Marshall on economic chivalry and business ethics

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1.
(Free competition under bounded rationality)

2. Context-dependency in a firm
2-1. Context-dependent recognition

We economists were taught and accustomed to regard perfect competition as a reference point for which ‘perfect rationality’ was one of indispensable conditions. But, instead of assuming perfect rationality, many of the economists nowadays are inclined to assume ‘bounded rationality’. Although there are minute differences of meanings attached to ‘bounded rationality’, it seems that it has been recognized as a legitimate analytical assumption to start with. As a consequence, the existence and the role of routine behavior which was once regarded as not being rational have come to attract much attention. Acknowledgement of bounded rationality has produced not only fruitful theoretical contributions but also revaluation of past theoretical contributions. It is hopeful that revaluation of Marshall’s economics can also benefit from these contributions.

One of the obvious tasks to be done for the revaluation of Marshall’s economics is to resurrect major concepts used by him. One of such is his Normal Equilibrium concept. The once wide-spread interpretation that it is a convenient but not wholly tenable, I think, needs to be revaluated because such an interpretation is based on the assumption that perfect rationality will prevail, at least in a theoretical world if enough time is allowed. In the last paper which I presented at the first ESHET-J SHET meeting held last December at Nice, I proposed to interpret Marshall’s Normal Equilibrium on the basis of context-dependent recognition. Context-dependent recognition in my usage means that what and how agents recognize differ according to the contexts they belong to. So, the recognition by the agents in one context differs from that by those in another even if they look at the same situation or the same fact. And the reason lies in a simple fact is that one is akin to have much knowledge of a certain field if he values that field higher than others. A similar set of recognition tends to be shared among the members in the same context. For that reason, context which comprises of common knowledge
and common value judgment functions as a common ground for recognition. Or more shortly, a context embeds members within it a similar cognitional framework.

There is seemingly some resemblance between context-dependent recognition and bounded rationality in the sense that both view our recognition to be imperfect. But, when we look at them closely, an important difference comes to a surface. Bounded rationality says that our recognition is not perfect because our ability to handle knowledge is limited. But, in the case of context-dependent recognition, recognition is not only imperfect but also is socially conditioned by context, the emphasis being on the latter. While I must admit that the term ‘context-dependent recognition’ is only my contrivance, I think its use is legitimate considering the fact that Marshall repeatedly emphasized not to assume perfect rationality. Being normal in Marshall’s usage means just that decisions conform to conditions of a particular context.

We may say that the course of action which may be expected under certain conditions from the members of an industrial group is the normal action of the members of that group relatively to those conditions. (PE, 34; emphasis in original)

2-2. A firm as a context

Although a context can be used to mean a variety of spheres such as a nation, a local community, an industry, or even an academic society, we restrict it to mean an organization of a firm until section 4 in this paper. The indispensable role of an organization of a firm in Marshall’s economics has been reevaluated and resurrected to its due status thanks to many post-Marshallians. So, we do not need dwell on the matter. The shared understanding of the role of an organization in Marshall’s economics, if we briefly summarize, is that an organization helps to integrate production knowledge so as to execute production activities. The need for integration arises because, contrary to exchange activities, a variety of production knowledge need to be gathered and arranged to implement production activities. The more production activities become to be specialized, the more production knowledge becomes diversified and fragmented. Therefore, the necessity to integrate production knowledge becomes to be greater as more specialized production develops. Thus an organization of a firm is best to be regarded as a knowledge community.

As we have already noted that a context has two dimensions, the one being
knowledge and the other being value. So, we can say that a context of a firm comprises of shared knowledge and shared value. Shared knowledge refers to how production activities are performed. Shared value refers to how rewards are distributed among the members so as to coordinate diversified interests of them. Shared knowledge and shared value contribute to integration of an organization of a firm. Without these, an organization of a firm cannot perform well-concerted production activities. Formally, the organization of a firm is just one of many kinds of contexts. But, its influence on the members within it is estimated to be greater than other contexts exert. The reason is that its influence is both direct and constant. It is direct because more concentrated attention and energy are paid on our own works than any other activities because the rewards from work are the keenest incentive among others. It is constant because time spent on work is much more than any other activities. For these two reasons, an organization of a firm is exerts stronger influence than any other context.

