

January 2013

International Journal of Research in Education and Applied Sciences

Volume 2: Issue 1-(1-9)

Towards an Economics Methodology: Exploring the Philosophical Foundations of Economics

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Abstracts

Concerned with the contradicting approaches to ethics and economics in business management, the author examines the decision-making patterns of workers and managers of a construction firm. The drive behind the workers (and managers) falls roughly into three categories of incentives. The incentives coincide with the three tendencies in man which define the Plato-Aristotelian psychograph. When the tendencies are in accord with the Aristotelian *bonum rationis* (good of practical reasonableness), there is synergy in the incentives. The alignment of incentives calls for fundamental behavioral postulates which should underpin ethico-economic systems.

Keywords: incentives, virtue, economics, profit, ethics, goals, end, factors, synergy, alignment of incentives, common good, practical reason, motivation.

Introduction

A bright student who has been attending lectures both in the Faculty of Commerce and the School of Humanities and Social Sciences of a renowned university once confronted his philosophy lecturer with a startling query. “Sir”, said the whiz kid, “in the business school they tell us that the profit motive is the supreme law of success in any business enterprise: managers of joint-stock companies are supposed to maximise shareholder value. But in the School of Humanities, they deny this... Why don’t you guys make up your mind?” Indeed many a person —not only the economist— is likely to view with raised eyebrows the following assertion by a well-known Chicago economist: ‘A person is reliable if and only if it is more advantageous to him than being unreliable (...) someone is honest only if honesty, or the appearance of honesty, pays more than dishonesty.’ⁱ Virtue is fully placed at the service of owner value maximization..

Yet a score of economists with qualms on the sheer exploits of so-called ‘turbo capitalism’ have tried to save the situation by postulating the concept of *Corporate Social Responsibility* which, I feel, is like throwing a bit of holy water at an unhappy business venture in order to appease one’s conscience. In 1970 Milton Friedman published a short but extremely controversial essay in which he denied that corporate executives had any moral duty to relax the conditions of profit maximization on behalf of the wider interests of society.ⁱⁱ They are under a strict contractual duty to act for the owners of the company (the stockholders). For executives (or, indeed, owners) to use company resources to advance social goals (such as affirmative action in the workplace, social justice remuneration, and rigorous environmental constraints that exceed the requirements of positive law) would be for them to usurp the political function. Needless to say, the student was right...academia is hobbling, now on one foot, now on the other...resulting in confusion in the minds of many students.

Following on the principle of the unity of truth, economics and ethics —fields of studies both purporting to speak for man— should have a unified approach. But then the big question arises: how on earth is this to be achieved? This paper is an attempt at laying out a template for an integrated approach to ethics and economics.

The Case of Quest Works Company Limited

Quest Works is a general building contractor. Unlike well established companies in building construction and general civil engineering works, *Quest Works* is a relatively late entry —established in 2008 and made up of very young engineers and quantity surveyors. It therefore came as a surprise that they won the bid to build Strathmore Phase III and still a greater surprise that they did it in record time and for a whopping KSh 300 million (US\$3.5 million) less. A decision was made to carry out a qualitative survey of the company and the objective was to find out what drives the employees to attain such great feats and with little supervision. The interviews were conducted on the 27th and 28th of January 2012

We set out to gather an in-depth understanding of the fundamental behavioural postulates and reasons that govern such an achievement. We set out to investigate the *why* and the *how* of the decision-making patterns of these workers, not just the *what*, *where* and *when*. We worked on a small but focused sample of about 30 employees. Interview transcripts were categorised to facilitate analysis. By summarizing the prevalence of codes, discussing similarities and differences in related codes from distinct original contexts, or comparing the relationship between one or more codes, we came to a near perfect confirmation of our hypothesis.

Light and Fire

Man is not characterised in terms of rationality for nothing. He thinks all the time. He tries to figure out how to optimise his welfare. Contrary to popular belief that the majority of mankind can pass a whole lifetime without ever eliciting a single thought, man evokes reason to help him rank his preferences according to the satisfaction they afford him. He decides, for example, because he is asthmatic, to change from a well-paying job as a factory manager in a large flour firm to being a taxi operator because of the implied health hazards; or perhaps he decides to take public means of transport to his work place rather than his car because he wants to save for a mortgage he has taken out; or again he postpones a holiday abroad in preference to a local one to be able to afford fees for a child who has been accepted to a good but expensive school, etc.

