

A Plain Man's Response to Professor Jensen

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Whilst I am pleased that my after dinner remarks² should have attracted the attention of so distinguished a scholar of organizations as Professor Jensen³, I am concerned lest the reader of his article should be left with a mistaken impression of my own position. In this brief response I defend my position against his criticisms, offer some further thoughts, and argue that the concept of *Resourceful Evaluative Maximising Man* that Professor Jensen offers as an alternative to that of *Rational Economic Man* is without empirical content.

First, Professor Jensen claims that I 'attack the use of incentives for corporate executive compensation'. Such was by no means my intention. Indeed I said explicitly that 'I do not mean to say that there is no place for economic incentives - only that they are less likely to be paramount....the greater is one's responsibility to others'. Elsewhere I note that a CEO will often be placing his reputation and human capital at risk in making difficult decisions, so that it might well be appropriate to reward him well if the outcome is successful to make up for the costs he would have borne if the outcome was unsuccessful'. Again, I remark that 'incentives, if used wisely will be used moderately...to provide encouragement'. Thus I do believe that there is a place for incentives in

² Published as 'Incentives, Rationality and Society' in *The Journal of Applied Corporate Finance*, Vol. 7, Summer 1994, 31-39.

³ "Self-Interest, Altruism, Incentives, and Agency Theory", M.C. Jensen, *Midland Journal of Applied Corporate Finance*, Vol 7, Summer 1994, 39-45.

executive compensation, but I reject the position, which is implicit in the simple agency model, that the decisions of corporate executives are motivated solely by their personal financial incentives. Other, ethical, considerations, such as duty, responsibility, honor, and a sense of fairness are important also.

Professor Jensen claims further that ‘I am not fond of the agency model’. In fact I recognize that the agency model has made an enormous contribution to our understanding the nature of financial contracts, and elsewhere have written that ‘Jensen and Meckling were epochal in introducing into financial economics an owner-manager decision-maker within the corporation’⁴. I object only that the simple agency model is too simple to explain the structure of executive compensation. In this I am not alone. Professor Jensen himself has written⁵: ‘Many common features of compensation systems are not easily explained by traditional economic theory. Some, like Jensen and Murphy, and Dickens, Katz, Lang and Summers, argue that economic analysis can only go so far; at some point we must defer to political pressure or to behavioral notions of fairness, social responsibility, trust or culture.’

The importance of ethical considerations in business decisions is receiving increasing attention. Most business schools now offer courses in business ethics; many corporations have drawn up ethical codes and some have even appointed ethics officers

⁴ ‘Corporate Finance over the Past 25 Years’, M.J. Brennan, *Financial Management*, forthcoming.

⁵ ‘Compensation and Incentives: Practice vs. Theory’, George P. Baker, Michael C. Jensen, and Kevin J. Murphy, *Journal of Finance*, 1988, Vol 43, 593-616.

One reason for this is that 'Under most circumstances, good ethics is good economics'⁶. As Noreen⁷ points out, economists as distinguished as Arrow, Becker, Harsanyi, Kurz and Hirshleifer have recognized that certain kinds of ethical behavior are essential for the efficient functioning of markets. He quotes Arrow:

It can be argued that the presence of what are in slightly old-fashioned terminology call virtues in fact plays a significant role in the operation of the economic system..[T]he process of exchange requires or at least is greatly facilitated by the presence of several of these virtues (not only truth, but also trust, loyalty, and justice in future dealings).

and McKean:

Unwritten agreements and trust (that is, confidence in each other'svoluntary compliance)...[play] pervasive roles in business and social intercourse. Written agreements in business hit only the highspots of agreements; like the bulk of an iceberg, an enormous portion of such mutual understandings is unseen..Many small, yet in the aggregate highly significant, instances of trust exist...without the pressure of competition or the threat of a lawsuit.

Casson⁸ writes that 'Overall economic performance depends on transaction costs, and these mainly reflect the level of trust in the economy. The level of trust in turn depends in turn on culture..the success of an economy depends on the quality of its culture'. He presents vivid vignettes of business and social life in two cultures characterised by

⁶ Cf. "Economics and Ethics: the Case of Salomon Brothers", C.W. Smith, *Journal of Applied Corporate Finance*, Vol. 5, Summer 1992, 23-28. Smith uses the example of the Salomon Brothers scandal to argue that private markets provide powerful economic incentives for ethical behavior.

⁷ 'The Economics of Ethics: A New Perspective on Agency Theory', Eric Noreen, *Accounting, Organizations and Society*, 1988, Vol 13, pp359-369.

⁸ *The Economics of Business Culture*, Mark Casson, Clarendon, Oxford, 1991, p 3.

different levels of trust⁹.

Since Adam Smith wrote his *Wealth of Nations* economists have expressed wonderment at the Second Theorem of Welfare Economics, that (under the appropriate assumptions) the pursuit of self-interest will lead to a Pareto efficient allocation. This attitude of course takes the institutional arrangements of contract, exchange and private property as given. But these are social constructs, and ones that require that men limit their pursuit of self-interest for the common good. Without general self-denying behavior which acknowledges the legitimacy of other's property and routinely settles legitimate debts, and generally eschews criminal behavior, the market economy as we know it simply would not work. Indeed the current difficulties that Russia is experiencing in making the transition to a market economy stem in large part from the atrophy during the communist period of the civic virtues that undergird the market economy. Thus the wonder of the market economy is not that it allows for the unbridled pursuit of self-interest, but that it restricts competition to those functions in the social arena in which it has positive social value¹⁰.

