TEACHING BUSINESS ETHICS DURING AN ECONOMIC CRISIS

Item Type	Conference proceedings
Authors	Sójka, Jacek
Publisher	ISBEE
Rights	With permission of the license/copyright holder
Download date	2026-07-14 02:19:04
Link to Item	http://hdl.handle.net/20.500.12424/188736

TEACHING BUSINESS ETHICS DURING AN ECONOMIC CRISIS

Jacek Sójka

Adam Mickiewicz University, Poznań, Poland

In 2003 a conference took place at Adam Mickiewicz University, organised by the Polish chapter of EBEN and the Institute of Cultural Studies of AMU and dedicated to the "post-Enron trauma" in business ethics teaching and research. We still discussed the issue even after the conference and finally the proceedings were published in 2005 under the title "Post-Enron business ethics".[1] All authors were convinced that business ethicists witnessed a kind of a turning point: such a shock should have a healing long term effect. Once we had witnessed the consequences of an unethical and, in most cases, simply criminal behaviour – nothing of that would be allowed in the future. Managers would learn the lesson as well as governments, public opinion and the whole range of other stakeholders. For business ethicists it was an opportunity to analyse corporate governance problems, to ask whether similar breach of all basic rules would be possible in Europe and to use this case as a basis of class discussions at universities and elsewhere.[2]

At that time (and today) "Enron" of course was a symbol of the whole series of bankruptcies caused by questionable business behaviour that shook the American economy. Many prominent figures of American business and politics deplored about the erosion ethical standards and about greed as a driving force of many American companies. Among them are Henry Paulson, Paul Volcker and Alan Greenspan who are not – as noted by Laczniak and Murphy – "left-wing crackpots, socialist university professors, or third-world antiglobalists seeking to derail capitalism. They are among the most respected captains of the American economic system, and they are shocked, saddened, and growingly disturbed about the practices and veracity of the business and financial system."[3]

What did Paulson, Volcker and Greenspan said or might have said about present crisis (or rather continuation – some people tend think – of that crisis signaled by the bankruptcy of Enron) we know or we can guess. How, then, can we teach business ethics today when all post-Enron hopes for improvement have failed? How to teach during the crisis which was caused in the opinion of many observers (an participants) by excessive greed and risk-taking. Even "The Economist" used the word "greed" in its report.[4] Since our students study management, and not sociology or psychology, the question should be generalized: how should we teach management, on the basis on which curricula, in order not to jam the message sent by business ethics class. I am convinced that success or failure of this endeavor depends on both: teaching strategy of business ethicists as well as on the content of other classes.

The late Sumantra Ghoshal advised business schools that in order to prevent future Enrons they "do not need to create new courses; they need to simply stop teaching some old ones."[5] Some topics from strategic courses should disappear as well as agency theory as a part of corporate governance courses. Of course outside GB and USA prevail other traditions and other types of higher education institutions. In Poland and Germany there had been five years management programs which did not require professional experience and were more concentrated on theoretical analyses and were based on a wider range of courses including sociology, psychology and philosophy. The so-called Bologna reforms have introduced in all EU countries three or four years of undergraduate studies plus 2 year of master studies which – in the field of management – become similar to the American MBA program. (Although no professional experience is needed.) There is a fear however that within two years studies there would be

---

[1] J. Sójka (ed.), Etyka biznesu „po Enronie". Humaniora – EBEN Polska, Poznań 2005

[2] See e.g. A. Tonge, L. Greer, A. Lawton, The Enron story: you can fool some of the people some of the time... "Business Ethics. A European Review" 2003, nr 1, p. 17

[3] G.R. Laczniak, P.E. Murphy, Ethical Leadership for Improved Corporate Governance and Better Business Education. In: R. A. Peterson, O.C. Ferrell (eds.), Business Ethics. New Challenges for BusinessSchools and Corporate Leaders. M.E. Sharpe, Armonk, New York 2005, p. 181

[4] Greed – and fear. A special report on the future of finance. "The Economist" January 24th 2009

[5] S. Ghoshal, Bad Management Theories Are Destroying Good Management Practices. "Academy of Management. Learning & Education" 2005, vol. 4, nr 1, p.75

no time for a larger perspective in teaching about social or cultural issues, although not directly related to business but still relevant to today's management (e.g. patterns of consumption or ecological issues). One course of business ethics might not be sufficient.

