Beyond Economic Criteria

The importance of economic factors in management has been greatly exaggerated in recent decades. It has been claimed that a company's ultimate objective should be to maximize its value for shareholders. Organizations must go further than this, however; they must add learning to the equation – the learning that changes their members' knowledge, skills and attitudes – and include ethics in their decision-making model.

Executive Summary

The IESE Alumni Association has awarded Prof. Josep M. Rosanas the 2008 Research Excellence Award for the article "Beyond Economic Criteria: A Humanistic Approach to Organizational Survival" published in the *Journal of Business Ethics*, 2007, no 78. In this article he puts forward a humanistic view of organizations that goes beyond the short-term outlook so prevalent nowadays, while at the same time providing a scheme of thought that takes all parties' interests into account.

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Incongruities arise in the development of any academic discipline. Even mature disciplines such as Physics have experienced (and in many cases continue to experience) periods of substantial disagreement. At times, mutually inconsistent theories that explain certain real-world phenomena in completely different and incompatible ways have coexisted. In astronomy, for example, Ptolemy's geocentric theory, accepted for many centuries, was incompatible with Copernicus's heliocentric view, subsequently developed by Galileo and Newton. And yet the two coexisted for almost fifty years. That similar incongruities should be found in the field of management is hardly surprising. The late Sumantra Ghoshal, professor at the **London Business School**, made this abundantly clear in a famous article published in 2005, not long after he died. This is no cause for alarm, however. An old cartoon shows a group of people standing blindfold around an elephant. By touch they have to guess what it is they have in front of them. Those who touch a leg say it is a column; those who touch the trunk say a hose; those who touch the ears, a fan; those who touch the tail, a rope; and so on. None can see the whole. All simply hazard a guess at what it is they can feel.

In many ways we are the same. As I said, though, this is no cause for alarm. Fifty years are nothing in the history of a science, so it would be surprising if we were any different. We are the same, however, in the sense that, although there are different ways of seeing the world of business, many approaches see only part of the picture.

More specifically, there has been a tendency in recent years to place the emphasis almost exclusively on economic variables. As long ago as the thirties, however, one of the classics of management theory, Chester I. Barnard, said that he did not really start to understand the phenomena that occur in organizations until he relegated economic theory and economic interests to a secondary, albeit, of course, indispensable, place.

In the last two or three decades the importance of economic factors has been greatly exaggerated. However indispensable (to use Barnard's term) economic factors may be, that is no reason why everything else should be subordinated to them; rather the opposite. Economic goods are not the purpose of human beings; they are means, among others, by which human beings may achieve well-being. And yet, from the mouths of theorists and practitioners alike, we have heard grand pronouncements to the effect that companies' supreme objective must be to maximize their value for shareholders. This is a strictly economic objective. It is also an objective more honored in the breach than the observance, as we saw last year, when shareholder value was destroyed on an unprecedented scale, especially perhaps in the companies that have been most vociferous about maximizing shareholder value. We have also seen how, both in strategy and in organization, companies have adopted economic models based for the most part on the hypothesis that human beings seek only their own self-interest.

This tendency is attributable partly to the development of financial theory, partly to the use of economic tools in strategy formulation (industrial economics), partly to the economic models of organization ("agency theory", for example), and partly to cultural influences. In the United States the eighties were baptized the "Decade of Greed"; some even described the nineties as the "Decade of Evil". That is because, as we said, a key assumption underlying the economic models is that people act exclusively out of self-interest. Sometimes, the reference is to "enlightened" self-interest, understood to mean acting without causing unnecessary harm to others and helping others in the expectation that they will help us. At bottom, however, self-interest prevails.

Even purely as a description of the way things are this is patently false. The world is full of parents who make sacrifices for their children, friends who do favors asking nothing in return, people who perform acts of heroism for NGOs in countries at war. Examples abound where self-interest does not prevail. The great flaw in this view is that it overlooks three basic facts, which are interrelated: bounded rationality, ethics, and the way people learn. I should hasten to add that there are economic models which include some notion of learning, though invariably in a very limited sense, as we shall see later. What none include are notions of ethics.

The opposite extreme in management theory, at a far remove from the economic models, is organizational behavior. In organizational behavior we find a concern for human beings as such, i.e. beyond their immediate economic interests, taking their other needs into account, as companies must if their people are to be profitable to them. The problem here is, first, that human beings are often seen as means to an end. In other words, even though the goal is not explicitly to maximize shareholder value, human beings are valued only insofar as they are profitable. The second problem is that these approaches often make no reference to ethics. The most common of them, institutional theory, claims that human beings seek to legitimize themselves by doing what others do;

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and that companies do the same. At best, there may be a certain esthetic, but not ethical, preference as to what it may or may not be legitimate to do to another person.

