

Applying Rawls' Theory of Justice To the Practice of Finance

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Do what is profitable. This monolithic commandment of finance has undermined the success and credibility of the financial industry. This article proposes ethics for finance founded on the philosophical contributions of John Rawls. The concepts of the social contract, social cooperation, and fair play provide a democratic and secular framework for ethical behavior.

The Problem

Recent public indignation against financiers indicates a sense that while obeying the laws, these professionals still behaved unethically. At the same time, financial professionals appear uncomfortable defining and teaching ethical behavior in finance because of the explicit assumption that profit maximization is the ethic. This ethic has been accepted in finance and beyond because of the dominance of free and efficient market ideology in the Anglo-Saxon world over the past quarter of a century.

In the larger, contemporary cultural context, society largely takes a relativistic and subjective approach to morality. Yet, the financial crisis of 2008 demonstrates that we need ethical principles that are generally acceptable to guide behavior when regulations and regulators cannot monitor every transaction.

One Answer: A Rawlsian Approach to Finance Ethics

The answer to these two conflicting considerations lies in Rawls' Social Contract theory and proposed duty of fair play.¹ The duty of fair play arises when members of society agree to fair practices or rules to govern behavior; the duty is

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¹ As found in: 223-51; Rawls, John. "Justice as Fairness." *The Philosophical Review*, Vol. 67, No. 2 (Apr. 1958): 164-194. Rawls, John. "Justice as Fairness: Political not Metaphysical." *Philosophy and Public Affairs*, Vol. 14, No. 3 (Summer, 1985):

good-faith adherence to those rules. This obligation is based upon the social contract. Therefore, to understand the duty of fair play and how it fills the ethical vacuum in the world of finance, we must examine two important concepts.

The first concept is how a rule of fairness or ethical behavior can be binding upon members of society. This concept is most important when the rules are not enforced broadly enough or when a person discovers a lucrative loophole in the law, which she would like to exploit. Rawls claims persons have a duty to act fairly anyway, based on the social contract in the society into which they have entered.

The second concept is Rawls' proposed definition of fairness, which provides a method by which persons of any religious or moral background can agree upon basic practices and principles for guiding behavior.² We will see that Rawls leads us to expectations of ethical behavior to which all individuals in finance can abide, without running afoul of contemporary relativistic moralities. By the end of this discussion, readers should have an understanding of Rawls' contribution to the idea of fair play and how this contribution can provide an ethics for finance.

State of Nature

How does the social contract bind actors to act ethically? The answer starts with a discussion of Thomas Hobbes' state of nature. In finance, as elsewhere in our professional and private lives, individuals are repeatedly faced with choices requiring a distinction between one's own self-interest and the interests of others. A person then has two choices about how to behave. She can act selfishly, refusing to weigh the impact of her actions on others. Alternatively, she can act benevolently, giving due weight to the interests of other people. If she decides to act selfishly, she might be doing so in a society where everyone else is acting benevolently. As a result, she would receive the benefits of everyone else's benevolence without having to reciprocate. However, if she decides it is therefore most beneficial to act selfishly, it is possible that everyone else in society will come to the same conclusion.³ Society would then be filled with selfish actors, struggling against each other's demands. This is the equivalent to Hobbes' "state of nature".⁴

Hobbes painted a dark picture of the state of nature. Everyone needs the same basic things to survive – food, clothing and shelter. These things do not

² "Justice as Fairness: Political not Metaphysical," 225

³ Rachels, Stuart. *The Elements of Moral Philosophy*. New York. McGraw Hill, 2010. pp. 84-87.

⁴ *Ibid.*

exist in abundance. Individuals in the state of nature will have to compete for these necessities. However, no individual will be strong enough to secure whatever she wants against all challenges. The strongest individual is simply not strong enough to challenge the collective of many. In this struggle, people care most about themselves and fight when their interests conflict with one another. According to Hobbes, the basis of society is a need to avoid this state of existence. Being a member of society allows one to attain the necessities of life while avoiding constant battle with competitors for those resources. It also means living with the burdens and restrictions necessary to make society function.

