Review Article

LIES AND CAPITALISM

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Why We Lie:
The Evolutionary Roots of Deception and the Unconscious Mind
David Livingstone Smith
New York: St. Martin's Press, 2004; 256 pages, $24.95 h.c.,
ISBN 0-312-31039-0

The Battle for the Soul of Capitalism
John C. Bogle
New Haven, Conn.: Yale University Press, 2005; 288 pages, $25.00 h.c.,
ISBN 0-300-10990-3

Capitalism and Morality

The moral foundation of capitalism holds that the wealth of a nation is enhanced (utilitarianism) by providing individuals with the freedom and liberty to do what comes natural, pursuing their own self-interests (egoism). When alignment between individual interests and general welfare is achieved, even if unintentionally achieved, minimum paternalistic governmental oversight and intervention is needed.

Honesty and promise keeping are other essential moral values in capitalism. Managers promise to invest financial resources wisely on behalf of owners, to provide a particular product or service for customers, to meet a particular payment schedule for suppliers, and to pay a particular salary to employees. When these promises are broken or activities misrepresented, inefficiencies, lawsuits, and government regulations are the result.

Honesty is essential because, according to David Livingstone Smith's book *Why We Lie: The Evolutionary Roots of Deception and the Unconscious Mind*, lying is also natural to the human condition. We tend to lie when it is in our self-interest to do so—"of course I didn't take the last cookie"—or to reduce the suffering of others—"of course you look wonderful."

Trained in protestant theology, Adam Smith was well aware of the human proclivity to deceive and lie when he theorized about the benefits of an economy based on freedom to pursue one's self-interests. He maintained that, although there are infinite opportunities to act immorally, most of the time we choose to act morally. We do not act on all of our impulses, particularly the immoral ones. Our conscience, belief in God, concern about moral agents observing us, and ability to be reasoned with place limits on our behaviors. When these mechanisms fail, then a system of justice must punish the wrongdoer to protect the public from our most egregious immoral actions (Smith 1759/1976).

This brings us full circle. Since most business people do not want to be regulated by government, it is in their self-interest to behave morally in economic affairs. Over time, laws have been constructed and modified to reinforce this point. Corporate executives have a legally binding duty not only to maximize shareholder interests, which forces an alignment between managerial and owner interests, but also to convey honest information about the company to shareholders. As backup, a host of watchdogs, including auditors, lawyers, boards of directors, research analysts, media, and regulators, have a professional and legal duty to make sure such honest information is forthcoming.

Mutual-fund founder John Bogle's book, *The Battle for the Soul of Capitalism*, argues that this system of watchdogs failed during the 1990s, culminating in the Enron debacle. Executive misrepresentations regarding a company's financial performance were passively, and sometimes actively, reinforced by watchdogs pursuing their own economic self-interests.

Bogle's descriptively compelling insider analysis could have been strengthened by Livingstone Smith's deeper understanding of the human psyche.

The Human Propensity to Lie

Livingstone Smith's *Why We Lie* combines Charles Darwin and Sigmund Freud, situating the survival of the fittest mentality in our unconscious mind. Humans deceive each other, and themselves, because it enhances their likelihood of survival.

According to Livingstone Smith, a philosopher/evolutionary psychologist at the University of New England, we tend to lie in circumstances in which telling the truth is likely to generate a lot of psychological, physical, or economic pain. Sometimes this is a conscious decision, we choose to lie. At other times it is unconscious, our brains are simply operating on automatic pilot. Over time, conscious deceptions and lies may evolve into unconscious ones.

Deceit is normal and natural, Livingstone Smith argues, not a function of moral failure. This is true for bacteria, plants, and animals, as well as us humans. Viruses deceive our immune systems, mirror orchids impersonate the smell of female wasps to achieve pollination, and animals misrepresent where precious food is hidden. Camouflage, hiding one's real presence, is a basic survival skill in the nonhuman world. Hawks take on the appearance of turkey vultures to capture their prey. Stripe patterns and colors make the zebra nearly invisible to its predators.

As demonstrated by these examples, Livingstone Smith relies on a very broad definition of lying: "[Lying] is any form of behavior the function of which is to provide others with false information or to deprive them of true information" (14).

