

# THE ECONOMICS OF TRUST

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## Abstract

This is a philosophic discussion regarding the economic benefits of truth-telling and its associated variable, trust. Religion and certain ethical philosophies present a rules-based, deontological view of truth-telling. The economic argument, we shall discover, is utilitarian in nature and compelling. Recent literature in the social sciences falls short of defining an adequate theoretical basis, or philosophic framework, upon which this subject may be studied. A distinction between basic and professional trust is made. The implications for Business Management are profound. We begin the discussion with the nuances of “the truth.”

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## Key Words

Trust; ethics; economic efficiency; profession.

## INTRODUCTION

The question concerning the benefits of ethical behavior, if any, is common. Leo Durocher, legendary manager of the New York (baseball) Giants famously implied that “nice guys finish last.”<sup>1</sup> It is reasonable to assume that he may have had in mind, *inter alia*, telling the truth as a common, “nice-guy” trait; it is safe to assume that nice guys are truth-tellers. This statement is often, and perhaps erroneously, interpreted as meaning that tough, unethical men, that is, men who are deceitful and not trustworthy, have the tactical advantage and will “win.” Is this correct?

Why should one be honest? At a fundamental level, we must first examine the very nature of “truth” itself. In fact, truth-telling is not necessarily a matter of the simple truth versus a simple lie. The following joke is illustrative:

*A mathematician, an accountant, and an economist all apply for the same job. The interviewer asks the mathematician, “How much is one and one?” “Two.” “Exactly two?” asks the interviewer?” “Exactly two,” the somewhat befuddled mathematician retorts. In walks the accountant. “Well, usually it’s two, but there’s some wiggle room here. It all depends on the accounting assumptions we employ.” Last, comes in the economist. Upon hearing the question, he gets up, locks the door, shuts the windows, leans over to the interviewer and whispers, “How much do you want it to equal?”*

The nature of the truth itself and any benefits that accrue to the truth-teller shall form the key preliminary issues to be addressed in this paper. The nature of truth interacts with the level of trust with which one endows another. Once we have developed an idea of what truth is, we shall proceed to discuss the interpersonal benefits of its sharing, individually and in the aggregate; we will find that there are profound personal and macroeconomic benefits pursuant to truth-telling and trust. The implications for Business Management personnel are profound.

## THEORY: THE NATURE OF “THE TRUTH”

Can it be said that any of the three parties has lied? To be sure, the mathematician could not lie; to her the truth is absolute and incontestable. Thus, the mathematician is prone by her very nature to always tell the truth - even when her listener does not understand what is being related due to the complexity of the subject. The very inclination to lie may be absent.

Has the accountant lied when she chooses, for example, to present LIFO-based profits rather than FIFO-based? The accountant is trained in providing different versions of the truth, any of which version is still “true.” She uses different accounting “methods” in order to offer different presentations of the truth, or different “perspectives,” and will choose that perspective which best represents what she wishes to show. “[A]ccounting may be untrue, but it is

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<sup>1</sup> Durocher, in fact, stated with regard to a certain team: “...they are all nice guys. They will finish last.”

not lies; it does not deceive because we know that it does not tell the truth..." (Baxter and Davidson, 1962, pp. 44-55). In this instance, there is no "objective" truth, and so the potential for, and proclivity to, deceive are endemic.

Is it wrong for the economist to offer to position the truth in a manner that satisfies her constituents? Viewed negatively, as the joke would lead us to see the matter, there certainly are parties for whom the truth is a pecuniary or personal matter. Most moral people would find this behavior distasteful at best, but a deontological question remains: why tell the – absolute – truth, especially in the case where multiple perspectives may be equally valid? And what is wrong with lying? Apart from religion, natural law, or justice reasoning, all of which call upon either the metaphysical or pure rationality, there must be an empirical foundation for mandatory truth-telling. Hence, our argument in favor of truth-telling shall essentially be economic and utilitarian in nature.

The telling of the truth – or not – is intertwined intimately with the matter of "trust." How does the listener assimilate the information she hears from each of the three interviewees? To what extent are such statements accepted as "true"? How are the statements internalized and acted upon? What damages may result from misinterpretation or the conveyance of outright falsehood?

