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Josep M. Rosanas*

Abstract

Recent business scandals have undermined confidence in companies and their managers. In many countries, special legislation has been introduced to tighten controls, and this is expected to improve things in the future. In this paper we argue that there is unlikely to be any improvement unless changes are made elsewhere, in areas less to do with board-level corporate governance than with the control system that evaluates people's performance day to day and determines rewards and punishments. The systems currently in place, based on large monetary incentives, are one of the causes of the problem. What is really needed is a change of mentality among managers and management theorists and a greater emphasis on cooperation between people than on systems based exclusively on economic variables.

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MANAGEMENT INDICATORS, INCENTIVES, MOTIVATION AND ETHICS IN MANAGEMENT CONTROL[1]

Introduction

It may seem paradoxical that recent financial scandals should have coincided with rocketing executive pay. On a naive level, one might think that current levels of pay (mainly in the U.S. environment) "ought to be enough". In fact, exorbitant pay and scandals are the two most urgent problems concerning the behavior of top executives in recent years (Osterloh and Frey, 2003). As we shall see, however, not only are these two phenomena not incompatible, they are actually complementary. In fact, excessive pay is most likely one of the causes of the scandals.

The scandals obviously have not benefited the economy or public confidence in companies and their managers, and their harmful effects will continue to be felt in the future. In a recent informal online reader poll by *Forbes* magazine, 90% of respondents considered Bernard Ebbers (who was sentenced last March, but has appealed) guilty of the problems at WorldCom. And nobody is going to accuse the readers of *Forbes* of being anti-business. The general public has more faith in the military than in big business (four out of five, compared to one out of five), so, at least in the public mind, there is a serious problem.

This is what makes it so important today to grasp the real cause of the problem and try to avoid it in the future. While scandals may have legal implications and people have ended up in prison, it is unfortunate that so many of the proposed solutions should be punitive or coercive, as there is always a way around things. Any genuine solution to the problem must tackle the root causes. As I will try to show in this paper, even though the law can always be improved, the causes are not to do with any lack of legislation. The causes lie in a certain conception of what it means to manage a company, what instruments are needed to manage a company, and how these instruments are to be used. If I may be forgiven a football analogy, blaming corporate scandals and outrageous executive pay on the law is like blaming the football rules for certain coaching tactics or player compensation systems that encourage foul play, boring games or individualistic behavior within the team. Management ethics (or the lack of it) is an important part of it. But the causes of the problems are the existing control systems, performance indicators, concept of employee motivation and management style. We need to think seriously, as a society, about

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what management is, what it should be, and what kind of purpose and mission we can attribute to companies. In this brief article we shall try to lay the groundwork for this task.

Two levels of control in organizations

There are two completely different levels of organizational control which are often confused. First, there is the more "conventional" control by company owners and society, exercised through the board of directors and other bodies at a similar level (executive committee, CEO or sole administrator, and so on). The term "corporate governance" is widely used in this context, although it can be (and has been) used at the second level, discussed below. The first level of control clearly has a legal component: it identifies the people who are responsible for the company or organization's behavior and who will be answerable to the courts if there is any wrongdoing. The second level is what is generally known as the management control system. This includes all the tools, procedures and methods used to determine whether the organization is top management would desire, assess people's performance, and distribute rewards and punishments accordingly. Management control, which is management in practice, encompasses every level of the organization, from the board of directors to top management, from top management to second-level management, and so on.

The two types of control are qualitatively different. The first operates through the legal system and the capital markets, while the second operates directly within the organization. The first is therefore necessarily legalistic and impersonal, while the second is, and must be, highly individualized and dependent on the actual people involved. The first type of control, acting through the markets, has been solidly grounded in economic theory ever since Alchian and Demsetz (1972); more than thirty years ago. Alchian and Demsetz saw the company as a team of people collaborating in a common task, where one person specializes in monitoring the rest of the team. This is necessary because each person's contribution to the final outcome cannot be measured objectively. If it could, there would be no need for companies because the markets could allocate resources efficiently on their own. But then, the fundamental question becomes, who monitor the monitor? In theory, the monitor could do things for his own benefit that were undesirable for the company as a whole. The conventional answer is that property rights take care of this. The monitor is the owner and the owner has both the residual decision rights (i.e., the right to make any decisions that are not made by others in the performance of their duties) and the residual profits (i.e., any value that is not assigned by contract to others). Given the limitations of accounting profit as a measure of value, we have to turn to the capital market if we want to be (reasonably) sure that this works. The market will measure the value of the shares and the resulting value (which goes directly to the owner) will be the tool of control. According to this theory, therefore, the overseer will make decisions so that the residual profits, and thus also the value created, are as high as possible.

