Armchair versus Armchair: Let’s Not Try to Guess the Social Value of Corporate Objectives

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ABSTRACT

Jones and Felps claim that social welfare would be enhanced, if corporate managers adopted the goal of directly improving the happiness of their stakeholders instead of profit maximization. I argue that their argument doesn’t establish this. They show that a utilitarian case for profit orientation cannot be made from the armchair. But neither can the case for Jones and Felps’ preferred alternative. And their defense of it relies on empirically unsubstantiated assumptions.

IN A PAIR of recent articles, Thomas Jones and Will Felps (2013a, 2013b) argue that (2013b: 354, emphasis in the original):

for publicly-held corporations in developed economies, the direct pursuit of social welfare, through a corporate objective we call stakeholder happiness enhancement (SHE), should replace the profit motive as the driving force behind economic activity.

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In other words, instead of trying to maximize return on investment for shareholders, managers should aim to increase aggregate happiness across all stakeholder groups. Their argument is based on the assumption (granted here) that the moral foundations of capitalism are utilitarian: economic activity ought to be organized through markets because this results in high social welfare. In the first article, Jones and Felps (2013a) argue that shareholder wealth maximization (SWM) cannot be defended as the corporate objective most conducive to social welfare. In the second article (Jones and Felps 2013b), they propose that SHE is superior.

Jones and Felps’s articles point to important limitations in the way that SWM can be defended by appeal to economic first principles. Such arguments cannot succeed insofar as they rely on false empirical assumptions. However, Jones and Felps’s own defense of SHE is only slightly superior in that regard. While the assumptions they rely upon are not obviously false, Jones and Felps fail to present evidence that they are true. This would be unproblematic, if they presented their argument as a hypothesis to be tested empirically. Instead, they present their assumptions as neo-utilitarian axioms, thereby committing the same mistake as the armchair proponents of SWM they target.

The utilitarian argument for SWM that Jones and Felps aim to undermine claims that SWM is a crucial element within a system of competitive markets that deliver a socially optimal allocation of resources. Just as Adam Smith’s (1976: 18) proverbial butcher, brewer, and baker are promoting social welfare by pursuing their own self-interest, so too corporations promote social welfare by pursuing profits. This implies, in turn, that managers, tasked with steering such corporations, ought to pursue profits (Jensen 2001). This link from the pursuit of self-interest to the promotion of social welfare can be mathematically proven—but only under a set of extremely restrictive assumptions (Arrow and Debreu 1954). Jones and Felps’s strategy is to show that these assumptions don’t hold in 21st century US capitalism. They identify four points at which the assumptions underlying the case for SWM are empirically false. I will take a closer look at their discussion of two of those.
First, Jones and Felps point out that real-world markets differ from the world of ideal market competition which exhibits, most prominently, the absence of externalities, market power, and information asymmetries. This is particularly significant in light of what we know about the relationship between ideal and non-ideal markets: as long as real-world markets fall short of the ideal, we cannot presume that they work better the closer they get (Lipsey and Lancaster 1956). Thus, we cannot simply assume that, in the real world, the pursuit of self-interest will result in an efficient allocation of economic goods. These points are well-taken and their importance is difficult to overstate. Unfortunately, Jones and Felps (2013a: 218) go on to draw an erroneous inference.

. . . if the conditions required for perfect competition actually existed in twenty-first-century US market capitalism, SWM might be a viable means of maximizing social welfare. These conditions don’t exist, so it seems wise to seek credible alternative corporate objectives.

Taken at face value, it is hard to imagine a clearer example of the fallacy of denying the antecedent. That real-world markets fall short of idealized economic models may be sufficient to undermine arguments for SWM from economic first principles. However, even if no such argument from the armchair succeeds, we cannot conclude that SWM is not a viable means of reaching utilitarian objectives. The failure of an argument doesn’t entail the falsity of its conclusion. What Jones and Felps need is more than an argument that SWM is not the perfect utilitarian tool it would be in the world of idealized economic models. They need to show that SWM is inferior to SHE in the real world. They set out to do this in the second article. But, here they abandon the empirical stance employed to criticize the argument for SWM.

Jones and Felps base their claim that SHE is preferable to SWM by utilitarian lights on the comparative performance of the two models under the following criteria. They advance these criteria without argument, but take them to be so closely related to social welfare as to be appropriate touchstones for a utilitarian assessment of corporate objectives (Jones and Felps 2013a: 225–226; 2013b: 360–362):
1. Corporate objectives based on realistic assumptions about the nature of economic competition are more likely to provide greater social welfare.

2. Corporate objectives that allow for efficiencies based on trust based relationships with stakeholders provide greater social welfare than those that require the pursuit of profits.

3. Corporate objectives provide greater social welfare if they explicitly account for the cost of negative externalities.

