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Compass and dead reckoning: the dynamic implications of ISCT

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Abstract:

The dynamic relationship between hypernorms and microsocial contracts can explain novel, evolutionary changes in economic life. The conceptual machinery of Integrative Social Contracts Theory (ISCT) can be expanded in order to understand dynamic moments in the evolution in economic life such as the economic crisis of 2008-09. When a transition of the ethical interpretation of economic events occurs over time, it can be understood as a transition from the opaqueness of hypernorms to the relative clarity of microsocial contracts. This phenomenon deserves more study than it has received, and entails, at a minimum, the application of an enhanced, more dynamic interpretation of ISCT.

Compass and dead reckoning: the dynamic implications of ISCT

Tom Dunfee and I enjoyed debating issues with significance for ISCT. One of our favorites was whether hypernorms could evolve over time. He argued that they could; I disagreed. We never resolved the issue. But we always agreed that that moral knowledge evolves over time, especially in the form of changing microsocial contracts.

In this paper I want to extend the thread of that concept. I want to show how the interplay of hypernorms and microsocial contracts can explain novel, evolutionary changes in economic life. The conceptual machinery of Integrative Social Contracts Theory (ISCT) (Donaldson and Dunfee) can be expanded in order to understand dynamic moments in the evolution in economic life such as the economic crisis of 2008-09. When a transition of the ethical interpretation of economic events by market participants occurs over time, it can be understood as a transition from the opaqueness of hypernorms to the relative clarity of microsocial contracts. This phenomenon deserves more study than it has received, and entails, at a minimum, the application of an enhanced, more dynamic interpretation of ISCT.

First, it is worth reminding ourselves of ISCT's basic conceptual machinery. ISCT is a theory founded upon two kinds of contract, namely, "macrosocial" and "microsocial." The former, the macrosocial, is a hypothetical agreement about a broad normative framework designed to guide all economic arrangements; the latter are norms created by "economic communities," i.e., self-determined groups who carry on economic activity, that reflect agreement attitudes and behaviors of most members of a community. Microsocial contracts make up the ethical rules of the economic game from the vantage point of communities of players. They represent a general consensus among community members about economic rules

and propriety, and may or may not be reflected in black-letter or formal rules, such as laws or codes of conduct. Important for our purposes is that microsocial contracts can include both unwritten agreements and agreed-upon procedures that have grown slowly within an industry or other economic unit to handle a specific problem. (Donaldson and Dunfee Chapters 2-4)

Clues to a dynamic interpretation of ISCT can be discovered in non-economic contexts. Modern medicine stands out as an example. It is worth reflecting on the way in which modern medicine exhibits a recurring pattern over time: new medical technologies create ethical confusion, only later for the confusion to be abated as society develops new ethical precepts and practices. Consider: during the twentieth century, medical science became increasingly adept at extending human life beyond traditional limits. The invention of feeding tubes, respirators, bottled oxygen, and kidney dialysis extended the lives of patients who before would have died quickly. This new technology meant not only that patients lived longer, but sometimes did so with many normal abilities impaired or destroyed. Old practices thus confronted new realities. A patient with a terminal illness who had already lost the ability to talk, to focus visually, and to chew food could now be kept alive with an invasive respirator and feeding tube. But this same patient might have abhorred the prospect of such a fate, and may even have earlier shared his abhorrence with friends and family. Hence family members, patients and doctors found themselves facing the implications of new technology *de novo*; as they first groped their way through these new challenges, they understandably resorted to broad, normative principles about managing medical care such as found in the *Hippocratic Oath (Hippocrates)*. They cited hypernorms such as the "benefit and do no harm" precept from the *Hippocratic Oath*: i.e., "I will follow that system of regimen which, according to my ability and judgment, I consider for the benefit of my patients, and abstain from whatever is deleterious and mischievous."(Records)

Other broad moral norms such as the right of family members to choose for other members mentally impaired, the norm of individual autonomy, and the sanctity of human life were also invoked, sometimes with contradictory implications.