A context of a firm must be designed so as to realize concerted production activities because how a firm performs depends on how well it coordinates the members within it. If production activities of a firm are relatively simple, the amount of common knowledge and common value necessary is not large. So, the task of the design is fairly a simple one. But, as a firm becomes larger and comes to run more complicated production activities, the design of common knowledge and common value becomes more difficult. Because both the variety and the extent of specialization of production activities tend to be large, it becomes difficult to provide appropriate subsets of a context according to the types of activities. In addition, much of management activities must be entrusted to salaried managers and officials. Then, a new seed of coordination failure gradually grows.

And indeed this tendency to an increase in the size of businesses introduces an ever-growing discord into industry. The owner of a business, when contemplating any change, is led by his own interest to weigh the whole gain that it would probably bring to the business against the whole loss; but the private interest of the salaried manager or official draws him in quite another direction. For the trouble of a new experiment will come largely on him. If it fails, he will have to bear much of the blame; and, if it succeeds, only a small part of the consequent gain will accrue to him. So, the path of least resistance, of greatest comfort and least risk to himself is generally that of not striving for improvement himself, and of finding plausible excuses for not trying an improvement suggested by others, until its success is established beyond question. (Memorials, 307)
It is clear from the above that Marshall was fully aware of management problems.

3. Entrepreneur in Marshall
3-1. Two faculties of an entrepreneur

An entrepreneur can design a context of a firm through acting on common knowledge and common value. Then, how should he behave? Marshall says that there is no universal formula for that question. Rather, he emphasizes the difficulty to generalize the conditions for an ideal entrepreneur. He thinks that necessary faculties are different according to industrial specificities and/or sizes of firms.

The abilities required to make an ideal employer are so great and so numerous that very few persons can exhibit them all in a very high degree. Their relative importance however varies with the nature of the industry and the size of the business; and while one excels in one set of qualities, another excels in another; scarcely any two owe their success to exactly the same combination of advantages. (PE, 298)

Marshall wholeheartedly supported the view of Francis Walker as shown below.

For indeed the stock of capital has grown so much faster than the scope for its use in industry, that capital is always at the command of those who have the mental faculty and the moral character for turning it to good account. The keynote of this change was struck by the American Francis Walker, who said as early as 1876 that the man who has the faculties required “to shape and direct production, and to organize and control the industrial machinery [rises] to be master of the situation. It is no longer true that a man becomes an employer because he is a capitalist. Men command capital because they have the qualifications to profitably employ labor. To these captains of industry [capital and labor resort for opportunity to perform their several functions.” (/T, 168-169, emphasis added)

Entrepreneurs are qualified to be such because they “have the mental faculty
and the moral character for turning it to good account.” It is not farfetched to interpret this passage in the sense that mental faculty refers to production knowledge and moral character refers to value. In fact, Marshall lists up two requirements for an entrepreneur. One is leadership in production knowledge.

The manufacture who makes goods not to meet special orders but for the general markets, must, in his first role as merchant and organizer of production, have a thorough knowledge of things in his own trade. (*PE, 297*; emphasis in original)

And the other is leadership in value judgment.

But secondly in his role of employer he must be a natural leader of men. He must have a power of first choosing his assistants rightly and then trusting them fully; of interesting them in the business and getting them to trust him, so as to bring out whatever enterprise and power of origination there is in them. (*PE, 297*; emphasis in original)

As we have already shown, a context consists of two factors, i.e. knowledge and value. Now, we are allowed to say that the role of an entrepreneur resides in constructing an appropriate context for a firm. But, one question naturally arises. The question is why Marshall required an entrepreneur to have leaderships in both production knowledge and value judgment. With regard to a leadership in production knowledge, we can easily find the answer for it. As production becomes more and more complicated, it gets more difficult to operate production activities because relevant knowledge for production swells in terms of both width and depth. Among others, it gets more difficult to discern values of relevant faculties of men.

The value of a machine to a business cannot be calculated on the basis of its efficiency for its immediate work. But the value of an employee must be estimated, partly by instinct, with a view to the probable development of his capacities: and the difficulty of his task is increased by the conditions of modern business. (*IT, 350*)

The requirements for an entrepreneur far exceed the abilities of ordinary persons, who rather choose to be employed. The person who has more relevant knowledge of a field than ordinary people is entrusted the task of integrating diversified
production knowledge and becomes an entrepreneur. It is very probable that Marshall observed the fact that more and more people moved from self-employed status to employed status and that more and more firms became bigger.

