have an objective, which is to advance productivity and choice. That's what they should be delivering for people so that people can essentially have

more choice among products and get them cheaper for a given quality. Burden firms too much and they won't do that well. So there is an important tradeoff implicit here.

On the issue of profit yield, or bottom line, I have my views on what we should replace shareholder value maximization with—loosely speaking, maximize the interests of those who invest either financial, physical, or human capital in the firm in a way that is hard to reverse—but it's not some made-up notion of an all-encompassing social welfare function.

Turning to scams in the financial sector, profiteering by a few does happen. That's where having deeper, more efficient markets will help. It does allow for easier trading in and out, but it does reduce the possibility that someone has privileged inside information and makes money off it. Accordingly, we also have rules in place to try and minimize that. For example, the "pump and dump" strategy is still practiced in some emerging markets where you pump up a stock's price and then, as everybody comes in to buy it because it's done well, you sell out all your stock and disappear. This used to be rampant in the US in the nineteenth and early twentieth century, but regulations have reduced that considerably.

These days there is also concern about discrimination in financial markets via the use of data. It's something that regulators focus a lot on. Are algorithms using data to essentially discriminate against people of a certain race or people of a certain sexual preference? Are you indirectly practicing discrimination? This is one reason, reflecting the strength of regulation in the US, that folks are weary of using black-box or machine learning tools where they don't quite understand why the machine learning says, okay, these particular characteristics define somebody who's credit-worthy. They fear that if the regulators analyze the practice, they may find that there was some discrimination implied in these sorts of algorithms. There is a greater reluctance in the US unlike, say, in a market like China's to use non-transparent machine learning methods for screening who gets a loan.

Separately, there is an implicit concern about the optimal size of finance in the economy. Does finance absorb too many resources? Almost surely there are many activities in finance that are unnecessary. Do I really need somebody to be ferreting out to the picosecond what the stock price should be? Should it be trading so fast and does that really help stock prices become any more informative? Or are they just competing in a kind of zero-sum game, the same sort of waste of resources that miners of bitcoin, for example, impose on society? Is this really useful? Probably not. Much of it, especially the fast trading, may not be very useful. Is trading at all useful? I think it is. I do think that trading helps establish prices. Is a speculator useful? Yes, because if everybody was on one side, who would take the other side in hedging risks? You need some people willing to lose some money while they're betting. In other words, that some people call markets a casino is not entirely wrong. But it's not also entirely a bad thing because in order to absorb the risk of genuine hedgers who need to offset their risk, you need people to be willing to speculate and take the risk off their hands.

I would like to mention the role of finance in climate change. Here obligations are being imposed slowly but surely. For example, the Bank for International Settlements set up committees to look at whether firms should be investing in what may become stranded assets, such as coal-fired power plants, which in a few years may be declared controversial or delicensed. The point is to focus on the risk of investing in these assets today and thereby suggesting in fact this might be something we want to avoid. This amounts to saying climate change implies we need to change practice, which in turn implies that we should probably today not invest in some of these activities and operations. It's hard today to find many bankers that are willing to finance coal-fired power plants, for example.

Let me make two last points, one on the teaching of finance and the other about shareholder value.

First, teaching finance. Do we teach it as if to say, “here is the world as it should be according to finance theory and why aren’t the unenlightened out there behaving as the world should be?”. The answer is no. I think we lay out the theory because it allows us to appreciate how the real world differs, both in terms of how the assumptions don’t hold and in terms of how there are a variety of other behavioral incentives and informational issues out there, which make it much harder to operationalize the models. The way finance is taught in classes is much less about “here’s the theory and go out into the real world and try and change the world to fit the theory,” but rather “here is a starting point and how do you have to think about it when you’re out there in the real world?”. That I believe is what finance does and where I see it going.

Much of what I’ve said about shareholder value is about thirty or forty years old and we’ve been debating those points since. Indeed, today many more people talk about maximizing something different. Typically, anybody who invests in the firm, such as workers, comes into the maximization equation. Accordingly, we want to make it less of a fight between these stakeholders in the firm and more about maximizing the joint product. I like to believe that’s how sensible people teach finance nowadays.

Are shareholder preferences themselves evolving beyond financial returns? In thinking about this question, there is merit to what Milton Friedman said, which is if you really want corporations to behave in a particular way, then enact legislation. If you want them to take climate change into account, legislate it. His worry, which I think was legitimate, was that activists who weren’t strong enough to legislate were pushing corporations into activities that the broader public or democracy wasn’t willing to push. It should be the citizenry that pushes for laws (and regulations), which should be enacted by the representatives of the people. In other words, if we believe corporations should behave differently, then we need to lobby our representatives to legislate accordingly.