Today we face a financial crisis and many students join our classes with a conviction, fuelled by this almost global financial meltdown, that business has nothing to do with ethics. By "business" they mean what they have learned from documentaries, fiction movies or just news. When Enron collapsed the battle cry was "this can never happen again". Today we all know what Milton Friedman said in 2003; that we would see in the future similar events (since "market" had to eliminate bad companies), so "never again" would sound less convincing. So the challenge posed by the present economic situation can be summarized by the question what kind of argumentation could convince students that there is an "ethics" in business and that business ethics teaching has a practical significance, i.e. to help students become simply better managers. Management teachers, including business ethicists, will be more convincing if they first reflect on themselves and their field. One of the questions which can open such a self-analysis might be the one posed by Sumantra Goshal: are bad theories really destroying management practices, are they destroying capitalism?

Ghoshal suggested that "by propagating ideologically inspired amoral theories, business schools have actively freed their students from any sense of moral responsibility".[6] By ideology he understood liberalism, mentioned many times by Milton Friedman, along with its pessimistic assumptions about egoistic individuals and the necessity to design organizations in such a way as to make possible neutralisation of this tendency of individuals to act on the basis of selfish motivation. Ghoshal also rejected a long tradition of social theory which deals with the negative problem "of restricting the social costs arising from human imperfections."[7] This pessimism has been visible all too often in the social sciences which underlined the need to build institutions which would help to overcome the imperfect human nature. What is more, this pessimism of our theories tend to be self-fulfilling: expectations based on them can influence practice and generate opportunistic behaviour. As an example of such a theory Ghoshal mentioned the agency theory which has dominated the field of management since the 1970s.

In their classical paper Michael Jensen and William Meckling defined an agency relationship "as a contract under which one or more persons (the principal/s/) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal."[8] One can easily gather that Ghoshal did not agree with the second sentence of this passage and saw it as an evidence of ideologically inspired, pessimistic view concerning human nature. Although common sense – he said – and empirical evidence proved that human behavior can be influenced by altruistic motives, economists and managers prefer to embrace "ideology-based gloomy vision" of human imperfections, design institutions which are expected to overcome the consequences of this basic egoism of individuals, and support the beliefs of managers that this is a real picture of their personalities. "Combine agency theory with transaction costs economics, add in standard versions of game theory and negotiation analysis, and the picture of the manager that emerges is one that is now very familiar in practice: the ruthlessly hard-driving, strictly top-down, command-and-control focused, shareholder-value-obsessed, win-at-any-cost business leader of which Scott Paper's 'Chainsaw' Al Dunlap and Tyco's Dennis Kozlowski are only the most extreme examples."[9]

What is really wrong with the agency theory, one might be tempted to ask. Is it fundamentally false and "bad" by assuming that principals cannot fully trust their agents? Or perhaps all these critics

[6] Ib., p. 76
[7] Ib., p. 77
[8] M.C. Jensen, W.H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. "Journal of Financial Economics", 1976, vol. 3, nr 4 (an electronic version at: http://papers.ssrn.com/abstract=94043) p. 5
[9]S. Ghoshal, op. cit., p. 85. These ideas have many supporters, among them should be mentioned R. Edward Freeman who treats Ghoshal's view as parallel to his own thesis about dangerous "separation fallacy" or "separation thesis" which means "the exclusion of ethics from business judgments, but generalizable to a duality between the worlds of management and the humanities." R.E. Freeman, D. Newkirk, BusinessSchool Research: Some Preliminary Suggestions. A paper prepared for 1st IESE Conference on "Humanizing the firm and the management profession", Barcelona, IESEBusinessSchool, June 30 –July 2, 2008

witnessed a misapplication of this theory and made their judgments on that basis? That it was misapplied was acknowledged by Jensen himself.[10] But was it wrong from the start?