This point brings us back to the other option facing an individual deciding how best to act; she can choose to act benevolently. If she does so, perhaps selfish actors will exploit her benevolence by accepting its benefits without reciprocating. In fact, if any number of people decides to act benevolently, there might always be individuals who choose to act selfishly and free ride on the benevolence of others. This is a reason laws and regulations are essential: they make space for benevolent behavior by punishing selfish behavior.

These options form the basis of the Hobbes' social contract theory. Hobbes theorized that individuals decide to live together and cooperate in order to better provide for everyone's needs. They also agree on certain rules for everyone to follow, and upon ways to enforce these rules. It is this agreement that is called the social contract. The social contract underlies not just our obligation to act with benevolence towards others in general, but also our obligation to follow the rules designed to ensure unselfish behavior. In the world of finance, this idea of a social contract provides the foundation of legitimacy for the rules governing individuals, institutions, and their transactions. When the law is enforced and a person is sitting before a court of law, there is little debate about whether these persons⁵ are bound to obey the laws governing their transactions. Rather, the dilemma arises where weak enforcement or legal loopholes that leave room for exploitative, selfish behavior.

What Social Contract?

This problem is a cause of concern and debate because one of the principle criticisms of the concept of a social contract is that in actuality there is no such contract, and therefore people are not bound to follow any principles.⁶ This

⁵ Like Rawls, I will use the term "persons" broadly, to include both people and associations (like financial institutions). (see *Justice as Fairness: Political not Metaphysical*)

⁶ Rachels, James, and Stuart Rachels. *The Elements of Moral Philosophy: James Rachels; Sixth Ed. by Stuart Rachels*. New York: McGraw-Hill Higher Education, 2010. 93-94. Print.

argument proposes that where enforcement and punishment end, absolute freedom to pursue profit ensues. In terms of the social contract, it is argued that people generally do not choose to enter a particular society – they are born into one. How can one argue that they have willingly entered into a contract? Realistically, most people are unable to leave the society of their birth for one they prefer. In addition, there is no formal contract among members of society; we do not gather together to make agreements about how society should function and we have signed no document binding us to our commitments. Ultimately, then, the “contract” is hypothetical and cannot bind anyone.

This Social Contract

This argument indicates a misunderstanding of what constitutes a contract. Under the law of most U.S. states, “a contract may be made in any manner sufficient to show agreement, including offer and acceptance, [and] *conduct by both parties which recognizes the existence of a contract.*”⁷ When parties accept the benefits and behave according to the obligations of ordered society, we can say they are engaging in conduct, which recognizes the existence of a contract. Some persons do not behave in this way. In such cases, their behavior violates the contract. Thus, the rest of society is no longer bound by the contract and is free to administer punishment for the malfeasance.⁸ Because a contract may exist “even if the moment of its making is undetermined,”⁹ it is not dispositive that there is no historical moment in which society can pinpoint the formation of the contract. The conceptually weakest objection to social contract theory is there exists no physical contract. The requirement that a contract be in writing is a legal creation that, in the U.S., applies only to contracts for sales of goods above a certain statutorily set value.¹⁰ Contracts for less value can be formed without a written instrument, illustrating that contract formation is really fundamentally independent from the writing requirement. *The bottom line is that because a society behaves in accordance with a social contract and persons conduct themselves in ways that recognize the existence of that contract, there is, in reality, a contract.*

When applying social contract theory to financial institutions, this argument is even more persuasive. A financial institution is not born in the same

⁷ Uniform Commercial Code, §2-204(1). Available at <http://www.law.cornell.edu/ucc/2/>. This code describes the formation of a contract for the sale of goods; not a social contract, of course. Nonetheless, the code does illustrate the basics of contract formation in the American legal tradition.

⁸ Uniform Commercial Code, §2-601. This is an example of the principle that once one party to a contract violates its terms, the other party is no longer obligated to fulfill the contract.