Truth itself, except perhaps for mathematical truth, is subjective. It is trust which makes a statement or view truthful or not. We believe in the truth, by and large, because we accept certain individuals who hold to those positions as authoritative and truthful. We ourselves, as recipients of "information," are responsible for the truth, in a profound sense. This sentiment was expressed by Alfred North Whitehead (1925), himself both a scientist and a philosopher.

*Nature gets credit which should in turn be reserved for ourselves; the rose for its scent; the nightingale for his song; and the sun for its radiance. The poets are entirely mistaken. They should address their lyrics to themselves, and should turn them into odes of self-congratulation on the excellency (sic) of the human mind. Nature is a dull affair, soundless, colourless; merely the hurrying of material, endlessly, meaninglessly (p. 125).*

Our scientific observations may mislead, yet we still trust both them and our teachers who espouse the theories - until such time as they are proved incorrect. It was once believed that the earth was the center of the universe - until Copernicus proved otherwise. Who can say what the future shall bring? The list of similar stories is endless and need not be summarized here. In short, the truth is that which we accept as such.

Nevertheless, there is some validity to scientific truths as they clearly pass tests of reliability. I can be said with certainty the apples will fall from trees and that fire burns paper. Specifically then, how do scientific observations and experiences interact with trust? There must be a connection between observation and social science.

Accordingly, the author will present a deontological argument, grounded in religion and favorable to trust; it will be found that the deontological argument contains inherently social elements. Then, the author will distinguish between basic and professional trust. Last, the author will argue why professional trust is imperative, and why “basic” trust is advised.

## A DEONTOLOGICAL POSITION

Successful social systems must operate largely on “trust” because not all negative behaviors can be policed because they are not observed. Trust is not a novel concept; it is as old as the Bible. Leviticus (19:18) famously states: “...You shall love your neighbor as yourself...” Rabbi Akiva, the monumental Talmudic sage, comments that “this principle is of the greatest importance in the Torah, God’s law” (Rashi).<sup>2</sup> Indeed, the notion of reciprocal trust and respect may be found in many religions.

Why is this so important? The entire verse, only a portion of which was just quoted reads as follows: “You shall not take revenge nor bear a grudge, and you shall love your neighbor as yourself; I am God.”<sup>3</sup> Biblical scholars ask what is the difference between revenge and a grudge? Isn’t it all just a feud? We all recall the notorious 19th century feud between the Hatfields and McCoys. Their long-standing feud manifested in terrible violence.

The famous 11th century French biblical commentator known as “Rashi” averred that taking revenge is as saying “I won’t do for you because you didn’t do for me.”<sup>4</sup> In contrast, bearing a grudge is as saying “although you did not do for me, I will, in fact, help you.” There is obviously an implicit and substantive moral superiority intended in this latter view of bearing a grudge, but there is much more.

The provision of assistance to another person automatically elicits reciprocal trust – even from those with whom you were earlier at odds. Whether it be taking revenge or bearing a grudge, such actions are simply not virtuous. At the individual level, trust invites positive mutual exchange; it must first, however, be demonstrated behaviorally. Trust, however, may not be expected from everyone. One must therefore distinguish between basic and “professional” trust. For this, one may examine Aristotle’s ethics.

## BASIC TRUST

Aristotle espoused an ethical philosophy referred to today as “Virtue Ethics.” Think of Aristotle today, not as a philosopher in the modern sense, but as a scientist. True, he was concerned with “philosophic” issues, such as metaphysics and more, but he was most interested in studying plant and animal life. It was as a scientist that Aristotle developed his system of ethics.

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<sup>2</sup> Translated by the author.

<sup>3</sup> Translated by the author.

<sup>4</sup> Translated by the author.

As a scientist, Aristotle carefully studied and categorized many species of animal and plant life. Aristotle was concerned with finding the “Arete,” or “excellence” in Greek, in the numerous species that he studied. He sought to discover their special qualities or excellences, as it were. Perhaps he found that birds were excellent due to their ability to fly; perhaps fish were excellent for their swimming. Arete, is translated commonly today as “virtue,” or “manliness” in Latin, to be sure a mistranslation of the original Greek intention.