A different way of seeing things

Every business decision (except, perhaps, for trivial problems) has to do with human beings. This is both a drawback and an advantage. A drawback because interacting with human beings is more difficult than interacting with inert matter: inert matter makes no decisions and always reacts in the same way to human actions, whereas other human beings do not. And an advantage from every other angle, as people can have initiative, tackle problems as they arise, look for new ways of solving them, and so on. A humanistic approach must start from this premise.

Nowadays, we know exactly what it is like to interact with inert matter. We experience it every time we use a computer. If we perform a certain action, the computer always reacts in the same way. A computer can perform very complex tasks, but always in a purely mechanical way. Human beings, in contrast, learn. In other words, they modify their behavior in light of their experience. This means one can never be sure how a person is going to react to a given stimulus.

In the field of economics, agency theory has studied the interactions between human beings on a one-to-one basis, which obviously is the minimum for any relationship. It has done so in a very limited way, however, without acknowledging the learning that takes place. Here, drawing on the work of IESE professor Juan A. Pérez López, we shall briefly set forth what could be considered a general theory of agency.

Let's say a certain person, whom we shall call the "active agent" (and whom, to simplify, we may think of as "the boss"), wants to elicit a certain reaction from another person, whom we shall call the "reactive agent" (and whom we may think of as "the subordinate"). To elicit the desired response, the "boss" does something which makes the "subordinate" react. The subordinate's reaction may produce the result the boss was hoping for, or it may not. If it does, we can say that the boss's action was effective; if not, that it was ineffective. Either way, apart from the concrete results of the action-reaction sequence, the action inevitably has two other results that affect the two people involved: they both learn something. Figure 1 represents this situation.

By learning we mean, first, that the agents learn more about the initial problem. In the case of a sales action, for instance, both learn about the product, the customers and other related variables. At the same time, however, each learns to assess whether his own and the other person's actions and the results of those actions are what he really wanted or not; and also whether the results meet his expectations and therefore were worthwhile. More importantly, each learns whether he wants to continue to work with the other.

Why is this so important? Because it determines the future of the relationship between the two. Vicious and virtuous circles can arise. If one person feels "deceived" by the other, or feels he has been "obliged" by the other to do something against his principles, or that he has been "exploited" or "manipulated," the odds will be stacked against any further interaction between the two. Their capacity to work with one another will be undermined. Mutual trust will be weakened or destroyed. If both are satisfied, however; if both feel that what they have done was worthwhile and that working with the other person has been a good experience, then the potential for further collaboration and trust in the future will be increased.

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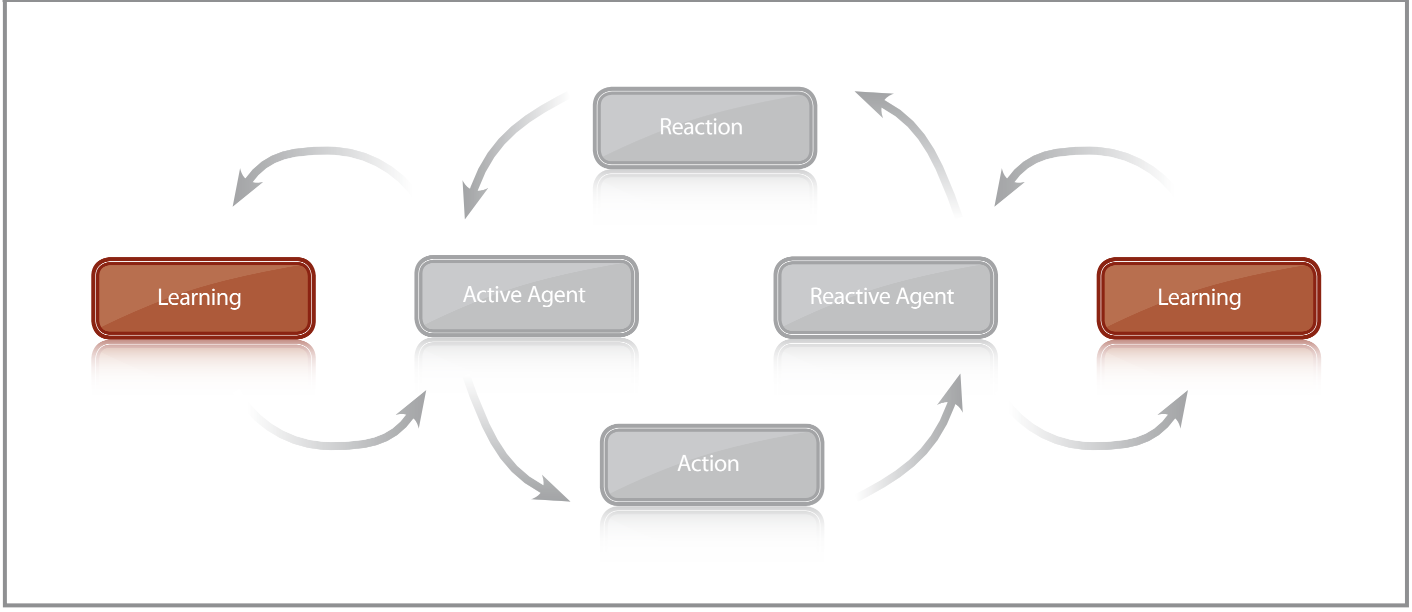
Three decision-making criteria: Types of motives

