"Responsibility: Insights from Economics"

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I. Introduction and Background

It has frequently been urged that corporate executives or labor leaders have a "social responsibility" that should take precedence over their "private" responsibility to themselves, or their stockholders, or the members of their unions. This is the area in economic matters in which the issue of "responsibility" has been most discussed and I shall restrict these comments to it.

The most frequent application of this doctrine is to the prevention of inflation. Inflation, it is said, is produced by wage rises which lead to price rises—through a so-called wage-price spiral or cost-push. The way to stop inflation, it is said, is for businessmen and labor leaders to behave "responsibly" by keeping wage rates and prices lower than would be most profitable to union members and business enterprises. This doctrine is enshrined by now in the so-called "guide-posts" to wage and price behavior first suggested some years ago by the Council of Economic Advisers as a most tentative suggestion hedged around with numerous qualifications. Year after year, the magic formula is repeated in the Annual Report, each time more confidently and each time with less emphasis on the qualifications.

This is only the latest version of an application of the doctrine that is almost as old as economic life. In ancient Rome, the "profiteers" were berated for producing inflationary price rises, and first entreated and then ordered to hold down prices. And so it has been whenever and wherever there has been inflation.

The most recent application of the doctrine is in President Johnson's message of February 10, 1965, to Congress on the balance of payments. In it he proposed "voluntary" restraint by banks in making loans to foreign borrowers and by business concerns in making investments abroad.

This particular application, especially to banks, recalls the attempt of the Federal Reserve Board in 1928 and 1929 to restrain stock market speculation by appealing to banks to avoid loans for speculative purposes. The resulting dispute between the Board and the New York Federal Reserve Bank on the "qualitative" *versus* "quantitative" approach to controlling speculation is an important episode in our monetary history that had far-reaching consequences. The balance of payments application recalls also the resort, both during and after World War II, to "moral" suasion on banks to restrict credit to "productive" uses and to refrain from loans that would contribute to inflation.

I cite these examples to make clear that there has been much experience with the doctrine under discussion and that there exists much historical evidence by which we can judge how it in fact operates—though I should warn you (but probably need not) that the following generalizations which I draw from this experience and which I believe to be supported by it but which I cannot here fully document may be affected by my own normative views about the doctrine.

The first generalization suggested by the experience is that the appeal to "social" responsibility or "voluntary" restraint has always occurred when the governmental agency which is responsible for the area of policy in question has been unable or unwilling to discharge its own responsibility. The agency wants both to shift the blame and to give the appearance of doing something effective, hence it blames "irresponsible" private action and calls for "voluntary" restraint.

Illustrations abound. Time after time the Prince, in earlier days, or the Treasury, in modern times, has resorted to debasing the coinage or in more sophisticated ways creating money to subsidize private favorites or governmental officials or to pay for legitimate governmental expenses and has then blamed the resulting inflation on the "profiteers" and called on them to repent and mend their ways. In 1928 and 1929, the Federal Reserve Board was unwilling to use the powers it had to restrain credit as it was urged to do by the New York Federal Reserve Bank and so launched its appeal to the banks. During and after World War II, the Federal Reserve was prevented by its self-imposed policy of supporting the price of government securities from taking effective action to restrain the growth of the money supply, so it appealed for voluntary credit restraint by banks. The calls for restraint in raising wages and prices are generally a result of unwillingness or failure to take the required monetary and fiscal measures to prevent inflation. Sometimes, however, they have resulted from unwillingness to take the governmental actions required to restrain the development of private monopolies, most notably, the unwillingness to apply laws against price-fixing equally to trade unions and business enterprises.