That said, there is still an enormous amount of discretion resting with corporations. It would, however, be a mistake to make corporations more like governments, having a huge, undefined social responsibility. Corporations ought to be responsible for all the stakeholders who make up the long-term health of the corporation. Playing off of one versus the other for short-term gains doesn’t make sense. Rather, it makes sense for the corporation to try and maximize the whole, which means paying attention to worker welfare while at the same time paying attention to shareholder welfare. This is how reasonable corporations behave. I think many of them have a broader sense of their mandate and behave accordingly. That mandate doesn’t mean any and everything goes. After all, if they do that, they might abandon their basic function of enhancing productivity and choice.

The Finance Paradigm

Marti G. Subrahmanyam

In this short chapter, I sketch out my perspective on the development of finance or financial economics as an academic field of inquiry, outline its central assumptions and ideas, and comment on how it has influenced both broader areas of economics and the social sciences, as well as practice.¹

While finance theory can be traced back to as early as eighteenth-century France ([Bachelier, 1900](#)) and the United Kingdom, modern finance is only about seventy years old. The foundational milestone events of the field in the 1950s/1960s were the publication of classic papers by Harry [Markowitz \(1952\)](#) on risk and diversification in portfolio investments, the earliest work on asset pricing, and by Franco Modigliani and Merton Miller (1958) on the financial leverage and dividend policy of firms and the cost of capital, the first rigorous analysis in corporate finance. Starting with a set of ideas taught at business schools, financial economics has, over time, taken its place as a legitimate academic field within the broader rubric of economics and business. Like economics in general, financial economics deals with the acquisition and allocation of scarce resources, but applied to the specific context of households, firms or corporations, and financial institutions, in the context of financial markets. Specifically, accounting for investment horizons, risk, and the preferences of investors (households, firms, and financial institutions) or other economic societal agents (e.g., government, central banks), finance addresses, from the perspective of a rational decision-maker, the optimal raising, pricing, and allocation of capital. More recently, the assumption of rational investors has been questioned by behavioral financial economists who propose alternative positive theories of investor decision-making and their consequences for household finance, corporate finance, and investments (see, for instance, [Thaler, 1980](#)).

Today, around the world, academics in finance form a large cluster within the business school community, separate from established economics departments, which are typically housed in graduate schools of arts and sciences. Financial economists have an important role in communicating their ideas to undergraduate and graduate students in business schools and broader economics/social sciences programs. Somewhat exceptionally for a social science, financial economics has had a major impact on practice in diverse fields ranging from household finance to corporate finance, investment management, regulation of financial institutions and markets, and financial innovation, many of which have broad societal ramifications. Markedly influenced by the rapid rise in computing power and the availability of large data sets, research methods and approaches in finance have been evolving and adapting

¹ I thank Patrick Augustin and Ruggero Jappelli for helpful comments.

to these changes. Recent developments in computer science and AI are already having an impact on many aspects of financial decision-making in corporations and financial institutions, a trend that is likely to accelerate in the coming years, and already influences academic research in finance.

In the remainder of this chapter, I will identify the key events in the evolution of financial economics and sketch out its key assumptions, concepts, and predictions of this academic discipline. This will be followed by a brief overview of the major research methodologies in the field and the role of databases and computing power, particularly recent developments in blockchain and AI. The chapter concludes with a summary of the applications of financial economics to the world of practice.

39.1 Foundations of Finance: Key Milestones

I first highlight the seminal contributions in academic finance by listing the most impactful academic papers in the field:

- (1) 1952: [Harry Markowitz](#) presents the first analysis of portfolio theory and diversification in a paper in the *Journal of Finance*.
- (2) 1958: [Franco Modigliani and Merton Miller](#) propound their arguments on leverage and firm valuation in an article in the *American Economic Review*.
- (3) 1961: [Merton Miller and Franco Modigliani](#) extend their irrelevance propositions to firm valuation and dividend policy in a paper in the *Journal of Business*.
- (4) 1964: [William Sharpe](#) derives the capital asset pricing model relating risk to return in a paper in the *Journal of Finance*. Similar ideas on the equilibrium pricing of risky assets are published shortly after by [John Lintner](#) in *Review of Economics and Statistics* 1965 and [Jan Mossin](#) in *Econometrica* in 1966.
- (5) 1965: [Eugene Fama](#) articulates his conception of efficient markets, in which stock prices incorporate all publicly available information, and shows how stock market data could be used to test market efficiency in an article in the *Journal of Business*.
- (6) 1969: [Eugene Fama, Lawrence Fisher, Michael Jensen, and Richard Roll](#) propose the use of stock market data to test theories in asset pricing and corporate finance, in the context of efficient markets, in an article in the *International Economic Review*. These ideas form the basis of portfolio performance evaluation measures such as the Jensen measure and the Sharpe ratio proposed by Michael Jensen and William Sharpe respectively, which are widely used in industry and academic research.
- (7) 1973: [Fischer Black and Myron Scholes](#) publish their paper on option valuation in the *Journal of Political Economy*. Contemporaneously, similar ideas are also proposed by [Robert Merton](#) in 1973, who emphasized the principle of replication, and are later elaborated on by [John Cox and Stephen Ross](#) in 1976. The ideas were influenced by the work of [Louis Bachelier](#) in 1900, who is regarded as the father of mathematical finance.
- (8) 1976: [Michael Jensen and William Meckling](#) propound their principal-agent and agency theory explanation of corporate finance in the *Journal of Financial Economics*.
- (9) 1977: [Oldrich Vasicek](#) applies the notions of arbitrage to derive the term structure of risk-free interest rates in a paper in the *Journal of Financial Economics*.