Among human beings, deceit and lies generate many favorable outcomes. We lie about our weight, salaries, family histories, alcohol consumption, and career aspirations in order to impress others. A Hobbesian war-of-all-against-all would break out if our prejudices, hatreds and lusts were not censored. Civil society would collapse if others knew the terrible things we sometimes think about them. We learn to hide our true feelings for the sake of future interactions and communal peace.

Lying is particularly salient in the mating process, the author argues. Men and women nonverbally deceive each other regarding their natural beauty—covering their perceived imperfections with make-up, deodorants, breast implants, and hairpieces. Lustful fantasies are suppressed when making polite conversation with a sexually attractive person. Verbally, individuals lie about their marital infidelities, and over- or under-estimate their sexual conquests based on whatever will make a bigger impression on the person they want to impress.

Livingstone Smith provides some statistics to support his analysis. Social science researchers report that, on average, people tell three lies during a ten minute conversation. In terms of those sitting in our classrooms:

- Undergraduates lie to their mothers every other conversation;
- 92 percent of college students have lied to a current or previous sexual partner;
- One in three job applicants lies when seeking employment.

Parents contribute to their child's proclivity to lie. Attributing the origin of gifts to Santa Claus and the Easter Bunny teaches children that lying is morally permissible in some circumstances. Parents tell children to express gratitude for a gift they hate, and repeat stories where deceivers, such as Trojans hiding in a wooden horse, claimed victory over their enemies. Older children and teens learn how to bluff and hide their emotions when playing poker, and how to fake an injury for the good of a sports team that has used up all of its time-outs. Some parents teach their children that lying and cheating are necessary to get ahead in life.

We claim selective persecution if caught lying or cheating because everyone seems to be doing it. After all, doesn't every driver speed, every company "cook the books" a little, every ballplayer take some performance-enhancing stimulant, every politician take advantage of public office for personal gain, every spouse cheat on his/her partner?

Being able to hide our lies, and to detect who is lying to us, is a competitive advantage in modern society. Livingstone Smith refers to this as mastering the Pinocchio effect. You want everyone's nose to grow when they lie, except your own. The most successful military strategists and poker players have perfected these skills. They closely observe an opponent's facial expressions, bodily movements, perspiration, and speech tempo to detect lies, while controlling their own.

The book's second half is less relevant to business ethicists. Livingstone Smith explores the structure of the unconscious mind and how it allows individuals to deceive themselves. The author admits that this stream of analysis is psychological conjecture and I wondered about the legal implications of such claims. If lying is an unconscious activity, then how accountable is former Enron CEO Ken Lay for lying about $7 billion in hidden losses, something he denied doing right up until his fatal heart attack?

Livingstone Smith's analysis could be strengthened with a competing values explanation. When faced with an ethical dilemma, people choose between two competing values. One can be honest and suffer the consequences, or lie and achieve more desirable consequences. Unlike the zebra, we choose our camouflage. In business during the 1990s, that camouflage took the form of accounting schemes.

Managerial Capitalism

Managers play with other people's money, notably those of investors and bankers, who demand an honest accounting. Protective layers consisting of auditors, lawyers, boards of directors, research analysts, and regulators fill the principal-agent gap to ensure that the truth is being told about company operations. According to Bogle, this system of checks and balances has significant problems. He warns that "we have come perilously close to accepting a system of dictatorship in corporate America, a system in which the power of the CEO seems virtually unfettered" (29–30).

Bogle knows that of which he speaks, having worked in the financial industry for more than half a century and served on many blue-ribbon committees. He is a staunch pro-capitalist Republican sounding the bell, not a distant wild-eyed anti-capitalist revolutionary.

The book's title, *The Battle for the Soul of Capitalism*, alludes to two versions of capitalism—owner capitalism and managerial capitalism. The latest round of business scandals, epitomized by Enron, demonstrated that managerial self-interest, not owner self-interests, lies at the heart of capitalism. Corporate executives maximize their financial interests at the expense of owners, and, with cooperation from the chief financial officers and chief accounting officers, lie about it.

