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AN AGENT MORALITY VIEW OF BUSINESS POLICY

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We develop a philosophical perspective on the moral obligations of managers, which we call agent morality, by examining the moral implications of agency theory. Our view is grounded in noninstrumental ethics, which we argue is logically superior to instrumental ethics. We show that the principal-agent model of the firm, once properly considered, requires that managers fashion business policies with reference first to certain moral duties and second to shareholder wealth.

Two normative views are common in the business policy and management literature about what principles ought to guide management decision making. Proponents of the first view hold that, because executive-level managers are agents for shareholders, maximizing the present value of the firm is the appropriate motivating principle for management. Proponents of the second view (e.g., normative stakeholder theory) hold that principled moral reasoning ought to motivate management decisions.

These views were once regarded as antagonistic in that the policies each view recommended to managers frequently diverged: shareholder interest and ethics often led to opposing policies. In the current "ethicized" U.S. consumer market, however, no such policy divergence need occur. (See *Business Roundtable*, 1992; Sethi, 1981.)

Indeed, the supporters of the wealth maximization view now usually amend their advice to take overtly into account legal, ethical, and social concerns. Scholars and business journalists now urge managers to employ ethics as a management tool when "strategic ethics" increases the present value of the firm.[1] More generally, managers are being told that

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[1] Goodpaster (1991) employs the term but does not endorse the concept.

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"good ethics" is "good business" and is, therefore, in the best interest of the firm and its shareholders (see, e.g., Blanchard & Peale, 1988; Kotter & Heskett, 1992).

We call this first view of ethics and business policy *instrumental ethics*. Its advocates employ the language of ethics to serve the goal of firm value maximization. Instrumentally ethical managers might do what is morally proper, but they do so to increase shareholder wealth.

The second view of the firm is necessarily agnostic about whether good ethics is good business. The "principled moral reasoning" view of business policy assumes morality is intrinsically, not instrumentally, good. That is, morality is an end in itself and cannot be justified with reference to the gain of a firm or its shareholders alone. Wealth considerations are not precluded from the analysis, but they cannot trump moral principle when wealth and principle conflict. We call this view *noninstrumental ethics*.

We argue that both normative business policy models are problematic in current U.S. business settings, though for different reasons. Instrumental ethics is logically problematic; in consequence, instrumental ethics is not, and cannot be made, morally binding on managers. It is also difficult to carry out organizationally. The *noninstrumental morality* approach to business policy produces policy recommendations that are morally binding on managers. The broad and open-ended duties generated by principled moral reasoning, however, appear vague and poorly focused compared with the sharp image of the manager as the wealth-maximizing agent of shareholders. Noninstrumental ethics, therefore, has been less persuasive to managers than the rigor of the analyses warrants.

We offer an agent morality view of business policy, a view that extends the logic of managerial agency. We show that the moral logic of market competition and the principal-agent model of the firm require managers to recognize at least four moral principles as a higher priority than firm profits. These principles are elements of ordinary morality, but we argue that they have special force in economic and principal-agent relationships. Managers as agents are especially bound by them: therefore, the term *agent morality*. Although we ground our arguments in an analysis of the moral foundations of economics and business, the principles that we show to be binding on managers are already commonly understood and agreed to by many U.S. citizens. This view might therefore prove to be persuasive in the U.S. business context.

SHOULD MANAGERS MAXIMIZE SHAREHOLDER WEALTH?

The Principal-Agent Model of the Firm

Business academicians and writers in the business press routinely advise senior managers of publicly owned U.S. corporations to follow a

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principle that *ought* to guide management actions: carry out only those policies that increase the net present value (NPV) of the firm (see, e.g., Drucker, 1984; Jensen, 1991). These advisors assume that managers of firms are agents of shareholders, who create firms (or invest in them) so as to increase their wealth relative to that provided by other available investment opportunities: Why otherwise would shareholders bother to invest money in firms?

Creation or investment for the end of wealth implies that owners expect those who are hired to run firms will work toward achieving the end—almost always wealth—for which firms are established. From the expectation of owners of firms comes the obligation of employees and senior managers. (See Arnold, 1987, for a functionalist desert theory of profits.) The duty of an individual to honor his or her agreements provides a justification, therefore, for the moral obligation of a manager to his or her shareholders.

This *normative* view of senior managers of firms as economic agents of the shareholders is commonly called the principal-agent model of the firm. It is a normative business policy model in that it offers a principle that managers *should* follow. The principal-agent model does not necessarily describe the principles most managers of most firms follow: This is not a *positive* model. Advocates of management buyouts of publicly held companies believe that managers of publicly owned companies rarely put owners' interests above their own (e.g., G. Donaldson, 1984; Jensen, 1989).

Managers, as do all humans, have many duties. Why should managers' obligation to shareholders to increase their wealth trump other moral duties when managers establish and carry out business policies?

According to the principal-agent model of the firm, the moral primacy of shareholder wealth compared with other obligations is derived from a consequentialist moral view of the world. The argument is as follows (we adapt Sen, 1985): the morally better world is one where the best consequences pertain; best consequences comprise a condition—Pareto optimality, and Pareto optimality occurs under efficient market conditions.