- (10) 1980: Sanford Grossman and Joseph Stiglitz introduce the notion of costly information and its impact on market equilibrium in a paper in the *American Economic Review*. This work, along with other work by Jack Treynor (under the pseudonym Walter Bagehot) and Albert Kyle, lays the foundations of the analysis of market micro-structure.
- (11) 1981: Robert Shiller challenges the efficient markets hypothesis and establishes the foundation for behavioral finance in a paper in the *American Economic Review*. Richard Thaler elaborates on the behavioral foundations of asset pricing in a paper in 1980 in the *Journal of Economic Behavior and Organization*.
- (12) 1983: Douglas Diamond and Philip Dybvig present the first analysis of information asymmetry, bank runs, and financial crisis in a paper in the *Journal of Political Economy*.

39.2 Core Assumptions and Ideas (and Areas of Disagreement)

The basic paradigm of financial economics makes several assumptions about individual behavior in the context of investments and financial markets. Some of these assumptions have been relaxed, modified, or even rejected by various researchers, but the basic paradigm is always the reference point of departure.

- 1 The economy is composed of households, firms, and financial intermediaries, who interact in financial markets. Households (i.e., the suppliers of capital, or investors) behave rationally. They prefer more to less and are averse to risk.
- 2 Firms (the demanders of capital) maximize their market value or, more narrowly, the market value of the shareholders' equity.
- 3 Financial markets are competitive—which is to say, all players are price-takers.
- 4 Securities that offer identical cash flows to investors will be valued the same. This is due to the law of one price, which is driven by arbitrage considerations.
- 5 Financial markets are efficient to the extent that there are no market or institutional frictions.

The equilibrium in the financial market is determined by the actions of firms and investors coming together to buy and sell securities so that supply equals demand. In the resulting financial market equilibrium, there is a tradeoff between risk and expected return: the higher the risk, the greater the return. Only risk that cannot be diversified away—that is, systematic risk—is compensated by higher return in equilibrium. Firms act as price-takers and issue securities that are priced in consonance with their risk and expected return. Financial intermediaries act as go-betweens in smoothing cash flows and risks (also known as risk pooling and sharing), subject to regulatory oversight.

39.3 Key Insights and Predictions

The fundamental insight underlying much of the paradigm is that there is no “free lunch” in competitive financial markets—one cannot make a return greater than the risk-free rate

without taking risk. Markets are efficient in the sense that one cannot use publicly available information to gain an advantage over other investors. Varying levels of market efficiency can also be defined by the level of publicly available information. The risk-free rate is determined by the return on government debt, which is guaranteed and, therefore, free of default risk. (To the extent that governments can default, the concept of the risk-free rate, which is ubiquitous in academic finance, has been questioned in recent years.) The risk-free rate may be determined by assumptions about the technology in the real asset side, which is generally taken as given in financial models, as well as by the policies of the central bank. The greater the (systematic) risk, the greater the return. Systematic risk is the component of risk that cannot be eliminated by diversification.

Firm valuation cannot be enhanced by issuing different types of securities—debt, equity, and hybrid—or by changing dividend policy, since capital structure and dividends are irrelevant, in the absence of frictions and taxes. Thus, firm value is determined purely by the investments the firm makes. Securities, especially derivative securities, can be priced by the no-arbitrage principle that there is no free lunch. Arbitrage-based pricing can also be applied to the pricing of fixed-income securities of different maturities as well as foreign exchange, commodities, and credit.

Financial intermediaries and markets are necessary to channel household savings into corporate investments. They may be subject to problems associated with asymmetric information and have the possibility of bank runs or even financial crises, which can only be averted by efficient regulation.

The above paradigm has been challenged by behavioral researchers who do not accept the assumption of rational investors but propose various types of behavioral biases that investors exhibit. Agency theorists argue that agents act in their own interest and not in the interests of their principals—managers maximize their own welfare rather than maximizing shareholder value, shareholders do not consider the interests of bondholders, and firm managers do not consider the externalities that they impose on society such as environmental, social, and governance costs. Another issue that is increasingly relevant is the assumption of price-taking by market participants, which has been relaxed by several researchers by allowing for differences in market or bargaining power of agents in the economy. These considerations may affect many of the conclusions of the basic paradigm of finance and are widely explored in the literature. More recently, many researchers have argued that corporations should also consider environmental, social, and governance (ESG) goals, in addition to the objective of shareholder wealth maximization. Topics relating to corporate governance and, more generally, ESG considerations have been receiving increasing attention in the finance literature. Thus, the definition of stakeholders is extended beyond the shareholders to include bondholders, employees, customers, and the public.