3-2. Sympathy and loyalty to a firm

Value judgment here is morality, that is, why Marshall required an entrepreneur of a leadership in morality.

As we have observed in the previous section, an entrepreneur is regarded as a leader with respect to production knowledge. Another question still remains as to why he is required to be a leader with respect to of value. The first thing to be noted is the very fact that we have just observed, that is, an entrepreneur is a leader with respect to production knowledge. Those who choose to be employees do so because they judged that becoming employed is a better alternative than becoming self-employed. If employment contract is short term, it is easy for both an employer and employees to find a fair contract. The agreement will be found on the principle that each employee should be rewarded according to his contribution to profit. But, this principle is applicable only if measurement of contribution of each employee is conducted fairly easily and at low cost. When a task is simple, this condition is roughly satisfied. But, as a task becomes higher in quality, it becomes for the condition to be satisfied. As the quotation just above shows, Marshall thought that estimating the value of an employee was not an easy task even at his times. The difficulty increases further in the case of core stuff whose task does not follow a fixed pattern and often require tacit knowledge. Marshall noted as follows.

Thus the head clerk in a business has an acquaintance with men and things, the use of which he could in some cases sell at a high price to rival firms. But in other cases it is of a kind to be of no value save to the business in which he already is; and then his departure would perhaps injure it by several times the value of his salary, while probably he could not get half that salary elsewhere. (PE, 626)

Employees entrust the residual right to an entrepreneur, to the direction of whose they are expected to work faithfully. So, in modern terminology, the head clerk is
under the risk of opportunistic behavior of the entrepreneur. The same applies to skilled worker mush of whose skill is firm-specific character. I they are thrown out of work, their income will be diminished greatly even if they managed to find jobs elsewhere. Then, a question naturally arises. Why do they ever agree to accumulate firm-specific knowledge or skills in spite of the fact such accumulation might jeopardize themselves? If they estimate the probability of opportunistic behavior by the entrepreneur to be high, it is too risky for them to build firm-specific knowledge or skills. Hence, Marshall noted that loyalty to a firm was becoming increasingly necessary.

(and) sympathy is the one solid and strong force which has in it nothing sordid, and permeates the whole of human nature. This is more important with regard to joint stock companies than to private businesses. For, when once the ownership of a business has left the hands of an individual, who might attach his chief employees to him by bonds of personal friendship; when once faithfulness to the business has ceased to be enforced by the warm instincts of loyalty, and has been left to the colder support of impersonal duty; from that time forward the moral coherence and strength of the business depend largely on the growth of an esprit de corps, of a spirit of loyalty to the business itself. (IT, 326)

It should be noted here that Marshall thought sympathy to an individual entrepreneur to dwindle its power as a firm got bigger. Or more precisely, as a firm proceeds from personally-owned one to corporate one, the mere proof that an entrepreneur as a leader is reliable does not suffice to warrant his firm will continue to be reliable. The decrease in the power of sympathy to an entrepreneur must be covered by loyalty to a firm. Then, how can he get loyalty to a firm out of employees? One obvious condition is that employees need to be convinced that their firm doesn’t behave opportunistically even when it finds itself in a position to do so. But, since it is impossible to make a perfect contract under the condition of bounded rationality, some room of opportunistic behavior on the side of a firm can not be eliminated. So, a contract cannot be sufficient to make employees to trust a firm. Here comes the complementary role of moral context. Moral context of a firm itself is an accumulated product of past management. There is no direct and quick-acting way for an entrepreneur to change it at a burst. All he can do is to work on it and tries to make it more reliable. We never assert that Marshall provided a systematic explanation of moral context of a firm. But it is very probable that he recognized the importance of moral context which contributed to formation of loyalty to a firm which was based on the expectation of employees that
the firm would not behave opportunistically.

4-1. the need for Economic Chivalry

So far in this essay, we have concentrated exclusively on a firm as a context which serves as a kind of common platform for the members belonging to it. We have observed that Marshall identified him as a leader of both production knowledge and value judgment in the context of a firm. Particularly, the necessity of leadership in value judgment or moral faculty is explained as a need to check opportunist behavior of an entrepreneur and to solicit loyalty out of employees. Now, in this section, we go on further to ask what is required for an entrepreneur to be qualified to be a chivalrous entrepreneur, and why he advocated economic chivalry.

In the essay titled “Social Possibilities of Economic Chivalry”, he described it as follows.

