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Economism, Practical Wisdom and the Deterioration of Moral Values with Management Techniques

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Abstract

Management has changed in the last few decades, in what Khurana (2007) called "the unfulfilled promise of management as a profession." The trends he observed then have since been confirmed and have even increased, and the invasion of the field of management, mainly by economics but also by other disciplines, has continued and expanded, leaving schools (and their graduates) in the hands of the market. If markets and organizations are two alternatives for organizing human cooperation, markets today seem to be managing organizations through mainstream economism—the belief that the elementary notions of economics found in any introductory textbook are a good description of the real world of organizations and the economy.

This paper seeks to establish that intellectual virtues (knowledge) and moral virtues (mainly justice) are necessary to successfully realize actions. It will show how the decisions of both consumers and organizations' employees depend on the knowledge they possess—more specifically, on Aristotelian practical wisdom and the "information of time and place" that Hayek (1945) considered fundamental to the efficient allocation of resources. It will also show that this kind of Hayekian information and practical wisdom both push in the same direction and that, to put decisions into practice, the development of moral virtues—mainly justice, but also temperance—are needed.

Keywords: management techniques, indicators, incentives, practical wisdom, moral virtues.

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"Consider well the seed that gave you birth.
You were not born to live your lives as brutes,
But to be followers of virtue and knowledge."

Dante Alighieri, *Divina Commedia*, Canto XXVI de *l'Inferno*

Introduction

Several years ago, Rakesh Khurana (2007) analyzed—in depth—the transformation of American business schools and what he called, in the subtitle of his book, "The Unfulfilled Promise of Management as a Profession." The trends he observed then have since been confirmed and have even increased, and the invasion of the field of management, mainly by economics but also by other disciplines, has continued and expanded, leaving schools (and their graduates) in the hands of the market. Indeed, if markets and organizations are two alternatives for organizing human cooperation, markets today seem, through mainstream economism, to be managing organizations.

The term *economism* describes the belief that the elementary notions of economics found in any introductory textbook are a good description of the real world of organizations and the economy and that, therefore, the economy should be left to grow through free markets and without (or with very few) regulations (Kwak, 2017). There has been abundant literature critical of this notion, mainly because the final outcome of the resource allocation process depends decisively on the initial allocation of goods and services, which may be perfectly unfair and would consequently produce an end result that is equally unfair. Furthermore, which shall be the focus in this paper, decisions may not be made correctly.

This analysis seeks to establish that intellectual virtues (knowledge) and moral virtues (including justice before any other) are necessary to successfully realize actions. We will see how both the decisions of consumers and those of companies depend a lot on the knowledge they have and, specifically, on the scientific knowledge and practical wisdom that Aristotle analyzed twenty-five centuries ago. In fact, I will try to show how practical wisdom has characteristics in common with the "information of time and place" that Hayek (1945) considered both fundamental to an efficient allocation of resources and the justification for the market economy. I will also seek to show that practical wisdom and this kind of Hayekian information push in the same direction.

The paper will proceed as follows. First, we will review Khurana's (2007) narrative of the transition from managerial capitalism to investor capitalism; second, we will return to the formal foundations of profit maximization to see what conditions must be met to justify concluding that profit maximization is the best goal—including the hunt for *homo economicus* and Pareto optimums. Third, we will analyze consumer decisions to show that, in order for them to be made sensibly, consumers need practical wisdom, which they often do not have or do not use. Fourth, we will turn to firms and argue that they, too, need practical wisdom to make business decisions, but also moral virtues, mainly justice, to make decisions that are "legitimate," even though modern management control systems (MCS) push people in the opposite direction. Finally, we will end by considering what conditions might be sufficient to guarantee that an outcome is, indeed, both Pareto efficient and just.