39.4 Research Methodologies

The basic approach in finance is based on standard ideas in microeconomics—rational households, firms, their supply and demand, and the concept of general equilibrium. Financial researchers have also developed new methodologies that have also been adopted by economists in other fields. In the early 1970s, Robert Merton introduced what were then new ideas of stochastic calculus into finance to solve problems of asset pricing. Since then,

over the years, various techniques of operations research, statistics, and computer science have been adopted by financial economists to create distinct methodologies, which have since been applied in other fields as well.

The advent of high-speed computing and emergence of vast databases have permitted the development of sophisticated econometric techniques and models; for example, millisecond data in financial markets, parallel computing, machine learning, AI, and so on. In the 1970s Robert Engle and several of his coauthors proposed several techniques in time-series analysis, particularly in relation to the behavior of volatility. Very few other fields in the social sciences have access to as much high-frequency data as finance. This data availability lends itself to the use of sophisticated econometric techniques, particularly related to analysis of time-series data, as well as a large cross-section of firms, investors, and securities. These advances promise to be the new frontier in finance, in which new computational techniques, particularly related to machine learning and AI, are applied to extend, modify, and clarify the central paradigm of finance.

The advent of new techniques augmented by the availability of more granular data has led to an explosion in research in finance in the past two decades. As with other scientific fields, the questions of reliability of the analyses and their conclusions have been subject to closer scrutiny. In particular, more recently, financial researchers are more aware of, and sensitive to, problems related to the confidential/proprietary nature of data. This makes verification and replication more of a challenge. At the same time, the availability of new computational tools and techniques makes such investigations more feasible. Recent episodes have highlighted these challenges with several published papers being retracted as a consequence of not being replicable. At the same time, several academic journals have heightened the requirements for data disclosure, and hence the bar for replicability of published results. A related issue is the possibility of manipulation of markets and the data that influence markets, which have also been studied in recent years.

Importantly, there is more detailed examination of the assumption of efficient markets, in the light of the availability of vast amounts of data. This has led to the discovery of market anomalies and new areas such as behavioral finance. Behavioral finance questions the assumption of “rational” investors and firms. Researchers in the field have highlighted several biases of investors including confirmation bias, familiarity bias, hindsight bias, overconfidence, anchoring, disposition effect, loss aversion, and herding. All these biases influence the predictions of the standard paradigm and are confirmed in specific contexts. Of course, the generality of some of these studies remains debatable, but some have endured. Nevertheless, the standard paradigm remains the benchmark for research in the field.

39.5 Impact of Databases and Computing Power

Among the social sciences, financial economics has access to amongst the largest and most detailed databases. (In the natural sciences, perhaps meteorology, astronomy, and biology are comparable on this dimension.) Millisecond-level quote and trade data are available in many markets including equity, debt, foreign exchange, commodities, and their derivatives. The value of such analysis using vast databases is widely recognized by market professionals such as hedge funds, as well as financial regulators, particularly in the United States, including securities agencies (e.g., the Securities and Exchange Commission) and

central banks (e.g., the US Federal Reserve, the European Central Bank, and others). Today, an entire industry has emerged for collecting, analyzing, and disseminating financial data (e.g., Bloomberg, Reuters, Markit, S&P, and Moody's) with a companion industry group consisting of investment banks, hedge funds, private equity funds, and asset management companies that use such financial data to gain a competitive edge.

39.6 Relevance for Practice

Since their origins in UK and France in the late eighteenth century, financial academics have been concerned with the practical relevance of their work. In the early days, their legitimacy as “academics” was even questioned. Yet, in the past half-century financial economics has come into its own as an academic discipline. The insights of financial economics have had an impact on investment management, pricing of securities, including derivatives, financial intermediation, and regulation. For instance, they have influenced the creation of index funds, new derivatives contracts, and the design of financial contracts, in general. At the same time, the rigor of the methodology and theories has been accepted by researchers in related fields, apart from the world of practice. Many of its central ideas and models, including risk measurement and management, derivatives pricing, and optimal corporate financial decisions, are today used widely.

On the other hand, financial economists using financial engineering have been blamed for market failures, including the stock market crash of 1987 (portfolio insurance), the downfall of Long-Term Capital Management in 1998 (derivatives), and the global financial crisis (credit instruments) in 2008. The consequences of these market crises have been profound for academic researchers who have been forced to rethink their models of market competitiveness and efficiency and incorporate financial regulation into the paradigm.

In response to these criticisms, financial economists have relaxed the assumptions of rational markets and maximization of shareholder value and have acknowledged the relevance of regulators and the role of financial oversight institutions. Today, most advanced economies have a plethora of regulators, such as the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Consumer Financial Protection Bureau, and the Federal Reserve System itself, in the United States.

