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Responsible Social Science in the Age of Economic Crisis

Abstract: The current economic crisis calls for a radical rethinking of the role of economics and other social sciences. It is a serious failure of social scientists when they solve the wrong problem precisely. This means that the problem formulation is inadequate, which may lead to disastrous consequences for the fate and well-being of the stakeholders. To avoid substantive failures in problem formulation social scientists should reconsider the basic assumptions of the system under study and include as many stakeholders' views as possible. Appropriate solutions should address all the important dimensions of the problem in question (the scientific/technical, the interpersonal/social, the systemic/ecological, and the existential/spiritual), and create an optimal balance among them. Social scientists should also investigate their developed solutions from a deontological point of view (i.e. which ethical norms are violated or satisfied by them?) as well as from a consequentialist point of view (i.e. what are the payoffs for different stakeholders?). The job of responsible social science is to contribute to long-term economic and social transformation by producing knowledge that is substantively relevant and ethically acceptable at the same time.

Keywords: economic crisis, Error of the Third Kind, holistic perspective, responsibility of social scientists

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Responsible Social Science in the Age of Economic Crisis

1 Introduction

The world is undergoing unprecedented changes and transformations in economics, business, management, technology, and politics. The responsibility of economics and other social sciences is pinpointed and elevated by the current crisis with no end in sight. Incorrect diagnosis of the crisis and insufficient proposals for "solving" the basic problems address the responsibility of economists and other social scientists who create theories and models that underline and legitimize the current flawed economic functioning. These influential but erroneous intellectual weapons include agency theory, corporate governance models, monetary incentive schemes for top management, and the ideology of shareholder value maximization.

In ethics the most advanced concept of responsibility was developed by philosopher Hans Jonas [11], [12]. He defines responsibility as a duty in caring for the beings affected by one's actions and policies. The beings to be considered may include human persons, social communities, non-human creatures, ecosystems, and future generations. [18]

Jonas underlines that moral responsibility concerns the fate of other beings. "I feel responsible, not in the first place for my conduct and its consequences but for the *matter* that has a claim on my acting." For example "the well-being, the interest, the fate of others has, by circumstance or by agreement, come to my care, which means that my control *over* it involves at the same time my obligation *for* it." [11]

Economists and other social scientists cannot ignore the effects and longer term consequences of their problem-analysis and problem-solutions on human communities, the natural environment, and future generations.

2 The problem of problem formulation

What is a problem? A problem is a gap between an "ought" and an "is," the difference between an ideal—something which is desired—and the actual situation as it is perceived. Important problems typically appear as "messes," which present themselves with no clear indication on how to solve them. It is neither easy to know what the ideal is, nor easy to state what the actual situation is. [9]

Mitroff and Silvers refer to John Tukey, the famous statistician, who once said: "I suspect that most failures occur because we attempt to solve the wrong problems in the first place, and not because we fail to get the right solutions to the right problems." [15] Substantive failures occur if one gets the solution to the wrong problem and then fools him or herself into believing that he or she has solved the right problem to begin with.

Harvard decision theorist Howard Raiffa labeled the error of "solving the wrong problem precisely" the Error of the Third Kind. He called the error of solving the wrong problem precisely the Error of the Third Kind because the Type One and the Type Two Errors were already well-known in mathematical statistics. [13]

Mitroff and Silvers argue that while the Type One and the Type Two Errors are taught in every course in statistics, the Error of the Third Kind is almost never discussed. The reason is that the

Type One and the Type Two Errors involve only a technical knowledge. In contrast, the Error of the Third Kind demands wisdom, the ability to exercise critical thinking (to be aware of and to challenge one's basic assumptions). [15]

A revealing example of wrong problem formulation is when business economics frames the main problem of managing a company as the *agency problem*. It suggests that there is an unavoidable conflict between the owners and the managers of the company. Managers tend to use the resources of the company for their own material interest, which results in loss of efficiency and profit. [10]