The Changing Status of Management

The idea that the economy works well on its own, without state intervention, comes from the eighteenth century, when first the physiocrats and later Adam Smith and the classical economists established the conceptual bases of economics and the purported optimality of free-market economies. Khurana (2007) notes that, as Chandler detailed in a series of famous studies, modern industrial capitalism was founded on the efforts of a "new type of individual," who was different from the robber barons, worked in the upper and middle ranks of large organizations, and was "a figure who did not fit into conventional economic distinctions between capital and labor.… Managers' work involved administrative tasks such as directing personnel, defining procedures for selling their firm's goods, and organizing processes for distributing those goods across the nation." Furthermore, "management was not subordinate to the authority of Adam Smith's *invisible hand*. Rather, this group constituted a *visible hand* operating in a new system of managerial capitalism, one in which the discipline of the market was attenuated and the scope for managerial choice considerable" (Khurana 2007, p. 2).

The crises of the 1970s changed that situation. There was a reinterpretation of economic history: managerial capitalism, as just outlined, was no longer portrayed as the key to America's economic success but as a liability. The new model that emerged is sometimes called *investor capitalism*, in which shareholders are believed to be the group that has the legitimate claim to the value created by corporations. Investor capitalism has since led to economism—the belief that the textbook notions of economics are a good description of the real world of organizations. The ideas from an elementary economics book can be summarized, in Kwak's (2017) view, as follows:

> According to an introductory economics class … you are necessarily paid the value of your work. Inequality simply reflects the fact that some people are smarter, more skilled, or more hardworking than others. Tinkering with the natural distribution of income—say, through taxes—would reduce the incentive to work, making everyone worse off. The law of supply and demand ensures that all resources are put to their optimal use, maximizing social welfare.… We live in the best of all possible worlds (or we would, if only we could get rid of those taxes and regulations), not because God would otherwise have made a different one, but because any other world would make everyone worse off. (p. 14)

If we believe that this theory reflects reality, as economism implies, then little effort is needed for the world to work well: "*laissez faire, laissez passer, le monde va de lui-même*," said the physiocrats in the eighteenth century. Ever since, there have been different formulations of the same idea: free markets, from which profit maximization follows. That is why Jensen (2000), for instance, claims that profit maximization "has its roots in 200 years of research in economics and finance." He does an excellent job of putting it in plain words:

> To see how value maximization[1] leads to a socially efficient solution, let's first consider a simpler objective function: profit maximization in a world in which all production runs are infinite and cash flow streams are level and perpetual.… In this simple situation, a firm taking inputs out of the economy and putting its outputs of goods and services back into the economy increases aggregate welfare if the prices at which it sells the goods more than cover the costs it incurs in purchasing the inputs. Clearly the firm should expand its output as long as an additional dollar of resources taken out of the economy is valued by the consumers of the incremental product

[1] For the sake of expediency, I will hereinafter use the expression *value maximization* as equivalent to *profit maximization* or *shareholder value maximization*. The first two can indeed be considered equivalent, since the only difference lies in whether one is considering a single period or multiple periods; *shareholder value* is often given as an objective from an ideological point of view but is, strictly speaking, technically incorrect (Jensen 2000).

> at more than one dollar. Note that the difference between these revenues and costs is profits. This is the reason (under the assumption that there are no externalities) that profit maximization leads to an efficient social outcome. (Jensen 2000, p. 43)

Unfortunately, from a scientific perspective, verbal arguments do not go very far. Indeed, the classic article arguing that profit maximization is socially optimal is by Friedman (1970), in which the arguments are purely verbal and are essentially based on the legal concept that stockholders are the owners of the company and that employees must therefore do anything that they ask within the limits of the law. His examples are also not particularly good for illustrating that profit maximization is all that firms must do; for example, he argues that they must not fight inflation by setting low prices when it would be in the best interests of the company to do otherwise. This argument is poor because pricing is a very complex decision that makes it difficult to determine whether setting prices high or low is good or bad for the company and whether the long-term effects will be favorable or unfavorable, which is always open to question.