39.7 Conclusion

Finance is today a dynamic field that is constantly exposed to the test of relevance. Financial economists started off as a “trade-school” fraternity and have gradually become more established as proper academics. The finance paradigm continues to influence and be influenced by the world of practice and policymaking. New developments in computer science and behavioral science are likely to have a major impact on the field in the years to come. Financial economists will have an increasing role to play in the regulation of financial markets and institutions and in improving their performance.

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Reflections on Rajan's and Subrahmanyam's Chapters - I

Susan Neiman

Rajan's and Subrahmanyam's chapters' basic assumption is clearly stated: "Households (investors) behave rationally." What isn't stated is the idea that the concept of rationality is self-evident. Presumably the concept being used is one entailed by *homo economicus*, defined by John Stuart Mill as the human being considered "solely as a being who desires wealth, and is capable of judging the comparative efficacy of means for obtaining that end." Mill added that no political economist "was ever so absurd as to suppose that mankind are really thus constituted." But Mill was writing in the nineteenth century, when it seemed self-evident that human reason could not be reduced to means-end reasoning about acquiring wealth, and where wealth itself was only one kind of value. To echo Mill, few political economists, or businesspeople, are so absurd as to actually claim that wealth is the only thing of value. Even on the narrowest conception of human goods, (some kinds of) health are surely a value that must be taken into account for those hoping to enjoy their wealth. Yet the language we use affects our conceptions of value in more and less subtle ways. Corporations that once spoke of "creating wealth" now speak of "creating value."

This is not harmless shorthand, but a sleight-of-hand that trains us to think of *real* value as something that can be quantified, much as young artists today are encouraged to develop their brand. It's language that sounds snappy, hard-nosed, and slightly ironic, to be contrasted with a reference to spiritual values—something decidedly otherworldly. We do not even notice how language like this affects our notion of value, and our theory of reason. To be sure, many allow that we desire other goods—love, meaning, community—but these are considered to be outside the realm of reason. But reason, in some traditions, is not merely a means to optimize values that come from desire; it can also be a means of determining value itself. Once value is reduced to wealth, consciously or not, much else follows: it becomes irrational to do anything but seek wealth in the most efficient ways. Behavioral economists accept this assumption; while arguing, as did Mill, that few of us behave this way most of the time, they conclude that this renders most of us irrational. Here is a prime example of a refusal to examine basic philosophical assumptions about reason.

Much of the economization of contemporary language—"human capital," "personal branding," and the like—is hard-edged in tone, suggesting that the speaker is committed to accepting the structures of the world as they are, without adding old-fashioned notions of ethics or value. When describing its own practices, however, business often reverts to just such notions. Is contemporary business committed to profit *über alles*? Of course not; it is driven by "responsibility to shareholders," an effective way of nipping any budding protest. Who will object to a business acting responsibly? Few stop to ask whether the single-minded pursuit of rising quarterly returns makes it impossible to fulfill any other

responsibilities—either global responsibility for the planet as a whole or local responsibility to the communities in which products are manufactured and sold. A business leader who attends to those kinds of responsibilities is unlikely to last long in a world where their competitors have convinced themselves that the only responsibility that matters can be measured in quarterly reports. I believe that unspoken assumptions about reason, and the language in which they're articulated, underlie most of the problems we now face. I have discussed this, as well as alternative conceptions of reason, in my chapter "Ideas of Reason" in *Performance & Progress* (Rangan, 2015).

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Reflections on Rajan's and Subrahmanyam's Chapters - II

Mathias Risse

41.1 The Problem

Presumably the availability of massive amounts of data as well as the increasing sophistication of machine learning will enormously increase the reach of the tools provided by finance and operations research. It is therefore of greatest importance that the ethical dimensions of their use are not neglected, either in teaching or in applications.

What I mean by “ethical dimensions” is consideration of how the use of these tools affects society as a whole, and how it engages with prevailing values. Addressing these dimensions would involve asking a range of questions that one would hope are raised where these methods are taught or applied.

I suppose generally finance tools will be taught with little attention being paid to these matters—presumably these tools will be taught as morally neutral, to be used for better or worse aims, but then little time will be spent on preparing students for distinguishing the one from the other. Presumably the rationale will be “we are just teaching certain tools and methods; what’s done with them is no more our responsibility than it is the fault of a car dealer that one of their customers used a car from their lot to rob a bank.” But again, this is increasingly problematic in light of what mathematical tools can do in the age of big data.

41.2 General Questions about Finance

- (1) Generally, finance tools will be used to advance the interest of certain clients who pay experts to deploy these tools. Depending on the circumstances, the clients’ interests might be advanced at the expense of those of others. Are the interests of these others considered at all, especially in cases where these interests might suffer rather severe setbacks?

Recently, Cathy O’Neil’s *Weapons of Math Destruction* (2017) has drawn attention to how the financial sector uses its tools to the excessive benefit of the wealthy. Highly risky assets might be sold broadly, but only the wealthy are in a position to get the right kind of advice to know when to buy and sell them—where the whole business model is based on the fact that these assets are sold at the right time. So that wealth buys good advice in this case is not an accidental feature to the success of the product but an essential one.