⁹ Uniform Commercial Code, §2-204(2)

¹⁰ Uniform Commercial Code §2-201(1), *Statute of Frauds*

way a human being is. The institution is formed when human beings decide to provide a service or good and pursue a profit. While humans have little choice about the society with which they contract, institutions have the choice. Those human beings could choose to form their institution anywhere; if they dislike the terms of doing business in the United States, they can incorporate under the laws of Germany, Japan or some other state. Upon incorporation – or other method of formation – the institution accepts the terms of the social contract in that particular locality. This arrangement strongly resembles an offer and acceptance contract formation; the host country offers benefits (*e.g.* legal protections, tax shelters, subsidies, and interest rates) but also proposes obligations (*e.g.* laws restricting business operations and employment policies). By forming in that locality, the institution accepts this offer and commits to abide by the terms of this agreement.

The legal formation of contracts was unimportant to Rawls. He acknowledged the historical fiction of Hobbes' state of nature, but did not see it as a problem for social contract theory. According to Rawls, the obligation to follow the rules comes from prior knowing participation in and acceptance of the benefits of a practice acknowledged to be fair.¹¹ By participating in the social order and accepting the benefits therefrom, persons form an implicit contract with society. This is essentially contract formation by performance, or "conduct by both parties which recognizes the existence of a contract," but Rawls did not think it was important to see it even as formation by performance.¹² For Rawls, the formation and evolution of this social contract was alive and active. After all, as a society we must choose fair practices and discard practices if we realize the practices to be unfair. In the past, we might have accepted unfair practices; provided we have justification, we can reject them now.¹³ Take for instance the abolition of slavery in the U.S., women's suffrage, and the civil rights movement. Arguably, every governmental election is a renegotiation of the terms of this contract, to some extent, in which parties to the contract accept or reject the current state of affairs, but this is of course not the only way the terms of our social contract are set.

As the social contract is a living thing that changes and is open to renegotiation, it is of utmost importance to know how to identify the fair practices that should constitute this contract. Rawls provided a method of determining fairness that he argued was independent from teleological or religion-based morals. This independence created an understanding of ethics that can be applied in today's world of finance without stepping on moral or religious sensibilities. This development is extremely important in ethical understanding.

¹¹ See *e.g.* "Justice as Fairness." 176, 179.

¹² *Ibid.*, at 179-80.

¹³ *Ibid.*, at 180

Our society values the struggle to reach the top and many people imagine they might become multi-millionaires. When we reject exploitative, profit-driven behavior, that rejection holds little water unless the activity violates actual statutes or regulations. One individual might want to assert that such behavior is un-Christian, or immoral on some other basis, but our society is unwilling to sectarian beliefs as a foundation for universal ethical principles. This is where Rawls' conception of fairness can be useful.

Rawls envisions the question of fairness arises when free persons, who have no authority over one another, engage in a joint activity. Together, they settle the rules, which define fairness and assign shares in the benefits and burdens of the joint activity.¹⁴ When determining the fairness of a practice, we must assume that the individuals concerned do not have authority over one another, or at least that any authority in another context is irrelevant to this context. Thus, the authority of an employer over an employee in a financial firm should not be relevant to the question of fairness.

Rawls uses a Kantian method to identify fairness. A practice is just or fair when it satisfies the principles, which participants can propose to one another for mutual acceptance.¹⁵ The parties will think a practice is fair if none feels that the practice exploits her or that she will be forced to give into illegitimate claims.¹⁶ In other words, a person will not accept a practice that places great burdens on her and grants most of the benefits to another person. The burdened person sees such an arrangement as unfair. Rawls asserts that the *benefitted* person should also be able to see that such an arrangement would be unfair. The benefitted person need only ask herself whether she would accept the practice if she did not know what her position would be. If an investment banker wants to know whether her methods are fair, she should consider it not from the perspective of an investment banker, but with the idea that she could be in the shoes of anyone involved in the transaction.

Financial Practice: A Duty to Fairness Based on Social Contract

¹⁴ “Justice as Fairness.” 178, 179

¹⁵ “Justice as Fairness.” 174, 178. This is not exactly what Kant argued. Kant proposed that one should consider the maxim underlying her action. If that maxim could be applied by everyone without contradiction, then it is an acceptable maxim to guide her action. Rawls statement is similar; that when proposing a practice, if everyone engaged in that practice and could be satisfied with the result, then it is an acceptable practice.