By comparing and grouping the codes, we found out that the drive behind the *Dream Team* —that is how we came to call *Quest Works*— falls roughly into three categories of incentives:

- The workers seemed to be motivated to work on account of internal reasons like the enjoyment this work gave them; they thought they were engaged in something important; or they simply felt that what they were learning in the process was significant in their career development.
- Yet they also felt compelled to work fast because of factors external to them like having very understanding bosses, bonus over Christmas and job security.
- But there was something else which they could not quite lay their hands on. Some described it as ‘good working conditions’ and others as ‘respect of staff’ or simply ‘the Strathmore spirit’. This is what is referred to later as transcendental incentives...

In effect, human preferences can largely be grouped into three main domains: a desire for a sense of fair play (the realm of *iura* — relating to rights and entitlements and regulated by the virtue of justice); desire for pleasurable goods (*concupiscibilia* — these are the goods that provoke pleasant sensations and are regulated by temperance, moderation or self-control) and the excitement derived

from the pursuit of the so-called arduous goods (*irascibilia* — the realm of power incentives regulated by courage).ⁱⁱⁱ The human being tries to figure out the preferences to settle for by means of what is known as practical syllogism, a form of deductive reasoning whose structure comprises a major premise, a minor premise, and a conclusion; for example, *All humans are mortal*, the major premise; *I am a human*, the minor premise; *therefore, I am mortal*, the conclusion... One does not actually need to formally frame the argument to himself; he can do all this mentally and almost unawares...

Now in a *practical* syllogism, as opposed to a *theoretical* one (as in the above case), the goal (or rather, the *desire* for it —motivation) is the major premise, while the means employed to obtain the goal —again, the desire for them because they are judged as *choice* worthy by prudence— represent the minor premise. What then in this framework would correspond to the ‘conclusion’? *Action*, of course... It follows immediately on the choice of a set of means to employ. Two things are therefore at work in every human endeavour: *motivation* and *reason*, incentive and intelligence. All of us need something, such as the fear of punishment or the expectation of reward, to induce us to action or motivate us to effort —the proverbial ‘carrot and stick’ method is not just mere talk. Yet we also apply ourselves with some level of acumen or even shrewdness —that is to say, not blindly— to whatever venture we consider worthy of pursuit. In order to be moved to *action*, man stands in need of *fire* in his heart and *light* in the mind... But let us take a closer look at the first of the pair...

Motivation

All human beings have need of incentives, a factor that *motivates* a person to achieve a particular goal. Incentives are like the driving force behind our actions. People need positive incentives to encourage them to exercise regularly and to eat healthily. Incentives are especially important for competitive sports. People who have to train intensively and strictly regulate their diets to achieve success. Incentives vary from individual to individual, but they fall largely within the three preferential domains discussed above:

- (1) *Intrinsic incentives*^{iv}: this matches the realm of sensory incentives (*concupiscibilia*) — values are grasped in the immediate and give rise to pleasant sensations, that is to say, a person does something for the enjoyment it affords him. The enjoyment does not have to be physical. This is the case, for example, of open-source nerds who dedicate lots of time and effort to developing systems which they then upload free of charge to the internet. In the *Dream Team* case they cited environment of freedom and respect and developing skills and abilities.
- (2) *Extrinsic incentives*: here values are grasped with some sense of externality —with some interval of space and time— and originate such reactions as aggression or impulsiveness because one has to overcome obstacles to obtain them. An example is a person who will go to great lengths to help you repair a flat tyre because he knows you can employ him and thus solve his financial woes —here money is the extrinsic incentive. In the case above they coded this as ‘good pay’, ‘bonus over Christmas’ and ‘provision of clean drinking water’. Both a) and b) are, by and large, within the realm of individual good. However, in the next group of incentives a different logic is at work.
- (3) *Transcendental incentives*: this is the classical case of doing things for God, family and patria. Here the principle of ‘the good of the other’ reigns supreme as a response to aspirations deriving from the social nature of the individual and incorporating the concern for third parties.^v One transcends, goes beyond and, so to speak, rises above his own good and pursues that of the others. One rejoices with the good of others —his main incentive— and becomes sad with their misfortune. A strong sense of achievement is driven by what he sees as the good of his family, country or ‘rights’ of God. This is what the *Dream Team* employees perceived in the so-called ‘Strathmore spirit’. They realized that the general environment was permeated by this ‘otherness’...from administrative staff to lecturers; from menial workers to professors...