The analysis to this point indicates nothing about firms per se or their role. Firms are not ends in themselves but are wealth-producing agents for their owners; as noted previously, owners would make different investment or consumption decisions if this were not true (Coase, 1937). When a manager does other than optimally increase the stock price of the firm, a distortion occurs in the investment market. Under efficient markets, then, the best allocation of social resources occurs when a manager of a firm maximizes that firm's stock price. All things being equal, the best allocation of resources is morally desirable, so the managers of firms *ought* to maximize the NPV of the firm. (See Drucker, 1984; Jensen, 1991, for examples of this type of argument.)

The justification for NPV as the motivating goal is, therefore, for the

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effect that targeting NPV has in a broader system of efficient markets, not by itself. In Sen's words, the moral defense of net present value is for its "instrumental moral relevance" (Sen, 1985: 10).

Instrumental Ethics

Instrumental ethics enters the picture as an addendum to the rule of wealth maximization for the manager-agent to follow. Firm profit opportunities apart from the efficient markets framework can arise from negative externalities, information asymmetries, and coordination in production problems. These problems are loosely termed *market imperfections* (in the first two cases) or *agency problems* (in the third). The profit opportunities realized from acting on negative externalities, and so forth, reduce society's wealth. Under these circumstances, the moral defense of NPV outlined previously does not hold.

Various theorists have proposed market-based mechanisms as ways of overcoming market imperfection problems. Arrow (1973) reviewed regulation, taxation, and civil liability as solutions to negative externalities and information asymmetries. Coleman (1990) and Williamson (1975) reviewed optimal contracting and other monitoring-as-policing mechanisms as solutions to a firm's coordination problems. Most radical of all is Jensen's (1989) argument that ending agency problems occasionally requires a management buyout of the corporation itself (cf. Demsetz & Lehn, 1985). (See Mitnick, 1980, for a review of agency theory.)

The common element to these mechanisms is that they change the economic incentives facing managers so that the interests of shareholders, managers, and society are aligned. According to this view, if owners or regulators give managers proper incentives, optimizing the present value of the share price of the firm again will coincide with society's welfare.

Another common element, however, is that these solutions are very expensive. The expenses of civil liability suits, government regulations, and so on, are well known. The costs of overcoming agency problems also are quite high (Coleman, 1990).

Economists and business theorists recognize that voluntary moral restraint is another (cheaper) way of overcoming externalities and other market imperfections (Arrow, 1973; Hardin, 1968). (For a review, see Hausman & McPherson, 1993.) That is, if we all practice moral restraint regarding externalities or agency problems, welfare gains to society will follow. Society and firms will avoid the deadweight losses of both welfare-reducing activities and the mechanisms used to prevent them.

Morality, its obvious advantages aside, is often rejected in this framework. Hardin (1968) and Arrow (1973) pointed out that, absent law or other control devices, moral agents will find themselves in a prisoner's dilemma setting when profit opportunities from exploiting market imperfections or agency problems are present. If they select morality, they pay a morality tax. Moral individuals and firms will lose over time to immoral

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individuals and firms. In Hardin's famous example of the cowherders and their commons, the ineluctable logic of economic competition leads each herder to contribute to the destruction of community property.

This microeconomic argument against moral restraint applies most clearly to markets that are contestable (in Baumol's language) or which lack a strong connection between social values and markets. Baumol quipped that "perfect market forms impose vice rather than virtue" (1991: 3).

Studies in socioeconomics, however, show that social values and market outcomes are frequently connected (see Axelrod, 1984; Bowie, 1991; Coleman, 1990; Etzioni, 1988; Frank, 1992; Sethi, In press). These scholars have raised two pertinent points.

First, cultural values bound the very structure of market competition (Granovetter, 1985). Indeed, market competition is dependent on some social values. Absent trust between and among potential market participants, how could very many market transactions take place (Hare, 1992; Hausman & McPherson, 1993)?

Second, cultural values that are strongly held by market participants will inevitably be reflected in market competition (Etzioni, 1988). Using Hardin's example, I will not add another cow to the common land if my neighbors' disapproval translates into their refusing to purchase my milk or beef or to look after my cows when I am sick. This approval or disapproval of my neighbors is an example of what economists call a *reputational good*. In cases in which reputation matters for market outcomes, instead of a morality tax, we might find a "naive economist" tax.

If a study of the ethical beliefs of my neighbors allows me to forecast their reaction to the additional cow, then knowing about ethical beliefs is useful to me in a market setting. More generally, as far as managers need to forecast consumers' or regulators' reactions to company policies, a study of ethical beliefs might be useful to agents in achieving the NPV goals of the firm.

Instrumental ethics, then, might enable managers to read and understand the social values that allow market competition and to avoid unintentionally violating shared norms. Instrumental ethics also might be useful to senior managers in persuading employees and managers at other levels to avoid shirking and other forms of opportunism.