In humans, he identified numerous virtues, to use the modern phrase, which made our species excellent.<sup>5</sup> These virtues could be developed and nurtured by education and habituation. When a person’s virtues are most highly developed, he would achieve “eudaimonia,” a phrase usually translated as happiness, but more accurately referring to a state in which one may be “flourishing.” Unlike the Bible, the wisdom of Confucius or Buddha, and many others who wrote about, or otherwise listed, various virtues, Aristotle’s virtue ethics was systematic.

What is remarkable here about Aristotle’s ethics is that it is directed inwardly, that is, for the benefit of the individual rather than for other people, or toward the fulfillment of some objective ethical principle. One usually thinks of ethical people or ethical behavior as selfless; by way of contrast, Aristotle’s ethics is, oddly, but compellingly, selfish. For Aristotle, ethical behavior provides for no greater good, nor does it satisfy some universal principle, as the moderns would have it over two millennia later. Is such behavior a social phenomenon, one, which may be learned or copied? What does this say about generalized ethics and basic trust?

## MORAL DEVELOPMENT

Aristotle advocated moral education and habituation. He believed that ethics may be taught, and that by practicing virtuous behavior one can eventually assimilate such qualities into his character. Indeed Maimonides, a medieval Jewish theologian and neo-Aristotelian philosopher, advocated the practice of virtue even when one did not “feel” virtuous; for example, he wrote that if one gave small amounts of charity on a regular basis, he would not feel that he is giving away much and would not experience any financial burden, but would develop over time a regular charitable habit (Mishneh Torah).

Regarding moral education, there has been some controversy as to whether ethics can be taught after a certain age. One researcher (Bigel, 2002) found that moral education can indeed be conveyed in the business school setting effectively; this study was effected experimentally by means of administering a well-know psychometric measure of moral development known as the Defining Issues Test (or “DIT”).

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<sup>5</sup> Aristotle identified many virtues and among them four principal virtues, which he regarded as “cardinal”: prudence, temperance, courage, and justice.

All measures of moral development, and certainly the DIT, rely on moral principles, such as the social contract, utilitarianism, and deontology, and the subject's ability to reason accordingly. No known measure of moral development tests, or measures, one's level of "virtuosity." Moral principles, as distinct from virtue, lend themselves more readily to professional ethics than to street (i.e., generalized) ethics. For example, it is difficult to assess fiduciary standards on the basis of Aristotelian virtues, but it readily translates into utilitarian or deontological language. However, in contrast, Aristotelian virtues may be applied both to the street and to the professional. The basis for a professional relationship is trust; this quality is absent in street ethics, which tends to be impersonal, although not exclusively.

## **DISCUSSION: PROFESSIONAL TRUST**

It has been shown in the cases of the interviewees that trust is largely contextual. A famous judicial case is illustrative of the dichotomy between basic and professional trusts. In this case, a legal dispute between two erstwhile business partners, *Meinhard v. Salmon*, rose all the way to the Supreme Court of the United States (1928).

Salmon obtained a lease from a third party and Meinhard provided the financing. After twenty years, at the term of the lease, the property owner, who had dealt all along with Salmon exclusively, offered Salmon alone, and not Meinhard, the opportunity to lease a much larger property, which subsumed the earlier one. Salmon agreed, and Meinhard, upon learning of this, sued his former partner on the premise that the very opportunity to renew and expand the lease belonged to their expired joint venture. Salmon, as managing partner, owed a fiduciary duty of loyalty to Meinhard, the financial partner, in relation to the new opportunity – or so it was claimed.

Of this Justice Benjamin Cardozo famously wrote:

*A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.*

Interestingly and importantly, there were dissenting opinions, which held, as it may be understood, that events subsequent to the dissolution of the partnership are of no import. Alternatively, as a practical matter, it may be argued that the offer belonged to the expired partnership because it emanated from that previous relationship. The question, again, is whether the partners' relationship is professional or merely competitive, albeit occasionally cooperative.

Ethically, it may be argued, Salmon did not treat his partner as he himself would have wished to be treated. They had a long-standing and intimate business relationship, yet did not nurture among themselves the trust that marks a professional relationship.