Profit maximization, according to Friedman, Jensen, and others, must be practiced within the limits of the law, as mentioned. Implicitly, then, the law determines what can and cannot be done and is thus the source of ethics. However, the law is to some extent arbitrary—that is, it comes from an implicit system of values and not from science—and therefore excludes some behaviors that might possibly be "good" in terms of increasing profits but that would enter into conflict (rightly, presumably) with the values system of the society.[2] In the twentieth century alone, we saw legal systems as different as those of the US, the UK, France, Nazi Germany, the Soviet Union, Yugoslavia, Mao's China, Xi's China, and Putin's Russia—firms operating under completely different legal frameworks, which are thus, from a scientific perspective, not a very good source of data about what can or should be done.

The specific issue of shareholder theory versus stakeholder theory has often been discussed in ideological terms: Should firms maximize profit (or value) or else satisfy a broader group of stakeholders? (Jensen 2000; Sundaram and Inkpen 2004; Werhane and Freeman 1999). What I intend to do here is the opposite: to reason rigorously from microeconomic theory to show the conditions under which maximizing shareholder value would be a good objective to pursue, which, as we will see, essentially means that the decisions are made "correctly." Studying economic problems within a formal context and being clear about the assumptions at the beginning (so that one can discuss whether they are realistic and what happens if one changes them) provides a good basis for analysis. The mathematical foundations of microeconomics are the basis of one possible formal system, and, in fact, there are no others. The advantages of using a formalized system are that (1) you do not introduce value judgments or value systems implicitly but must do so explicitly, which makes it possible to see their effects and to compare the results of different value judgments, and (2) the logico-mathematical derivation of the results allows you to ensure that the conclusions follow from the premises.

It is important, then, to seek a foundation for the objectives of a firm through the formal development of microeconomics because only then can we see what can go wrong with the market as the organizer of economic activity and find ways to counteract such failures. In fact, the existence of firms can itself be considered a market failure (Coase 1937; Williamson 1985), and it should therefore not be surprising that failures may occur in a firm's decisions.

[2] Also, the law is, to some extent, determined by the companies themselves, through a process of lobbying for the kind of "ethics" they want, and thus possibly becoming no ethics at all.

At present, the more or less intuitive ideas of elementary manuals are used too frequently (Kwak 2017); apparently, Samuelson was once asked what the use of research or advanced economics was because, after all, in practice, the economic measures being taken were those recommended by elementary textbooks. He replied that they were useful for identifying "what is wrong with elementary economics." We will therefore start with formalized microeconomics by asking how decisions are made so that we can see what can go wrong with elementary microeconomics; we will then proceed to how practical wisdom and moral virtues—mainly justice—are needed to obtain the desired optimal results.

The Formal Microeconomic Foundation of Profit Maximization

The formal foundation of the idea that shareholder value is the primary objective of a firm lies in microeconomic theory—specifically, the two fundamental theorems of welfare economics, although many of the idea's proponents never mention and may not even be aware of this. It is therefore worth briefly revisiting the formal theory, although we will do so only verbally, as we can rely on the detailed formalizations that can be found in any advanced microeconomics manual.

The free-market economy and its general equilibrium are based on two groups of agents, consumers and firms, with each agent making its decisions in a certain way, based on the following assumptions:

1. The first group of agents, consumers, have preferences for different goods and services, which can be represented by a utility function. This hypothesis is based on the axioms of rationality, which essentially mean that any consumer knows whether he prefers commodity (or bundle of commodities) A to an alternative commodity or bundle B; whether he prefers B to A; or whether he is indifferent. There are some other axioms of a more technical nature, but for our purposes, this is sufficient. Utility is then the index of preferences for all these commodities and is what the consumer wants to maximize, subject to their budget—that is, the total resources they have (wages, dividends from shares, etc.) and the maximum available to spend on purchasing commodities.

2. The second group of agents, firms, are abstract entities that want to maximize their profits. To say that an abstract entity "wants" something is, of course, an abuse of language, but it is generally accepted that this is what the shareholders of companies want. In fact, companies themselves are nothing more than a production function—a mathematical relationship between the inputs and outputs of the production process.

3. In a market with a sufficiently large number of agents (in mathematically rigorous terms, it should be an infinite number) that interact by supplying and demanding commodities—and if certain mathematical assumptions hold—there is an equilibrium price vector such that, when consumers maximize their utility and the firms maximize their profit (or value) with respect to those prices, the plans of all of them are consistent—in other words, for each product, the supply equals the demand and the economy is in equilibrium.