The results of a 1998 *Business Week* survey cited by Bogle emphasize this reality. Conducted at the height of the dot.com mania, 67 percent of 160 CFOs attending the annual *Business Week* CFO forum reported being pressured by other executives to misrepresent corporate results. Twelve percent of the CFOs agreed to do so, while 55 percent resisted the request.

How did this situation come about? Bogle grounds his analysis in Adolph Berle and Gardiner Means's classic book from the 1930s, *The Modern Corporation and Private Property.* For centuries, the owner and manager tended to be the same person or worked side-by-side. As capitalism evolved, ownership became more dispersed and owners could not monitor closely the managers hired to represent their interests. In order to protect their jobs, managers lie or not tell the owners the whole truth when things go wrong. The size of the split between owner and managerial interests reached Grand Canyon proportions by the end of the 1900s.

One of the biggest culprits was the issuance of executive stock options, which was meant to align managerial interests more closely with those of the owners. However, this principal-agent problem solution made managers even more powerful because they can buy and sell company stock based on inside knowledge of company operations before other owners. New laws were created to prevent this from happening. But executives found creative ways around these and other laws by co-opting each watchdog, as described below.

CEOs Capture the Board of Directors

Highly qualified CEOs are a rare commodity. The position demands tremendous knowledge, experience, and political savvy. One bad decision by a CEO can ruin a previously well-run company. The board of directors oversees the CEO on behalf of the shareholders, providing strategic advice as needed. CEOs like to be in charge and either serve as Chairman of the Board, or have a very strong voice in choosing the Chairman of the Board. Board members, many of whom are CEOs or high level executives within their own companies, are often recommended with the CEO's approval. If a board member is too intrusive, a highly valued CEO will request that the board member be replaced under threat of obtaining employment elsewhere.

Executive compensation is merely one example of how the board of directors takes management's view rather than that of the stockholders they legally represent. The Board's compensation committee employs a consultant to determine CEO salary, bonuses, and benefits. Then the pursuit of financial self-interest takes over.

- Compensation Consultant Financial Self-Interest:
  - If the relatively high compensation package pleases the CEO, the consultant's contract will be renewed.
  - If the relatively high compensation package pleases individual Board members, they might employ the consultant for their own company.
- Board Member Financial Self-Interest:
  - If the relatively high compensation package pleases the CEO, the Board members who recommended the consultant will be asked to serve another term.

- o The CEO's relatively high compensation package will serve as a new benchmark for their own salary determinations.

What sorts of perverted compensation agreements are reached as a result of this system? During economic downturns, executive stock options, which had initially been issued to align managerial interests with owner interests, are recalculated to reflect lower stock prices to keep executives from changing companies. If one CEO is granted a favorable loan condition or a unique perk, then all CEOs feel entitled to similar benefits. Since compensation consultants and committees benchmark a CEOs salary to other CEOs, rather than to the average employee, salary ratios of the average CEO to that of the average employee increased from 42:1 in 1980 to 531:1 in 2004.

CEOs Capture the Auditors

If the board of directors is failing in its responsibilities to adequately represent shareholder interests, there is always the auditor. However, the auditors are hired by the Board. Going against the Board and CEO is tantamount to client suicide. Auditors seek to please, not antagonize, the CEO in hopes of contract renewal.

With the approval of their auditors, executives overestimate assets and underestimate liabilities (particularly in accounting for the value of executive stock options), so that company stock becomes more appealing to potential investors. Auditors have also been known to ignore the executive practice of hiding excess revenue in reserves, and then dipping into these reserves when revenue totals need to be propped up.

Corporate executives align auditor interests with managerial interests, rather than owner interests, through consulting contracts. In 2000, Arthur Andersen received $23 million in auditing fees and $29 million in consulting fees from Enron. KPMG earned $3.9 million in auditing fees and $62.3 million for other services from Motorola, and $23.9 million in auditing fees and $79.7 million for other services from GE. For KPMG, losing an auditing contract could mean losing three to fifteen times that amount in other services.