Trust is something one merits because one earned it through demonstrated reliability. There was once a highly successful television commercial for a

brokerage firm, starring the venerable British actor John Houseman. The ad's famous refrain was: "We make money the old fashioned way; we earn it!" What they were really saying is that you can trust us – in spite of our being greedy capitalists, in the most pejorative sense. Implicit in this statement was their brokers' candid sharing of information – consistently and reliably. To be sure, many viewers did not buy into that line, but the ad campaign was hugely successful. People demand integrity and respond positively to those who exude and demonstrate trust and honesty. From here it is but a small step to the larger economic context.

## THE ECONOMIC ARGUMENT

Kenneth Arrow discussed trust in a professional venue (1973). He implicitly distinguished between the professional's and the commoner's ethics. Most experienced adults understand "street ethics," and are wary of the used car salesman's propositions. However, we typically imbue our teachers, physicians, and personal advisors with a great deal of trust; therefore, professionals must earn our trust. In the short-run, there are clearly many economic benefits associated with telling lies or not being entirely candid, as illustrated by the Meinhard v. Salmon case. In the longer-term, other considerations come into play.

Arrow (1972, 1973) promoted good ethics on the basis of "economic efficiency" (1973, p. 345). To him, in a world, which is naturally suffused with information asymmetry, i.e., wherein knowledge is not evenly dispersed, economic efficiency is enhanced when people transact business with one another on the basis of "trust"; in the end, all society is better off. His base example is similar to that of the physician who betrays his patient's trust - and the Hippocratic Oath. We trust the physician; we trust that the physician accurately diagnoses us, and that her treatment is effective and efficient. Doctors, we believe, do not provide medical solutions that do not serve the best interests of their patients. To be sure, this is not always the case, unfortunately. Abuse of trust may, in certain instances, result in the deprivation of the license to practice certain professions.

Accordingly, betrayal on the part of a mere few physicians would have a ripple effect, resulting in reduced public confidence in the profession, higher costs, and lower net revenues. Public health would decline and all of society would suffer.

If a patient did not trust his doctor, he would go to another physician for his medical needs. If many physicians acted in a less than trustworthy manner, people - en masse - would turn away from physicians in general, turning perhaps instead to barbers, in the medieval sense. In the end, the medical profession itself would suffer, and so too would medical care. (Today, of course, there are both medical malpractice and professional censure processes.) We would all be worse off. Similar, albeit less stark, arguments may be said of other professions and socio-economic relationships. This reasoning may be extended to all economic activities.



*[A] great deal of economic life depends for its viability on a certain limited degree of ethical commitment...There is almost invariably some element of trust and confidence. Much business is done on the basis of verbal assurance. (Arrow, 1973, p. 1).*

Certain professions carry explicit standards, such as medicine, while others may have implicit standards of practice. In any event, Dr. Arrow's argument is of course, economic – and utilitarian. Most believe that greater and greater wealth is desirable, despite scientific evidence that greater wealth does not, in fact, increase happiness. In any case, market efficiency is usually assumed to be a good thing as it increases wealth. In spite of the evidence concerning happiness, most people desire greater wealth.

Arrow isn't the only one who held this view. Sen (1999) argued that trust is critical to the working of markets. The former Fed chief, Alan Greenspan, expands the point stating that we are, in this country, by and large, a trusting people, illustrating his point by reference to, of all things, the financial markets, to wit:

*Despite each person's right in the West to file a lawsuit to address a perceived grievance, if more than a small fraction of contracts were adjudicated, our courts would be swamped to the point of paralysis. In a free society, the vast majority of transactions are thus, of necessity, voluntary.<sup>6</sup> Voluntary, in turn, presupposes trust. I have always been impressed that in the Western financial markets, transactions involving hundreds of millions of dollars often are simply oral agreements that get confirmed in writing only at a later date, and at times after much price movement. But trust has to be earned; reputation is often the most valuable asset a business has (pp. 140-141).*

Trust<sup>7</sup> makes it easier, simpler to engage in economic exchange, and thus increases economic activity, and, ergo, wealth. What effect does trust have on the national and international economies?

## TRUST AND THE MACROECONOMY

Some thinkers expanded these notions to the aggregate, national level. Donaldson (2001), borrowing from Ricardo's (1817) theory of "Comparative Advantage," argues that certain societies have competitive ethical advantages over others. He continues by citing Fukuyama (1995) who

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<sup>6</sup> I believe that Dr. Greenspan's use of the word, "voluntary," harkens back to a famous essay written by Dr. Milton Friedman (1970) in which he compares the capitalist system to socialism. Friedman states that capitalist markets are characterized by voluntary, non-coercive participation, whereas socialist markets are "unanimous," which I take as meaning that the socialist system requires participation in the economic markets as part and parcel of citizenship.