4. Corporate objectives focusing directly on well-being instead of wealth provide greater social welfare.

5. Corporate objectives applying an act utilitarian logic provide greater social welfare than those applying a rule utilitarian logic that depends on several dubious conceptual and empirical propositions.

Regarding criterion 1, Jones and Felps (2013b: 360) claim that, by contrast to SWM which depends on the existence of perfectly competitive markets, “SHE . . . doesn’t depend on any assumptions regarding competitive conditions in the US economy.” This mis-characterizes the situation in two ways. First, it is not SWM’s status as the most preferable corporate objective, but only the argument for this status from economic first principles, that depends on the existence of perfectly competitive markets. As, for example, Henry Hansmann’s (1996) work shows, not all arguments in favour of SWM rely on these assumptions. Second, pace Jones and Felps, their argument in favour of SHE does rely on a set of assumptions, namely the assumptions expressed in their list of criteria.

It is possible that the claims grounding Jones and Felps’s list of criteria are true. But all of them are open to empirical refutation, and Jones and Felps don’t provide empirical evidence to justify their reliance on them. Indeed, as the passage just cited shows, they appear unaware of making any substantive empirical assumptions at all. I cannot investigate here whether these assumptions do hold. But, most all of them have potential substantial objections. It may turn out that, contrary to criterion 4, trying to enhance happiness directly will actually result in less happiness for stakeholders (a version of the paradox of hedonism). Similarly, it has been argued (against criterion 1) that realistic assumptions don’t improve the quality of economic theory (Friedman 1970). Finally, rule-utilitarianism was developed in
response to the worry that act-utilitarianism may be self-defeating—precisely the opposite of the claim made in criterion 5 (Austin 1995).

Thus, Jones and Felps’s argument appears to be fallacious. The falsity of the assumptions underlying the armchair argument for SWM doesn’t entail the inferiority of SWM to SHE. This is particularly problematic for Jones and Felps, since their own argument in favour of SHE relies on a number of empirical assumptions that, while perhaps not as obviously false, are themselves somewhat dubious and entirely unsubstantiated by the empirical work that Jones and Felps cite. The US today is not the world of perfect competition described in micro-economics textbooks. But this by no means entails that it is a world in which the claims underlying Jones and Felps’s list of criteria hold true.

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Second, Jones and Felps point out that the argument for SWM from economic first principles relies on the assumption that economic goods are an adequate measure of social welfare. This assumption, they claim, is false. As recent research on happiness and life-satisfaction shows, material wealth is only weakly connected to happiness, and surely it is the latter not the former we really (should) care about. Thus, they suggest that we replace material wealth with experienced happiness as the measure for social welfare (Jones and Felps 2013b: 355). This argument suffers from a defect similar to the one discussed above.

It’s true that wealth is only a weak predictor of both experienced happiness and life-satisfaction. Moreover, Jones and Felps illuminatingly trace the history of economic thought to uncover how wealth came to be the measuring rod of welfare economics. While early economists conceived of their job as uncovering the principles by which economic activity would increase social welfare, difficulties in directly measuring welfare lead to the adoption of wealth as an easily measurable proxy. Over time this measure became so entrenched in economic modeling that the discipline lost sight of the question whether it actually is a good proxy for social welfare. And the new research in happiness studies throws this into serious doubt (Jones and Felps 2013b: 354–355).
The continued reliance of economic modeling on wealth as an indicator of welfare is indeed problematic. Unfortunately, Jones and Felps’s proposal to replace wealth with experienced happiness is problematic for the very same reason. Jones and Felps (2013b: 370) admit that adopting experienced happiness as their measure of social welfare is a philosophically controversial choice. This is to understatement a classic criticism of utilitarianism. Providing copious amounts of Huxley’s Soma to stakeholders might be an excellent way of improving their experienced happiness, but whether it would thereby increase social welfare is rather contentious. Jones and Felps (2013b: 370) defend their choice by arguing that adopting a more sophisticated theory of human well-being would present currently insurmountable problems of measurement. But this is exactly the move they criticised as inadequate justification for the reliance on wealth. Again, what is needed is not just an argument that wealth is a poor proxy for social welfare, but an argument that experienced happiness does better. Jones and Felps don’t provide one.\(^2\)

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In conclusion, while Jones and Felps are correct that the armchair argument for SWM fails, this doesn’t license their claim that SHE should replace SWM. To show this one would need empirical evidence that SHE leads to higher social welfare. What Jones and Felps provide instead is an armchair argument of their own.\(^3\)

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REFERENCES


\(^2\)Jones and Felps might find themselves at an unexpected dialectical disadvantage here. Given reasonable pluralism about what constitutes welfare on the individual level, we usually prefer to let people make their own choices (even if they choose poorly). The classical economic measuring rod of preference revealed by choice has a prima facie claim of respecting this liberal ideal better than the measure of experienced happiness.

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