Is this view too cynical given the professional obligations of auditors? Bogle suggests that the recent high profile accounting scandals are just the tip of the iceberg. Under the glare of media scrutiny, more than 1,500 companies restated their previous auditor-approved earnings between 2000 and 2004, seven times the number that did so between 1990 and 1994. Auditors were either knowingly letting executives aggressively manage earnings, or managers had become experts at hiding accounting manipulations from understaffed auditing firms.

CEOs Capture the Investment Community.

Certainly the financial community would expose any lies about a company's financial performance. Companies with sound management practices can more reliably repay their loans, and financial institutions could more reliably estimate the economic value of the pension funds they manage.

In addition, financial institutions have tremendous economic power over corporations. Whereas stock owners of a particular company might be too dispersed to organize against managerial self-interests, stock ownership in general is rather concentrated. The 100 largest financial institutions own 52 percent of all stock, with private and public pension plans alone accounting for 26 percent. The mutual fund industry has grown from $2 **b**illion in 1950 to $8 **t**rillion in 2005 and represents more than 100 million shareholders.

But rather than corporations and financial institutions keeping each other in check, they protect each other. Rule number one in management, be the manager employed by a corporation or financial institution, is to never bite the hand that feeds you. CEOs and their proxies offer financial institution executives the following deal: We will borrow money from you and let you manage our pension funds so that you can meet your monthly revenue goals if you, in turn, tell everyone to buy our stock. Financial institutions offer corporate executives the following deal: We will round up investors to fund your initial public offerings (IPOs) and expansion plans and tell everyone to buy your stock if you, in turn, borrow money from us and let us manage your pension funds. Corporate and financial institution managers were playing the same tune from different sides of the same instrument.

Any financial institution that publicly exposes corporate mismanagement risks losing as a client not only the corporation being exposed, but also the companies of the CEOs on the exposed corporation's board of directors. In addition, CEOs of other companies, not wanting to be similarly exposed, will employ a competitor. As a result, brokerage firms rarely recommend publicly that investors sell a particular company's stock. During the first-quarter of 2001, with a recession well underway, the typical brokerage firm made 1,028 stock recommendations, of which only seven were sell.

Figure 1, which I created based on Bogle's analysis, diagrams how the relationship between corporations and financial institutions led to the 1990s stock market bubble. An intricate network of financial incentives and lies led to highly overvalued stock.

But wouldn't financial institutions be able to sell more loans for future corporate expansion, earn better long-term returns on their stock investments, and attract more investors if they honestly assessed corporate financial performance?

Theoretically, yes; but practically, no. Bogle maintains that financial institutions have changed their conceptual framework from long-term stock ownership to short-term stock rental. Even though low turnover funds consistently outperform high turnover funds and research analysts were not publicly issuing sell recommendations, mutual fund traders sold just about everything in the fund on a yearly basis. The annual mutual fund turnover rate (how much of the fund's stocks were sold in