In the markets in which reputation matters and industry concentration is high, a firm probably can "nurture a corporate culture that puts high value on ethical and socially responsible behavior" as a way to "insure long-term above-normal profitability for the enterprise" (Sethi, In press). In such a case, moral choice does not take place in a prisoner's dilemma setting. Setting corporate strategies *without* considering the ethical judgments of consumers or regulators might threaten a firm's profitability.

Simply put, an NPV defense of ethics is now widely made in terms of an agent's obligation to promote shareholders' economic interests. For

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companies such as Johnson & Johnson, ethics is an *invisible asset*, which allows the company to solve coordination and other problems. Ethics is a *strategic tool*.

Therefore, instrumental ethics and shareholder wealth are not necessarily in contradiction. As Jensen noted, "In this sense, there is no conflict between management's service to its stockholders and to other corporate stakeholders" (1991: 21). Instrumental ethics is sometimes essential for achieving the firm's NPV goals.

Not every company, of course, is similar to Johnson & Johnson, which makes and sells consumer medical products and, therefore, is exceptionally sensitive to consumer reaction. Reputation might matter more for this firm than for almost any other U.S. firm.

This situation raises the important point that, for the instrumentally ethical manager, behavior is situationally determined. In the current "ethicized" U.S. business environment, the long-term benefits of a reputation for ethical behavior usually outweigh any short-term gains from, for example, taking advantage of consumers or suppliers. Enlightened self-interest leads managers to "ethical" behavior.

In those business settings, however, with either short-term time horizons (e.g., strong quarterly profit pressures) or information asymmetries (e.g., some international markets), instrumentally ethical managers might behave very differently. Here, the benefits of unethical behavior might exceed the costs, as in the contestable markets described by Baumol (1991). Instrumentally ethical managers might reasonably hope to "get away with" unethical behavior.

Are there many U.S. companies, however, whose stock prices would not currently gain from at least the perception that their managers were ethical? Managers are now routinely urged to pay attention to ethics as, at least in the U.S. situation, good ethics often makes for good business.

The Difficulties With Instrumental Ethics

Instrumental ethics is problematic, nevertheless, for several reasons. First, if what is useful to managers about ethics is to be able to forecast how share prices are affected by the actions of consumers or regulators, managers should study socioeconomics directly. Why not avoid the long journey through philosophical ethics? Markets reflect cultural values, but these values are not only (or even usually) derived from principled moral reasoning. Consumer or regulator reactions will not necessarily reflect moral considerations.

What is needed for shareholder wealth typically is the "trust" of consumers, not managerial moral rectitude itself. The two are obviously related sometimes, but other times they are not. For example, we see many allegations that Japanese corporations practice fierce discrimination against women and other minorities in the United States and Japan. U.S. consumers, however, trust that Japanese companies will produce products that are reliable and safe. Consumer trust and good company reputation might be the byproduct of sound ethical policies, but it might be

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more efficient for the managers of companies to aim directly at achieving trust. Managers' ethical obligations, of course, are not exhausted once they have achieved a good public reputation.

Second, the moral logic of the principal-agent model is problematic as currently conceived. The moral defense for the primacy of the obligation of shareholder wealth maximization is that increasing stock price, now joined by ethics, can produce (under constrained circumstances) the best social outcomes. The best social outcomes, of course, are what is morally desirable.

This model begs one question: Why not do directly that which has the best social outcome? If that happens to be increasing the price of a common share of stock, do that; if not, do something else that has better social outcomes. The moral argument that helps managers choose among competing duties based upon the best consequences must inevitably oblige managers "to do that which is best." Discussions about stock price movements, instrumental ethics, and shareholder wealth obscure the true moral argument.

Another problem with the moral logic of the principal-agent model is that the usual moral defense of the manager's duty to maximize stock price conflates levels of analysis. Using NPV > 0 as a way of making decisions is a particular form of cost/benefit analysis in which each act is evaluated in comparison to other acts in terms of financial benefits to the firm. Most forms of ethical analysis, however, offer basic moral principles as guides for action. Few, if any, consequentialist philosophers would say that the estimated financial consequences to a firm should alone be used to evaluate moral questions. Further, the appropriate relevant units of moral analyses are the welfare or rights (or both) of members of societies, which are not at all the same as wealth.

A third problem with instrumental ethics is that it might not be possible to carry out because it negates reciprocity and, therefore, part of its advantage to the firm. If the senior managers of a firm employ ethics "instrumentally" or with "enlightened self-interest" or any other restrictive caveat, why will not employees at lower levels of the firm (or suppliers or customers) also employ ethics instrumentally? Can owners of firms expect ethical restraint from executive managers if the owners show interest in ethics only because ethics leads to optimum gain for owners? Can you be a "little bit ethical" without having everyone else also be only a "little bit ethical"? Can executive managers really expect to "fake" integrity if their real motivation is solely economic gain? How can instrumental ethics solve externality and agency problems if the justification for ethics is shareholder self-interest? These observations lead to a testable research proposition.

