

Responsibility through Moral vs. Compliance: What about Integrity?

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How can a classically educated economist - who is not an old fashioned libertarian but an enlightened liberal economist believing in the necessity of public and merit goods, what by the way F. A. v. Hayek also believed in without any ‚fear of physical contact‘ in his later years, and who internalized the latest developments in economic theory including i.e., moral hazard, hold up, adverse selection on one side and agency costs in principal-agent-relationships on the other side evaluating these developments as a huge enrichment of economics – think and talk about ethics and moral without having studied half of his life philosophy and the philosophers from Platoon to Socrates, Kant und other moral philosophers? In plain English: I want to because for me as an economist it is important but I rather do not know how!

Even the profession of business ethics is discussing about the right place of business ethics. From the moral feeling of the individual to the general structure and order of the economic system of the society many places are found where business ethic could be placed and localized. This discussion reminds of the dispute over the importance of notions which has no more any value at least after the argument between Popper and Wittgenstein in Oxford. The intellectual has the ‚damned‘ duty to express himself very clearly and understandably say what he means.

The common discussion about moral and ethics in the business world confuses me. But I know and I agree that this discussion is very important. This is the reason why I look for ways to intrinsically and/or extrinsically take part in this discussion despite my limited abilities as a classical educated economist. During this search for respective possibilities I stumbled on a vein of gold. Michael C. Jensen, emeritus Harvard Professor, especially Theory of Finance, co-founder of the Principal-Agent-Theory and the Agency Cost Theory, applied the ‚emergency brake‘ after 30 years during which he looked for efficient market solutions against high agency costs in public (i.e., Enron, WorldCom etc.). He demands CEO’s integrity as agent towards the shareholder as his principal. This was the only way how high agency costs could be avoided. But this discovery was not the end. Starting with ‚Integrity: Without it Nothing Works‘ in 2009 Jensen further developed the icon ‚integrity‘ until 2015 when he called for a change of paradigm especially in the theory of finance. The positive economic model ‚integrity‘ should be core to economic theory and policy. This was according to Jensen the only way to theoretically explain and politically deal with dramatic current economic and political phenomena.

The most extending information about the positive concept of integrity is offered in a paper from *Erhard/Jensen/Zaffron (2009)*. The authors indeed differentiate between

integrity of persons and integrity of objects, systems, groups of persons and organizations. But basically they do not see differences between integrity of subjects respective objects in different contexts. *Jensen* (Research Paper No. 07-01, Research Paper No. 10-042) defines positive integrity as follows:

“In *Webster’s New World Dictionary* “integrity” is defined as:

- The quality or state of being complete; unbroken condition; wholeness; entirety;
- The quality or state of being unimpaired; perfect condition; soundness; and
- The quality or state of being of sound moral principle; uprightness, honesty, and sincerity”. (Erhard/Jensen/Zaffron, 2014, p. 4)

“An individual is whole and complete when their *word* is whole and complete, and their word is whole and complete when they *honour* their word. We can honour our word in one of two ways: first, by keeping our word, and on time as promised; or second, as soon as we know that we won’t keep our word, we inform all parties involved and clean up any mess that we’ve caused in their lives. When we do this, we are honouring our word despite having not kept it, and we have maintained our integrity.

If you are serious about being a person of integrity, you will think very carefully before giving your word to anyone or anything, and you will never give your word to two or more things that are mutually inconsistent. As they should, many people focus on the importance of *keeping* their word; however, if one does not consider how to maintain integrity when one *cannot* keep one’s word, this is sure to lead to out-of-integrity behaviour at some point. If you’re up to anything important in life, you will not always be able to keep your word, and that’s alright, but if you are a person of integrity, you will always honour your word.

Integrity is important to individuals, groups, organizations and society because it creates *workability*. Without integrity, the workability of any object, system, person, group or organization declines; and as workability declines, the opportunity for performance declines. Therefore, integrity is a necessary condition for maximum performance. As an added benefit, honouring one’s word is also an actionable pathway to being trusted by others.” (Research Paper No. 10-042) „In short we assert the following simple, general rule: As integrity declines, workability declines, and when workability declines the opportunity for performance (the opportunity set) declines.“ (*Erhard/ Jensen/Zaffron*, 2009, p. 40f)

Integrity not only applies to individuals but also to institutions and systems. Especially regarding institutions and systems integrity has to be regarded in a broader sense. Highly relevant is integrity not only of components respective persons as part of the system on one side nor the relationships between components resp. persons in the system on the other side but in particular the integrity of the system design and the integrity of the usage of the system. „ ... the available opportunity set for performance of a system

is conditional on the integrity of the components and relationship between components necessary to the designed standard of performance, and the integrity-of-design, and the integrity-of-use.” (*Erhard/Jensen/Zaffron*, 2009, p. 44)