Unfortunately, the market appears to be less than perfect when it comes to evaluating companies' performance. If it did it properly, there would have been no scandals, as scandals usually arise when the market puts a high value on companies whose real situation is masked by false accounting or misleading forecasts. Usually, the main problem is the priority given to short-term results over long-term results; that is, the fact that the markets (which is to say financial analysts and investment banks) assign a positive value to anything that has positive consequences in the short term, even if it may have negative consequences in the long term. This encourages managers to do everything they can to obtain short-term results, sometimes even using unjustifiably optimistic, or even illegal, accounting methods.

Part of the problem is that the markets can only evaluate companies impersonally. The valuations are made by people (mainly financial analysts), but impersonally. Often they are based exclusively on companies' financial statements or mechanical projections of financial statement numbers. The "markets" cannot possibly assess business opportunities, as such opportunities always include unquantifiable intangibles such as direct knowledge of customers and their needs, customers' sales potential, knowledge of the company's distinctive competency, its production capabilities, specific opportunities to exploit these capabilities in certain markets, etc. All these things are, by their nature, subjective and debatable. They cannot be made objective, much less translated into numbers. In fact, F. Hayek's (1945) classic justification of the market economy was based on the fact that the people who manage companies have specific information that cannot be transmitted or verified and that cannot be used without their active cooperation. We often forget that, if this were not so, companies would not have differentiated strategies. If everything could be objectified and reduced to numbers, everybody would choose the same strategy; namely the one that yielded the greatest profit. In fact, this is precisely the implicit assumption of conventional microeconomic theory, which sees companies as a technology (a function of production), which explains in turn why many theoretical economists are incapable of understanding organizations. The fact is that each individual company strives to acquire a distinctive competence, i.e., the ability to satisfy certain needs of certain customers better than any other company, and so make a better living than they do. That is its strategy. So how can anyone who is not involved in management and who sees only the accounting numbers possibly judge whether a given strategy is good or bad? A classic case illustrating the impossibility is Xerox and the "xerocopy". Apparently, many years ago, Xerox offered its xerocopy patent to IBM three times, and three times IBM turned it down because it thought there was no market for the product. Today we know there was a much bigger market than anybody imagined, and people at Xerox could see the opportunity more clearly than the managers of the business machine giant. To put it another way, there is no way anybody can know, objectively, whether a given strategy will be successful or not. And if just any competitor could implement the same strategy, the company would never have a competitive advantage. The directors of companies beyond a certain size cannot be directly involved in management, so they cannot know the details.

I shall try briefly to illustrate this argument. Let us go back a few years to the meeting of the board of directors of Enron in 1999. Everything seemed to be going swimmingly. A few people knew the lurid details (Andrew Fastow, for example, the CFO who had dreamed them up). But, for a time, even Fastow thought there were no problems and never would be; that it was simply a matter of keeping the stock price from falling. Now let us imagine that a director who knew enough about accounting and finance (the chairman of the audit committee, Robert Jaedicke, a distinguished Stanford professor of accounting) took a closer look at the financial reports (a Herculean task, by all accounts, requiring an extraordinary amount of time, much more than any director could probably give to it) and found something suspicious. With time and effort, it would not have been impossible: there were things that were suspicious and a distinguished professor of accounting would be perfectly capable of detecting them. But let us continue with our hypothesis: the director finds these things and goes to the board and reveals what he has found. How are the other directors going to react? Perhaps by tapping their foreheads and rolling their eyes. If everything is going swimmingly, why is this accounting professor telling us about small technical issues that most of us do not understand? Forget about it! Let's change the subject, and long live the CEO!