4. The two fundamental theorems of welfare economics assert that (1) the competitive equilibrium thus achieved is a Pareto optimum and that (2) any Pareto optimum in the economy can be achieved as a competitive equilibrium with an adequate a priori redistribution if needed.

A Pareto optimum is a situation in which, within the resulting allocation of resources (which is not necessarily fair or just), it is not possible to improve the welfare of one of the agents without worsening that of another. Therefore, although a Pareto optimum is not necessarily fair or just, it is clear that a Pareto optimum is better than a Pareto non-optimum because, by definition, we can go from the latter to the former without harming anybody. However, we should note that if we do not like a given Pareto optimum because of our value system (which, say, negatively values inequality) and want to move to another through a redistribution, that redistribution should occur before competitive equilibrium—in other words, we should let market forces operate again after the redistribution because we would otherwise have no guarantee that the second allocation is a Pareto optimum.

If the world were exactly as described by the basic microeconomic model we just reviewed (i.e., people are utility functions that, without doubt or contradiction, can assign to any good or service an index that indicates their preferences—a creature that has often been called *homo economicus*; companies are a simple production function that automatically and efficiently deliver the products that are requested; and both companies and consumers exist in sufficiently large numbers in a perfectly transparent market), then the conclusions of microeconomics, including the two theorems of welfare economics, would be fact. After all, they are mathematical theorems, so if the premises are true (such as the existence of *homo economicus*), the conclusions are then necessarily also true. Thus, simply leaving economic problems to the market, in a totally laissez-faire manner, would result in them being solved automatically. If we then did not like the resulting Pareto optimum because of our value system, we could obtain another that we liked better simply by redistributing the existing resources and letting the market find the desired optimum.

Fortunately, the world is not like that, if only because it would be rather boring. However, that the world is otherwise allows things to happen that we may not like at all, and laissez-faire in general—and what has come to be called neoliberalism in particular—has therefore been highly criticized for various reasons. With no claim of exhaustivity, some of these criticisms include the following:

1. Inequality is created that, at the present time, is growing even in countries where it used to decrease.

2. Markets are less than transparent; in fact, the very existence of firms is partly due to the fact that knowing relevant prices is by no means trivial (Coase, 1937). Therefore, neither the consumer's nor the company's calculations can be readily performed without problems.

3. Companies often have externalities—external effects—that can be positive or negative. Air and water pollution are often listed among the negatives, while the creation of employment or the training of employees are listed among the positives. Such effects do not go through the market, so the market cannot make an optimal allocation, which applies particularly to public goods (that is, those goods from which a large number of citizens can benefit without the benefitting of one citizen diminishing the utility of the same good for another citizen).

4. The number of companies in some (or many) industries may be very small, constituting an oligopoly or even, in practice, a monopoly.

Nevertheless, though noting their significance, we will not delve into these issues here; instead, we will look at others that have to do with specific decision-making, first for consumers and then for firms.

Decisions by Consumers

As we have seen, economic theory assumes perfect knowledge on the part of consumers of (1) their preferences and (2) the market, which has homogeneous products and perfectly known market prices and suppliers, i.e., total market transparency when making consumption decisions. Unfortunately, these two conditions are seldom met.

Consumers rarely have completely clear ideas regarding their own preferences—what they really want. First, as their purchases are not made all at once, they may, at some point, regret purchases already made, not because of the purchases themselves, but because they have spent a part of their budget and cannot now buy something else that interests them more.

Second, most products are not homogeneous, possessing different qualities and brand names, and consumers are thus not always able to assess the quality of what they are buying. Advertising by producers or distributors does not help much in the assessment of quality or delivery dates and thus in distinguishing between alternatives.

Third, consumers may discover that they like something they have bought less than they thought, which will occur mainly among durable goods. When introducing the concept of bounded rationality, Simon (1954) notes that "It is a commonplace experience that an anticipated pleasure may be a very different sort of thing from a realized pleasure. The actual experience may be considerably more or less desirable than anticipated" (p.83). Of course, consumers can also never know how much they would have liked what they did not buy.