How does one know which one of the motives is operational or dominant at any given time? Well, by asking or by carrying out what one would call an *inter-motivational* check. For example, a Sales Manager is asked by his boss to earn extra money by going off to a promotional rally on a Sunday afternoon but declines the offer and instead takes his family out for a cricket match. Here incentive types c) and a) override type b). We will be able to appreciate later on how this perspective is the basis for a “virtue system” for lack of the right terminology.^{vi}

But one could argue that motivation —see types a) and b)— is much too self-interested a claim to be used as a paradigmatic benchmark for a value system. Yet well understood, self-interest can very well serve the social purpose. Indeed, as seen in the case above, in order to reach long-term goals, a sense of achievement must be reinforced continually by successful completion of short-term intermediate (self-interested) goals.

Love for Oneself and the Common Good

Adam Smith may have been right after all... at least to some degree: the ‘selfish’ pursuit of one’s own good could serve a social purpose. And this is putting it mildly. The material standard of living people in the West enjoy today is due to little else but the ‘selfish’ pursuit of profit. It is a point that Adam Smith emphasized in *The Wealth of Nations*: “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.” Far from being the fatal defect of capitalism, it would seem to be the very reason capitalism works.^{vii}

In effect to many, the term selfish has the meaning of ‘self-centred’, ‘self-seeking’, ‘self-interested’ or ‘egocentric’ as opposed to altruistic. Yet well understood self-interest could have the meaning of ‘pursuit for one’s own *true* good’. As long as this good is a *true* good of the individual then, far from working against the social purpose (common good), it enhances it. Adam Smith’s only ‘error’ was to have a partial and reductionist conception of the individual good — conceiving it only in materialist terms, that is to say, he was concerned mainly with the individual being better off as opposed to being better. This approach, involves a two-fold *reductio* with regard to the understanding of the true individual good: first from true self-interest to inordinate self-interest (greed) and then from inordinate self-interest to material self-interest. Needless to say, this approach impoverishes economic analysis, e.g. characterising development only in terms of GDP per capita.^{viii}

There is a world of a difference between greed (a vice) and true self-interest. In a scenario of true individual and common goods what is optimal for the consumer is optimal also for the community of persons to which he belongs (the family, the firm, the state). This is because the firm or the state is a social organization in which individuals demonstrate a willingness to join forces in the pursuit of a common goal that does not negate the private goals of the individuals themselves, which is why they join the organization in the first place (Fontrodona 2003).^{ix} The individual’s goals are inextricably bound up among themselves and with the common goal that unites the organization, etc.^x

Manifestly, whatever fosters individualism is evil, works against nature and leads to skewed incentives. Greed and covetousness, the desire to have more than our due share of the things of the earth, develop the evil traits of that selfishness which is the radical defect in fallen nature. He, who yields to selfishness and greed sets himself apart from his neighbour, enters into rivalry with those whose interests compete with his own, hardens into an unfeeling individualist and thus becomes a disruptive element in the social life of mankind —disruptive because of the misalignment of incentives (witness the recent financial crash).