⁹ An interesting example from my own experience concerns transactions in real estate. When selling a house in Canada some years ago my only expense was about \$250 for the lawyer who not only saw to the exchange of contracts but exchanged the proceeds into US dollars and remitted these to me. Buying a house in California on the other hand required payment of about \$2000 to an 'escrow agent' whose sole role appeared to be to ensure that two of the most ingenious criminals could engage in a real estate transaction without fear that either would be cheated by the other.

¹⁰ Cf. Lionel Robbins: "it is the hand of the lawgiver which withdraws from the sphere of the pursuit of self-interest those possibilities which do not harmonize with the public good." Lionel Robbins, *The Theory of Economic Policy*, London, Macmillan, 1952. We note in passing that mating patterns also exhibit competition, but competition that is severely circumscribed: it is no longer acceptable for mating rights to be determined by

What therefore concerns me is that the identification of rationality with self interest that is used as a convenient analytical simplification in presentations of the agency model may have a pernicious effect on students, and therefore on business life. This concern was aroused many years ago when I attended a seminar by a professor of accounting in which he was explaining the agency model. To illustrate it, he informed the audience that his salary included a free supply of paper and coloring pencils for his children. He explained that it was too expensive for the dean to monitor the stationery supplies and that it was therefore rational for him to help himself as he wanted. My reaction was to ask whether in that case there were any tulips left in the parks of that city since it was also too expensive for the city to monitor them, and it was therefore rational for the citizens to pilfer them. If a professor can draw such misguided conclusions from the way in which the model is presented one cannot but worry about the effect on students.

Since my speech was published, I have found that I am not alone in my concerns. Eric Noreen¹¹ emphasizes the assumption at the heart of agency theory that people will act unreservedly in their own narrowly defined self-interest with, if necessary, guile and deceit. He states that

Business school instructors may have some influence over the values that their students take with them into the workplace..We need to keep in mind that while our [agency] models presume that businessmen are opportunistic..it does not follow that businessmen are or should be opportunistic. It would be a

trial of strength.

¹¹ Noreen (1988), *op. cit.*

mistake to wittingly or unwittingly inculcate in the next generation of accountants and managers the notion that it is foolish, naive or abnormal for businessmen to feel constrained in their actions by ethical considerations.

Similarly, Bohren¹² writes:

The positive effect of an increased trust between contracting parties with asymmetric information is a welfare-economic justification for addressing educational impacts of the Principal Agent Model. Without running the risk of pushing one's own ethical standing on others, it can at least safely be concluded that accounting and finance professors should be more explicit to their students as to what are the ethical assumptions of the Principal Agent Model. Also, the relevant ethical alternatives should be highlighted, and it should be pointed out that the agent's insensitivity to honesty issues in the Principal Agent Model may have negative economic externalities by influencing, not just himself, but also the future transaction costs for society at large.

Professor Jensen quarrels with my attack on the identification of rationality with self interest, and claims that 'rational individuals always choose the option that makes them best off as they see it'. Such a claim is either tautological or false. It is false if it is intended as an empirical description of the way in which people behave, or the reasons that they would honestly give for the behavior. I may help an old person across the street even though it is inconvenient for me, or send an anonymous donation to charity, or even pay my taxes when there is negligible risk of evasion being detected, or even in exceptional circumstances place my life in grave danger to rescue others. None of these actions makes me better off in any reasonable sense, yet all are rational. I do them because I am generous and recognize that someone else's need is greater than my own,

¹² 'The Agent's Ethics in the Principal-Agent Model', Oyvind Bohren, unpublished manuscript, Norwegian School of Economics, 1994.

or because it is my duty to do so, or because I have a commitment to make the world a better place in which to live.

I do not believe that Professor Jensen would dismiss these as irrational acts. Rather, he would argue that they all make me better off in some sense. In other words, because I act rationally in doing them they must make me better off - perhaps because other people's welfare is 'an argument of my utility function'. But as Amartya Sen¹³ points out, 'As we consider departures from "unsympathetic isolation abstractly assumed in Economics" to use Edgeworth's words, we must distinguish between two separate concepts: (i) sympathy and (ii) commitment. The former corresponds to the case in which the concern for others directly affects one's own welfare. If the knowledge of torture of others makes you sick, it is case of sympathy; if it does not make you feel personally worse off, but you think it is wrong and you are ready to do something to stop it, it is a case of commitment'. Professor Jensen fails to make such a distinction, so that even when he acknowledges altruistic behavior he feels bound to explain it as ultimately self-interested: 'In seeking to achieve the greatest possible good for themselves.... people choose from an "opportunity set" that includes...the welfare of others.' This is to treat the identification of rationality with self interest as tautological¹⁴. There is of course nothing

¹³ In 'Rational Fools: A Critique of the Behavioral Foundations of Economic Theory', in *Scientific Models and Man*, H. Harris (Ed.), Oxford University Press, 1978.