This is not intended to be an exhaustive description of the failed assumptions of economic theory. Indeed, it is also a common observation that markets, in general, are not transparent and that consumers therefore may not know where to find a product or whether the price is right once they have found it. All these limitations—and likely others—make the ex post competitive equilibrium less efficient than it was supposed to be ex ante.

However, it can also be argued that, statistically, an error by a consumer may compensate for an opposing error by another, such that the allocation of resources in the economy is practically unaltered for the economy as a whole. Alternatively, it can be argued that consumers learn when making mistakes and that their decisions thus improve over time. However, this may be more wishful thinking than anything else; a consumer buying narcotics, for example, may be making a decision that encourages worse decisions over time.

To avoid such mistakes, which can easily lead to a misallocation of resources, knowledge is needed on the part of consumers—specifically, the kind of knowledge that Aristotle called "practical wisdom." "Know thyself" was one of the basic postulates of Greek philosophy and can be applied to the context of making consumer choices "optimal." As we will see, this is even more important in decisions made by firms, but for the time being, it suffices to note that this self-knowledge, which is part of practical wisdom, is important if we want to have good resource allocation in a market system.

It is well-known that the two basic elements of the microeconomic model—consumers and firms—do not enjoy the unbounded rationality that would allow the former to know exactly what their preferences are and to order them rationally and transitively and would allow the

latter to make decisions under uncertainty with the required rationality. Demand may therefore not correspond to the real interest of consumers and supply may not correspond to real costs of companies, incorporating a rational consideration of uncertainty. For example, food products with a lot of sugar, which children crave, can cause irreparable harm if given in excessive amounts over extended periods. Likewise, drugs, including alcohol, and many other products, such as junk TV, can do the same: the market can drive society to a place that may not even be in the neighborhood of a Pareto optimum and that everyone considers undesirable. Practical wisdom is then indispensable, together with a minimal arithmetical ability and knowledge of product properties, market prices, and market opportunities.

The search for housing (Stigler, 1961) is a good example of the information limitations that a typical consumer must bear for a problem that is actually very common. Practical wisdom is, then, absolutely necessary for consumers to buy the right products within their budget, but once they have made the decision to buy—or not to buy—a product, they need some moral virtue to be able to put that decision into practice: mainly justice, temperance, and fortitude.

Decisions by Businesses

Business decisions made by firms are not really made by the firms themselves but by specific people within them; they are thus at least as complex as consumer decisions. First, uncertainties are always present and may be of substantially different kinds, and there is also Knight's (2018) classic distinction between uncertainty and risk: risk is when the possible outcomes have a known and objective probability distribution, while uncertainty is when the probability distribution is not known. Making decisions under risk is difficult, but making decisions under uncertainty is decidedly more so.

Under risk or uncertainty, it is important to distinguish between a decision that is "right" and a decision that is successful because, by definition, success depends on "luck": if the outcome is uncertain, an unfavorable outcome might always transpire. A decision is therefore "right" if it has been analyzed correctly, with realistic assumptions, considering all relevant factors, and so on, but it will be successful only if the uncertain variables turn out to be favorable—or, at least, not unfavorable. Making the "right" decision does not guarantee success at any given time, but by making all the decisions "right," one should get, on average, good results. Of course, for this to be possible, it is necessary to have a good estimate of the probabilities of uncertain events: an essential characteristic of a good manager is achieving better estimates of the probabilities of uncertain events than an average manager. Indeed, as we will see, Hayek defends the free-market economy precisely because not all the information necessary to make economic decisions can be summarized in statistics.

Besides uncertainty in the outcome, there is an additional difficulty in any kind of complex decision: unforeseen consequences. In complex situations that encompass many variables, the results of a decision may not only be the ones the decision-maker wants; there may be others that are unforeseen, perhaps undesired, and possibly only in the long term. Rosanas (2013, 2020) analyzes these concepts and their relationships in more depth, but for our purposes, it is enough to consider that handling such decisions requires a good amount of practical wisdom. No scientific knowledge is enough because of the complexity of the problem, the interactions between the variables, and the uncertainties.