By the close of the Twentieth Century, however, more specific principles and practices eclipsed generic ones. Debates still raged, but they did so over narrower and narrower matters. It is worth asking what precisely happened in this evolution of moral understanding about death and dying. The answer is that detailed processes and agreements came to be substituted for generic hypernorms. Chief among them was the right of people to adopt *ex ante* "living wills," documents that specified more precisely what an individual wanted at the end of his life. What is more, the institutionalization of hospital ethics committees, new, agreed-upon definitions of "death" that depended more on brain activity and less on physical respiration, and finally systems of "code" designations for critically ill patients played important roles. Even the *Hippocratic Oath* was revised. In place of the simple "benefit and don't harm" provision, modern versions tend to underscore the complexity of the dying process. One widely-used and more modern version of the Hippocratic Oath reads: "Most especially must I [the physician] tread with care in matters of life and death. If it is given me to save a life, all thanks. But it may also be within my power to take a life; this awesome responsibility must be faced with great humbleness and awareness of my own frailty." (Hippocrates)

This ethical evolution spawned by the advent of new technology has occurred frequently in medicine and biology. Inventions such as in vitro fertilization, animal cloning, and most recently the use of stem cells in research, all provoked moral confusion at the outset, only later to give way to the development of specific principles and practices. We confront novelty at first with the only conceptual tools that we possess, ones that are shaped to fit almost any dilemma.

These are hypernorms. Later, we reach agreements about specifics. These are microsocial contracts.

The pattern of confronting technological novelty with hypernorms, then later designing and implementing microsocial contracts, extends beyond bioethics. Consider another example: the ethics of war. The development of submarine warfare, aerial bombing, and weapons of mass destruction all provoked moral confusion at their inception. When poison gas was first used widely in WWI, few limits could be either imagined or specified. The debate at the time centered around traditional hypernorms from the "*Jus ad Bellum*" or "Just War" theory developed in the Middle Ages. Again, we confronted the challenge at first with the only tools that were handy, i.e., hypernorms. Enhancing ethical precision takes time. Such precision in the instance of poison gas awaited the the development of the Geneva Protocol of 1925 and the subsequent Chemical Weapons Convention of 1993, agreements in which poison gas is both banned in certain instances and also regulated.

Some technological inventions take even longer. We still lack significant microsocial contracts for regulating aerial bombing. The hypernorm principle from the *Jus ad Bellum* tradition declaring "noncombatant immunity" is now employed by different sides both to justify and to condemn forms of aerial attack. Consider the 2009 conflict between Gaza and Israel. Israel argued that in contrast to Hamas, its actions respected the principle of non-combatant immunity. It used "smart" munitions and always chose military targets, in contrast to Hamas, who used homemade rockets incapable of distinguishing military targets from non-combatants. Ironically, however, Hamas used the *same* generic principle of non-combatant immunity to condemn Israel. When Israel used aerial bombing and rocket strikes, Hamas noted, Israel clearly foresaw that many non-combatants would be killed. By January 30 of 2009, Gaza health

officials said that the overall Palestinian death toll had passed 1,200, with women and children making up about 40 percent of the dead. The Israeli death toll on the same day reached 13, including ten soldiers and three civilians. So who, Gazan officials asked, was respecting the principle of non-combatant immunity? Until participants in wars move beyond the generic hypernorms such as "non-combatant immunity" to more precise agreements and principles, i.e., some form of microsocial contracts, there can be no further clarification of the issue at hand.

Ethical clarity in the wake of technological change thus involves a transition from general to specific, from hypernorms to microsocial contracts. The analogues in economic life are easy to spot:

Example #1: Highly-leveraged derivatives:

Banks in the US and UK, such as Bankers Trust Co. and Goldman Sachs, pioneered in the late 1980s a new, powerful financial tool called "derivatives." So-named because they "derive" their value from an underlying asset such as currency, bonds, or commodities, derivatives are often useful in managing risk. Derivatives purchased by a gold mining company can soften the company's exposure to wildly fluctuating gold prices. In turn the mining company can focus on what it knows how to do best, i.e., mine gold efficiently, instead of subordinating operations to predictions of future swings in the price of gold.