Thomas Donaldson [5] demonstrates that this problem formulation is essentially wrong. He developed an impossibility theorem for corporate governance that clarifies how agency theory neglects normative concepts in a way that compromises their application to governance. For example, "agency theory neglects to consider what general obligations, moral or otherwise, principals might have either to their agents or to other groups inside or outside the firm. (...) One may ask whether a manager is obliged to lie to employees (thus violating the implicit obligation to tell the truth) in order to effect a marginal benefit for shareholders, whether a manager is obliged to violate an employee's right to privacy to marginally enhance the property rights maximizing impact for shareowners, or whether a manager is obliged to engage in environmental abuse when operating in countries with insufficient environmental protections." [5]

For avoiding substantive errors in problem formulation different advice has been developed in research methodology: Russell Ackoff [1] suggests reconsidering the basic assumptions of the

system under question [1]; Ian Mitroff urges the inclusion of as many stakeholders' views as possible in the process of formulating the problem [14].

Economists and other social scientists need critical thinking to define the right problem. Assumptions about the stakeholders and their broader social context should be scrutinized. Social scientists should pick the right stakeholders, and this generally means expanding the set of conventionally accepted stakeholders. To define the right problem precisely holistic thinking is indispensable to avoiding the "Error of the Third Kind."

The systems methodology developed by Russell Ackoff and his colleagues at the Wharton School states that a system performance is determined by the adequateness of the basic assumptions on which it functions and on the way the system is capable of pursuing its objectives. Problems indicate that the basic assumptions are inadequate and/or the system is incapable of performing adequately. [1]

Corporate governance models typically favor institutional arrangements in which executives are accountable to the Board of Directors and not directly to the stockholders or other representatives of society. This kind of arrangement makes it easy for corporate executives to avoid full responsibility for their decisions and policies affecting the future of the company and the well-being of diverse stakeholders including the company's stockholders. In this way corporate executives are discouraged to serve as guardians of society's vital interest. The result is corporate "short-termism" and malfunctions even from a narrow economic point of view.

Lynn Stout forcefully criticizes the so-called “shareholder myth”. [16] She shows that putting shareholders first harms investors, corporations, and the public. The assumption that corporations should maximize shareholder value fails to capture the real structure of public companies with directors, executives, shareholders, debtholders, and other stakeholders. The first fundamental error of the shareholder paradigm is the belief that shareholders own the corporation. However, the corporations are independent legal entities that own themselves. Shareholders own shares of stock, not the corporation itself. The second erroneous belief is that shareholders are the residual claimants in the corporation. In reality the corporation is its own residual claimant, and the board of directors decides what to do with the corporation’s residual. The third mistaken belief is that shareholders are principals who hire directors and executives as their agents. But corporate law renders that the corporation is controlled by the board of directors, not by shareholders. Shareholders have certain rights – the right to vote, the right to sue, and the right to sell their shares – that can be used to influence the board but these rights have little practical value in seeking to make directors serve the interest of the shareholders.

Widespread empirical evidence shows that shareholder value maximization hurts not only stakeholders and society but also shareholders themselves, both individually and immediately, as well as collectively and over time. [16]

3 The problem of developing ethically acceptable solutions

Solutions developed for practical social problems are never ethically neutral. They confirm or violate the stakeholders’ ethical claims and generate different payoffs for the stakeholders.

The standard solution to the agency problem is to provide managers of the company with high monetary incentives including excessive pay and bonuses. This solution may become counterproductive as it generates adverse effects on managerial performance and creates negative effects for the employees and the society at large.

High monetary incentives usually have an adverse effect on managerial performance in a broad sense. Ims, Pedersen, and Zsolnai [8] argue that one-dimensional economic incentives may crowd out existential, social, and ecological values that influence the manager's commitment to ensure responsible business conduct, and have negative spillover effects that reduce the manager's performance. [2], [6], [9], [14]

Psychologists Deci and Ryan have illuminated the relationship between intrinsic and extrinsic motivation, that is motivation inherent in the task itself and motivation that relies on external rewards or sanctions. [4] In Economic literature, the crowding-out effect, that is instances where external rewards in fact reduce the motivation of the actor, have been explored both conceptually and through a number of experimental studies. [6]

Ims, Pedersen, and Zsolnai [8] show how high-level compensation crowd-out not only intrinsic motivation of managers, but also existential, social, and ecological value considerations that influence the managers' commitment to responsible business conduct. Excessive compensation schemes may be detrimental to the inclinations of managers and their organizations to act responsibly. The crowding-out effect is often referred to as "the hidden cost of reward" [3]. It can be called the hidden existential, social, and ecological costs of one-dimensionality.