These issues are compounded by the fact that the results of many business decisions cannot, for several reasons, even be measured with any degree of accuracy. These reasons include discretionary expenses, which are perhaps more important than ever because of decreases in

operational or engineered costs due to automatization and robotization. There is no mechanical or engineered procedure to determine the optimal number of discretionary items that should be paid for because, by definition, they depend on the subjective criteria of the managers making the decision. If discretionary expenses were fixed to maximize short-term accounting profit, this would inevitably lead to "wrong" decisions for the firm by reducing such expenses in a way that would harm future profits. "Wrong" decisions might include failing to make profitable investments for the future because they do not yield quick returns or, conversely, "milking" the firm in some way, like decreasing costs by hiring less qualified employees, using cheaper materials, or implementing pricing policies that maximize contributions in the short term but are bad in the long term. All such profit-maximizing decisions may have a favorable effect in the short term but an unfavorable one—possibly of greater magnitude—in the long term.

Maximization of *accounting profit*, therefore, is almost always the wrong objective. One of the classic authors in management accounting has claimed that profit maximization is "unrealistic," "too difficult," and "immoral" (Anthony, 1960) because, crucially, accounting profit does not consider in any form the purely qualitative variables that determine the future of the firm. Such variables include, among many others, the extent to which the firm's distinctive competence has improved or deteriorated during the period, the extent to which its employees identify with the company, and the firm's development of new products and innovative procedures.

It might be claimed that the maximization of *shareholder value* is optimal for the economy as a whole in the long term, which was the first rationale behind the stockholder value approach (Rappaport, 1986). However, what seems at first to be impeccable, almost linear reasoning has important problems. The immediate one is how the value of a firm is established. Typically, this is done with an assessment of the future prospects of the firm in a process in which financial analysts and investors play an important role. One of the crucial inputs to that process is the short-term accounting profit, which is exactly what Rappaport sought to avoid by using the idea of maximizing shareholder value instead of maximizing accounting profit.

Indeed, a firm can make decisions (real decisions in production or marketing or merely accounting decisions) solely to boost short-term profits, which will artificially increase its short-term value, but this effect may be only a vague amalgam of the short-term expectations of different investors who have different information and different a priori beliefs and may be impossible to quantify in the long term. "Manipulating profits over the short term is much easier than building wealth over the long term. Thus, whether intentionally or not, firm value maximization will almost always become, by default, short-term profit maximization" (Senge 2000, p. 63–65).

Practical wisdom is therefore absolutely necessary for complex decisions. Of course, there are other, simpler decisions for which basic techniques can accomplish important parts of the analysis without major complications, but for even these, some practical wisdom is needed (Cugueró-Escofet and Rosanas 2020). However, practical wisdom alone in not sufficient. Often, as stated earlier, "good" decisions have not-so-good effects in the short term or may harm other people or other organizations, so some moral virtues are needed as well. Two such virtues are particularly important: justice, which considers the (just) interests of other persons or institutions, and temperance, to ensure the decision-maker can put the decision into practice no matter how unpleasant the short-term results may be. Many current problems in business have to do with stakeholders other than shareholders and with short-termism and a focus on quarterly earnings instead of a long-term perspective. Nevertheless, justice is indispensable to ensure an allocation of resources that actually corresponds to the basic postulates of a competitive equilibrium, as are temperance and other moral virtues, depending on the circumstances.

Organizational Structure, Organizational Decision-making, and Evaluation

Business decisions are made within organizations, and it is "the organization" that determines who makes what decision and in what circumstances. This is a crucial point in terms of ethics because the organization may promote decisions that favor or oppose ethical behavior.

To analyze this, we need to further consider what an organization is. A formal organization is a "system of consciously coordinated personal activities or forces of two or more persons" (Barnard 1938, p. 72). This definition obviously implies that the activities of the people involved must be coordinated; that is, they must all be willing to act in a way that can be coordinated with the activities of others, not necessarily what they would like or even what would seem best to them. In other words, each person must accept limits to their discretion in order for their joint action with others to be the best possible under the circumstances. As we will see, this makes it particularly important to consider justice as a fundamental moral virtue.