Derivatives are not *biological* technology such as birth control pills or in vitro fertilization, yet may be seen as a form of *economic* technology. They are often structured in complex ways that make the extent of the risks and the rewards opaque to all but the most sophisticated financial minds.

While derivatives manage risk, they can also enhance it. Because any derivative is essentially a bet about the future, derivative products can become bets gone bad. The problem is exacerbated when the bets are "highly-leveraged" and also when used not to manage risk but to earn money for a company on the side, i.e., outside its normal operations. In the late 1980s and early 1990s, a few corporate treasurers and even the public treasurer of Orange County, California, Robert Citron, made bets with derivatives that lost their organizations hundreds of millions of dollars. Orange County alone lost more than $1.6 billion and was forced to declare bankruptcy. (Pollack) Gibson Greeting Cards, Inc., and Proctor & Gamble, Inc., both sued Bankers Trust Company after derivatives the companies had purchased from Bankers Trust lost tens of millions of dollars in the early 1990s. The companies claimed that they had not properly been informed of the risk associated with the derivatives sold by Bankers Trust. Even the slightest swing in, say, bond price, can turn a highly-leveraged derivative into what Warren Buffett famously called a "financial weapon of mass destruction." (Buffett 15)

As banks and their customers grappled with the fallout from this new, financial technology, they could be seen following the same temporal pattern seen in other spheres: a move from hypernorms to microsocial contracts. They first attempted to apply the time-tested principles of investor protection: namely, "suitability" and "appropriateness." A risky stock sold to a pensioner on a fixed income might fail both precepts, and regulations in the security industry commonly invoked such concepts. But the new instruments were also starkly different from ordinary brokerage products. They were typically sold to very sophisticated counterparties (corporate treasurers usually possessed advanced degrees in finance), and information about what was or was not "suitable" for a company was so strongly linked to the company's closely-held business strategy that third parties, including banks, were in a poor position to evaluate it.

During this period, the word “derivative” acquired a distinctly immoral connotation for some. A joke circulating at the time had it that the word, “derivative,” and the word, “devil,” both begin with the same letter.

As time passed, however, new procedures and concepts began to infiltrate the derivatives business. Even today the sale of derivatives is not heavily regulated by the government, but companies and customers have devised new techniques to come to grips with the risks derivatives pose. So –called “sensitivity analysis,” mathematical techniques that attempt to reflect and make transparent the underlying risks of derivatives have become increasingly sophisticated and accurate, leading to greater confidence on both sides of the transaction. Internal policies at banks and bank customer companies have also evolved to limit risk. Today, banks reward employees who sell derivatives in more complex ways than simply “marking-to-market” the net present value of the derivative; and bank customers utilize norms that restrict treasurers from making hidden bets that will damage the company. Derivatives can still be “weapons of financial mass destruction” but they do not evoke the same black and white moral controversies of the 1990s. Our ethical treatment of derivatives has become increasingly sophisticated. It is noteworthy that the microsocial contracts that now surround them are mostly informal, in contrast to government statutes or regulatory norms.

Example #2: Securitization in the Economic Crisis of 2008.

The economic crisis unfolding at the time of this writing, 2009, bears all the earmarks of earlier clashes of new technology with general norms. This time the new technology involves among other things the so-called “securitization” of debt, a novel, ingenious financial technique

to allow routine financial obligations such as mortgages, credit card debt, and auto debt, to be repackaged into bulk units that are then sold as securities in a broader market.

This new form of financial alchemy took pools of mortgages or credit-card loans and bundled them for sale to investors around the world. The bundle was sliced into different tranches, each of which carried a different level of creditworthiness. The top tranches were the first to be paid, and thus they held higher ratings than the lower ones. But the bundled products were notoriously hard to value, and this was true even before the limited markets for the products nearly vanished in 2008. Methods of valuation for these highly sophisticated securities varied depending on the firm; there was no uniformity and hence no agreed-upon price. To make matters worse, these securitized products sold only rarely, making their market value opaque. (Nocera)