<sup>7</sup> Roth (2009) adduces three distinct kinds of trust: (1) thick trust, or the kind of trust between family members, (2) interpersonal or generalized trust, and (3) systemic or institutionalized trust. It is generalized trust that is the focus of this paper.



posited that some societies have innate cultural advantages, i.e., a kind of “social capital,” which provides them with structural, ethical, and hence, competitive national economic advantages. This logic parallels Porter’s (1990) claim that some countries have certain intrinsic, structural advantages over others.

Positive ethical advantages, as it were, include the protestant work ethic, respect for intellectual property, protecting the environment, equitable distribution of “primary” (as opposed to “luxury”) goods so that no one lives in economic misery, and a lack of negative values and behaviors such as bribery. Whiteley (2000) indicated that trust reduces transaction costs, reduces abuses of public goods, and mitigates agency costs. He further asserted that “values play a key role in explaining cross-national variations in economic performance” (p. 460).

All told, these factors add to the “wealth of nations” in a manner beyond the famous considerations that Adam Smith (1776) posited. Societies exhibiting such positive traits benefit - in the aggregate. Is there any scientific evidence that countries with higher levels of trust benefit economically as manifested by higher growth rates?

Roth (2009) cites numerous studies correlating trust and economic growth. Interestingly, he also adduces some evidence that the relationship is possibly dynamic.

*In countries with low initial levels of trust, an increase in trust leads to an increase in economic growth... In countries with high initial levels of trust, an increase in interpersonal trust leads to a decrease in economic growth... Once a threshold is surpassed, an increase in trust harms economic growth. (123-124).*

The author provides no explanation as to why this phenomenon may be manifest. Roth’s focus was on increases rather than on absolute levels. He did not distinguish between generalized trust and subcomponents thereof, namely between street ethics and professional confidence. Finally, he used an instrument, i.e., the “World Value Survey” (WVS), which he confides “presents only limited data on trust” (p. 109). Roth cites Olson (1982) who asserts that advanced societies may develop and accumulate special interest groups, which harm aggregate economic growth (Roth, p. 106). In the end, Roth confesses that “it is possible that the findings are partly due to the omission of some variable not considered, or that measurement error affected the results, or that the model is misspecified in other ways” (p. 124). No doubt, an adequate philosophic framework has yet to be developed.

## **THE EFFICACY OF THE LAW**

Why talk about trust and philosophy when society has mandated The Law to govern our activities? Can we not fall back on the law to ensure that trust and operating economic efficiencies are optimized?

New York State Governor Eliot Spitzer (2005) summarized his views about commercial and corporate ethics. Paraphrasing Robert F. Kennedy, Mr. Spitzer said that “if you don’t play by the rules because it is the right thing to do, do it because it is good for business and the economy.” This sounds much like Dr. Arrow; his statement is notably utilitarian. He added that there is a mistaken belief that law enforcement is bad for the economy based on the outdated notion of intrusive government regulation in the distant past. “Any of the targets of enforcement are now stronger companies.”

Let us examine three notable quotes:

1. The evidence is clear that the companies involved in these scandals were well aware of their wrongdoing. In fact, they had consciously decided to descend to the lowest common denominator based on the belief that competitors would violate the rules even if they didn’t. It was only when government stepped in to enforce legal and ethical boundaries that this downward spiral was stopped and true competition was restored.
2. Second, enforcement of the rules has helped prevent continued misallocation of capital. Honest companies could not attract capital in competition from hyped dot coms – they couldn’t grow and create jobs.
3. Third, enforcement of the rules has helped maintain investor confidence. They are now comfortable to invest.

Finally, Spitzer summarizes by stating that recent scandals have shown us that honor codes among CEOs failed, that board oversight hasn’t worked, that self-regulation failed, and that law enforcement worked. The scandals he, no doubt, had in mind then were Enron, Tyco, Worldcom, and numerous others that are rapidly fading from memory, given the pressing and prolonged effects of the recent sub-prime mess, and looming international economic and financial risks.

