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Main Flaws in the Contemporary Mainstream Financial Research Paradigm and Suggestions for Improvement

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Abstract

This paper outlines the primary shortcomings of the contemporary mainstream financial research paradigm, highlighting issues such as a disorganized discipline structure, ongoing debates over the relationships between risk and return, return and social responsibility, and financial environments and governance, among others. These deficiencies have led to numerous instances of financial decision-making failures and issues related to corporate social responsibility. The core of these major flaws can be traced back to four assumptions that are detached from social reality: "corporate legal fiction", "individualism", "rational economic agents", and "perfect markets". Building on this, the paper proposes several ideas for refining the mainstream financial research paradigm. These include adopting assumptions like "corporations as socio-economic entities", "individuals within an economic ecosystem", and "economically rational agents with bounded rationality". Additionally, it introduces the concept of an "economic ecosystem" and the notion of "maximizing societal total contributions" as a decision-making criterion.

Keywords

Finance, Research Paradigm, Economic Ecosystem

Introduction

Scientific research rests on three pillars: theoretical understanding, practical application, and intellectual frameworks, with the essence of the latter being the research paradigm. Finance, emerging from microeconomics in the late 19th century, maintains a critical role within economics. Despite substantial contributions since becoming a distinct field, research predominantly focuses on theory and empirical validation, with scant exploration of financial paradigms. This oversight means mainstream finance still relies on outdated neoclassical assumptions—corporate entities as legal constructs, individualism, rational economic agents, and perfect markets—carrying forward its inherent limitations. Modern finance has tried integrating new institutional and behavioral economics, along with stakeholder theory, yet struggles with fundamental flaws that question its real-world applicability. The plethora of failed investments, management blunders, and environmental impacts underscore these issues. Identifying and addressing these flaws in the financial research paradigm is crucial for developing more relevant and effective financial theories.

Analysis and Paradigm Enhancement of the "Corporate Legal Fiction" Assumption

The core concept of the "corporate legal fiction" posits that a corporation is not an autonomous entity, but rather a legal construct and a nexus of contractual relations among individuals, with corporate actions emerging from a complex equilibrium process within these contracts. Jensen and Meckling (1976) observed, "The firm is not an individual. It is a legal fiction that acts as a focal point for a complex process in which the conflicting objectives of individuals are harmonized within a contractual framework". (Chen 2007)

Despite prevailing views in textbooks and scholarly work that frame "corporate finance" as the financial dealings of a corporation towards its goals and management, mainstream economics and finance do not see corporations as independent market entities. Instead, influenced by firm theory and further elaborated by Coase (1937, "The Nature of the Firm") and subsequent scholars, corporations are often reduced to a nexus of contracts or interest distribution mechanisms (Li 2010). Financial goals have traditionally focused on "profit maximization" or "shareholder wealth maximization", with a recent shift towards "corporate value maximization" still largely grounded in stock market values, reflecting a shareholder-centric view. Thus, in mainstream finance and even in corporate financial accounting, which slightly leans towards the corporate entity theory, corporations rarely achieve full entity status. This is evident in profit calculations where costs like interest, taxes, and wages underscore that, fundamentally, corporations are viewed and managed as extensions of shareholder interests, not as fully independent entities.

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According to mainstream economics and finance's stance on the nature and status of corporations, if corporations are not considered entities in their own right, they lack autonomous objectives. The so-called "corporate objective function" is, in essence, the objective function of its shareholders. Thus, Jensen and Meckling (1976) argued that posing questions like "What is the goal of the corporation?" or "Should corporations bear social responsibilities?" is fundamentally flawed (Chen 2007).

In practical terms, the law typically treats corporations as legal entities. When shareholders establish a company, their contributions become corporate property, owned by the company rather than the shareholders. The company, as an independent legal entity, enjoys economic rights and assumes obligations. Shareholders, including managers, are liable for any harm caused by negligence. Economically, there's a growing tendency to view companies as separate economic entities. In the stock market, investors focus more on a company's financial condition and efficiency than on shareholder affairs. Corporate financial accounting standards increasingly emphasize the balance sheet, reflecting the shift towards viewing companies as economic entities rather than mere vehicles for profit.

To address the contradiction between the "corporate legal fiction" hypothesis and the reality of "corporate entities", stakeholder management theory posited the concept of "corporate entities" and, predicated on the "corporate entity assumption", advocated for the corporate financial goal of "maximizing stakeholder interests". This theory also made a theoretical case for the necessity of corporations to take on social responsibilities. However, the operability of stakeholder financial theory is undermined by the inherent dangers in pursuing a multiplicity of objectives, among other factors. This has prevented stakeholder financial theory from definitively resolving the ongoing debate and confusion over corporate financial goals within the context of corporate objectives, the extent and nature of social responsibilities corporations should assume, as well as addressing how to measure the success of achieving the "maximizing stakeholder interests" objective and how to quantitatively evaluate a corporation's fulfillment of its social responsibilities.