> *Proposition 1: Ethics policies that are justified in instrumental terms are less likely to elicit support from firm employees (and other corporate constituents) than are ethics policies justified in noninstrumental terms.*

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The compelling evidence is that instrumental ethics is hard to carry out in a corporate setting (see Jones, In press). First, ethics is hard to fake. People are adept at detecting attempts at deception (DePaulo, Zuckerman, & Rosenthal, 1980; Frank, 1988). Once people detect faking, they are likely to adopt similar behavior (Jones, In press). As employees look to executive-level managers for their moral cues (Treviño & Youngblood, 1990), the instrumental use of ethics by executive managers will lead to others using ethics instrumentally. Second, through a self-selection process, truly moral individuals, if they detect moral fakery, are more likely to leave the organization than are those for whom moral deceit is less problematic. The risk of instrumental ethics is that it might leave the corporation, in the end, worse off. In terms of an empirical proposition:

> *Proposition 2: Ethics policies that are justified in instrumental terms are less likely to benefit the firm economically in the long term than are ethics policies justified in noninstrumental terms.*

A final problem with instrumental ethics follows from the analysis of Baumol (1991) and Sethi (In press). Instrumental ethics might give firms an advantage in some market circumstances, especially imperfect markets. Market circumstances, however, change frequently in this increasingly Schumpeterian world economy, as IBM, among others, has discovered. Instrumental ethics might give a firm an advantage now, but it might not later. We do not know what the consequences might be to a firm of disestablishing a culture that emphasizes ethics, but they are unlikely to be positive.

Thus, instrumental ethics is hard to undertake, and the consequences of it being revealed as an opportunistic venture are severe. We doubt, however, that the ethics movement could have achieved as great a hold on senior managers and business academicians if the main motivation for the concern for ethics were solely shareholder wealth. A genuine concern with ethics undoubtedly motivates many managers, perhaps abetted by the prospect of gains to shareholders from a firm's honorable conduct.

For management scholars, several questions follow from the spread of the idea of ethics as a management tool. For example, are market forces alone leading U.S. managers to adopt ethics programs? According to Baumol (1991) and Sethi (In press), if market forces are driving the "ethics as a management tool" idea, we would expect the following propositions to be true:

> *Proposition 3: Corporate ethics programs will be most common among firms whose markets are not easily contestable and where reputation is a corporate asset.*

> *Proposition 4: Corporate ethics programs are more likely to be justified in the language of shareholder wealth maximization than in the language of noninstrumental morality.*

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A competing proposition is that the spread of the ethics movement among U.S. managers is part of a broader change in the values of U.S. culture. We might infer support for this proposition, if we were to find that neither market structure nor reputational effects predicted the presence of corporate ethics programs.

SHOULD MANAGERS DO WHAT IS MORALLY RIGHT?

Noninstrumental Ethics

The other normative business policy model is found in the ethics and management literature. It recommends that managers act according to moral principle in business as well as in all other aspects of life. Businesses have no special rules or states that waive the moral obligations that managers have as humans (see Goldman, 1980).

The argument is here no different from the arguments that moral philosophers have made for centuries. (See Beauchamp & Bowie, 1993; Donaldson & Werhane, 1993; Paine, 1985, for reviews of basic ethical theories with an application to business.)

Most moral philosophy begins with the proposition that certain duties adhere to us by virtue of our humanity. That which is most human about us is not our interests or our desires—the members of other species have interests and desires, too—but our rational minds.

A rational mind will wish to act from principles that are impartial and universal. These principles may be generated from a reflection on rights or consequences. The core principles that we all recognize, which include "avoid harm to others," "respect the autonomy of others," "avoid lying," and "honor agreements," are generated in either case. Acting with regard to these principles is the moral obligation of all humans, no matter what profession or position.

Philosophers, of course, differ on the length of the list of those moral principles that are impartial and universal. A distinction is often made between minimalist principles, which appear on everyone's list, and welfarist principles. Welfarist principles include the duty to promote the well-being of others (the duty of beneficence) and the duty of fairness. Welfarist principles are rejected especially by libertarian philosophers, but the principles previously listed are usually held to be impartial and universal. (For a discussion and derivation of minimalist principles in a business context, see T. Donaldson, 1989: 62–87.)

It is not our task to defend the validity of moral reasoning; its defense has been the task of moral philosophers for generations, and we have nothing original to add. We also find it unnecessary to point out the fallacies in the line of argument regarding the claim that business has a special ethic. Goldman (1980) and Hare (1992) already have accomplished this.

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Why Are Business Ethics Problematic?

One difficulty for the noninstrumental morality view of business policy is that the recognition of moral duties superior to an agent's obligations to shareholders is problematic in U.S. business settings. Part of this follows from the traditions in corporate law: *Ford v. Dodge Bros.* settled the issue that shareholder wealth was the appropriate aim of the corporation. Subsequently,

> case law on managers' fiduciary duty of care can fairly be read to say that the manager has an affirmative, open-ended duty to maximize the beneficiaries' wealth, regardless of whether this is specified in any actual contract. (Clark, 1985: 73)

Profits are not, of course, an unconstrained duty in U.S. corporate law. The *business judgment rule* allows management wide latitude in business policy, if the justification for the policy is cloaked in the language of shareholder benefits. Further, the 1984 draft of the American Law Institute's (ALI) Principles of Corporate Governance mandates that managers obey the law.