I do not mean this to be understood as an attempt to exonerate the directors. Some of the directors (a medical doctor, for example) seem to have been out of place on the Enron board. Other should at least have blown the whistle. Admittedly, it was not easy for them.

Nor was it easy for the auditors, financial analysts and investment bankers or, looking even further back, for individual and institutional investors. Some of them probably understood the situation better than some of the directors. But, being further away, they were much less able to do anything about it. Enron was an important customer. Sometimes it had good reason not to be entirely orthodox. Analysts often confine themselves to looking at the big numbers, in an industry-wide perspective, and they do it very mechanically. Not to mention investors, many of whom know almost nothing about the companies they invest in. To sum up, we could say that from the point of view of formal or legal systems, the problems that led to the scandals remained unrecognized on three levels: the board of directors, the community of experts, and investors.

Visceral, legalistic, simplistic and incomplete solutions

Faced with certain problems, human beings often adopt visceral and simplistic rather than cerebral solutions. The adage that hard cases make bad law also applies to accounting (and management in general). So far, the response to the scandals has been to tighten regulations at different levels. The idea is that directors must understand more, be more independent of management, devote more time to their board duties, apply stricter financial controls... And above all, anyone found guilty of wrongdoing must be more severely punished.

The result may not be as expected, however, because this is a complex process. Osterloh and Frey (2003) provide data to show that neither board independence, nor directors' competency nor stricter financial controls necessarily lead to better results. There is nothing particularly surprising about this: we all know there is always a way of getting around things, as we said earlier. In fact, simplistic and visceral solutions can make the situation worse, because they are so incomplete. Companies need flexibility to act appropriately, pursue a differentiated strategy, establish their own culture and do things differently from their rivals, which is what will give them competitive advantage. A rigid, strict solution cannot possibly take account of all these variables. If companies are subjected to rigid regulation, they will not have the necessary flexibility.

So the question is, why do we opt for this type of solution? Why do we advocate remedies that do not work and may even make the problem worse? Argyris (1990) suggests an answer: most human beings, when they feel threatened or challenged, act in accordance with a human theory of control. The problem is that this human theory of control is counterproductive and prevents any objectivity, rigor or verification of conclusions; i.e., it prevents productive reasoning. What Argyris calls "espoused theories", what people say they believe, are very rarely put into practice. In place of productive reasoning, people adopt defensive routines to protect their behavior. These can be interpreted as spontaneous reactions based on simplistic rules of behavior. The theory that people actually put into practice is what Argyris calls "theory-in-use". With a primitive theory people often feel they are "doing something", whereas if they do not act spontaneously and simplistically they feel they are "not doing anything" and so are uncomfortable with themselves.

Obviously, looked at "from above", there is not much more we can do at board level or at the level of regulations in society as a whole. If we take this point of view, the only way to improve the situation and avoid future disasters is through formal, impersonal mechanisms (what, to simplify, we could call "legalistic" solutions): independent non-executive directors, better training for board members, stiffer penalties for those who infringe laws and regulations, stricter regulations, etc. This is typically what various global bodies and commissions have proposed, even though, as we said and as Osterloh and Frey (2003) have shown, such measures often do not have the desired results. We also cited the case of R. Jaedicke at ENRON and pointed out that the sheer volume of information in any large, minimally-complex company makes board control an almost impossible task. Moreover, if the external auditors (whose job it is to discover this type of thing) have so often proven ineffective, who can take their place? The Enron case put one large audit firm out of business. Can heavier penalties improve the situation? Can the board of directors really do anything? Can a company be properly governed by its board of directors, without running the risk that the company's funds are misused or misappropriated? On the other hand, board independence and in-depth knowledge of the company may very well be contradictory. If a director knows the industry well, where does that knowledge come from? If it comes from the competition, that is a bad sign; if it comes from the company itself, the person's independence is questionable.