On the issue of breaking through the "corporate legal fiction" assumption to refine the theories related to modern mainstream corporate finance, my perspective is as follows: Corporations are economic production units within the social framework and subsystems of the socio-economic system. "Their basic duties and behavioral constraints are defined by societal norms" (Li 2009b), thus they possess inherent social characteristics.

In modern societal structures, corporations are recognized as independent legal entities with economic rights, obligations, and responsibilities. This delineation, excluding political rights and duties, aligns with their role as specialized economic producers rather than political actors. To most members of society, corporations present a distinct social identity, separate from their shareholders or managers, characterized by unique cultural values, business philosophies, and operational styles. Thus, corporations emerge as concrete, independent socio-economic entities that rely on, yet stand apart from, their resource providers, challenging the notion of being mere legal fictions. From the perspective of contract theory, corporations represent an aggregate of economic contracts forming a network with a core entity dependent on the company's status. These contracts fall into two categories: explicit economic contracts, which define clear economic relations between the corporation and specific entities, and implicit contracts, reflecting less defined economic relationships with unspecified parties or social contracts. This streamlined approach captures the essence of corporations' role and structure in the economy, moving towards a narrative more aligned with the preferences of American academics, emphasizing clarity and conciseness.

Understanding corporations as socio-economic entities clarifies that: (1) recognizing their true nature aligns our perception with reality; (2) it corrects the misclassification of contracts into economic and social ones, thereby resolving the false dichotomy between corporate social and economic responsibilities. This simplifies integrating social responsibilities into financial management; (3) it explains the necessity for adaptive governance mechanisms, providing strategies for customizing these mechanisms for various corporate types. This concise approach fosters a clearer understanding, suited to the preferences of American scholars, by emphasizing practical application and simplifying complex concepts. Shareholders, who provide the most capital and bear the highest risks, naturally control corporations. However, this control entails responsibility, limiting shareholders to residual rights to profits and assets. If shareholder actions risk damaging other stakeholders, especially when these risks surpass shareholder liabilities, control should rightfully transfer to the affected stakeholders (Peng 2011). This streamlined perspective ensures corporate governance fairly balances all interests, suitable for the clarity preferred by American scholars. "For instance, under normal circumstances, shareholders own and control the enterprise; when the enterprise enters bankruptcy or liquidation, creditors gain ownership and control; in cases where the enterprise severely damages public or societal interests, ownership and control often shift to the government or similar organizations representing the victims, such as in significant pollution incidents or serious workplace accidents, which may result in the enterprise being seized (Peng 2011)." (4) The essence of corporate financial objectives lies in aligning stakeholder actions to maximize the company's social contribution. Theoretically and practically, this involves coordinating economic relationships and implementing strategies, including social responsibilities, to safeguard long-term interests. This streamlined goal supports the broader aim of optimizing social contributions while ensuring benefits for shareholders and managers, tailored for clarity and practicality in an American academic context. The term 'total social contribution of an enterprise' refers to the sum of the social contributions (or societal costs) generated by the enterprise itself, and those led or orchestrated by the enterprise among all stakeholders (Peng 2011). (5) Corporations exist not only to lower transaction costs and reduce opportunism but also for three critical purposes: to unify economic preferences, thus preventing conflict; to build and optimize a stable economic ecosystem, crucial for expansion; and to ensure rational collective decision-making based on cost-benefit principles. This concise rationale is tailored for the clarity preferred by American academic discourse.

Analyzing "Individualism" and Refining Research Approaches

The "individualism" concept centers on: (1) using the "economic agent" as the core unit of analysis; (2) each agent prioritizes maximizing self-interest, disregarding others' benefits and feelings; (3) transactions inherently involve financial competition among agents.

Mainstream financial models, like portfolio analysis and pricing models, embody this assumption by overlooking the interests and reactions of others, particularly in transactions. This streamlined summary is tailored to the concise and direct style preferred by American academics.

Mainstream financial theories based on "individualism" focus too much on the financial efficiency of "economic agents" and the associated economic principles, often neglecting the social dimension of corporate finance. The prevalence of unethical business practices prioritizing profit over social responsibility, such as environmental destruction and various forms of misconduct, can largely be attributed to the application of these flawed, "individualism"-based theories in corporate finance. Additionally, the absence of social public interests, norms, and institutional considerations in financial studies is significantly due to the enduring influence of the "individualism" assumption (Li 2009a).

