CHAPTER 1

The Ethics of Corporate Governance: What Would the Political Philosophers Say?

Colin Read

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INTRODUCTION

Ethics involves a determination of what is right and what is wrong; or in the words of the Greek philosopher, Epicurus, ethics "deals with things to be sought and things to be avoided, with ways of life and the (end of life)" (Laertius 1925). Ethics extends beyond the individual and invokes a permanent rather than a situational perspective. (However, the existential theory of Jean Paul Sartre would argue otherwise.) Ethics invokes the management of the environment within which we function from a perspective broader than, but obviously inclusive of, the current cohort. Again borrowing from the Greek, the terms *ecology* and *economics* share a root in the Greek word *oikos*, literally meaning *house*, but interpreted as meaning the environment within which we live. While ecology is the logical study of the environment, economics is the management of the environment within which we operate. Since the corporate environment is in theory an infinitely lived entity owned by finitely lived shareholders, a governance ethic must represent a system that serves the needs of the current ownership while preserving the ability of the corporation to sustain itself and benefit future cohorts.

Before engaging in the techniques one could use to frame governance problems within an ethical foundation, let us bound the argument by two extremes, and from there gain confidence that the ethical solution lies somewhere in between. The first argument states that the corporation is here only to serve the current cohort. That argument cannot serve as a truly corporate ethic because the argument could have been made generations

ago and generations hence with equal conviction but without equal correctness. It would instead create a series of mutually exclusive governance prescriptions without regard for the costs imposed upon any future cohort wishing to invoke the same situationally convenient argument.

Alternately, we can dispense with the second argument, that the corporation should perpetuate itself in its current form. The market forces thrust upon a corporation are in constant flux, and hence preservation of its current state is impossible. Instead, this latter argument might be to try to manage the corporation for maximum preservation. Such a preservationist argument would preserve all corporate capital for future generations. Of course, we should anticipate using capital at some point since, by doing so, one cohort can benefit and no other cohort would suffer. (This notion of an ethical decision is also an efficient decision. It is named the Pareto Principle, after the Italian economist who originated the notion.) The ethical quandary would then be the determination of which generation should be permitted to benefit from the value of the corporation. Should we delay paying out dividends indefinitely by constantly retaining earnings, even if the capital is depreciated through obsolescence? If such were the case, and hence no single cohort benefits, we would violate the premise that decisions are to be made for things sought and to be avoided in life.

The corporate ethic must then lie somewhere between these two extremes. It must necessarily promote efficiency in coexisting with the environment to generate the quality of life for a current cohort and yet also provide an equity that does not disadvantage a future cohort by the decisions of a current cohort. Our test for a corporate ethic must establish a balance between these two competing views.

As an example to further explore this balance, consider corporate perks, bestowed on the current cohort of principals or agents, always at the expense of future cohorts, or even some current cohorts deluded by accounting practices that mask such perks. While such violations by agents of principals' interests impose inefficiencies, we shall next see that they also impose intertemporal inequities. Negotiations over improvements in current accounting can mitigate the delay in costing such practices. However, the decisions of mortals will always favor benefits that come with delayed costs. The insights of Robert Solow question this ethic.

THE THEORY OF SOLOW IN A CORPORATE CONTEXT

Let us begin by offering up contributions from some eminent social and economic philosophers. I begin with Robert Solow, a contemporary economist who won the Nobel Prize in economics for his study of optimal eco-

nomic growth. In determining the level of optimal growth, Solow observed that we can accelerate current growth simply by "eating the seed," or growing presently by detracting from the wellbeing of those that follow. Indeed, even we as individuals are familiar with that concept. In the cartoon *Popeye*, Wimpy was always willing to pay you Tuesday for a hamburger today. Economic theory deduces all of us would rather consume a certain amount today than trade it for the same amount a year from now. This universal discount for the future is a mere expression of our mortality rather than a flaw in our individual ethic. However, it would be a flaw in the corporate ethic. Society is infinitely lived and cannot say that one cohort is more important than another. Hence, Solow argues that the only ethical discount rate is a zero discount rate—in other words, no decision, benefit, or cost ought to be more highly valued in one generation than another. As a consequence of this governance ethic, we must include in our theory an intergenerational benchmark, with all generations weighted identically. This is not to say that a decision should not be made that would benefit one generation. Rather it states that benefits incurred by one generation be balanced against, and indeed should bear, the costs to others that follow.