- (2) Do the tools in question depend on or advance discriminatory practices in society by using data or proxies that reflect past and ongoing injustice? One may think here of algorithms used in contexts such as creditworthiness, insurability, loan or mortgage rates, or plain availability of loans or mortgages to begin with.
- (3) Is an analysis conducted to determine the exact range of people affected by the tools deployed or measures taken? Are their interests properly considered? As appropriate, are they being given a voice? How about non-human animals, environmental concerns, and other matters not reducible to how humans are faring?
- (4) Are the tools that are being used mostly useful because they are involved in feedback loops with other innovations (say, in the tech branch) that cumulatively only benefit the wealthy, or are these tools also useful to the less economically privileged?
- (5) Are finance tools used in ways that could at least in principle be made transparent in appropriate ways to all relevant agents?
- (6) Is there a critical attitude toward how uncertainty and risk are captured? If epistemic input is guesswork, models will merely create an illusion of precision.
- (7) Are the data that are being used themselves raised in ways that are justifiable? Does their collection violate legitimate privacy concerns of those who generate the data? For instance, are data collected in one context where nobody would expect that anything serious comes of it used in another context where that assumption would no longer apply? (For instance, one could imagine that data are being collected on speed of typing, but these data could then also be indicative of an underlying muscle disorder that has not fully broken out—and an insurance company might use these data to deny coverage.) Are data and tools used in a way that contributes to an increasing commodification of all of reality (as recently critically assessed in Shoshana Zuboff's *The Age of Surveillance Capitalism*, 2019)?
- (8) What is the impact on society as a whole if the relevant tools are used broadly? If business and perhaps also government is dominated by people trained in methods organized around the narrow understanding of rationality, then in due course society as a whole might be negatively affected because too many other concerns fall by the wayside.

41.3 Specific Questions about Finance

- (1) Finance aims to enable the proper allocation of private capital across alternative opportunities. It estimates specific returns and risks to guide that capital allocation. In other words, capital is directed in ways that create more capital, regardless of what social purposes are pursued in this way. For this to be socially acceptable, one would need to have much confidence in the invisible hand. Are there ways of directing such investments in more focused ways to address recognized social problems?
- (2) To bring future returns into the equations finance deploys discount rates, which creates a challenge. All positive discounting implies that future generations get relatively little consideration, and the higher the discounting, the more quickly future generations drop from any consideration. (Economists like to point out that future generations will be richer anyway, so this is not a problem because they can take care

of themselves—but when it comes to environmental degradation, this is an unsatisfactory answer.) On the other hand, if no discounting is used at all, the future dominates the present because it is likely that there are yet more humans to come than live currently. This problem seems to have no good solution. How are these matters reflected among finance professionals?

- (3) As the chapter on finance notes, financial economists were widely blamed for market failures, especially in the aftermath of the global financial crisis in 2008. Is this in some ways due to the way asset pricing is done? Finance assumes informational efficiency but by now we realize that bubbles are a regular occurrence, and can to some extent be brought about through manipulation. Prices have both an informational and an incentive function, and the incentive function can undermine the informational function—which will also create power differentials since wealthy clients with access to insider advice will be able to navigate this landscape better than low-level investors. Are there ways of strengthening the informational value of asset prices—which would also be necessary to make sure earnings per share is a good basis for valuation—or are we forever at risk of bubbles?

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Afterword

Evolving the Theory, Actors, and Practice of Business

Ebba Abdon Hansmeyer

What kind of world do we wish to live in and what kind of economy will best enable that for us? An economy not regulated and compromised into something we grudgingly accept to live with but an economy that we collectively choose for it to become and so each strive to enact. It was in this spirit that in 2013 we initiated the Society for Progress, of which the esteemed and endearing Ken Arrow was a founding fellow (along with a majority of the contributors to this volume). As far back as 1962, Arrow had exclaimed:

Since knowledge differs from one individual to another and therefore the market prices do not reflect all the knowledge in the economy, the usual arguments for the efficiency of the price system are incompletely valid. It is necessary to add moral codes of behavior to permit markets to function, and it is essential to study how they might best be created and commonly accepted.

Arrow's sentiments characterize beautifully the *raison d'être* of the Society. In this Afterword, I want to briefly reflect on the Society's evolution—its hopes, work, and insights.

The Society for Progress: Evolving the Paradigm of Business

Measured in terms of material output and monetary wealth, we live in an age of abundance. For a person from even one hundred years ago, our daily lives today would likely appear surreal, with the struggle for subsistence largely alleviated. Science, technology, and market institutions have advanced and they have expanded dimensions of life in terms of quality, affordability, freedom, and choice, matched by a mountain of know-how and entrepreneurial spirit.