The law, however, is both a moving target and, by its very nature, incomplete. It is well-known that government prosecutors relish bringing cases against famous and well-heeled individuals and corporations in order to deter others from emulating their illicit behavior. Case law and precedents are established in this manner. Moreover, laws are not written for every possible action that one may do. What was once legal (i.e., not explicitly illegal) becomes illegal. In this manner, the law evolves.

## **CONCLUSIONS AND IMPLICATIONS: WHAT IS BETTER – PHILOSOPHY OR CORPORATE COMPLIANCE?**

Since the passage into federal law of the Corporate Sentencing Guidelines in 1991, there has been an increasing focus on internal compliance and policy. How do rules-based compliance systems stack up against a more ethics-based compliance system? There are numerous faults with the corporate rule-based enforcement systems (Berenbeim and Kaplan, 2007):

1. A pure compliance, rules-based focus undermines the conditions and habits of mind necessary for ethics, such as principled, philosophic inquiry and autonomy;
2. Compliance rules often will squeeze out ethics; rules trump ethics;
3. Companies and individuals often avoid dealing with harder issues that a more values-based approach may require.

Ethical behavior first demands awareness (Rest et al. 1999) that ethical issues are present; secondly, some cognitive ability is required in order to engage in reasoning about the ethical matter, and, to ultimately, arrive at a decision (Bigel, 2002, 2005). Were recent financial miscreants aware of what they were doing – ethically? If so, did they pause to consider and think through its economic effects? Should they have? Enforcement, at times, is necessary, after all, especially insofar as it fosters deterrence.

The typical business relationship is characterized by the presence of a contract rather than by trust (Adkins). A trusting, or “covenantal” relationship, is better than the ex-post facto strong arm enforcement of the law. A professional relationship must deontologically reflect trust; professional oaths are often involved. While it is preferred that individuals cooperate with one another at the street level with absolute trust, the utilitarian benefits are not apparent and are usually of no concern to the individual. If we view business as a profession, it is morally imperative the business people comport themselves with the greatest degree of trust.

This discussion begs the real question. It has been a matter of great debate whether business management is a profession, as are the law and medicine, or merely a “street activity” (Khurana, 2007). Academic, as opposed to vocational, schools of business, have been promoting the professionalization of management for over one hundred years. Academic and the business community together must decide what they wish business and management practitioners to be.

## SUMMARY

At the professional level, acting in a trustworthy manner is both a utilitarian good and a deontological imperative. Nevertheless, one cannot ever rule out the necessity of law and compliance. The age-old question of whether business is a profession precedes the level at which we must view the moral responsibilities of the business-person.

There is no doubt that, at the basic street level, trust provides a clear utilitarian advantage, however quixotic. Is there an ethical imperative at the level of street ethics? Various arguments may be made in favor of this position: egoistic,<sup>8</sup> Aristotelian, or deontological, but not utilitarian as its adherents may feel disadvantaged. One may wish to earn a good reputation so that economic benefits come his way. A person may wish to develop

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<sup>8</sup> Many will argue that egoism, or the moral justification of an action based solely on selfishness, is not a moral principle.

personal virtues that exemplify excellence of character. Perhaps one believes that God is watching.

Why then do people leave good tips when eating at restaurants in faraway places to which they will never once again visit? A more integrative approach is required than those which have already been employed; this is especially necessary in the absence of professional ethics and regulation. Social science studies using surveys must be combined with philosophic and psychological frameworks in order to advance our knowledge of how economic markets and trust interact.

## DISCUSSION

Most moral arguments concerning business decisions today rely on rule-based, deontological or religious foundations, rather than objectifying the morality of the means by which business is conducted. Even Adam Smith depended on aggregate economic outcomes that were clearly separate from the offensive intervening means of business themselves. He decried the means, but lauded the outcomes.

So far, no one has examined the nature of Utilitarianism, which is the principal basis upon which businesses operate in terms of its decision-making, as possibly being, at times, a viable and inherently moral rationale and decision tool. While Utilitarianism cannot be implemented in all cases, there are clear instances in which the means are intrinsically and immediately satisfying. This paper opens up the discussion of Utilitarianism as a viable mode of reasoning within a limited professional business context, i.e., that of Trust.

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