The Moral Constraint to Managerial Behavior*

Management education needs to address the issue of a moral constraint in cases where organizational goals may be achieved by illegal or unethical means.

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Most lists of organizational goals include maximizing one or more of the following: (1) sales; (2) market share; (3) asset values; (4) earnings per share; (5) shareholder utility; and (6) shareholder wealth. Recent research by this author has indicates that it may be possible to accomplish any of these objectives illegal means.[1] Therefore, behavior that might once have been thought part of the agency problem—the possibility that managers could act in a manner inconsistent with shareholder interest—might now be viewed as a genuine attempt to enhance shareholder wealth.

Given the possibility that shareholder wealth can be increased through illegal actions, management education needs to place greater emphasis on moral behavior as another constraint on the managerial decision-making process.

Needed: More Textbook Discussion

Economics and finance textbooks abound with discussions of the numerous constraints facing managers (agents): the budgetary constraint or operating with the limits of the firm's resources, the technological constraint or the limits of current expertise; the competitive constraint or the limits of the market place; and the managerial constraint or the limits of the decision maker's ability to act.

Notable by its absence, however, is mention of the moral constraint—the limits set by the aversion to using illegal means to accomplish legitimate organizations goals.

Texts on financial management typically express the goal of shareholder wealth maximization without reference to any moral constraint. The following represents a sampling drawn from three of the more prominent texts:

> "The most important theme of this chapter is that the objective of the firm is to maximize the wealth of its shareholders. In spite of the [agency problem], we shall assume that managers always make decisions which maximize the wealth of the firm's shareholders" [2]

> "The primary goal of financial management is to maximize shareholder wealth."[3]

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[1] Dale O. Cloninger, "Moral and Systematic Risk: A Rationale for Unfair Business Practice," *Journal of Behavioral Economics* V. XI (Winter 1982) no. 2, pp. 33-50.
[2] Thomas E. Copeland and J. Fred Weston, *Financial Theory ad Corporate Policy*, Second Edition, Addison-Wesley 1983, pp. 19-20.
[3] James C. Van Horne, *Financial Management* and Policy, Sixth Edition, Prentice-Hall, 1983, p. 6.

"In this book, we assume that the objective of the firm is to maximize its value to shareholders"[4]

Most texts do go on to discuss the agency problem, alternative goals and the social responsibility of the firm. None of these topics, however, addresses the present issue of a moral constraint in cases where organizational goals may be achieved by illegal means. One reason for this benign neglect could be the belief that agents who decide to employ illegal acts are behavioral anomalies acting in their own behalf.

Once it is seen, however, that traditional organizational goals may be accomplished by resorting to illegitimate acts, systematic behavior involving these acts becomes not only possible but also viable—particularly in the absence of legitimate alternatives.

Increasing their risk, decreasing their potential gains, increasing their penalties, and producing legitimate alternatives may reduce use of illegitimate acts. Appropriate filtering of potential and current managers might be another effective means of establishing moral integrity among the organization's management.

Needed: Expanded Awareness

In addition, management education can help implement a more restrictive moral constraint in tow ways: (1) by attempting to increase the agent's aversion to crime and (2) by increasing the agent's awareness of investor's aversion to those actions they consider unethical, immoral or illegal.

Although management education's ability to modify the agent's crime aversion is open to question, management education may be able to effectively impress upon agents the existence and importance of the moral constraint imposed by investors in general and the firm's shareholders in particular.

Agents' crime aversion need not be equal to or greater than that of investors. *Agents need only be convinced that their behavior is clearly subject to the moral constraint imposed by investors*. As long as agents operate within that constraint their own moral convictions are irrelevant.

If at least some shareholders are crime averse—those who would resort to criminal activity only if benefits were sufficiently high to offset their repugnance to the activity or if the costs of not acting illegally were too great—the sudden discovery of illegal activity by the market could reduce shareholder utility and hence the price of the shares. Even if shareholders could be convinced that the illegal activities would result I either risk reduction or return enhancement, the results may not raise their expected utility sufficiently to over come their aversion to these activities.

Agents could avoid the problem of shareholder aversion to crime by conducting illegal activities clandestinely. Investors would then recognize only the firm' financial performance had improved but would fail to perceive the improvement was due to illegal activities. Thus, clandestine business practices have not only the obvious advantage of avoiding the authorities or

[4] J. Fred Weston and Eugene F. Brigham, *Managerial Finance*, Second Edition, The Dryden Press, 1981, p.3.

regulators and any associated sanction but they also have the advantage of increased share values that might not have otherwise materialized had crime-averse investors known of their existence.

On the other hand a type of clientele effect may develop where shareholders of a particular firm may have slight crime aversion, crime neutrality or even crime preference. It, thereby, would be possible for agent's crime aversion to be greater than that of the firm's shareholders. For this reason, and the fact that investor other than the firm's shareholders also effect the share price, reference to shareholder crime aversion would more appropriately be confined to the general investor.

Moral constraints and their appropriateness in management education is, of course, nothing new. However, given that illegal practices by management are not necessarily inconsistent with legitimate organizational goals, emphasis on the nature appropriateness of the moral constraint is even more critical than when corporate criminality was considered either the isolated actions of ales than scrupulous few or part of the agency problem. Therefore, the dearth of discussions of the moral constraint financial and economic texts needs to give way to more explicit treatment, especially because the implied acceptance of a moral framework is no longer sufficient, if it ever were.

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