Chivalry in business includes public spirit, as chivalry in war includes unselfish loyalty to the cause of prince, or country, or of crusade. But, it includes also a delight in doing noble and difficult things because they are noble and difficult. It includes a scorn for cheap victory, and a delight in succouring those who need a helping hand. (Memorials, 330)

The key word of the passage above is ‘public spirit’, which can be paraphrased as a sense of duty to society. So, here is the appropriate place to add one more context, a society. Like any other context, a society as a context consists of common knowledge and common value, both of which serve as a platform for those belonging to it. However, a difference from a firm as a context must be noted in the sense that there is no leader in a society that is comparable to an entrepreneur. Without a leader, contexts in a society are just molded gradually through interactions by the members belonging to them. Then, two questions arise. The first is who judge what is good for society. Since what is good is never answered without identifying for whom, there is no general answer to it. There is no way but to say that what is good is judged by Marshall implicitly in this case. What, then, did Marshall consider to be ‘noble and difficult’ things to do? In this connection, it should be pointed out here that he believed the most fundamental question for economics to be the problem how ‘the healthful exercise and development of faculties’ become possible (Memorials, 310). So, it is very reasonable to speculate that Marshall considered helping to develop faculties as ‘noble and difficult’. The second
question to be asked is whether there is any natural tendency for contexts to approach toward a good society. In this connection, it should be recalled that Marshall didn’t favor the idealistic interpretation of evolutionism by Spencer, which equated the fittest with the best.

The law requires to be interpreted carefully: for the fact that a thing is beneficial to its environment will not by itself secure its survival either in the physical or in the moral world. The law of “survival of the fittest” states that those organisms tend to survive which are best fitted to utilize the environment for their own purposes. Those that utilize the environment most, often turn out to be those that benefit around them most; but sometimes they are injurious. (PE, 242)

So, the answer to the second question is definitely no. Putting the two answers together, it is easy to conclude that those firms that try to contribute ‘the healthful exercise and development of faculties’ don’t necessarily survive. Believing that happiness consisted in acquiring and exercising abilities rather than acquiring wealth itself, he emphasized the necessity to inquire into a way to modify a social context in favor of such firms.

It is needful then diligently to inquire whether the present industrial organization might not with advantage be so modified as to increase the opportunities, which the lower grades of industry have for using latent faculties, for deriving pleasure from their use, and for strengthening them by use; since the argument that if such a change had been beneficial, it would have been already brought about by the struggle for survival, must be rejected as invalid. Man’s prerogative extends to a limited but effective control over natural development by forecasting the future and preparing the way for the next step. (PE, 248)

4-2. Public opinion and economic chivalry

Then, what is the means to support chivalrous firms? It is obvious that preaching chivalry is too feeble a way to support them because it often happens that non-chivalrous firms never pay attention to it. If an entrepreneur restricts his scope strictly within his firm, his behavior is destined to contradict with social duty. They would change their minds only if they realize economic chivalry counts. The means Marshall resorted to was public assessment, to which he referred as ‘informal Court of
Honour.’ He said as follows.

An endeavour should be made so as to guide public opinion that it becomes an informal Court of Honour. Then wealth, however large, would be no passport to social success if got by chicanery, by manufactured news, by fraudulent dealing, or by malignant destruction of rivals: and that business enterprise which was noble in its aims and in its methods, even if it did not bring with it a large fortune, would receive its due of public admiration and gratitude; as the work of the progressive student of science, or literature, or art does now. (Memorials, 343)

One might wonder whether ‘informal Court of Honour’ is substantially different from preaching economic chivalry. Although these two might seem very similar at first sight, they are certainly different. Whereas preaching is purely individualistic behavior, ‘informal Court of Honour’ is social assessment behavior. Although he has been criticized of seemingly-moralizing statements, it should be noted that he himself denied the effectiveness of preaching.