The most recent example is another apt illustration. President Johnson is understandably unwilling to take in sufficient degree to guarantee success any of the governmental measures that would offset or eliminate the balance of payments deficit (selling our gold freely, governmental borrowing abroad, tighter money at home, higher tariffs or other restrictions on trade of which the extreme would be direct exchange controls, or changing exchange rates and abandoning a fixed price for gold either through a supposedly once-for-all devaluation or through letting exchange rates and the price of gold float). Hence, he resorts to exhortation. For reasons that cannot be gone into here (mostly, the behavior of other countries), I happen to believe that the chances are good (perhaps two or three to one) that we shall weather the present difficulties without a major crisis, in which case the exhortation will doubtless receive some credit. If the less likely occurs, and we have a major crisis, the blame will appear clear.

A second generalization from experience is that, unless there is an iron fist in the velvet glove of appeals to voluntary restraint (as in Britain with appeals to the very small number of commercial banks), the appeal to "social responsibility" has little effect. Under some circumstances, particularly in the emotional atmosphere engendered by war, it will initially be effective at least to a limited extent. But the effect will quickly be eroded. The program either breaks down completely and is ultimately discarded or it is replaced by a compulsory program—as voluntary price control in the United States in 1941 was replaced by legally imposed maximum price legislation in early 1942.

To go beyond straightforward empirical generalization, the failure of truly voluntary programs is inevitable and is not attributable in any way to a lack of "patriotism" or social consciousness. If the appeals were strictly and fully honored—even assuming they could be, which is by no means obvious—if they had some bite to them so that they were more than pious platitudes, and if they covered a sufficiently broad area, the result would be an intolerable situation that would make inevitable compulsory governmental intervention, and an economy tightly controlled from the center. The doctrine of social responsibility, if taken seriously, is a truly subversive doctrine in a free society. The next section tries to explain why this is so.

The failure to recognize the subversive character of the doctrine of "social responsibility" and the great hopes placed in the doctrine reflect from one point of view naïveté, from another *hubris.* The naïveté consists in the belief that the only problem is one of the will, that if something bad occurs, it is because men have evil motives, that if only people (in this case businessmen and labor leaders) behaved "morally" or "properly," all problems would be solved. The *hubris* consists in the confidence which the people who appeal to social responsibility have in their own understanding of such problems as inflation, balance of payments, and the like. The combination of naïveté and *hubris* explains not only this instance but the more general phenomenon of so many of our preachers and teachers thinking themselves competent to predict the consequences of policies in areas in which they have no special training or understanding and hence competence to prescribe policies in such areas. Naïveté and *hubris* explain why the preachers and teachers are often so intolerant, so ready to regard disagreement with them as a matter of moral turpitude rather than honest difference of opinion, why they find it so hard even to entertain the notion that they may be mistaken, and why with such good intentions they are capable of doing so much harm.

II. Problems Raised by the Doctrine of Social Responsibility

a. Conflict of responsibilities

The most obvious issue raised by the doctrine of social responsibility is the conflict of responsibilities. Consider a bank official currently asked by the President in the name of "social responsibility" to refrain from making a profitable foreign loan. Let us waive for the moment whether he is in fact promoting in some relevant sense the social interest by not making the loan and assume that he is. He is still faced with a real moral conflict. He is a salaried official who is an agent of his stockholders. If he refrains from making the loan, he reduces their income. In effect, he is violating his contractual obligation to them. Perhaps he can rationalize refusing the loan by arguing that he is serving their long-run interest because otherwise the government will impose compulsory control on loans or a tax (like the interest equalization tax) on them. But in that case, he clearly will conform to the President's request to the minimum extent necessary to prevent the compulsory measure. We are simply evading the issue: the President's request has changed what is in the private interest of the stockholder and hence the bank official; the bank official is not accepting a "social" responsibility overriding his private responsibility.

Let the bank official accept a "social" responsibility. Is it to be overriding? Should he refrain from making the loan no matter how heavy the cost to the stockholders? Or only if the cost to them is "tolerable"? Who is to decide what is tolerable?

The same problem arises in each of the applications of the general doctrine. A trade union official has a clear responsibility to the workers he represents. Again, assume for the moment that it is clearly in the social interest for the wage increase to be smaller than the increase that would be in the private interest of the workers. Is it proper for him to sacrifice their interests? After all, he was hired (or elected) by them to represent them; he is not a public official. How far should he go in sacrificing their interests?