Economic sense of the past decades guiding business, government, and society alike has by and large reflected the idea that *a rising tide lifts all boats*. The positive dynamic of an unfettered economy lifting society is not an entirely invalid belief and economic actors have by and large acted accordingly. Whether the belief is entirely valid and the extent to which it more reflects our hopes and aspirations for it to be that way is a different yet increasingly important matter. Casual and not so casual observation suggests that in our modern economy the proverbial tide often lifts all “yachts” but not all boats. Of course, between lurching unevenly toward prosperity and stagnating or sliding back, the choice for growth seems logical, and, to a certain extent, even moral.

Yet, it is not a little ironic that while we declare allegiance to science and reason, a first precept of which is to continuously question and upgrade theory to one that better reflects reality, the paradigm of modern business and more fundamentally the liberal economic system has come to possess a virtually sacrosanct status of immunity, shielding it from scrutiny. Economic theories of efficiency have been elaborated but questions of equity are still largely relegated to politics and government. Political theorists and philosophers have of course articulated perspectives and critiques on capitalism, yet, all things considered, serious investigation has only sparingly aimed for and actually managed to reach into the core of economic theory. Perhaps this is because money business is still considered beneath serious scholarship, too banal and messy to make high theory out of. The net result is that we have kings of money and their ideological gurus on the one hand, and critical philosophical commentators on the other, with their respective worlds far apart.

Another factor in why critiques of capitalism have not led to greater reform is possibly an overinterpretation of Adam Smith's key message. A couple hundred years on, Smith's notion of the magic of the invisible hand continues to command our respect verging on reverence. This again is not entirely incomprehensible. If total wealth was the goal, then Smith's ideas have delivered. Yet new conceptions of national success reflecting well-being and sustainability are making some headway and policy analysts are establishing gauges (such as the Organisation for Economic Co-operation and Development's (OECD's) Better-Life Index) that are closer to reality than conventional GDP accounting. Those and other efforts including those of our Society are essential and urgent in evolving a more satisfactory theory of business economics that addresses not only the financial, operational, and transactional but also how matters play out in people's daily lives and how economic actors serve (or exploit) society.

One radical call for change that has gained some attention is the idea of "de-growth." It appears founded on the view that the zealous pursuit of economic growth leads us to over-exploit the natural world, and that the only way to stop the harmful onslaught is to adopt a de-growth aspiration. Alas, a major shortcoming of this idea is that we risk throwing out the baby with the bath water. Not all growth entails extraction and exploitation of nature and people and not all growth is propelled by and propels overconsumption and addiction, which are serious issues of concern that ought to be addressed in their own right. Not to mention, if we suppress the freedom of economic pursuit, we may risk muffling a good part of the dynamic of innovation.

It comes back to the fundamental question about how to regulate interdependence among ourselves and with nature and future. The unpacking of this question is what can lead us to create an economy that is more nuanced, more dignified, more stable, and more long term. And what follows of that reasoning is that capitalism depends on how we approach individual and collective opportunity and freedom, very much pushing governance to the forefront as our perhaps most pressing economic concern: economic theory must recognize and integrate into its core theory the responsibility for the freedom it relies on. That recognition is what we mean by "moral," which does not signify self-righteous or moralistic, but instead self-aware, self-critical, and using reason to shine light on itself, the theory it relies on, and the practice it propagates.

It is this quest that has been keeping us busy over the past decade and it was in this looming mood that we convened an academically diverse and independent group of scholars and leaders under the anticipative appellation of Society for Progress. While theories of

performance were explored by business scholars with training in economics, psychology, sociology, and operations, ideas of progress fell more in the realm of philosophy. We hence reached out to and then brought together eminent philosophers and business scholars to discuss, debate, and grapple collaboratively to fill in the sorely missing moral and conceptual foundations that Arrow alluded to.

The work of the Society, at its inception, in 2014, centered around “the problem” of the incomplete paradigm of economics and capitalism. That work was shared in a first volume, entitled *Performance and Progress: Essays in Business, Society, and Capitalism*, published by Oxford University Press in 2015. In a second work, we explored whether as justifiable reasons for economic action we could supplement strictly mutuality-centered ideas with those based on morality and propriety. Admired societies are seldom just the products of an optimal social contract; they reflect too moral goals, roles, and choices of elites, elders, and economic actors. Our second volume, *Capitalism Beyond Mutuality?* (Oxford University Press, 2018), explored and illustrated these ideas. Greater attention to fairness, well-being, and sustainability seems the firm way to restore trust in the economic system.

But why was this not already happening? To what extent was this because economic actors are not educated and embedded in a more integrated paradigm? What are the root causes of the problems we explored in the first volume? It was these sorts of questions that led us to this our current and to date most ambitious work. The aim, as we’ve seen, has been to explore the existing business paradigm’s assumptions and limits, and to explore the fundamentals of business theory. If we wish to avoid sliding involuntarily into an illiberal order (and ceding to reactionaries), it is time to stop perpetuating flawed assumptions of intellectuals past, brilliant as they may have been in their time. These assumptions, perhaps not so harmful a century ago, are surely part of why economic actors and the modern economy has a hard time attending adequately to fairness, well-being, and sustainability.