To make a business decision in a non-trivial context (i.e. a decision affecting other people) three types of outcome must be taken into account: the explicit, intended result and what each of the two people involved learn from their interaction. Normally, any management procedure, technique or decision is judged mainly (if not exclusively) on its explicit result, which for the company as a whole means profit, or stock value, or some other economic or financial variable. This might be justified, up to a point (though not entirely, as we shall see), if the interaction between two people (or more, in the general case) took place once and never again. If the interaction is repeated, however, as it usually is in organizations that aim to survive in the long term, such a criterion is unjustifiable. Today's effectiveness is measured by explicit results, but what the agents learn from their interaction today will determine the outcome of their subsequent interactions in the future. Cooperation, interpersonal relations, and

Figure 1. General Agency Theory



attitudes and skills in an organization depend on what the people in the organization learn.

Most importantly, the three criteria give rise to three types of motives for any decision maker.

First, the explicit results are pursued for extrinsic motives associated with the mainly material rewards that come from achieving those results.

Second, an active agent who wants to learn has intrinsic motives, i.e. is motivated by the job itself and has a certain attitude toward the results of his actions and toward other people.

Lastly, when an active agent cares about what the reactive agent learns, i.e. whether and to what extent the reactive agent's real needs are satisfied, then we can say that the active agent has transitive motives, i.e. motives directed toward the well-being of others (the reactive agent).

In order to improve (or merely not to deteriorate) as a person, a person must take into account the impact his actions have on others.

Motives and ethics

A person who does not have transitive motives and who is indifferent to what happens to the reactive agents he interacts with has no ethics. A person who ignores the effects his actions have on others neglects his most basic duties; he also deteriorates as a person. A person who steals becomes a thief; a person who kills, a murderer; a person who cheats, a swindler. And a person who deceives his bosses, subordinates or colleagues in more minor ways becomes an undesirable. This is what classic ethics would say. In order to improve (or merely not to deteriorate) as a person, a person must take into account the impact his actions have on others.

Moreover, what we have said so far is that in organizations, where the same people interact again and again, for a person to ignore what others learn from his actions and not care how they react is simply short-sighted. It means not realizing that future results depend on other people's reactions. In organizations, therefore, it is in a person's own long-term self-interest to take other people into account. Not to do so would be to disregard one's own interests, one's own learning. When a person acts in a way that is harmful to himself in the long term or prevents him from learning, he is being short-sighted and impoverishing himself.

The organizational context

The diagram in Figure 1 on the interaction between two people can also be used for the interaction between two groups of people. The active agent could be "the company", for example, and the reactive agent, "consumers". This would give the following scheme:

1. **Extrinsic results for the company:** the key economic and financial variables, i.e. profit, stock value, return, etc.

2. **What the company learns:** how to enhance its distinctive competence, i.e. what the company does better than anybody else, what gives it the competitive advantage that guarantees future profitability.

3. **What consumers learn:** whether and to what extent the company's product satisfies their real needs and whether they can trust the company to meet those needs. This will only happen if the company's employees try to make it happen, i.e. if they identify with consumers' needs in the course of their interaction.

Summing up, in this article we have discussed how the mechanical models of organizations and human beings can be superseded by a model that takes account of learning, which changes people's knowledge, skills and attitudes. Taking account of what others learn from our actions brings ethics into play and so integrates ethics into the organizational decision-making model. The end result is a new approach to decision making, one that supersedes the short-term outlook so prevalent nowadays, while at the same time providing a scheme of thought designed to take all parties' interests into account and thus develop a humanistic view of organizations. ■