One crucial function of executives is then to promote and obtain essential efforts from the participants in the organization (Barnard 1938 p. 217). Formal coordination is typically done through the MCS of the organization[3], which consists of (1) a hierarchical structure, such as might be depicted by an organization chart and (2) communication processes (up, down, and lateral) by which the people at lower levels are assigned tasks, coordinate their assignments with others at the same level, and report the results upwards. The two formal elements of this coordination are the evaluation of the performance and of the remuneration (financial or non-financial) of those involved.

The Economistic View of a Firm

The economistic view of a firm and of its MCS is rather simplistic: the objective of an organization as a whole is exclusively profit maximization, and this is therefore the essential measure for the chief executive. Measurable objectives are then established for each person (or group) in the organization, with an associated (often strong) incentive to achieve those objectives. If one accepts that profit maximization is the only objective, that the choice of measurable variables is correct, that their measurement is exact, and that people are interested only in money, then this might be a reasonable setup. However, these conditions are never met. Measurability is the most crucial issue, as explained in the earlier section on business decisions: the uncertainties and the timespan of the results are such that they make profit (or value) maximization imprecise, manipulable, and in some cases meaningless. A costly investment in employee training, for example, lowers the current year's accounting profit but is expected to increase profits in the subsequent years, yet there is no way to make a precise assessment of how much. It is therefore, to some extent, absurd to say that a firm's goal can be defined in terms of profit: it has to be defined in terms of profit and of the other variables that will condition future profits, which are typically qualitative or not susceptible to measurement with any precision.

[3] We must be careful with the term *management control system* because, in practice, it (a) may be considered reserved to the higher levels of the organization and (b) may be confused with *internal controls*—that is, with specific practices intended to prevent the improper use of resources, operational and physical security measures, and the scrutiny of actions taken, such as audits and investigative methods to identify irregularities. Such activities may well be *part* of a management control system, but they are by no means the system itself, which is supposed to achieve higher purposes. It is with this broader meaning that the term is used in this paper.

The Informal Organization

Barnard (1938, p.114) recognized something that is nowadays often forgotten: that besides the formal organization, an informal organization is needed as a complement—"Persons are frequently in contact and interact with each other when their relationships are not a part of or governed by any formal organization." By an informal organization, he therefore means the aggregate of personal contacts, interactions, and associated groupings of people.

This is clearly related to the type of knowledge that Hayek (1945) analyzed in a classic article:

> Today it is almost heresy to suggest that scientific knowledge is not the sum of all knowledge. But … there is beyond question a body of very important but unorganized knowledge which cannot possibly be called scientific in the sense of knowledge of general rules: the knowledge of the particular circumstances of time and place.... Practically every individual has some advantage over all others in that he possesses unique information of which beneficial use might be made … only if the decisions depending on it are left to him or are made with his active cooperation … knowledge of the kind which by its nature cannot enter into statistics.... The statistics which such a central authority would have to use would have to be arrived at precisely by abstracting from minor differences between the things, by lumping together, as resources of one kind, items which differ as regards location, quality, and other particulars, in a way which may be very significant for the specific decision. (p. 522–523)

Hayek used this idea to show that a decentralized economy—i.e., a free-market economy—was better than any alternative, if only because of the existence and use of this type of knowledge. Going a little further, this principle should also be applied *within the firm* because the upper levels of management cannot make use of the information that lower levels possess unless they obtain their *active cooperation*, which cannot be obtained without the informal organization maintaining *communication*, *cohesiveness*, and *willingness to serve*. Yet, all this is ignored by the economistic model, which contemplates only money and material incentives as sources of motivation.