Virtue and Reason

Now virtue is the main *motivational agent*.^{xi} This is because it fixes the incentives —the desires within the three great domains seen above— in the will, creating, so to speak, a second nature in us. This makes one derive some delight in pursuing virtuous goals, much in the same way as an accomplished musician —having ‘fixed’ the principles of music in his mind— enjoys playing a musical instrument... and can do it even when unawares. As they are built into the psyche (will/reason), the *desire for goals* —the incentives— then act as the major premise of practical discourse and hence facilitate a correct decision-making process. When we say reason, we mean practical reason and reason in its perfection of prudence, the chariot driver of all virtue. The good ‘motives’ —incentives— fixed by virtue in the will rectify prudential discourse by providing it with the correct compass reading, the correct premise which is a pre-requisite for a good conclusion (action in the moral order). Prudence then proceeds to determine the golden mean for virtue to choose —the right set of means for a given pursuit. The two (moral virtue and prudence) are then, as it were, in a symbiotic relationship: [moral] virtue —the rational desire for the correct mix of concupiscible, irascible and the just good —rectifies [prudential] decision while prudence facilitates [virtuous] choice by indicating the golden mean. This is what makes for the correct alignment of incentives in the activities of reasonable individuals —a Pareto optimality of sorts. It provides for synergy in our desires and hence a unique focus of approach to issues.

It is important to emphasize that incentives are, so to speak, fixed in the psyche by acquiring virtues. Although concerned with choice, virtue produces its effect in the realm of goals while economic factors are just that, ‘factors’ in this whole scheme of things. “The ultimate ends of the activities of reasonable beings are never economic. Strictly speaking, there is no ‘economic motive’ but only economic factors conditioning our striving for other ends. What in ordinary language is misleadingly called the ‘economic motive’ means merely the desire for general opportunity, the desire for power to achieve unspecified ends. If we strive for money it is because it offers us the widest choice in enjoying the fruits of our efforts”.^{xii}

Every individual has to work at his own ‘virtue system’ because the incentives which are at the root of the major premise of a practical discourse cannot be transmitted from individual to individual. Each individual has to work them personally into his psyche. Centrally planned economies therefore make very little sense. There is not a single moment when a state or government can claim to know what is optimal for any of its citizens. The role of the state is to provide an enabling environment and act as arbiter. As for the Human Resource departments of firms, one hopes that their main focus is to scout for individual attitude, that is to say, a virtue system —albeit a budding one and hence only a potential of virtue—which ensures a correct alignment of incentives, and then train for skills. This was the happy experience of *Quest Works* management. They literally went out and ‘poached’, not the most skilful workers, but those who had ‘good attitudes’. On seeing the pace and intensity of work at the site a consultant who was used to seeing ‘slave drivers’ wondered aloud: “where are the supervisors?” One really hopes that more surveys can be conducted in this area in the near future.

Conclusion

This essay has highlighted the central idea that, in the final analysis, market outcomes, socio-political issues and government actions should be judged in terms of valuable *human ends* (the motivational aspect). Now, in practical life the *ends* (not the ends in themselves, but the *desire* for the end —the incentives) are the major premise, the principles or point of departure upon which all the conclusions depend — or, if you wish, the fundamental behavioural postulates on which a value system rests.^{xiii} An error in the premise leads to wrong conclusions. Wrong incentives lead to asymmetrical value systems. Stephen Hawking may have had this in mind when he said, ‘No matter how powerful a

computer you have, if you put lousy data in, you will get lousy predictions out.^{xiv} Now, virtue — in its intentional aspect — consolidates the right set of incentives thus grounding the premises of prudential syllogism. The absence of these *true* fundamental postulates would jeopardise the very quest for a balanced value system and disrupt the harmonious operations of a family, a firm or a state.

There is, therefore, a need to consolidate the premises from which our value system takes its departure. This can only be done from a deeper understanding of the human person. We propose to summarise the behavioural postulates into four fundamental principles, namely:^{xv}