The discussion of the integrity of organizations has to consider some specific aspects. The ‘word’ of the organization is the ‘word’ which is given by a authorized person belonging to the organization i.e., manager or board members of a firm. Informal groups very often present a speaker which would be authorized formally or informally. Just as with individual persons it holds as well for organizations: Their word is given through the actions of the organization (their actions are their language), their commitments, their formal contracts and their communications within business reports, business policy, slogans and advertisement as well their behavior concerning clients, employees and suppliers for material, parts, services and capital. If an organization wants to have and keep integrity this organization has to be keen to efficiently control those who speak in the name of the organization and to ensure that the word given by the organization is to be honored. (*Erhard/Jensen/Zaffron*, 2009, p. 58f)

The problem with manager integrity is according to *Erhard/Jensen/Zaffron* (2009) that the every-day life reasoning holds the thesis that a high integrity just produces only costs in the short run and only in the very long run could create some benefit for the manager. Therefore it seems to be very difficult to introduce a positive performance factor of integrity into the manager’s view of business life. *Jensen* contradicts this thesis und accounts the observed deficit of integrity with the ‚veil of invisibility’. The veil of invisibility prevents that the direct and immediate benefit of integrity can be seen and been observed.

In the context of integrity the authors are confronted with the so-called ‚Integrity-Performance Paradox’. It says that managers with regard to high performance objectives of their company are convinced to be forced to dispense integrity but in truth dispense high company performance by renouncing integrity. Accordingly integrity does not create costs but dispense of integrity produces high costs through low performance which comes from high agency costs. It is blindness of those responsible for the company to the high performance creation of integrity which is the reason for the veil of invisibility.

“Examples of out-of-integrity behavior are legion; we list but a few. As individuals we regularly:

- make promises and commitments we do not keep,
- show up late and/or not prepared for meetings, or don’t show up at all,
- surreptitiously read documents, answer emails, work on other matters while in meetings,
- fail to return telephone calls when promised,
- violate or play games with negotiated agreements,

- lie to others including our spouses, children, partners, friends, organizations (including not being straight when it is merely uncomfortable to do so),
- cheat on spouses,
- cheat on taxes,
- steal (e.g., keep the excess change mistakenly given at the checkout counter, or padding expense reports),
- fail to return found items even when the identity of the owner is clear,
- using the web for personal reasons while working, including shopping on line,
- and on and on.

Raising the ante to more serious levels, one only has to peruse the pages of any recent newspaper to find multiple examples of violations of integrity of the following kinds:

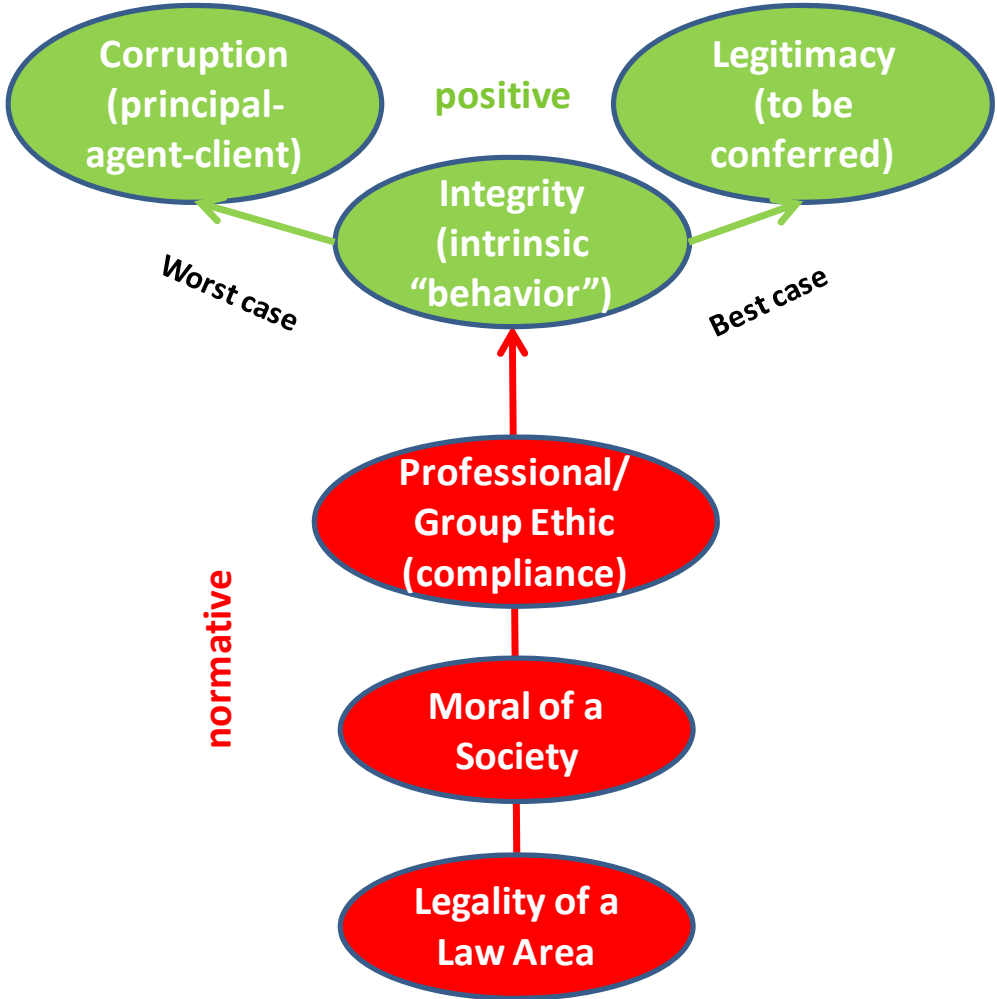
- students cheating in their undergraduate and graduate courses,
- individuals and organizational entities cheating on their taxes,
- politicians and lobbyists intentionally misleading their constituencies,
- corporate officers not enforcing their stated ethical codes,
- corporate managers not keeping their word,
- corporate managers not keeping their company's word,
- corporate officers stealing from their companies,
- corporate officers systematically backdating their options award so that the exercise prices were the lowest for the quarter or the year,
- individuals, brokers and corporate officers engaging in insider trading,
- corporate officers knowingly lying to shareholders, creditors, analysts, customers and others about their financial status,
- millions of people stealing music and movies over the internet in violation of copyright law while denying those violations,
- Catholic priests sexually abusing children,
- doctors abusing their patients and defrauding Medicare and other insurance companies,
- lawyers committing fraud in their practice of law,
- scholars and writers committing plagiarism or other fraud.” (p. 71ff)