Agency theory was an answer to management practices of the 1950s and 1960s. Shortly, executives were building large diversified conglomerates in expectation that the size and diversification would shield them from the risk: a slowdown in one industry could be compensated by profits in other industries. Generally however size mattered more than profitability; top executives interests prevailed over the interests of shareholders. Agency theory was going to change this anomaly by introducing several well known recommendations: stock options as a part of executives' remuneration which should make them more focused on increasing the value of their firms, de-diversification (let investors compose a diversified portfolio), the use of debt as an instrument of financing acquisitions and risk monitoring by making boards more independent of top management teams.[11]

The implementation of those prescriptions followed but rather in a very selective way. For instance, stock options were warmly welcomed but the new regulations did not guarantee that executives would hold equity for a longer period of time. As a result a short-termism became all too popular among top managers and the interests of executives and the interests of stockholders diverged once more.[12] Similar misapplication took place in regard to all other recommendations of the agency theory proponents. All these developments encourage greater risk taking which, additionally, was hidden from the shareholders and led to spectacular failures at Enron and other companies in 2001. "These changes then encouraged banks, insurance companies, and industries to assume speculative risk at the end of that decade, contributing to the Great Recession."[13]

Let us return to the phenomenon of the so-called short-termism. Dobbin and Jung pointed at "the wider misapplication" of the compensation formula which went beyond the industrial world. "Investment banks had been organized as partnerships, but now they listed themselves on the stock market, making their partners wealthy through initial public offerings and ensuring that executives no longer faced the downside risk they had faced as partners."[14] The same applied to hedge funds and private equity funds managers who were paid on the increase of the market value of their corporations and soon fall prey of that appeal of short-termism.

The logic behind remuneration based on stock options, according to agency theory, is that the closer is the status of managers to the status of shareholders – the better for the company. In this sense a partnership would be the best solution: partners participate both in gains and in losses so their motivation seems to be more complete and mature. Also – closer to the original entrepreneurial spirit. In fact however, as Dobbing and Jung describe it, the whole system of remuneration functioned more like a casino and the logic of gambling prevailed.[15]

This is not the end of this story. Regardless of any misapplications of agency theory, Jensen was right in choosing the title of his article from 1989: "Eclipse of the public corporation".[16] Since 1997 the number of these firms dropped by 38% in America and by 48% in Great Britain. "Going public no longer has the glamour it once had. (...) The result has been a revolution: one third of America's tax-reporting businesses now classify themselves as partnerships."[17] So definitely legal forms of economic activities are still changing along with the developments in economic, political and social environments. Corporate governance is still the issue.

Agency theory was misapplied and misused. Probably such a process occurred not for the first time. Perhaps one should speak not about a misapplication of a theory but of the misapplication of the recommendations ensuing from this theory. Application of recommendations is always contingent on many non-theoretical factors such business culture, political configurations or global trends. In any case

[10] M.C. Jensen, K.J. Murphy, Performance pay and top management incentives. "Journal of Political Economy" 1990, v. 98, nr 2
[11] F. Dobbin, J. Jung, The misapplication of Mr. Michael Jensen: How agency theory brought down the economy and why it might again. In: M. Lounsbury, P.M. Hirsch (eds.), Markets of Trial. The Economic Sociology of the US Financial Crisis. Emerald, Bingley 2010, p. 332
[12] Ib., p. 341
[13] Ib., p. 357
[14] Ib., p. 359
[15] Ib., p. 360
[16] "Harvard Business Review" September – October 1989
[17] Briefing: The endangered public company. „The Economist" 2012, May 19th – 25th, p. 25-26

the mechanism of promoting this concept in business and in academia seems to be fascinating topic for economic history, sociology of knowledge, as well as business ethics (and perhaps academic ethics).