There are only two ways out of this conflict. One is to make the appeal to social responsibility not to the agent but to the principal. We can appeal to the owners of the bank or to the workers to instruct their agents, the bank official and the trade union official respectively, to use a certain fraction of the potential income of the bank or of the potential wage increase of the workers for the social purpose in question. At least in that case, each man is being asked to spend his own money, not someone else's, for a social purpose. In effect, this is a system of voluntary taxation, with each person *deciding for himself* how much to contribute, though in a concealed form which would make it particularly difficult for it to be successful.[1]

A second way out of the conflict is for someone other than the agent or the principal to specify the precise content of the socially responsible action, which means in practice a government official, or a governmentally created committee, which typically will be composed of representatives of the industry. For example, in the wage case, the Council of Economic Advisers' guideposts are intended to specify precisely what wage and price behavior is in the social interest—though I hasten to warn you the specification is far from unambiguous (see forthcoming article by A. F. Burns in "*Harvard Business Review*"). In the balance of payments case, the President proposes that joint industry-government committees be formed and has asked Congress to exempt such committee actions from the anti-trust law (an obvious reflection of the incompatibility of "social responsibility" and free competition.),

In effect this, too, is a system of voluntary taxation, but with the size of the tax being determined implicitly by someone else, namely, the government official or the private committee.

This analysis perhaps already makes it clear why there is such a uniform tendency for programs of voluntary restraint, after perhaps some initial success, to be ineffective unless backed up by the coercive power of the state—either explicitly as when the arrangements are made compulsory, or implicitly as when threats of income tax investigation or anti-trust prosecution are used to back up appeals to social responsibility (as most dramatically in 1962 in connection with steel prices). The action which people are being asked to take is against their private interest—else appeals to social responsibility would be unnecessary. The larger the number of people who cooperate and behave "responsibly," the greater the gain that can be reaped by the "irresponsible"—the bank that might never have had a chance to make the profitable foreign loan sees its competitors voluntarily bow out and leave the field to it; the trade union leader who has never been able to win a union election is now in a position to offer gains to the workers if they will only elect him that the "responsible" official cannot promise. The "irresponsible" is bolstered by the conflict of responsibilities, so he can feel morally justified; even if he recognizes "social responsibility," he can question whether the action he is asked to take—on the say-so of some official or private group and without formal legislative enactment—is truly in the social interest and regard himself as no less competent to decide what is—the notion that what is good for General Motors is good for the country is universal. Let one or a few behave "irresponsibly," and the pressure on the others to do likewise is greatly increased—they are being penalized by behaving "responsibly" and in the process the alleged social objective is not even being achieved.

Let us, however, waive these problems of non-compliance for the time being, and assume that everyone wishes to behave in accordance with his "social responsibility." That will enable us to examine the problem we waived earlier—how to know what behavior is "socially responsible."

b. Knowing what to do

A corporate executive or a union leader who is seeking to discharge his private responsibility has a clear objective, though, needless to say, the particular actions that will promote that objective may not be at all easy to determine. However, his principals have definite criteria by which to judge him, and a straightforward way to reward him for success or sanction him for failure. This process gives some assurance that even if the very fittest may not be the ones that survive, at least the really unfit will be weeded out.

The appeal to social responsibility is very different. The objective is always diffuse ("balance of payments equilibrium," price stability, etc.), the precise actions that will favor the objective hard to define, and, as already noted, a tendency for perverse selection to occur—for the unfittest, as judged by their willingness to conform, to survive. However, for the present, assume away this final problem by supposing that conformity is complete.

Consider the apparently simple case of the foreign loan. First of all, it is clearly not desirable to cut out foreign loans completely—that cure would be worse than the disease. How is the individual banker to know whether the particular loan he is considering is one that should be refused? Is he to use his own judgment? If so, by what criteria is his judgment to be informed? He can tell pretty well what loans will be most profitable to the bank, but how is he to know what loans will do the most harm to the balance of payments?