According to this persons and organizations sacrifice integrity in the name of performance increases but in truth sacrifice performance doing this. The authors show in their footnotes on pages 71ff of their paper (*Erhard/Jensen/Zaffron, 2009*) very clearly how huge the decreases of performance can be without integrity. They do not talk about 2 to 3 percent of decreases of performance. Integrity instead can increase performance by double or even more. In relation to the value of a company on the capital market this implies that integrity could lead to a tremendous increase. Thereby integrity becomes a value driver par excellence which persistent investors should look and care about very strongly. The Veil-of-Invisibility makes it so difficult for the managers and the investors to recognize the relationship between integrity and performance and therefore to act

and decide accordingly. Here it can be shown that tools and procedures to judge and value the integrity of a company and its management could lower the degree of non-information. To reveal out-of-integrity-behavior therefore could be highly valuable for principals, which are the investors, but also for agents, which are the management and the board of a company.

Decisive is that integrity implies ethics, moral and legality. Ethic is understood as accepted general rules and norms of a specific group i.e., professional ethics of specific professions and branches. Moral is understood as accepted general rules and norms of a specific society. Legality is understood as accepted general rules and norms of a specific law area. Damit ist in diesem Konzept der Platz für Ethik und Moral gefunden. Each individual in business is part of a group, a society and a law area so that we know now where ethics is located, in the 'word'. Not ethics, moral and legal rules which are normatively important but positive integrity is decisive for the question of performance and efficiency of the business actions and economic order.

The following graph shows the dimensions of the positive economic model 'integrity':



For additional insights in the economic concept of integrity contract theoretical arguments can be valuable. Doing this the following relations to the economic contract theory can be seen:

- *Integrity* → no Hold Up → New opportunities arrive if two partners of a relational contract can rely on each other and therefore are able to undertake transaction specific investments.
- *Legitimacy* → no Moral Hazard → constructive cooperation whether horizontal or vertical leads to higher performance.
- *Professional ethics* → no Adverse Selection → high efficiency of market processes leads to the superior and optimal market results according to liberal economic theory.
- *No corruption* → no breach of the indispensable rules of the liberal market system → high market efficiencies especially of the role of the important role of market intermediaries. Complex proposals in an early market process phase are crucial for a good market result but are highly endangered by corruption.

An additional approach to look at the positive economic model 'integrity' could lie in the area of the economic game theory. It is the question of corruption vs. non-corruption. Integrity is indispensable to overcome the prisoner's dilemma because cooperation between both imprisoned has to be based on trust and the security that both fulfill their 'contract'. In this case both have integrity and cooperate. This would create new and superior opportunities.

Positive responsibility in politics, business and society needs normative basic conditions. That is why responsibility is linked to moral and/or compliance defining compliance as generally accepted rules and norms within a group which is defined by Jensen as 'ethics'. According to the picture above responsibility can only be exercised through integrity because responsibility needs moral and compliance which are implicitly in the word of integrity. To give your word, to keep your word or to honor your word towards everybody with whom you have an implicit or explicit contract is key. Ethic resp. compliance and moral according to the understanding of Jensen are not excluded but in contrary heavily included. They are settled in the respective professional ethics and the moral of the society.

Now I understand. We do not have to discuss so much moral vs. compliance. It is not so complicated. All we need is integrity. Integrity of the ones who have responsibility implies moral, ethics and compliance.

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