The WorldCom case

In mid-2005 a sentence was passed in the United States which, under U.S. law, set a precedent for other cases awaiting trial. Bernie Ebbers, CEO of WorldCom until the notorious accounting scandal broke, was sentenced to 25 years in prison. The jury did not believe what the prosecution sarcastically dubbed the "Aw, shucks!" defense, which basically consisted of saying he knew nothing. We accept that there is an element of truth in Ebber's argument: he could not possibly have known every last detail of the dishonesty that was going on in his company, just as he could not have known all the good that was being done. Many details never reach the top of an organization. But is it possible that Ebbers knew nothing? Is it conceivable that the head of a large organization can be unaware of an 11 billion dollar fraud? Above all, who instigated the things that went on? More specifically, what type of behavior did Ebbers encourage among his colleagues and subordinates? Let us take another football analogy. Let us imagine a team in which a prize of (say) 5,000 Euros is offered to any player who scores a goal. In such a team, would it be surprising if a player spoiled a better-positioned team mate's chance at goal in an attempt to score on his own? Of course not! Who would be to blame? The player would obviously bear part of the responsibility - he is the one who decided to shoot, against the interests of his own team. The fans would probably be furious with him. But what about the person who offered the incentive? He is at least as guilty as the player! Let us take this argument a little further: can we solve this problem once and for all by punishing any player who misses a shot at goal when he could have passed to another player? Obviously not, it seems to me. We would probably just make things worse: nobody would shoot at goal. So this, in a nutshell, is the problem. But there is another complicating factor: what we shall call the "Pahom syndrome".

The Pahom syndrome and maximizing incentives

Pahom is a character in a short story by Leo Tolstoy called *How Much Land Does a Man Need?* Pahom is a peasant who struggles to make a living working for other people. He dreams of having enough land to support his family. That is all Pahom wants: enough land. One day his dream comes true. A plot of land is for sale and he is able to buy it by selling some of his possessions and paying part of the price in installments. He works hard to get what he wants and in the end he has it. But he wants more. So he buys more. But still he wants more. Eventually, he hears that in a distant region he can buy as much land as he can walk around in one day for a very modest fixed sum. When the sun comes up, he starts walking. All the land he walks around during the day, until the sun sets, will be his. He can go as fast as he likes, he can even run: all the land he covers will be his. But he must get back to his starting point, otherwise he will lose the money. Pahom is happy, he reckons he can easily cover the amount of land he needs in one day. But obviously, he could always try to cover a bit more and so improve things for himself later. So he tries to cover more ground, and as he runs, his ambition grows, so he goes further and further. In the end, when the sun sets, he has marked out an enormous plot of land, which would make him a rich landowner. He manages to get back to his starting point, but he will never live on the land he has bought: he dies of exhaustion on arrival.

For human beings nothing is ever enough. As the Greek philosophers said, man is a needy being. He is perfectly capable of acting against his own real interests (like poor Pahom) by wanting more. Wisdom, according to Greek philosophy, consists precisely of knowing what is good for oneself; for example, not going to excess in the pursuit of material goods. Knowing when "enough is enough". So we human beings must do all we can not to encourage others to harm themselves. We can do this, for example, by not creating incentives (if it is in our power to create such incentives) that may cause the Pahom syndrome. In the case of managers of modern companies, this syndrome can be fatal (ending in heart attack) and lead to all kinds of problems. In recent years, however, it has been taken for granted that economic incentives are the key to organizational growth and performance. As we shall see, not only does this potentially generate scandals, it also fails to achieve the desired results in the medium and long term.

Management control systems and goal congruence

The purpose of a control system is to change people's behavior. A management control system, therefore, always contains an element of manipulation, in that it is designed to maneuver individual interests into line with organizational interests. To do this, companies define measures of employee performance and link these measures to incentive systems. This is done partly through formal systems (i.e., pre-established procedures, applied almost mechanically) and partly by informal means (i.e., direct, subjective assessment by people in positions of power within the organization).

This is the second level of control we mentioned earlier. The informal means include direct relationships between people within the organization. Personal relationships offer many more opportunities for control than the purely formal external control system based exclusively on standards and procedures. This is not to say that internal control is perfect. Nothing is perfect in this world and, as we shall be arguing, management control systems often have serious limitations. Nevertheless, they can achieve much more than formal systems. Often there is another important element in this context, namely a system of goals, targets or milestones to be achieved, usually in relation to a planning system, expressed quantitatively in a budget. In the classic textbook formula, the basic criterion for judging a control system is "goal congruence". This is clearly stated in what is perhaps the best known, pioneering book on the subject:

> *"In a goal congruent process, the actions that people are led to take in accordance with their perceived self-interest are also in the best interest of the organization" (Anthony and Govindarajan, 2003, p. 93).*

Ideally, therefore, the "interest" of individuals (particularly those at the top of the organization) and the "interest" of the organization as a whole should coincide or, at least, be aligned ("interest" being understood in a broad sense).