One way out is for the President or a private committee to decide on a target. Say, to cut out 20% of all foreign loans? But 20% of what? Of loans requested? Once restraint sets in, requests will go up. Of some earlier amount of loan? That is the backward-looking device that almost every allegedly forward-looking scheme of direct government controls of economic transactions ultimately adopts for want of a better.[2]

But even such a target is only the beginning, not the end. Which 20%? Is each bank to be allowed to choose for itself? If so, it will clearly choose to eliminate the least profitable. The borrowers will then bid against one another for the privilege and (with perfect voluntary compliance) the interest rate on foreign loans will be bid up to a level at which the amount of loans demanded is equal to the target amount. The voluntary exercise of social responsibility has become a governmentally approved cartel to keep up the price to foreign borrowers! An alternative to a tax on foreign borrowing (itself an illiberal restriction on trade and the equivalent of partial devaluation) has become a tax but with the proceeds going to the banks instead of the government.

The only alternative is for the government officials or the private committees to decide which loans to eliminate—for the voluntary equivalent of wartime Capital Issues control. But they, too, have no better criterion than the individual bank. From the point of view of the balance of payments, those loans appear least harmful that will be spent predominantly in the United States. However, let this criterion be used, and very rapidly borrowers will juggle their own purchasing arrangements or make deals with other foreigners purchasing in the United States so as to make it appear that the proceeds are all being spent here.

But suppose somehow this problem were solved. Difficulties would not be at an end. Foreign borrowers would seek indirect ways to achieve their end—*e.g.*, by having domestic United States firms make loans from banks that indirectly are channeled to them and by other stratagems that you and I are not smart enough and ingenious enough to figure out in advance.

I know that your reaction at this point is likely to be that I am making mountains out of molehills or deliberately obfuscating the issue; that surely there must be some fairly simple way to tell people precisely what is in the social interest which I am concealing either through malice aforethought or ignorance. Let me assure you that that is not so, that actual case histories of which this hypothetical story is a pale imitation abound.[3] (For a detailed and fascinating examination of another existing program, the wage-price guidelines, see the article by A. F. Burns referred to above.)

c. Replacing the price system

I cannot hope within the confines of this paper to explain in full why it is that difficulties in knowing what to do to be "socially responsible" are not adventitious but inevitable and why they tend to grow and extend their scope. However, perhaps I can suggest the reason briefly.

Almost without exception, appeals to "social responsibility" arise because of an unwillingness to let the price system work. They constitute an attempt to replace the price system by some alternative device. But no one has yet invented or discovered a device that can do the job which the price system does: of coordinating the activities of countless millions of people impersonally and without any need for central control; of providing a mechanism that simultaneously transmits information about changing demands and availabilities, gives economic agents an incentive to act appropriately in response to the information transmitted, and adjusts consumption to available supplies in the short run by rationing the supplies while simultaneously providing for adjusting production to consumption in the long run. The attempts to use alternative devices have been numerous and often on a very large scale—witness legal price control in the United States during wartime or central economic planning in Russia. In all cases, they have been largely unsuccessful, and the price system, albeit with large scale distortions introduced into the signals on which it operates, has remained a major means for organizing economic activity.

Because the price system works impersonally, automatically, and quietly, because it has no press agents, there is a tendency when it works well to take it for granted and for the non-economist hardly to recognize that it is performing a function. It is natural for him to think he can manipulate prices without any serious consequences; but he invariably finds when he does so that he has mounted the tiger, and he is driven to an ever-widening range of measures because of the difficulty of dismounting. Our agricultural price-support program, no less than legal price-control, and the voluntary restraint programs are all striking examples.

d. The political issue: who is to decide?

Let us waive all the preceding problems: let us suppose complete voluntary compliance, and let us suppose that each individual businessman and labor leader can know what action is called for by his social responsibility. There still remains a basic political problem.