THE THEORY OF KANT IN AN ENVIRONMENTAL CONTEXT

Immanuel Kant provides us with the notion of universal law. Kant states, "If we now attend to ourselves in any transgression of a duty, we find that we actually do not will that our maxim should become a universal law—because this is impossible for us—but rather that the opposite of this maxim should remain a law universally. We only take the liberty of making an exception to the law for ourselves (or just for this one time) to the advantage of our inclination" (Kant 1993). In this argument, my current generation could not determine it correct to irreversibly consume corporate capital to the detriment of any other (now or in the future) that would also like to consume that resource but cannot because of my decision. In other words, I cannot rationalize my decision to consume and deprive others simply because I am fortunate enough to be in the circumstance that allows me to make such a decision. (This circumstance-specific decision making is often called a *situational ethic*.)

THE THEORY OF RAWLS IN AN ENVIRONMENTAL CONTEXT

Finally, let us have the (up to very recently) contemporary economic philosopher John Rawls weigh into the discussion (Rawls 1999). Rawls

argues for distributive justice. He acknowledges that our decisions are almost fatally influenced by the self-serving benefits and less influenced by the costs of our decision borne by others. As a consequence, a wealthy person finds herself believing in low taxes and a poor person believes in a highly progressive tax structure. As an environmental ethic analogy, those living today naturally believe in dividend payouts today with less regard for the consequences tomorrow, and those living tomorrow would prefer dividend payouts tomorrow without regard for the sacrifices we make today to allow their greater consumption tomorrow. Rawls' resolution to this dilemma was to impose a *veil of ignorance* on the decision-maker. Under this technique, a decision is made without regard (or perhaps with equal regard) to which class (of those that benefit or those that pay the cost of the decision) the decision-maker may find herself in.

To some degree, we all go through a Rawlsian veil. For instance, I may make self-sacrificing decisions for the benefit of my daughter, as may a grandmother for her grandchild. The philosophical biologist Hamilton formulated what has become known as Hamilton's Rule to explain such a phenomenon (Hamilton 1964). Within the parlance of economics, he recognizes that an externality exists when a decision is made that confers the benefits b on one agent, while imposing the costs c on another. One makes the correct decision only if an agent enjoys the positive externality he generates on another. Of course, if he is so positively related to the other (a relatedness coefficient r equal to one), then the other's benefit is like his own, and he is willing to incur the costs to obtain benefit for another. Indeed, he will make the decision if:

$$rb > c$$

(Actually, Hamilton's Rule is most often expressed as $rb - c > 0$, but has been modified to more closely conform with the economic rule for efficient decision making that $MB = MC$, where MB is the marginal benefit earned by making an incremental decision and MC is the marginal cost incurred for such a decision.)

In a Rawlsian world, correct decisions would be made if the relatedness coefficient would be equal to one for all decisions and all decision-makers. Perhaps the most useful implication of this notion in our context would be to have all decision-makers feel equally wed to all future generations as their current generation, a notion consistent with Solow's notion of a zero social discount rate. Yet this is at odds with most mortals' and markets' natural inclination to adopt a positive discount rate approximated by the prevailing return to capital.

TOWARD AN INTEGRATION AND AN EMERGING GOVERNANCE ETHIC

Let us again frame the governance problem. Decision-makers make decisions based on their perception of the benefits and costs flowing to them and perhaps their current cohort. These benefits are in the form of a consumer's surplus, the amount gained through the decision in excess of the amount given up. When there is a simultaneous benefit conferred or cost incurred upon the current cohort in a market-based decision, we can use the political process to correct the self-serving nature of a marketplace populated by finite-lived individuals who collectively determine the value for infinitely lived corporations.

This complementarity between market and individual decisions can work well in theory if transactions costs are low and information is good. However, the marketplace is decidedly oriented toward current market participants, while corporate politics caters primarily to current corporate executives, directors, and shareholders. Neither mechanism can be expected to make decisions based on a universal governance ethic unless at least a majority of the political constituents desire decisions based on that ethic, or unless almost all market participants act consistently with the ethic.

CONCLUSION

Given the unrealism of an emerging corporate ethic through the actions of mortal cohorts, it is difficult to develop an institution that creates the appropriate incentive for ethical corporate decisions. There emerges no single theory of a corporate ethic. Indeed, the marketplace is at odds with the principle of a zero social discount rate. Nonetheless, these theories all suggest a corporate ethic that recognizes the relationship between intergenerational decision making.