In practice, however, when we think of "interest", we often implicitly or explicitly reduce it to short-term, narrowly-economic interest, such as quarterly earnings for an organization or material incentives (annual salary, say) for individuals. We thus have two different levels of reductionism: interest is reduced to economic interest, and economic interest is reduced to short-term economic interest (quarterly earnings, annual incentives). Clearly, this can have undesirable consequences. First, it can lead us to underestimate non-economic or non-quantifiable variables; perhaps one of the greatest failings in recent years. We often forget that money is not the only thing we need in order to live, that we all need other things, and that companies, as groups of people, also need other things. At the very least, companies need to maintain their distinctive competence, so as to continue to have competitive advantages in the long run. They need to retain the good will of their customers and employees. They need to maintain and enhance employee training. They need to develop new products for the future. And so on. All these variables are neither quantitative nor are they reflected in short-term profit.

In practice, a formal control system consists of: a) a system for measuring and evaluating results; and b) a formula for calculating the compensation or incentives to be paid to the individuals concerned. These two things could be considered the pillars of the technical structure of the system. At the same time, there is a process for setting goals, targets and milestones. The process is less than perfect, however, because goals are always slightly (or very) ambiguous, mainly because several goals are to be achieved at once and, as we said, some of them cannot be measured. Also, the relative importance of each goal is highly subjective. What any organization really needs, therefore, consists of a set of variables, comprising some that are not measurable, and an aggregate in which the relative importance of each variable is difficult to determine.

Moreover, every organization defines its goals as it goes along. What starts as a relatively vague idea slowly crystallizes. William Hewlett and David Packard said that business school professors used to be disappointed with them, because they would confess that, in the early days of Hewlett-Packard, they would do anything to earn a few dollars and had no clear product strategy. On the other hand, however, they did have a very clear idea of their institutional strategy, that is to say, the type of organization they wanted to be. Hewlett-Packard went on, of course, to become one of the great personalities of corporate history. But it illustrates very clearly how, at some stage, goals can be rather diffuse, only to be defined gradually over time.

The formal control system, by contrast, consists of an evaluation and measurement system that has to be mechanical; it cannot leave room for ambiguity. When assessments are made subjectively, we are talking about the informal control system. By the same token, the incentive system must also be mechanical, based on objective, measurable facts, with monetary awards determined in accordance with these objective, measurable values. What is measured, therefore, and the actual goals to be achieved are generally two different variables. They will usually be correlated to some extent, but only imperfectly. Only in very mechanical jobs, where the goals are clear-cut, can the correlation be at all high or close to one. In unstructured jobs, such as those normally done by managers, any measure will have a relatively small correlation with actual goal achievement. Baker (1992) and later Gibbons (1998, 2005) state the problem in formal terms (in symbolic language). Gibbons also provides an excellent summary of the findings of the theoretical literature. Based on these authors' analyses, the problem can be formulated as follows: Any action by the "controlled" person necessarily has an impact (not necessarily a positive one) on the organization's actual goal achievement, on the one hand, and the measure of goal achievement, on the other. The two may differ significantly. Therefore, the "controlled" person will sometimes have to choose between an action that brings the organization closer to its goal but is not fully reflected (or is reflected negatively) in the performance measure and an action which substantially improves the performance measure but does not bring the organization any closer to its goal (or even takes it further from its goal). The manager's choice will naturally depend on the organization's incentive system.

Let us assume, to start with, that the organization has no explicit incentive system. In other words, managers' rewards (tangible and intangible) are unrelated to the actions they take or the results of their actions. They will choose their actions based on two variables:

1. First, their self-interest, which we usually understand to mean making no effort and working as little as possible, but which may also entail the opposite, i.e., doing a technically perfect job, just for the pleasure of it, but without solving (external or internal) customers' problems. In other words, the first criterion will be the utility or disutility the action and/or outcome has for the person concerned.