Mitroff [14] suggests that there are four dimensions of any problem that should be taken into account: the scientific/technical, the interpersonal/social, the systemic/ecological, and the existential/spiritual.

The *technical/scientific* dimension is the dominant perspective in today's Western culture and favors technical solutions to the problems, even when other solutions are more appropriate. This techno-centric bias is partly explained by the status and prestige that engineers and economists enjoy in our culture.

The *interpersonal/social* dimension concerns the way the problem is perceived from a social, a group, and a family point of view.

The *systemic/ecological* dimension takes into consideration the long-term consequences of how the problem is solved. It assumes that all things are interconnected. One may define this kind of thinking as involving the perspective of future generations and nature. This perspective goes beyond geographic borders and narrow time limits.

The *existential/spiritual* dimension emphasizes the lives and fates of individual human beings and the impacts on their life-worlds. Feelings and meaning are important aspects in this dimension. The important existential questions are as follows: Who am I? Who do I want to be? How do my actions influence my life project? Which give meaning and purpose to my life? Ultimately, all important decisions and acts influence the self of the decision makers and decision receivers. It is important to emphasize the existential/spiritual dimension because it is usually ignored or even denied in social science literature and thinking. [9]

Appropriate solutions for social problems require addressing all dimensions of the problem (the scientific/technical, the interpersonal/social, the systemic/ecological, and the existential/spiritual) and integrating them into answers that can create a new balance among them.

There are two main paradigms in ethics that are relevant for assessing the ethical validity of solutions developed for social problems. One such paradigm is called "consequentialism" while the other paradigm is called "deontology." *Consequentialism* bases the evaluation of an act solely on its real world consequences. In this paradigm the ethical value of an act depends only on the goodness of its consequences for the stakeholders. Contrary to this, *deontology* favors the evaluation of an act on the basis of its correspondence to the relevant ethical norms. In this paradigm the ethical value of an act depends on its rightness in ethical sense. Deontology disregards the actual consequences of an act.

Verschuren and Zsolnai [17] argue that one has to use *both* the consequentialist and the deontologist paradigms in assessing the ethical value of solutions developed for social problems. The ethical value of a solution is largely determined by its service to the stakeholders. A solution can be considered good if it meets the needs and wants of the stakeholders. The limitations of this approach can be surpassed if one introduces deontological considerations into the evaluation. Certainly, a solution should satisfy the basic ethical norms that are commonly accepted by the moral community of stakeholders and the general public. How well a solution comes up to the relevant ethical norms constitutes the intrinsic value of the solution.

Excessive pay for business executives has been criticized by many stakeholder groups as well as the general public. Many people including politicians and employees believe that the extremely

high salaries and bonuses of business executives violate the principles of fairness and social justice. [7] Even more importantly monetary incentives induce corporate behavior that results in detrimental effects which may lead to further destruction of the company and its business ecosystem. [8]

3 Conclusions

In the context of the current economic crisis we can define *responsible social science* as an activity that contributes to long-term economic and social transformation by solving the right problems in ethically acceptable ways. It involves defining the problems in the right form and developing solutions that meet the relevant ethical norms of the affected communities and generate true benefits for the stakeholders.

To avoid substantive failures in problem formulation economists and other social scientists should reconsider the basic underlying assumptions of the system they study and should investigate the chosen problem from a wide range of perspectives taking the views of different stakeholders into consideration.

In avoiding ethical failures in developing solutions, social scientists may use systems methodologies. Appropriate solutions should address all the important dimensions of the problem in question (the scientific/technical, the interpersonal/social, the systemic/ecological, and the existential/spiritual), and integrate them into solutions that create an optimal balance among them. Social scientists should investigate their solutions from a deontological point of

view (Which ethical norms are violated or satisfied by them?) and also from a consequentialist point of view (What are the payoffs for different stakeholders?).

Economists and other social scientists should take up the challenge of responsibility, which demands genuine care about the fate and well-being of all the stakeholders and their wider environment. The job of responsible social science is to produce knowledge that is *substantively relevant* and *ethically acceptable*.

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