The ALI code also qualifies shareholder wealth as a goal by adding that the corporation "may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business" (Paine, 1993; see also, Goodpaster, 1991). Moreover, Bowie (1988) and Dworkin (1977a) noted that judges often look to moral principles for guidance in settling cases.

Moral theorists, however, reject the qualifier *may*. From the moral view perspective, ethical duties are mandatory, not optional. Even if members of the community were *not* to recognize a moral duty as reasonably appropriate for responsible conduct of business, the moral duty would still be binding on managers (cf. Goodpaster, 1991).

The very language of moral discourse is at odds with the dominant language of description in business, which is that of economics: self-interest versus duties. The discourse matters because the vocabulary of profit and self-interest nurtures in corporate employees a world view at odds with one that nurtures their moral sensibilities (Jones, 1989). The ideas and methods of moral philosophy do not find their way into the language and methods of either business or modern economics (Sen, 1987).

Several scholars have translated moral ideas into a business setting to make the language of discourse more accessible to senior managers of corporations and business students. Two laudable efforts are Freeman's stakeholder approach to management (1984; Evan & Freeman, 1988) and Tom Donaldson's social contract approach (1982). Both embed deontological ideas in a business framework; both have had some success in reaching managers and students. (Not all stakeholder theories are deontological in origin. See Meznar, Chrisman, & Carroll, 1991, for a review of nondeontological stakeholder theory.)

One strength of these approaches is that each writer recognizes the

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importance of noninstrumental morality to a "business system." Freeman and Donaldson pointed out the ways in which noninstrumental morality solves many of a market society's problems.

Another strength of the approaches used by both Freeman and Donaldson is that their arguments are grounded in the practices of firms. Donaldson's work, for example, derives management obligation from an implicit social contract between the firm and society. Freeman's stakeholder theory does not employ social contract theory, but it too uses a business-specific convention. The firm is a prism through which Freeman derived moral principles (in light of the effects of corporate actions on stakeholders) that should guide management strategy.

In both stakeholder theory and social contract theory, the firm, not the individual manager, is the relevant unit of moral analysis. The principal-agent model, in contrast, views the individual manager as the relevant moral actor.

The grounding of these moral frameworks in a business setting is not without a few problems, however. The firm-society social contract framework is open to the criticisms aimed at social contract theory. What implicit social contract? with whom? Is this contract necessary and binding?

The stakeholder approach is open to the charge that its view of the firm is too static. As Coase (1937) noted in his analysis of principal-agent relations, the firm per se is hardly an appropriate unit of analysis in competitive markets. Firms rise and fall; suppliers, employees, and customers shift loyalties; shares are owned by huge pension funds that buy shares of a given firm on Monday and sell them on Tuesday. In such a dynamic world, is a firm the relevant moral unit?

The "real contracts" objection applies equally to stakeholder theories and social contract theories. Both models' theorists claim that the real contracts that Coase envisioned between the principal/shareholder and agent/manager are sometimes to be trumped, either by implicit stakeholder claims on the firm or by an implicit social contract between the firm and society. Why, however, do implicit stakeholder claims on the firm or the firm's implicit social contracts supersede a manager's explicit, legally specified, agency obligations to shareholders? If a manager's explicit obligations are sometimes trumped by the implicit obligations of the firm, when and to what degree do stakeholder or community claims trump the real contract that a manager has with shareholders?

Another question for both approaches follows from Fama's (1980) argument that there is no such thing as a "firm," at least not in any representative sense. Fama suggested that each firm has its own founding contract and goals. In this light, whether the firm's implicit social contract or its relations to stakeholders can be the foundation of its moral obligations is arguable, even for those committed to a noninstrumental ethics view of business policy.

Donaldson and Freeman met many, perhaps most, of these objections. Donaldson and Dunfee (In press), for example, addressed Fama's

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objection by examining firm-specific social contracts. Evan and Freeman (1988), for another, pointed out the ways in which various court cases and legislative acts have circumscribed the shareholder wealth doctrine. They claimed that the law on agency obligations now has a "stakeholder" cast to it.

It is, however, at least as accurate, and possibly clearer, to say that humans have moral obligations, whatever their position in a company, than it is to talk about "the firm" in any abstract sense. The clarity and validity of the moral arguments regarding individual obligation, as we noted previously, have not yet led to their acceptance as guidelines for business policy.

An intuition behind both Donaldson and Freeman's work must be right, therefore. Morality needs to be grounded in a well-understood business or cultural context before managers will be persuaded to look to it for business policy guidance.

For management scholars, one task is to explore the other side of the instrumental ethics fad: Why is the discourse of noninstrumental morality unpersuasive in the U.S. business environment? Has it always been such? Is the law regarding shareholder wealth an impediment to moral discussion?