To illustrate the complexity and opaqueness of the financial technology of securitization, consider a single example discussed by Bajaj and Labaton: a security that in 2009 was trading at 38 cents on the dollar. The bond was backed by 9,000 second mortgages from borrowers who put down little or no money to buy their homes. Nearly a quarter of the loans were delinquent, and losses on the defaulted mortgages were averaging 40 percent. But, remarkably, this same security once had a top rating, i.e., triple-A.(Bajaj and Labaton) Of course we all know now that Moody's and Standard & Poor's botched their analyses of such securitized mortgages, but few if anyone could have anticipated that the price of a security backed by home mortgages could fall sixty percent within a year or two. (Lewis and Einhorn)

As economies around the world reeled in reaction to the financial explosions set off by the securitization whirlwind, moral criticism followed traditional, hypernorm-guided patterns.

Simple greed caused the problem, pundits and editorialists shouted. And simple lack of self-control by home buyers who stretched beyond their means to commit to mortgages aggravated the bankers' greed.

But while no doubt greed played a role in the crisis, it has been a powerful influence in business in every period in every age. There is little new about greed. The first decade of the twenty-first century may have witnessed a sudden spike of greed (although it is hard to know how such a spike could be proven), but it also saw the age-old motive acquire a remarkable new tool: the securitized investment loan.

No one can reliably predict the outcome of the 2008 economic crisis, but the manner in which society's ethical attitudes towards securitized loans evolve is likely to be similar to the way its attitudes towards ethical issues sparked by other novel technology. In short, we will over time substitute more tailored norms and practices in place of simple moral dictums such as "avoid greed" and "don't take out loans you can't pay off." Already in 2009 a series of suggestions for new norms and practices had been made inside and outside the banking industry. In addition to higher capital requirements for banks and more direct regulation, they included industry norms requiring that issuing banks maintain a significant position, say, twenty percent, of the securitized products they market to others. Still more, Treasury Secretary Bernanke and others pushed for a new "awareness" among banking executives about the quality of loans and the due diligence that preceded loans, including those made to hedge funds.(Bernanke) One can predict that once more hypernorms will give way over time to microsocial contracts tailored to the precise ethical challenges of securitized loans.

Interpreting ISCT dynamically in this manner is a reflection of how specific problems require specific approaches, and that until we discover them we use general approaches. Consider the analogy of flying. Sometimes a pilot can know by GPS or visual memory his exact location and where he must guide his plane. Other times he must proceed by compass and dead reckoning, i.e., the process of estimating ones current position by utilizing a previously known position and then advancing that position based on known speed, elapsed time, and course. When new economic technology, whether highly-leveraged derivatives, SIVs (special investment vehicles), off-book entities such as the infamous "raptors" used by Enron, credit default swaps, or CDOs (Collateralized Debt Obligations), is introduced we first resort in the only way possible: to our moral compass and a process of dead reckoning. Later, we develop more precise means of guidance.

Interpreting ISCT dynamically in this manner is compatible with even conflicting views about the way in which moral knowledge is said to evolve. One view is that morality is silent with regard to new situations such that new norms need to be developed in order to provide guidance. Another possibility is that persons gain a better understanding of what morality requires in situations not previously encountered. The former is like a process of *construction*; the latter is more like a process of *discovery*. We do not need to decide whether the development of microsocial contracts that solve new economic challenges involve, at least partly, a deepening of our understanding of hypernorms, i.e., a process of *discovery* in order to note that the evolution of the process creates a solution set of understandings, rules, and procedures, i.e., microsocial contracts.[1]

[1] I am indebted to my colleague, Nien-he Hsieh, for drawing my attention to this issue.

To conclude, we have seen how issues of ISCT can be understood in a dynamic and not merely static context, a context that sheds light on the way in which novel innovations in economic activity challenge existing ethical conceptions and, in turn, force the search for new interpretations. What is becoming increasingly obvious, and merits more attention, is how new economic technology spawns a dynamic pattern of hypernorm interpretation followed by the creation of new microsocial contracts. When such a transition in ethical interpretation occurs over time, it can be understood as a transition from the opaqueness of hypernorms to the relative clarity of microsocial contracts. It is interesting to speculate about whether patterns can be discerned for successful vs. unsuccessful evolution to microsocial norms.

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