2. Secondly, we cannot rule out the possibility that the action will be chosen in accordance with what the person understands to be the organization's interests.

A perfectly selfish person would think only of the first criterion, but (fortunately!) nobody is perfectly selfish. In fact, it has been argued in the context of agency theory that it is relatively common for managers to work longer hours than they should and become workaholics, perhaps to satisfy their vanity but also perhaps out of concern for their company's future. A manager will strike a balance between the two things. The final outcome will depend on the specific circumstances and the personal characteristics of the manager concerned, which will strongly influence the manager's assessment of the organization's interests and his own personal utility. A perfectly selfish manager (which, as we said, does not exist) would always put self-interest before the organization's interest, whereas a person who identifies wholeheartedly with the organization (William Whyte's organization man, perhaps) would put the organization's interests first. The reality obviously lies somewhere in-between.

Now let us assume, in contrast, that the variable to be measured has an explicit, quantifiable (not necessarily monetary) incentive attached to it. In this case, the subordinate (controlled person) will be more inclined to do anything that will improve this measure, which is only imperfectly correlated with the organization's real goals. If the incentive is strong enough, therefore (and in recent years it often has been, for example in the form of stock options), we should not be surprised to see managers doing anything in their power, even fraud, to improve the performance measure, whether it contributes to the organization's goals or not. Given the Pahom syndrome, moreover, the greater the incentives, or pay in general, the greater the likelihood of scandal.

This argument is built on the works of Baker and Gibbons cited previously. Baker's main conclusion is that, to induce an agent to do what is best, there has to be a contract and certain incentives that are matched to the benefits to society as a whole. Generally speaking, this is completely impossible, with trivial exceptions where very mechanical or programmable tasks are concerned. The "tournaments" that have become fashionable recently, aimed at seeing "who performs best" in economic theory do little to help. As this same theory acknowledges, an employee may find it more advantageous to sabotage a colleague than to do anything that actually benefits the company. So whether an incentive system does actually align a manager's interests with the organization's goals or not (with or without the use of explicit incentives), it will be purely by chance: it will happen only if the individual's self-interest (in terms of enjoying the job), the explicit and implicit incentives, and the interest the organization arouses in the individual happen to coincide. Control systems and incentives must therefore pursue somewhat more modest goals: "An adequate control system will at least not encourage individuals to act against the best interests of the organization." (Anthony and Govindarajan, 2003, p. 94).

The folly of rewarding A, while hoping for B

More than thirty years ago, in 1975, Steven Kerr published one of the most famous articles in management history. It proved so popular that it was republished twenty years later, with a few changes which revealed the limitations of the journal refereeing system. The gist of the article was that, in certain situations, there are implicit incentive systems that make people not do what they should do or what it would seem logical for them to do. In other words, in the terminology we mentioned earlier, there is no goal congruence. What is perhaps most remarkable is that Kerr's examples, taken from the military, health care, academia, etc., are as pertinent today as when the article was first published. That is to say, we have not learned much. On republication, the editors noted that to say that the folly was alive and well was an understatement.

Our earlier analysis helps to explain why mankind has not learned: because the problem cannot be eradicated. It may be logically impossible to establish an explicit incentive to accurately offset an adverse implicit incentive. In other words, the conditions that we would like to see met simultaneously are incompatible with one another.

Fortunately, the underlying problem is not insoluble. It would be if there were no other way to motivate people than through material incentives. The fact is, however, that there is much more to human motivation than this. Since Herzberg and McGregor's classic works, we know that there are also intrinsic motives, which we may perhaps interpret as the motives that make us "enjoy" the work we do. Indeed, there is another type of motives, what Pérez López (1993) calls "transcendent motives" or what Osterloh and Frey (2003) refer to as "obligation". People often strive to achieve what they believe is worthwhile for other people or for society as a whole, despite the fact that there may be nothing in it for them, apart from the satisfaction of having done something for others. As early as the 1930s, Chester Barnard, another management classic, said that an organization did not necessarily have to have "objective incentives" (i.e., material incentives) to elicit the effort that was needed for the organization to exist. It could achieve the same result, he said, by changing "states of mind", that is, through persuasion (1938, p. 141). Persuasion consists essentially of what we have been saying: making another person see that what we are trying to achieve (the goal, target or milestone) is worthwhile. And this is impossible to do using formal control systems. Only personal relationships can do it. Immediate economic interests need no persuasion. What does need persuasion is the kind of action that demands effort today (and therefore is less immediately attractive) in order to gain something worthwhile tomorrow, or something worthwhile for other people today.