AN AGENT MORALITY VIEW OF BUSINESS POLICY

The dilemma of this article is that noninstrumental ethics is logically sound. Noninstrumental ethics does not, however, resonate in the U.S. business environment, where the principal-agent model of the firm is well established. The efforts of several scholars to amend ethics to make it more persuasive in a business setting use conventions that are more open to challenge than is noninstrumental ethics itself. Instrumental ethics, in contrast, is unsound ethics, but its appeal has reached fadlike qualities in the U.S. business community.

Instrumental ethics is logically inadequate but persuasive; noninstrumental ethics is coherent, but unpersuasive. What are we to do?

The Principal-Agent Relationship Revisited

How can noninstrumental ethics as a business policy be persuasively defended in the U.S. business context? The principal-agent model has widespread currency in the U.S. context. Can we reconceive it to specify properly the general moral obligations of agents and principals while retaining the notion that managers are agents for shareholders?[2]

We believe that the model can be properly specified. We noted previously that some principles constitute the minimal set that applies in all settings, presumably including business settings. Among these are

[2] Hare's (1972) essay, "Can I Be Blamed For Following Orders?," is the inspiration for this argument.

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avoiding harm to others, respecting the autonomy of others, avoiding lying, and honoring agreements.

We can make a stronger claim for the recognition of at least these moral principles in a business setting. The recognition of these four principles is a precondition either for the efficient working of markets or for the principal-agent model itself to hold. The acceptance of these four principles as norms of business is what enables an agency relationship to exist in the first place.

Two principles are generally acknowledged to be part of the implicit morality of the market itself: the moral rules without which markets fail (see McMahon, 1981). The first, honoring agreements, is the principle at the root of the principal-agent model and must be generally respected for the particulars of the principal-agent contract to hold. The second, avoiding lying, is a principle whose recognition is widely believed to be a prerequisite for the efficient functioning of markets (Hausman & McPherson, 1993).

Two other principles, avoiding harm and respecting autonomy, are central to economic relations, including principal-agent relations. Individuals' recognition and respect of them is what gives rise to the condition we call liberty, at least in its more limited conception (Mill, 1859: 141–144; see also Berlin, 1969). Liberty is a necessary condition for efficient markets (Friedman, 1962), and it is also what allows individuals to make morally binding contracts with each other. Liberty therefore plays two important roles as an antecedent condition for economic activity in general and the principal-agent model in particular. Absent liberty, economic transactions are unlikely to be efficient, and contracts cannot be held to be morally binding.

Few would deny, at least in the U.S. context, that individuals have a right to liberty. As Dworkin (1977b) and Mill (1859) each argued, if one person has a right, others are morally obliged not to infringe upon that right, and a person is likewise morally obliged to respect the right of others. Therefore, anyone in a business context, including managers as agents, must first respect a right, in this case to liberty, held by everyone.

If you recognize that individuals have a right to liberty, you necessarily must recognize the principles that give rise to liberty. Avoiding harm to others, which would otherwise infringe on their liberty, and respecting the autonomy of others, which is a central tenet of liberty, are therefore morally binding obligations. Wealth considerations for the firm cannot supersede the claims to liberty of third parties, because the principles that give rise to liberty are antecedent to the principal-agent relationship.

What this means is that the principal-agent model holds only if embedded in the setting of these four moral principles. Only with the prior recognition of these moral rules can the principal-agent view of the firm hold at all.

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The duties and rights of which we speak are not legal duties and rights, at least not necessarily. Social science researchers show almost innumerable instances in which the power of rent-seeking organized interests induces one or more of the three branches of the U.S. government to infringe both on rights and public welfare. Our concern is with rights and duties that follow from moral principles, not law.

Considering these principles and their correlative rights and duties, we next examine the logic of agency theory, beginning with the owner (or principal) of a firm. The proponents of the principal-agent view of the firm claim that the owner's managers are his or her agents (e.g., Coase, 1937; Jensen & Meckling, 1976). That claim is usually taken to mean that managers should act in the owner's economic interests (Friedman, 1970; reprinted in Beauchamp & Bowie, 1993).

This logic must also mean that the owner's moral obligations to respect basic principles pass through to and are obligatory for senior managers (see DeGeorge, 1992; Goodpaster, 1991; Hare, 1972), because moral principles enable the principal-agent relations. It is unclear what valid arguments could make the case that agency *did not* include other moral obligations. Can it be validly argued that the owners of capital are exempted by property ownership from general moral obligations? Obviously not. Thus, it must follow that those who are hired to manage the owner's interests are similarly bound to acknowledge and act upon the owner's obligations. Otherwise, the business firm would serve as an institution that dissipates moral obligation.

Consider the role of agents. May an agent sell (or alienate) his or her general moral obligations to advance the economic interests of a principal? If an agent is paid a fee to alienate his or her moral obligations, is this not the same thing as saying that, when it is in an agent's self-interest to do so, he or she may ignore moral obligations? From a moral perspective, this argument is contradictory. (See Hare, 1972; for an application to a business setting, see Bowie, 1985.)

