Researcher considers the role of morality in modern economic theory

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Professor Douglas E. Stevens is with Florida State University. Credit: Ray Stanyard

The worldwide financial crisis in 2008, which led to what many in the United States now call the "Great Recession," has caused researchers to rethink traditional economic theories of financial markets and the corporate world. Even renowned financial theorist Michael Jensen, whose widely cited work has laid the foundation for the broad use of stock options as an executive compensation tool, has called on his fellow researchers to incorporate "integrity" into their economic models.

Douglas Stevens, an associate professor of accounting at The Florida State University, is among those who for years have proposed incorporating morality within traditional economic theory. He has published a number of experimental studies documenting that economic decision-makers frequently factor morality into their judgments and behavior.

Now, Stevens and a colleague have published a paper that incorporates morality into the economic theory of the firm that Jensen made dominant in accounting and finance. The paper, by Stevens and Alex Thevaranjan, an associate professor of accounting at Syracuse University, is titled "A Moral Solution to the Moral Hazard Problem." It was recently published in the peer-reviewed journal *Accounting, Organizations and Society*.

In that dominant economic theory of the firm, known as principal-agent theory, a principal must hire an agent to perform some productive effort. A "moral hazard" arises, however, because the principal cannot observe the effort of the agent and the agent is motivated to shirk. Under the traditional assumptions of the model, the principal must pay the agent a financial incentive to induce any effort from the agent.

The principal-agent model has been useful in accounting and finance because it addresses conflicts of interest that arise within the firm, according to Stevens. However, a common complaint is that it relies too heavily on financial incentives to solve the moral hazard problem. The high-powered financial incentives prescribed by the theory have been criticized for generating excessive executive compensation and risk-taking — which analysts say precipitated the recent financial crisis.

Stevens and Thevaranjan extend the traditional principal-agent model by endowing
the agent with "moral sensitivity" — that is, a disutility for breaking a

previous agreement. Thus, their model answers Jensen's call to incorporate integrity into economic theory. This is significant because principal-agent theory, the most mathematically formal economic theory of the firm, has previously been closed to moral content.

Incorporating moral sensitivity into the traditional principal-agent model allows Stevens and Thevaranjan to make several contributions to the theory. First, they are able to contrast the efficiency of their moral solution with the traditional incentive solution that becomes necessary when moral sensitivity is assumed to be zero. Second, they are able to demonstrate the benefit of the agent's moral sensitivity to both the principal and the agent, and thereby point out the potential cost of ignoring this moral sensitivity.

Stevens and Thevaranjan conclude that adding moral sensitivity increases the descriptive, prescriptive, and pedagogical usefulness of the model.

"We know from simple observation that the traditional principal-agent model is not fully descriptive of real-world behavior," Stevens said. "A majority of people are paid a fixed salary in their jobs and yet provide sufficient effort for their pay. This is particularly true in professions and nonprofit firms where the financial incentives required by the traditional model are difficult if not impossible to arrange. The traditional principal-agent model can't explain this behavior. Our model, however, demonstrates that a principal can pay a morally sensitive agent a fixed salary that is increasing in the productivity of the agent's effort."

Their model also demonstrates the value of moral sensitivity to the firm and society.

"Our model suggests that moral sensitivity increases the efficiency of principal-agent relationships within the firm — which makes more of

these relationships possible — and allows the agent to receive a fixed salary that is increasing in his or her productivity or skill," Stevens said. "Thus, moral sensitivity increases the general welfare of society by decreasing unemployment and increasing the productivity and pay of those who are employed. This explains the emphasis placed on moral training within the firm and society at large. This also provides a warning against letting moral sensitivity diminish."

Stevens and Thevaranjan have used their model to teach accounting and MBA students the importance of professional ethics. Whether the traditional approach of ignoring morality and emphasizing financial incentives caused the financial meltdown is debatable, but Stevens believes it is time for business schools to return to emphasizing professional ethics.

"Every financial crisis and scandal is a wake-up call — for both practitioners and academics," Stevens said. "Hopefully, we won't waste yet another financial crisis."

Provided by Florida State University

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