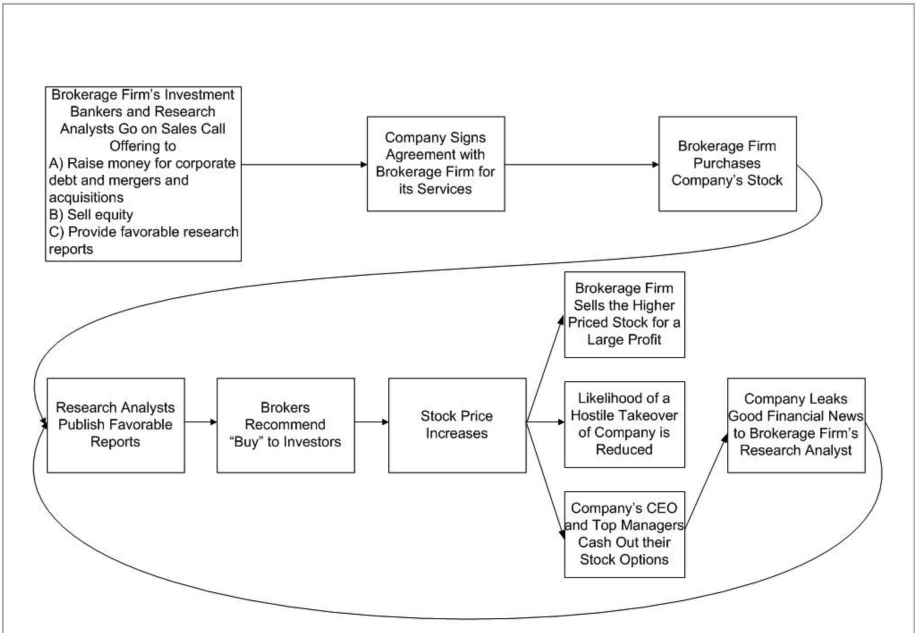

Figure 1. The Making of a Stock Market Bubble

a given year) averaged a steady 15 percent for decades and then took off during the mid-1980s, reaching more than 100 percent by the late 1990s.

Once again, just follow the money trail for an explanation why. Traders have a short-term financial incentive to sell, not hold, a stock because they earn commissions based on the number of transactions. Financial institutions focus on the company's daily stock price and bet on whether it will go up or down the next day, week, or month, instead of making investment decisions based on the discounted value of a company's future cash flow, which would be a long-term approach.

Following the money trail also helps to explain the lack of vigilance by mutual fund managers. A fund manager's compensation is based on the size of the fund's assets, not the financial returns of the fund itself. As a result, fund managers focus on short-term growth opportunities.

Fund managers also engage in their own web of lies on behalf of their favorite customers. Several major mutual fund management companies have been indicted for market timing violations (readjusting end of day sales based on whether the stock went up or down overnight), selling low quality funds that had higher commissions, selling their own funds to customers without telling them, and offering better commissions and future business to small brokerage firms that favored their fund over that of competitors. Similar to corporate executives, these fund managers pursued their financial self-interests at the expense of transparent transactions.

CEOs Capture Lawyers, Regulators, and Journalists

Lawyers, like auditors, are hired by the corporation. If they wish to keep the corporation as a client, the law firm must work in cooperation with the corporate executives, not against them.

Regulators face different pressures. Part of the regulatory failure during the 1990s came from corporate lobbyists pressuring politicians to keep regulators at bay. In addition, regulatory bodies were underfunded and understaffed.

In their cost-cutting efforts, newspapers have reduced the number of investigative journalists and are more prone to publishing corporate public relations announcements as news items. Bogle side-steps the issue of corporate control of the media and the increasing importance of advertising for newspaper survival during this period of retraction.

What should be done about the power of financial self-interests to override conscience and other moral restraint mechanisms? Bogle quotes Descartes witty summary of human nature from three-and-a-half centuries ago: "A man is incapable of comprehending any argument that interferes with his revenue." Not much has changed.

As a conservative, Bogle's first response is a call to return to tradition, despite Descartes's quote. This includes a return to the high moral principles of the Founding Fathers (minus their views on slavery), a return to an ownership society (rather than a managerial one), and a return to virtue ethics.

From a policy perspective, Bogle calls for a National Commission to implement the practical recommendations offered throughout his book. He favors separating the roles of CEO and chairman of the board, prohibiting auditors from conducting any consulting work, increasing board independence, linking CEO pay to company performance rather than the pay of other CEOs, and full disclosure accounting, among a host of other reforms.

Bogle wants the owners of the world to unite and flex their muscle by becoming more informed and exercising their voting rights. Will these changes occur? Auditor conflict of interest has been noted for about a century, yet auditors are still being paid by their client rather than from an independent body. If the pace of change remains slow, at some point the dam will burst and rapid repairs will be needed, such as Sarbanes-Oxley, to enhance market and corporate credibility.

Arthur Levitt, Bogle's friend and former SEC Chairman, covered similar ground in his exposé *Take on the Street*. Levitt surmises that if capitalism is viewed as a nine inning ballgame, we are in the top of the third inning. Livingstone Smith's analysis suggests that the relief pitcher's arsenal will have to include a psychological understanding of lying and its role in human nature.

Changing rules is good for a quick fix, but permanent fixtures require additional work on the conscience and other moral restraints. Fortifying external checks and balances must be accompanied by a fortification of internal checks and balances.

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