One objection to this argument might be that a manager has promised to maximize shareholder wealth. Keeping this promise has the same primary moral status for an agent as do his or her other moral obligations, irrespective of the principal's moral obligations. When keeping the agent's promise to the shareholders conflicts with other moral duties, the agent might need to use a form of cost-benefit analysis to "break the tie."

This argument is not valid, however. Moral principles are antecedent to the contract between the principal and the agent and cannot be suspended by agreement between them. Keeping a promise to maximize wealth does not have the same primary status as does, for example, avoiding harm to others.

Further, it is not sensible to talk about the morality of promising to ignore other moral obligations to advance the wealth of someone else. After all, the moral logic that leads to the conclusion that one is obliged to honor a contract to advance the interests of someone else is the same

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moral logic that says that one has moral obligations. How can one be morally bound to an agreement to ignore one's other moral obligations?

Another possible objection is that two moral principles—avoiding harm and respecting autonomy—might be at odds with the efficient functioning of markets. If so, the principles could not be part of the implicit morality of the market (see McMahon, 1981).

The argument that the efficient functioning of markets sometimes requires a relaxation of moral rules is puzzling, however, and perhaps wrong. McMahon (1981) suggested that adhering to the principle of respecting the autonomy of others would require, among other things, that employees participate in company decisions, which would potentially reduce efficiency. Following the principle of avoiding harm to others would mean, McMahon also suggested, that managers could not lay off employees in difficult times.

First, we should leave the empirical question of whether or under what circumstances employee participation increases a firm's profitability or social welfare. The more general question is whether following the principle of respecting the autonomy of others mandates employee participation. It might, for example, be argued that employees who choose to work at a firm with no participation scheme (instead of a firm with such a scheme) are opting for that form of labor contract. Presumably, respecting the autonomy of others would lead us to agree that employees are free to make such a choice.

The second question is whether an owner illegitimately harms someone by, for example, laying off him or her. Employees of firms with layoff provisions are, in the United States, in effect agreeing to higher wages in return for less job security. In contrast, employees of firms in countries with restrictions on layoffs generally have lower salaries, as do employees of U.S. firms that tend not to lay off workers in troubled times. (See Quinn & Rivoli, 1991, for the development of this argument and the supporting evidence.) If an employee agrees to a contract under which he or she receives high wages but has less job security, he or she has chosen a labor contract with a different risk/return ratio from another labor contract in which he or she receives lower wages in return for more job security. Presumably, a respect for autonomy would lead us to agree that individuals may make the riskier choice in labor contracts. This choice implies that it is not a violation of the principle of avoiding harm if managers lay off workers when the firm is in economic trouble. (When employees are laid off for arbitrary reasons, it is a different matter entirely.)

Given that these objections do not hold, the inevitable result of the moral logic of agency is that some moral obligations trump the promise to maximize profits when the two conflict. If we accept that managers have a moral duty to maximize the wealth of shareholders, we must also logically accept the following: managers must settle on business policies that do not contravene the four moral principles upon which economic activity and agency relationships are founded.

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As noted previously, other principles of ordinary morality (a duty to fairness, for example) apply to all settings, including business. Our argument regarding agent morality in no way conflicts with this claim. Nothing within the moral logic of the principal-agent model of the firm, however, mandates the acceptance of the other moral principles of ordinary morality. Their moral force is derived instead from sources other than agency obligations.

Agent Morality and Business Policy

What are the implications of an agent morality view of business policy for management research and business policy practice? In a sense, business strategy as a modern academic discipline derives much of its intellectual force from industrial organization (IO) economics. Traditionally, IO economists took their task to be the increase of social welfare through studying ways in which market imperfections could be eliminated (see, e.g., Scherer, 1970).

The strategic management literature turned the insights of industrial organization economics upside down by proposing that exploiting and even developing market barriers are a legitimate corporate strategy (Porter, 1980). As IO economics is a consequentialist discipline unconcerned with rights, nothing in the logic of IO economics prevented the translation of its study of market barriers into strategic management's creation of market barriers.

Business policy research also has little concern for rights, with one exception. The exception is shareholder (or principal) rights in contracts with managers (agents): the principal-agent model of the firm. This exception is fundamentally important as it allows an agent morality view of business policy to introduce corporate goals beyond shareholder wealth into strategic management while retaining the principal-agent view of the firm. It specifies which types of contracts between senior managers (agents) and shareholders (principals) can have force. No principal can offer, and no agent can accept, a contract that takes increasing the wealth of the shareholders as the unconstrained goal of the firm.

At a minimum, this implies that the managers of firms may not involuntarily deprive others of goods or states that they currently possess without some claim to compensation or other redress. Managers would otherwise violate the principles of respecting the autonomy of and avoiding harm to others. In the context of the agent and the principal and their agreement about which considerations will determine business policy, the agent cannot offer a contract to a principal under which he or she agrees to advance the principal's interests when that involves violating the liberty of others. Shareholder's wealth considerations must necessarily be constrained by agents' (managers') antecedent obligations to respect moral principles.