I think that, when the academic student takes on himself the role of a preacher, he is less effective than when he treats the problems of life objectively; that is when he assumes no major premises based on his own views of duty, his own ideals of social life. (Memorials, 397)

As we have been insisting, what Marshall thought necessary was not an appeal to individual conscience but transformation of contexts; in this case, transformation of social contexts. Of course, establishing ‘informal Court of Honour’ is much more difficult than mere preaching. Considering the difficulty, some might even say that direct regulations by legislative measures are much easier and more effective than recourse to ‘informal Court of Honour’. Acknowledging indispensable minimal function of legislative measures, however, Marshall never regarded these measures to be central because the effectiveness of them were easily impaired by bureaucratic rigidities or corruptions. However long time it might take for ‘informal Court of Honour’ to become dominant, there is no other way than to transform social contexts toward it. Surprising it might seem, he was rather optimistic of the possibility of economic chivalry. Probably one of the reasons of his optimism can be found in his view that reputations were intangible assets.
The marketing reputation and connection of a business may be a larger (or ‘capita’) in proportion to its earnings, than is the fixed plant of a manufacturer in some industries. Reputation for fairness and generosity in doing, is property seldom acquired without special effort and sacrifice, and is a powerful factor of success in all the undertakings of a business. The reputation acquired by a large general advertising is easy of attainment, though expensive. It is indeed seldom of much value, unless accompanied by capable and honourable dealing. (17, 270)

In the last section, we have observed that an entrepreneurial leadership in morality within a firm is expected to promote developing faculties of employees by restraining entrepreneur’s opportunistic behavior so as to evoke loyalty from them. We can understand economic chivalry in a similar way. Building up and maintaining good reputation inhibits firms from opportunistic behavior so as to credit them brand loyalty from customers and good trade connection with suppliers. We should recall here that Marshall distinguished a special market from a general market. It is easy to understand that brand loyalty contributes to enlarge a special market which is guarded to some extent from the pressure of harsh price competition. Similarly, good trade connections with suppliers contribute to reducing costs. In this way, economic chivalry is expected to promote survival of chivalrous firms by providing them intangible assets such as brand loyalty and good trade connections.

The second source of his optimism may be found in his observation that diffusion of knowledge reinforces public opinion.

The Strength of public opinion is steadily increasing with the increase and the diffusion of knowledge, and with the constant tendency of what had been regarded as private and personal issues to become public and national. (Memorials, 285)

I One might doubt the possibility above. But, it is very probable that the more knowledgeable and the less naïve people become, the more critical power they come to have. Thus, public opinion is strengthened so as to support chivalrous firms by means of credit and loyalty given to them. Since employees working in chivalrous firms have more chance to develop their faculties, prosperity of chivalrous firms bring about an increase of people with more developed faculties, strengthening public opinion further. We can find a virtuous cycle comprising of public opinion, economic chivalry and development of faculties. That is to say, public opinion supports economic chivalry, and
then, economic chivalry supports developments of faculties, and developments of faculties support public opinion. The following passage shows that Marshall observed this virtuous cycle not to be just an imaginary idea but to be operating in fact at his age.

This loyalty is being fostered by a multitude of movements, designed to give the employees a direct interest in the property of the business for which they work; while others aim at developing their intelligence and ability in ways, some of which are likely to promote their efficiency as employees; and some, which are desired only as contributing to their higher well-being, are among the best fruits of the larger sense of social duty which is characteristic of the present age. (17, 327, emphasis added)

It is not too much exaggeration if we evaluate him as one of the early advocators of Corporate Social Responsibility.

5. Social choice of social contexts?

Individual rationality has been almost the sole criteria for checking the legitimacy of economic theory. But, thanks to the resurgence of bounded rationality, those social elements such as custom, norm, commitments etc. have come to attract much attention and to be revaluated. Stimulated by these recent changes, this essay also tried to reevaluate the implication of Marshall’s economic chivalry. As we have shown, economic chivalry is not a mere plasterwork of Victorian time-spirits, but is an integral part of his economics in the sense that a state of morality as well as a state of production knowledge matters. The fundamental logic that we have adopted to derive this conclusion is that we who are bounded-rational agents never live in the one general context, but live in a set of particular contexts in which we recognize and decide context-dependently. So, there are as many conceivable states of an economy as there are social contexts.

Even if admitting the above, one might ask whether economic chivalry can indicate an ideal state of an economy. Or more concretely, can it provide an answer to such a question as how much social responsibility firms should owe? If one insists that firms should owe as much responsibility as possible, an economy will approach toward the verge of socialism. Contrarily, if firms are allowed maximum liberty, an economy will make advances toward a libertarian state. In the former case, too much requirements for morality will suffocate an economy. In the latter, economic chivalry
will have no role, and the possibility that strong but non-chivalrous firms will sweep chivalrous firms increases. All we can say definitely is that Marshall denied both extremes. If asked further, he would repeat his well-known phrase.