It is entirely reasonable that stockholders should be permitted to choose who shall manage their capital—or workers who shall be their representatives. But if the businessmen and labor leaders are to discharge a "social" responsibility that is something other than and in conflict with their private responsibility, and if in doing so they affect matters of great social importance, is it tolerable in a democracy (or for that matter any other political system) that they be either self-selected or selected by self-selected groups of stockholders or workers? I believe not. If these businessmen and labor leaders are "public" servants who are exercising a "public" function, then it is inevitable that sooner or later they be selected through an explicitly political process and their powers be circumscribed and their responsibilities delineated by a political mechanism.

That is the basic reason why ultimately the doctrine of "social responsibility" in the form which it has taken is subversive of a free society.

III. The Reconciliation of Social and Private Responsibility

The way out of the apparent dilemma is as old as Adam Smith's invisible hand. There is no natural harmony between social and private interests—Mandeville and Bastiat to the contrary notwithstanding. But it is possible for an economic, social, and moral framework to exist within which "every individual," as Adam Smith wrote, "generally neither intends to promote the public interest, nor knows how much he is promoting it. … He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote and end which was no part of his intention. Nor is it always the worse for the society that it was no part of his intention. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it." Within such a framework, the social responsibility of the individual, whether he be a worker, a professional man, an entrepreneur, a corporate executive, or a labor leader, is to pursue his private responsibility, *i.e.*, his private interests, as best he can. The chief characteristic of the economic framework which produces such a happy outcome is that it fosters free competition over as broad a range as feasible. We are far more ignorant of the social and moral framework required, though as suggested by van den Haag in his paper, it included some basic commonly accepted set of ethical and moral values or standards. There is more than one possible set that will do, but we know all too little about what alternatives will work. (For a stimulating discussion of one facet of this issue, see Edward Banfield's, *Moral Basis for a Backward Society*.)

The preceding paragraph is at best a dogmatic assertion which cannot be developed here. But one point I would like to emphasize. "Private interests" are not to be taken to coincide with "narrow, material, selfish interests." The man who devotes his life to being a religious missionary under vows of poverty is pursuing his private interests no less than the man who accumulates money to spend on wine, women, and song. The pursuit of "private interests" has built the churches, the private universities and research institutions, hospitals, and the art institutes of this country no less than the movie theatres, the beach resorts, the athletic stadiums, and the myriads of automobiles.

I cannot refrain from closing with another line from Adam Smith: "I have never known much good done by those who affected to trade for the public good."

Notes

1. A personal experience many years ago impressed me with the much greater flexibility of individuals who are spending their own money than of individuals who are agents for others. At the Treasury in 1942, I was involved in working out a program for taxing insurance companies. In discussing alternative possibilities with representatives of the industry, I was struck with the difference in attitude of two groups: the owners of some rather small scale stock (*i.e.*, profitmaking) insurance companies and the hired lawyers or actuaries of large scale companies, mostly mutual (*i.e.*, theoretically nonprofit cooperatives). The owners were reasonable and could be appealed to on the ground of what was fair in light of the wartime need for revenue. The hired representatives were rigid and unyielding; they had a job to do, namely, to keep the taxes on their companies as low as possible, and were single-minded in accomplishing it.

2. Since this was written, this solution has apparently been adopted. *"Time Magazine"* reports (February 26, 1965) that banks have been told to hold to 5% the increase in foreign loans from 1964 to 1965. Federal Reserve Banks are to check compliance, their power to refuse discount facilities presumably being the iron fist in the velvet glove (though this is not stated in *"Time"*). Business enterprises have been told to keep the net dollar outflow in 1965 to 85 to 90% of their net outflow in 1964. The Department of Commerce is to check compliance. The implicit sanctions are easy to conjecture.

3. To avoid misunderstanding, let me state explicitly that I am *not* asserting that the program may not, at least for a time, reduce substantially the outflow of dollars—the iron fist will very likely have considerable effect. What I am asserting is that the particular distribution of any reductions will be essentially arbitrary and not appropriate to the ultimate objectives.

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