Therefore, at a minimum, a manager cannot agree to undertake business policies that lead to arbitrage profits for the firm from exploiting

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negative externalities or unfair information asymmetries, for example. These actions involve involuntarily depriving others of goods or states that they currently possess. More generally, a manager cannot agree to a contract in which he or she is charged to pursue profit opportunities if these involve violating rights that are derived from the basic moral principles advanced here.

Agent morality, then, means that agents must first attend to basic moral duties; agents have no special dispensation from moral obligations, theirs or the principals'. Once these obligations have been met, shareholder wealth considerations can have priority.

This view of business policy might prove to be persuasive in the U.S. business setting at several levels. The metaphor of principal and agent is how the firm is generally understood in the United States. We do not challenge this view of the firm but show to managers and business academicians that the duties that follow from the principal-agent model of the firm require the recognition of four moral principles. Market competition depends on the existence of liberty, which follows from two principles—avoiding harm and respecting the autonomy of others. Principal-agent relations are premised on the recognition of two principles—honoring agreements and avoiding lying. Although these principles have special force for managers as agents, they are fully compatible with the tenets of ordinary morality widely held by members of U.S. society. The language of liberty has long been part of U.S. political and cultural discourse, and all four principles are consistent with the Judeo-Christian theological views of many U.S. citizens.

CONCLUDING COMMENTS

We offer an agent morality view of business policy. This view is grounded in noninstrumental ethics, which is logically superior to instrumental ethics, the latter's fadlike popularity notwithstanding. The first consideration for senior managers is to do that which is morally right in the business policies they undertake; the very logic of their agency obligations leads to that conclusion.

The agent morality view of business policy has much in common with two other normative approaches to business policy, the stakeholder approach and the social contract approach. All three advocate that managers fashion business policy so that moral considerations trump profit considerations when the two conflict. Each seeks to embed considerations of noninstrumental ethics in conventions that are specific to business practice in order to be persuasive to managers.

The distinguishing feature of this approach is the logic of the principal-agent relationship, which leads to the inclusion of some of the same moral considerations as do the other noninstrumental ethics views of business policy. The agent morality view of business policy preserves,

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however, the widely held intuition that managers are the agents of shareholders. Thus, the agent morality view of business policy might prove to be persuasive in the U.S. business context as it grounds moral considerations in a well-understood language. We recognize, however, that describing this or any other moral argument in terms that make it more persuasive to managers might create secondary problems. (For example, describing agent morality in terms that make it persuasive in the U.S. context raises the question of its applicability in a non-U.S. context.)

Being convincing to business leaders is, nevertheless, an important criterion of success for a business policy proposal. The original principal-agent model of the firm fails this criterion in practice. The executive managers of *Fortune* 500 firms appear to depart generally from the moral duty to maximize shareholder wealth that is specified by the original principal-agent model (e.g., G. Donaldson, 1984; Jensen, 1986). But, as we have shown, the moral argument about the duty regarding shareholder wealth is inadequate and is therefore not binding on managers. How can this inadequate argument possibly be persuasive to managers? Is it a surprise that the policy recommendations of an invalid argument are not widely adopted?

This conclusion suggests that some findings from the financial management literature regarding managerial agency problems need to be reexamined. In these studies, a "perfect" agent is one who makes decisions that are financially optimal for the principal: the "shareholder wealth" hypothesis (see Bhagat, 1983; Walking & Long, 1984). Deviations from shareholder wealth maximization suggest "imperfect" agency in which the agent diverts some firm wealth to himself or herself in "on-the-job consumption": the managerial welfare hypothesis (see Bhagat, 1983; Jensen & Meckling, 1976; Walking & Long, 1984).

Our analysis suggests a third possibility, which is not considered in any of these studies. Perhaps some diversions of firm wealth are done to meet the moral obligations described previously, which might be expensive (at least in the short term) to the firm. Agent morality might be at work in many U.S. corporations. Scholars in financial management need to establish both the destination of and motivation for wealth "diversion" from the shareholders and not simply assume managerial opportunism.

Two challenges to management scholars follow from the arguments in this article. One challenge is empirical. We offer a series of descriptive propositions about the nature and effects of instrumental ethics, which other scholars may examine and, depending on the evidence, refute. The more important challenge is normative. We argue that managers *ought* to respect four basic principles in making business policies. This argument is not presented in the social science language of hypotheses and propositions, but it is advanced using the method of normative analytic philosophy. Our argument is open to challenge, nonetheless. Perhaps our arguments are invalid, or some of our assumptions are unsound. We encourage other scholars to undertake the task of examining our norma-

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tive argument. Much is at stake because the conclusion of our argument is that a person who wishes to be moral *must not* put duty to maximize the wealth of shareholders ahead of four moral principles.

In the end, the principal-agent view of the firm does not do away with general moral considerations. Quite the contrary, once properly reconsidered, the principal-agent model of the firm yields strong obligations to senior managers to attend to basic moral duties in fashioning business policies.

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