This would seem to be one of the fundamental goals of management: to convince (persuade) the organization's members that certain things are worth doing. In other words, bring them to a certain degree of goal congruence by dint of enthusiasm. And, as we have seen, there is no mechanical way (using explicit incentives) to achieve goal congruence. The only way goal congruence can exist (and even then only to a limited extent) is when the person *wants* to achieve (i.e., internalizes or identifies with) the organization's goals. This does not usually happen spontaneously. Someone who knows the organization, its products, its customers and its employees has to "make the other person see".

Clearly, this is quite contrary to the assumption of unbounded rationality used in economic analysis. Herbert Simon studied these phenomena and the specific mechanisms of identification in some of his classic works. It is surprising that his ideas seem to be somewhat (or very) neglected nowadays. For instance, he describes and analyzes what he calls role behavior. Basically, this refers to the way a person's behavior varies depending on his position in an organization (Simon, 1964). Rosanas and Velilla (2003) have studied how loyalty, which is obviously closely related to identification, develops. Note, however, that we are talking here about intangible variables rather than immediate material benefits and incentives. So the organization's members will naturally have to be persuaded that it is worth satisfying other people's needs: the needs of customers and other members of the organization. "Transcendent" or "obligation" motives will therefore be crucial for organizations to function properly. Note also that, in spite of everything, we are talking about for-profit organizations (companies), not charitable organizations (to which all this may be doubly applicable, though with certain qualifications for which we do not have space here). Hewlett-Packard, for example, was for many years one of the most profitable companies in the world, and yet it had a basic mentality of satisfying customers' needs first, before making a profit. In fact, the founders preached that profit was dispensable in order to be able to do what Hewlett-Packard had to do, which was to advance the progress of technology in order to satisfy customer's needs.

Two opposing concepts of management

There are at present two conflicting conceptions of management (and perhaps there always have been, at least ever since management has existed as an academic discipline, though possibly more visibly now than ever before.) On the one hand, there is an economistic view, in which the only thing that matters is profit or, more specifically, profit for shareholders. It should be added that this is in theory or on paper. Because, in practice, profit for management matters at least as much as profit for shareholders. In any case, the other people who participate in the company are mere instruments and it is assumed that they, too, pursue exclusively economic goals. Therefore, all that is needed to make a company or organization work is the right incentive system. The formal control system is enough to ensure the desired results and will obviously have to be designed to minimize these other people's share of the profit. This is the view of conventional agency theory. But it is also (at least partly) implicit in supposedly more "humanistic" approaches (in the field of organization behavior, for example), where people are mere instruments who can be manipulated to achieve management's goals (which is what it is all about).

The other notion of management assumes that companies in particular and organizations in general are instruments of human cooperation, made up of people, and that people are the primordial value. It is only fair to say that this has always, implicitly or explicitly, been the theory behind the large companies that have featured in the various published lists and studies of "corporate excellence" over the years. Companies such as the "old" Hewlett-Packard preached and practiced exactly that. The HP Way essentially meant trust and respect for individuals, high quality for customers based on state-of-the-art technology, uncompromising integrity, team work... And the same can be said of Johnson & Johnson, Southwest Airlines and so many others. In these companies, building trust is considered more important that designing material incentives. Incentives, especially the "strong" incentives, based mainly on stock options, that have become the norm in the "new economy", are at the root of the scandals. They constitute a formal control system that drives people to achieve economic objectives, forgetting values such as those we have just mentioned. And obviously, the stronger the incentives, the stronger the drive. This leads to a crowding out of people's other goals: intrinsic or altruistic motives are crowded out by extrinsic motives (Osterloh and Frey, 2004). The mechanism is that of a self-fulfilling prophecy: we preach that people only respond to economic stimuli, we provide strong economic stimuli, and so we make our premise true, even though it may not have been true initially (Ferraro, Pfeffer and Sutton, 2005). As a result, people stop thinking about how to solve customers' real problems or cooperate with colleagues and focus instead on maximizing their income. From here to "creative accounting", fraud and scandal is a short step. If the reward for "cooking the books" is meager, many people will never be tempted; if it is very substantial, the temptation will be that much stronger. This easily explains WorldCom's $11 billion.