¹⁴ Amartya Sen describes refers to this strategy as 'definitional egoism' and remarks that 'then, no matter whether you are a single minded egoist or a raving altruist or a class conscious militant, you will appear to be maximizing your own utility in this enchanted world of definitions', in 'Rational Fools: A Critique of the Behavioral Foundations of Economic Theory', in *Scientific Models and Man*, H. Harris (Ed.), Oxford University Press, 1978.

wrong with this in principle; Professor Jensen is free to use words as he likes. In his article he is clear that my model of self interest is not his. However, what one may ask is the advantage of defining self interest in this broad inclusive manner ? Well, for the economist, it allows him to subsume all rational behavior under the paradigm or metaphor of utility maximization subject to constraints. I have no objection to this technical device so long as it is recognized as such. What I do object to is that the student who is told that rationality is identical with self interest and is then exposed to the logic of rational individuals acting in the framework of the agency model is liable to forget (if he is ever told) that the definition of self interest that is being employed is a special technical one. As a result, he is liable to be led to believe that, placed in a similar situation himself, rationality demands that he act in his self interest as commonly understood. Indeed, even if he recognizes that a rational individual may have the welfare of others as arguments of his utility function, he may conclude that he personally does not include this as an argument, and that therefore rationality for him demands that he act in his narrowly defined self interest. In other words, he may not recognize that he has a duty in many circumstances to act in ways that are contrary to his self interest. There is evidence that training in economics makes students less likely to co-operate with others. In the study I cited in my presentation, Frank, Gilovich and Regan *et al*¹⁵ find evidence that economists tend to exhibit less cooperation than other groups, and that these differences in cooperative behavior are caused at least in part by training in economics.

¹⁵ 'Does Studying 'Economics Inhibit Cooperation?', R.H. Frank, T. Gilovich, and D.T. Regan, *Journal of Economic Perspectives*, Vol. 7, 159-171.

This should be a matter of serious concern to teachers in economics departments and business schools, not only for its adverse consequences for society as whole, but because narrowly self-interested behavior may be self-defeating even at the individual level. The same authors report, what common sense would suggest, that experimental evidence implies that even brief encounters involving strangers often suffice to reveal who will cooperate and who will defect in prisoner's dilemma type games, so that "If people are even better at predicting the behavior of people they know well - a reasonable enough presumption - then the direct pursuit of material self-interest may indeed often be self-defeating". Note that this criticism of the self-interest hypothesis cannot be evaded by claiming that even a self-interested person will co-operate when it is in his interest to do so, since once partners are chosen and the game commences, it is *not* in his interest to cooperate¹⁶. The self-interested person's problem here is that he cannot help revealing ex-ante that he will behave in a self-interested way when the time comes. Our characters are both influenced by, and influence, our actions. It may pay us in the end to have a good character¹⁷, and this will generally mean restraining our tendencies towards self-interested behavior.

My quarrel then is not so much with Professor Jensen's views as stated in his reply; indeed, he recognizes that 'we agree with Brennan, then, that people are much more than money maximizers'. My concern rather is with a use of language which, while

¹⁶ This issue is discussed in greater detail by Derek Parfit in *Reasons and Persons*, Clarendon Press, Oxford, 1984.

¹⁷ Note that this is not the same as a good reputation.

acceptable for technical discussions in academic journals where technical terms are not likely to be misunderstood, carries grave risk of misleading when carried over to non-technical discussion in the classroom.

Professor Jensen's new model of Resourceful Evaluative Maximizing Man explicitly recognizes that individuals are interested in more than their own welfare. The problem with this concept is that it has absolutely no predictive power. He claims that the test of such a model is the degree to which it is consistent with observed human behavior¹⁸. His model certainly satisfies this criterion. It is consistent with the behavior of a mother who abandons her child, and equally with that of the mother who sacrifices herself for her child; it is consistent with me giving a dollar to a beggar and not doing so; it is consistent with me stealing from my employer and not doing so; it consistent with obeying the speed limit and exceeding it. By suitable choice of objective function, any behavior can be rationalized. The economist achieves predictive power with his model of Rational Economic Man precisely by restricting the objective function to the consumption of goods and services. This drastic simplification works well in many circumstances that interest the economist - primarily market transactions where the other transactors are anonymous, though even there, as I mentioned in my article, considerations of fairness may supervene. The model works least well in non-market transactions where the identity

¹⁸ This attitude is at odds with the Popperian view, generally held by economists, that a scientific hypothesis is of interest, only to the extent that it is potentially falsifiable. An hypothesis that is consistent with any observations is empirically empty.

and welfare of others, as well as social norms¹⁹, are important. That is why I criticize the naive application of the simple agency model with its assumption of pure self interested behavior to issues of compensation where ethical considerations of fairness, duty and so on are likely to be important.

¹⁹ See D. Kahneman, J.L. Knetsch and R. Thaler, "Fairness as a Constraint on Profit Seeking: Entitlements in the Market", *American Economic Review*, Vol. 76, 1986.