- *The principle of individual liberty* (and its attendant responsibility)^{xvi} that translates into creating *space* for individual agency in the economy, in the social realm and in politics. Policy makers should allow for some slack in the social, business and political environment e.g. liberalised regimes, looser monetary and fiscal policies, more flexible labour laws, flexible educational policies, a level playing-ground, etc. Other than this, states should avoid the temptation of trying to ‘plan progress’ for their citizens. “The guiding principle, that a policy of freedom for the individual is the only truly progressive policy, remains as true today as it was in the nineteenth century.”^{xvii} Fill the world with good people and then set them free...
- *The principle of optimality* (or alignment of the incentives) ‘operationalised’ in the choice of the right mix of pleasurable and arduous goods. (Remember that what is optimal in whichever domain of consumer behaviour facilitates optimality both in the other domains and for the person.)^{xviii} A choice of too much (or too little) of a commodity may lead to hazardous consequences, as in the case of remunerating CEOs (chief executives) through stock derivatives like options.^{xix} This may lead to their overstating the firm’s financial position. Similarly, an executive who is averse to taking risks may not do well for his firm, just as the one who takes too much risk may lead his firm into serious jeopardy (witness Barings Bank).^{xx}
- *The principle of justice* by means of which rights and entitlements are guaranteed. A person’s entitlement set is a way of characterising his or her overall command over things —thus ensuring an incentive-based agency— taking note of all relevant rights and obligations. Whereas rights are generally characterised as relationships that hold between distinct agents (e.g. between one person and another person, or between a person and a state), a person’s entitlements are the totality of things he can have by virtue of his rights. Privations tend to arise from people not being entitled in the prevailing legal system of institutional rights, say, to food, water or education —without entitlement, there is no incentive to work.
- *The principle of rationality* (read prudence): this ensures that decisions are *optimal* not only according to self-interested pursuit of the material well-being but according to the total well-being of the human person (relating to his or her personal physical and mental well-being) and the agency aspect (relating to the goals that a person values, desires and has reason to pursue).

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Acknowledgments

It is a pleasant duty, for authors, to end by expressing their gratitude to their main collaborators. In no case would I have forgotten to do it. Yet my indebtedness to Strathmore University has far deeper roots than the occasion of carrying out a survey through the School of Humanities and Social Sciences. Here in Strathmore, nearly forty years ago, I found my vocation. The rest is history... But my gratitude also goes to the friends and colleagues who kindly helped me through a difficult task. To Raul Figueroa and Luke Ombati of *Quest Works Limited* for their cooperation and to Sandra Martha Wairimu Mututi and Thomas Muigua Raji who engaged the students of the School of Finance and Applied Economics in carrying out the survey. I beg to renew today the expression of my lasting gratitude.

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ⁱ Lester G. TELSER, 'A Theory of Self-Enforcing Agreements', *Journal of Business* 53 (1980), 27-44; cited in Robert H. FRANK, *Passions Within Reason: The Strategic Role of the Emotions*, New York: W. W. Norton, 1988, 75.

ⁱⁱ Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine* (1 September 1970). Reprinted in *Ethical Theory and Business*, ed. Tom L. Beauchamp and Norman E. Bowie (Englewood Cliffs, N.J.: Prentice-Hall, 1993).

ⁱⁱⁱ David Lutz and Paul Mimbi, ed., *Shareholder Value and the Common Good* (Nairobi: Strathmore University Press, 2004), 194

^{iv} Douglas MCGREGOR introduced the difference between extrinsic and intrinsic factors [*Leadership and Motivation* (Cambridge, Mass.:The MIT Press, 1966), 259 ff.]. His contribution, developed further by Juan Antonio Pérez López and Minerva Ullate Fabo, is cited in David Lutz and Paul Mimbi, ed., *Shareholder Value and the Common Good* (Nairobi: Strathmore University Press, 2004), 156.

^v Cf. Minerva Ullate Fabo, "The Objective of Maximum Profit, or the Wishful Thinking of a 'Hyper-Monetary' Economy" in David Lutz and Paul Mimbi, ed., *Shareholder Value and the Common Good* (Nairobi: Strathmore University Press, 2004), 156.