Three Insights from the Work of the Society

Among the many insights that the work of the Society has revealed, three stand out for me. (i) Economic actors, especially enterprises, are moral agents. Accordingly, business enterprises will need to formulate and enact not only competitive strategies but also contributive strategies. (ii) If we are to address distributional concerns effectively, then we have to some extent privatize transfers (without disregarding dialogue among and accountability of private actors). Tax and transfer are not the only way and may not even be an effective way *ex post*. (iii) Third and perhaps most important, trust in the economic system is not a problem of power per se, it is about the *exercise* of power. Power obliges, and the extensive power of firms relates to the freedom they enjoy. But freedom is sometimes misunderstood and mixed up with a free-for-all jungle. Actions may be voluntary and yet not reflect what is desired or desirable.

Education: Evolving the Actors in Business

Education undoubtedly has a vital role to play. The philosopher David Schmidtz, a fellow of the Society, has remarked: “Few things matter more than education. Yet education may be

one of the few human endeavors where our sense of the ‘good old days’ is accurate.” Reasoning used to be understood by the (eudemist) Greeks as a process by which a person seeks perspective on the larger world and its essence and then puts one’s own reality and actions in proportion and relation to that larger ideal. Yet, modern education, especially in business, has come to encourage a narrower overly self-interested view of reasoning and increasingly results oriented where we don’t educate to grow but to achieve specific goals. In some sense this has led to the over-extraction of nature, which no one may have specifically intended, and yet we have all contributed to. It is also the way of mass consumption where we simply want to buy one more cheap sweater and with that do not intend to contribute to the millions of tons of leftover textiles annually. Yet that is what happens when we reduce our perspective of our actions and their implications.

Integrating wealth and well-being is desirable and often feasible yet hardly automatic. Education in *integration* could work, especially if that education is based on well-founded and an appropriately evolved business paradigm that draws on moral philosophy and moral psychology. Precepts in moral philosophy (such as intrinsic ends and propriety) can help enlighten what the right thing is to desire and do, and virtues informed by moral psychology (such as caring and courage) can help counter “the strains of commitment” (why *I* ought to do the right thing). Such education can complement and, arguably, be even more effective than regulation.

Accordingly, drawing on the work of the Society, over the past three to four years, we have launched at INSEAD (the global business school) a suite of courses in both the MBA and in executive education. Through these courses students explore the paradigm of the decentralized modern economic system, which we acknowledge rests on two fundamental and effective pillars: *information* and *incentives*, conveyed, respectively, via market prices and private property rights. Yet markets are prone to failure in significant areas (e.g., environment, labor, privacy), and prices are often incorrect and insufficient. It is not easy to put a price on fairness, health, ecosystems, dignity, privacy, the future, or animal welfare. In these and other such cases, price information can and ought to be augmented by moral *reasoning*. After all, price and value are not always the same thing (think of the consumerism fueled by the fast-fashion business model). Likewise, material incentives can and ought to be supplemented by moral incentives that are intrinsic in *roles* inhabited by economic actors. Roles are institutions that reflect moral expectations pertaining to the use of discretion and power vested in economic actors (including executives, entrepreneurs, owners, investors, board members, employees, and customers). If economic actors are educated to construct and consult their moral identities, then they may come to be guided not just by the “What’s in it for me?” material query but also by the “Who am I?” moral query. Deepening the information and incentive pillars of the economic paradigm by integrating moral reasoning and moral roles is at the core of what we are attempting to propose as a “moral theory of economic action.”

Evolving the Practice: From Abstract to Applied

The focus of the Society during its first decade has been in unpacking and upgrading the “operating system” (or paradigm) of the economy. Looking ahead, we would like to explore the “apps” that may influence practice. We would, in other words, like to move attention

now from the abstract to the applied. We would like to deepen research on topics including circularity and regeneration (as it pertains to the bio-system including soil, oceans, atmosphere, and biodiversity). Other areas for research and teaching include well-being at work; caring consumption; adult labor reskilling and adjustment; technology and privacy; measurement of progress; collective choice and communicative rationality à la Habermas; corporate governance; and other related topics.

Beyond and related to the above, an important theme to (re)explore and clarify is the very question of growth. Whether it is in food, clothing, housing, mobility, or technology, if immoderate consumption and consumerism continue, then we may have growth but all the green innovations, regulations, and taxes may be insufficient to adequately stem crises. Before large emerging economies (like India and China) go too far down the same path, we have to revisit and clarify what growth we are pursuing and whether the problem is extraction and exploitation or growth per se (as some allege). Likewise, we must address the question of how to evolve from work-centric families to family-centric work. This will be key to addressing gender inequity and eventually perhaps fertility and demography. Government and enterprise are important pillars hoisting a society, but family and community are foundational. The Society for Progress initiative is at its core a cultural initiative that explores how we might come to enact an economy that is both modern *and* moral. Subi and I are deeply grateful to the friends and fellows of the Society for showing us the way.

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