Unfortunately, in recent years, MCSs have evolved to become more "technical"—searching for Eldorado within large sets of indicators, under the names of "KPI" or "balanced scorecard," which are meant to reflect a strategy and to offer an ideal tool for good results, if linked to (possibly strong) incentive systems. This is simply the economistic model, but with extra steps. Of course, "good results" is meant, typically, in the financial economic sense, which necessarily implies (even if the opposite is claimed) that such is the fundamental objective of the company. The people, individually evaluated with indicators that never perfectly reflect the objectives of the organization (Gibbons 1994; Rosanas and Velilla 2005) are then pushed to deliberate not on what is good for the company, customers, employees, or other stakeholders, but on how their decisions are reflected in the indicators and thus their own incentive payments. The capacity for deliberating—for practical wisdom—is then used for the wrong purpose.

The economistic model is therefore incompatible with the informal organization, and it is impossible for an organization to have only a formal organization in which it is pre-established, for all decisions, who should do what and when. All the people in an organization must make some decisions, of different importance and at different levels, for which they must use judgment (practical wisdom) to determine which alternative is good for the organization and to then choose it. And, since they cannot be told exactly what to do—that is, they are both making and implementing the decision—they need moral virtue to do so. Let us elaborate on this.

Virtue in Organizational Decision-making

Aristotle (2009, line 1105b) defines moral virtue as a state of character or *hexis* (εξις) that has been created by repeating the kinds of acts a virtuous person would do, although a *hexis* can also be bad, depending on the person's actions. Only by repeating the kinds of acts a virtuous person would do can people acquire virtue, and if they do the opposite, they acquire vice. In fact, in Aristotle's (2009) words, "moral virtue is concerned with pleasures and pains; it is on account of the pleasure that we do bad things, and on account of the pain that we abstain from noble ones" (line 1104b). Nevertheless, the habit of doing things that a just and temperate man would do develops virtue.

Some acts that a virtuous person would do can cause pain to a person who is not virtuous, but when virtue is acquired, virtuous behavior causes pleasure, not pain. Thus, acquiring virtue changes the state of character of a person and makes it very likely that, next time, they will do the virtuous act. Defective states of character exist as well, but these are inappropriate feelings that lead one to do something different from what a virtuous man would do. In this analysis, Aristotle wanted to show—contrary to what Socrates believed, according to Plato's account—that knowledge is not sufficient to do good things; you need also to have developed the appropriate states of character: "most people do not do these, but take refuge in theory and think they are being philosophers and will become good in this way, behaving somewhat like patients who listen attentively to their doctors, but do none of the things they are ordered to do" (Aristotle 2009, line 1105b).

Turning now to indicators—or KPIs or scorecards—and incentives: an employee in a firm must know what is good for the organization and make decisions with respect to that. This may sometimes be "painful" because of the effort or because of an unpleasant aspect of the job, but if this is what a virtuous man would do, then by doing it, the employee acquires virtue and does it with pleasure. Now, "money" always causes pleasure, presumably, and if the system of incentives is "strong," this pleasure will push employees toward doing what increases their incentive payments, not what is good for the organization. Therefore, not only does such a system not increase the moral virtues of the employees, it actually decreases them, especially justice and temperance (Rosanas 2020; Winter 2019), and the "ideal tools" thus inevitably lead to an economistic society that is conceptually and philosophically indefensible.

The economistic model then becomes a self-fulfilling prophecy: because it is exclusively based on quantitative indicators, the indicators improve but reality does not, and the eagerness of employees for incentives only increases. Reality goes far beyond shareholder value or any other indication of success for the firm as a whole because it has many long-term qualitative variables that will condition the future of the organization and of the individuals who work under its system.

Conclusion

The essential idea of this paper is to show, from the formal model of microeconomic theory, that to achieve the assumed Pareto optimality of a market allocation, decisions by both consumers and firms must be made correctly. Given the complexity of both personal and organizational objectives, a well-functioning informal organization is needed to accomplish this, which then makes practical wisdom and moral virtues—mainly justice and temperance—absolutely necessary. Technical tools to evaluate the performance of people and groups, if combined with strong incentives, may actually achieve the opposite, and thus undermine the morals of an organization and its people by driving individuals to look to their own individual good instead of that of the organization as a whole.

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