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- vi “We have seen that agreement on that complete ethical code, that all-comprehensive system of values which is implicit in an economic plan, does not exist in a free society but would have to be created”, F. A. Hayek, *Road to Serfdom*, (New York: Routledge, 1944), 159-161.
- vii *The Economist*, “Capitalism and Ethics”, *The Good Company* Online; available from <http://www.economist.com/node/3577141> [accessed 31 March 2012]
- viii Emma Oketch, Luis Franceschi and Paul Mimbi, ed., *Politics and the Common Good* (Nairobi: Strathmore University Press, 2005). 1ff.
- ix David Lutz and Paul Mimbi, ed., *Shareholder Value and the Common Good* (Nairobi: Strathmore University Press, 2004), 47ff
- x It is worth noting that profits (a material good) are a guide (by no means a perfect one, but a guide nonetheless) to the value that companies create for society. This is so because quantity, an all pervasive and fundamental accident of the physical universe, is a visible and measurable expression of the non-tangible aspects of reality.
- xi Aristotle’s definition of moral virtue as a capacity of discernment (*habitus electivus*) is pertinent ... “Moral virtue is a habit concerned with choice, lying in a mean, i.e. the mean relatively to us, this being determined by a rational principle, i.e. by that principle by which the man of prudence would determine it” (Cf. ARISTOTLE, *Nicomachean Ethics*, II, 6, 1106 b 36 – 1107 a 2.
- xii Hayek, F. A., *Road to Serfdom*, (New York: Routledge, 1944), 92-93.
- xiii ‘The propositions of economic theory, like all scientific theory, are obviously deductions from a series of postulates’ (Lionel ROBBINS, *An Essay on the Nature and Significance of Economic Science*, 2nd Ed., London: Macmillan, 1935; cited in HAUSMAN, *The Philosophy of Economics*, p. 119).
- xiv Stephen HAWKING, ‘Does God Play Dice?’ *Public Lectures*, at <http://hawking.org.uk/text/public/dice.html> [accessed 4 May 2000]
- xv In order to reform our social fabric, institutions are necessary but not sufficient. True reforms involve two things: a ‘hardware’, so to speak, and a ‘software’. The former is about the institutions themselves which are guaranteed by a good constitution which by and large should comprise the traditional four chapters: the Bill of Rights, the Executive, Legislature and the Judiciary... The ‘software’ in turn should take account of three issues: a) *education* (formation) in freedom and responsibility — human (virtues), professional, cultural, and why not, theological formation; b) *conviction* that true self-interest (particular good) serves the social purpose (common good); c) *brokenness* of man’s nature...this is the hardest part because it stands in need of divine intervention...
- xvi “Outside the sphere of *individual* responsibility (emphasis mine) there is neither goodness nor badness, neither opportunity for moral merit nor the chance of proving one’s conviction by sacrificing one’s desires to what one thinks right. Only where we ourselves are responsible for our own interests and are free to sacrifice them, has our decision moral value.” Hayek, F. A., *Road to Serfdom*, (New York: Routledge, 1944), 216. This principle concurs with that of *subsidiarity*, the idea that a central authority should have subsidiary function performing only those tasks which cannot be performed effectively at a more immediate or local level.
- xvii Hayek, F. A., *Road to Serfdom*, (New York: Routledge, 1944), 246.
- xviii The good of practical reasonableness (*bonum rationis* or the good of reason) is the object of Aristotelian *synderesis*: the simultaneously just, courageous and temperate. This is a good holistically considered, not merely a Utilitarian good. Consider the case of an overweight man who is on a diet. By choosing to eat a given amount of an unpalatable meal, he is making a delicate balance between his needs in terms of the quantity of food, the un-palatability of the food and the sense of duty he owes his dependants in terms of a long life of service.

- ^{xix} A stock option (or a share option in England) is the right to buy some of a company's equity at an agreed price, after an agreed length of time. (Not unexpectedly the stock market inflates the values of these options.) The spread of share options could distort the economy, contributing to a temporary overvaluation of equities, encouraging short-sighted managerial decisions and storing up problems for the companies in the future (cf. *The Economist*, 7 August 1999, p. 11).
- ^{xx} The Nick Leeson and Barings Bank case is a classic example. The imprudence of a 28-year-old trader on the Singapore Monetary Exchange (SIMEX) and the greed and stupidity of a 233-year-old bank combined to destroy an investment empire and in the process stunned the world. (Leeson had been appointed manager of a new operation in futures markets on the SIMEX and was soon making millions for Barings by betting on the future direction of the Nikkei Index. In his autobiography, *Rogue Trader*, Leeson said the ethos at Barings was simple: 'We were all driven to make profits, profits, and more profits I was the rising star.' Cf. <http://www.bbc.co.uk/crime/caseclosed/nickleeson.shtml> [accessed 4 May 2000].)