¹⁶ *Ibid.*, 178

Most important to the application of Rawl's theory to the world of finance ethics is the duty that arises once fair practices have been decided. This duty is the most important because our financial system is regulated; persons (whether people or institutions) have guidelines that have been agreed upon as fair through the mechanism of the social contract. In more concrete terms, we have elected officials whose law making we have agreed to accept. What arises in the professional world of finance are situations in which a person can act without violating the agreed upon practices, at least as they are spelled out in statutes, regulations, and business contracts. Nonetheless, that act might violate the intent of the established practice. Would that act be unethical, or would it simply provide an advantage available for the taking by the individual savvy and brave enough to take it? Rawls' response is that all involved persons have a duty of fair play. Once a person accepts a practice as fair, she has a duty to other persons to act in accordance with the practices when it falls upon him to comply. She also has a right to demand action in accordance with the practices when it is others' time to comply.¹⁷ Violating the intent of established practices is the same as violating the practices. The only difference between the two is when the letter of the law is violated and the transgressor is caught, she may be punished. When a person violates the intent of the law or practice, she violates the import behind the words of the agreement and she inflicts harm upon societal order by undermining our efforts to foster a society of benevolent actors.

Duty to Fairness Binds Across Religions and Cultures

According to Rawls, the duty of fair play is not found in natural law or religious beliefs. The social contract binds us in duty to fulfill our obligations. Not depending on religious beliefs is important for two reasons: The first reason is religious beliefs differ. In a society that values tolerance, imposition of morals based on any particular religion is sometimes problematic. The problem of moral relativism is one reason why the guiding standard of profit in finance is so enduring and pervasive: it is secular, widely accepted and acceptable.

The second reason is that cultural moral beliefs also differ. In some cultures, a purported "promise" to perform might be more akin to an affirmation of a real intent to perform, but not a guarantee of actually following through should something more important or lucrative arise. If promises and obligations have different meanings in different cultures – even in different cultures of the same religious heritage – it is difficult to argue the duty to fulfill an obligation is founded in a natural law.

Rawls started by assuring us that fairness does not require of anyone that she sacrifice her interests when everyone is deciding upon principles and practices

¹⁷ *Ibid.*, 179

to follow. At that time, everyone's interests are important to the calculation, and each stakeholder can negotiate to protect her interests. However, when later engaging in an activity governed by the agreed-upon practices, she might be required to forego advantages, which a peculiarity of her circumstance might present. Otherwise, she would circumvent the assignments of burdens and benefits that have been deemed fair.¹⁸ Therefore, even if an action does not violate the specific words of a fair practice, it can violate the intent by upsetting the balance of previously agreed burdens and benefits.

During his career, Rawls further developed this concept of fair play into a broader idea: social cooperation. He said that cooperation involves the idea of "fair terms of cooperation." These are terms that each participant may reasonably accept provided that everyone else likewise accepts them.¹⁹ These terms are based on an idea of reciprocity or mutuality. Those who cooperate with one another and do their part as the rules require will benefit. Justice as fairness, then, formulates principles that specify basic rights and duties within the main economic, social, and political institutions of society. The goal of Rawl's theory of justice is the benefits produced by everyone's efforts are fairly acquired and divided.^{20,21}

Rawls' purpose was to create a conception of justice as fairness that can apply in a constitutional democracy, where members of society view morality from a relativistic perspective, or at least are unwilling to impose their own moral beliefs on others. This purpose makes Rawl's propositions perfectly suited for the world of finance. First, the theory provides an ethic that is universally acceptable. Second, it discourages exploitation of others. Finally, the theory fairly allocates the burdens and benefits of our economic system.

¹⁸ *Ibid.*, 181, 183,

¹⁹ This is Rawls' application of the social contract theory.

²⁰ "Justice as Fairness: Political not Metaphysical," 232.

²¹ I want to note that I do not think Rawls was advocating distribution of wealth according to a socialist or communist perception of justice. Nor was he condemning profit. His point is that we should prevent exploitation of one by another or the gaining of a benefit by one person while imposing burdens on another.