The story of agency theory as embedded in the social, economic and political environment can help us deal with the question how to teach business ethics during the crisis caused in the first instance by “bad management practices”. Business ethics class should be based on economic history, on the history of management ideas (and management fads) and on an extensive knowledge on the market of concepts and theories and of consulting services. All this can create a background against which managerial failures and successes could be understood more fully. A descriptive part of ethical reflection seems to be crucial. Students are very eager to learn about insider trading scandals of the 1980s, about Enron and other companies which were ruined by their managers, about the more recent crisis and corporate downfalls.

This interest may seem somewhat suspicious. But it is not a new phenomenon; in today’s culture dominated by media – evil sells better. Their interest perhaps is fuelled by the conviction which they brought from outside the university that business has nothing to do with ethics. Here the role of business ethicist and other management teachers becomes crucial. They have to create curricula which would make a larger context visible. Even if it is a history of managerial failures or economic crises, such teaching strategy would not deserve the blame of spreading a gloomy vision, of being ideologically inspired (meaning, actually, blinded) and of formulating ideas which contradicts our common sense knowledge. The problem is that common sense can tell us many different stories.

One can cite more examples of fraud, corruption, negligence or simple shortsightedness in all areas of life than the examples of altruism or even simple honesty. Perhaps they are less visible, do not receive such a media exposure. But media create an image which our students bring to the class. The response should not consist in pretending that human imperfection do not exist. Probably this is one of few items on liberal agenda that stood the test. And ethical reflection cannot neglect this fact (if it would be possible at all in view of great liberal tradition in philosophy).

Ethics (not only business ethics but ethics in general) should be realistic in this respect: complete eradication of evil will never be possible. Of course there is a demand for angelical vision of the world. But on the supply side one can find mostly ideological, utopian offers.

I do not want to defend agency theory. It can defend itself. What has become the target of Ghoshal’s and other thinkers’ criticism was rather a theory in practice – the example of misapplication of theoretical ideas in the realm economic organisations. But agency theory cannot be reduced to its economic version; it is still an important area of research in political science and sociology. I think that interdisciplinary approach can offer a very interesting theoretical perspective. When a sociologist takes a closer look at the economic and managerial dilemmas she can tell us many interesting things, not only in defense of agency theory but first of all about phenomena that have caused the present crisis. A longer quotation seems necessary at this juncture.

“Although classic agency theorists seemed surprised when the world learned that their perfect incentives to align the interests of corporate executives and shareholders (giving the former stock options and equity ownership) might result in these executives contriving illicit schemes to inflate stock prices, sociologists, with our eyes on the bigger picture, surely were not. Nor are we convinced that these extraordinarily costly agency failures constitute a refutation of agency theory, as some suggest (...); rather, we argue that one needs a more nuanced understanding of principles, agents, and organizations when fashioning complex incentives. (Besides, we have been trained to be mindful of the unanticipated consequences of purposive social action.)”[18]

To notice the imperfections of human beings is not an ideological bias. Of course, this statement (that human nature is not perfect) cannot be a conclusion. Rather an encouragement to start to build a new type of institutions. Within ethics the lesson of the past is important, also for the understanding of human nature. Surprisingly this does not hold in the field of finance where trust serves as a crucial prerequisite. “The paradox is that financial markets can function again only if this lesson is partly

[18] S.P. Shapiro, Agency Theory. „Annual Review of Sociology” 2005, vol. 31, p. 279-280

forgotten."[19] Fortunately enough my interest in agency theory is a part of research in the field of business ethics.

[19] E. Carr, Greed – and fear. "The Economist" 2009, January 24th, A special report on the future of finance, p. 3