The culture of effectiveness

The first of our two opposing concepts of management is closely related to what has happened in the last fifteen or twenty years in business and public life, which is the spread of what we could call the culture of effectiveness: the imperative to achieve tangible, measurable and, if possible, monetary results in the short term by whatever means necessary. The other side of this coin is the prevailing view of the human person as *homo œconomicus*: unboundedly rational and exclusively interested in economic goods. Strong incentive systems based on measuring tangible results are the ideal tool to induce *homo œconomicus* to do what the company or its managers want him to do. This culture of effectiveness often manifests itself in "tough" managers, the kind who demand results whatever the cost; not always in return for monetary rewards, but also sometimes for fear of punishment. Carly Fiorina (former CEO of HP), for instance, apparently used to tell her subordinates that if they did not deliver the numbers, she would find someone else who could. In a recent article in the *Harvard Business Review* (Stalk and Lachenauer, 2004), this is called "playing hard ball", instead of "soft ball", which consists of treating people as people and not playing dirty tricks on competitors. The authors of the article in question suggest that hard ball tactics are effective, while soft ball tactics are not. Up to a point, this is true. The self-fulfilling prophecy works. You demand specific results, you put intense pressure on people to produce those results, and – no surprise - you get those results... but sometimes through fraud, by not playing straight, by committing crimes, or by simply doctoring the income statement. In a culture such as this it is hardly surprising that scandal should flourish. Nor is it surprising that the workplace climate should deteriorate.

We urgently need to change this culture and turn toward the second conception of management that we described earlier, in which people are not instruments but individuals who freely choose to cooperate; who are willing to be persuaded that something is worthwhile, but not to be manipulated by any manager in any direction; and who naturally want to earn a living as best they can, but without having to cheat to survive. So long as we continue to admire "effective executives", so long as managers insist on increasing effectiveness even at the cost of crucial intangibles (personal development and real service to customers), so long as business professors carry on preaching the value of the company's stock as the ultimate value, and so long as we continue to believe that only "strong" incentive systems provide the necessary motivation, we will continue to see scandals.

The management indicators we have been told are so effective are positively dangerous in this respect. They are dangerous because they accentuate the culture of effectiveness, unless we take certain precautions. Indicators can only measure some variables, not all the ones that matter. As we saw earlier, they also measure them imperfectly, so that the correlation with the desired variable is considerably less than one. This is not to say that indicators are not a useful, or even excellent, tool in many situations. Effectiveness (that is, obtaining specific, tangible results) is absolutely necessary. But it is nowhere near enough, for two reasons. First, because, as we said earlier, it does not take account of everything that people want when they act. Secondly, because the other things that people want influence the company's future effectiveness, as they have to do with what people learn. But this is a subject that would take us too far and we cannot do it justice in the space available. What we can say, however, is that the important thing in organizational decisions (indeed in any kind of decision) is what the people concerned learn from the decision, operationally, intellectually, and in terms of judgment and attitudes. This means, of course, both the person who acts and the person who receives the effects of the action. If we follow this rule, decision making is ethical by definition and takes the interests of all concerned into account. Similarly, if "those concerned" is understood to mean all the company's stakeholders, then decision making already takes account of every possible notion of social responsibility. At the same time, this is simply good management practice.

For better or worse, this has little to do with government regulation or seeing things from lofty heights, much less with quantitative factors. But it is very real and assessable. It is not so difficult to diagnose the state of an organization from this point of view. People and their attitudes paint a clear enough picture: organizational culture and management style are decisive. In the long run, everyone benefits. If we can only persuade company bosses that hard ball is stupid, we will have taken an important step toward preventing scandals.

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