In practice, "economic agents" are interdependent, constantly influencing each other within a shared societal context. Economic behaviors impact and are impacted by others, such as facing lawsuits for unfair competition or striving for innovation while competing with others. Thus, acting solely to maximize self-interest is unrealistic. The essence of their financial interactions is not competition but cooperation, a state of "co-opetition". For example, multinational corporations help develop markets in less developed areas, businesses support their supply chain partners to maintain smooth operations, and core companies within clusters assist peripheral ones to boost overall efficiency. These examples showcase that cooperation, rather than competition, defines the primary financial relationships among "economic agents".

Addressing the mismatch between the "individualism" assumption and societal realities, the advent of New Institutional Economics has led finance researchers to consider "economic agents" within their social contexts, highlighting the importance of people, institutions, and culture. This shift introduced tools like financial governance, mergers, bankruptcies, and game theory into finance, birthing Institutional Finance. However, this field hasn't fully integrated institutional dynamics or the social interactions of "economic agents" into its analysis, leaving concepts like information asymmetry and transaction costs somewhat isolated from financial decision-making models (Li 2002). This gap has led to a disconnection between theory and practice. Stakeholder financial theory made strides by linking corporations with their stakeholders, yet it didn't extend its analysis to the broader interactions and mechanisms among businesses outside its immediate scope.

To challenge the "individualism" assumption and refine theories in corporate finance, it's crucial to recognize corporations as assemblies of economic contracts with various stakeholders and as economic production units within the socio-economic system. This perspective reveals that relationships between corporations and stakeholders, as well as among corporations, are not merely individualistic but symbiotic. Within this symbiotic framework,"economic agents", institutions, informal organizations, and cultures contribute to an economic ecosystem at various levels. The economic actions of any agent affect the ecosystem's balance and prompt reactions within it, often extending to third parties. The direction and magnitude of these effects depend on the original action's impact, the responders' reactions, and the ecosystem's transmission and self-stabilization mechanisms. Thus, in making financial decisions, "economic agents" must consider these interactions and their potential impact on the ecosystem's equilibrium.

"Rational Economic Agents" Assumption and Paradigm Refinement

The "rational economic agents" assumption suggests agents are selfish, aiming to maximize their economic benefits, and rational, with complete information to make error-free decisions. This underpins equilibrium analysis in finance, emphasizing "maximization" and deterministic methods.

However, applying this theory often overlooks cognitive biases, irrational behaviors, and information asymmetry, which significantly influence financial decisions. Mainstream finance treats risks and behavioral factors as external, leading to practical failures in financial decision-making.

Reality shows agents are only relatively rational, influenced by emotions and biases. Collective decision-making, although reducing irrationality, cannot achieve absolute rationality due to cultural differences and authority. Furthermore, agents exhibit both self-interest and altruism, with economic behaviors reflecting a balance of diverse preferences, such as altruism based on kinship or reciprocity for future benefits. This refined explanation aligns with the concise, evidence-based style preferred by American academics.

Behavioral finance moves beyond the "rational economic agent" assumption by discarding first-order equilibrium frameworks and the price-taking hypothesis. It shifts focus to human behavior, integrating experimental methods from cognitive psychology to address finance issues, considering realities like asymmetric information, irrational behaviors, and dynamic disequilibria. It analyzes limited rationality and the constraints on arbitrage through preferences and beliefs, recognizing the roles of incentives and decision-making by agents. It introduces concepts such as contracts, rights, and decision-making psychology, and techniques like advanced game theory and psychological experiments under incomplete information, significantly enriching finance theory and expanding its applications. However, behavioral finance still faces challenges in reaching the maturity level of a discipline, with limitations in applying psychological findings universally across different cases and the unreliability of extrapolating experimental results to real-world economic activities due to inevitable differences from actual conditions.

Regarding breaking through the "rational economic agent" assumption to refine mainstream corporate finance theories, corporations, as economic production units within society, should focus solely on maximizing economic efficiency (i.e., their total social contribution) without delving into "preference functions". Yet, corporate decision-making, performed by inherently irrational humans, can only achieve bounded rationality. Under the "economically rational agents with bounded rationality" assumption, research must go beyond cognitive psychology, preferences, beliefs, and behavioral impacts on financial decisions to explore how these factors translate into corporate risks, what kinds of risks they become, and how corporations can mitigate these risks through organizational strategies.

"Perfect Markets" Assumption and Paradigm Refinement

The "perfect market" concept suggests resources are allocated at equilibrium prices, where no seller earns excess profits, and equilibrium prices match marginal costs. Its fundamentals include: (1) numerous traders engaging in unrestricted transactions of infinitely divisible assets; (2) homogeneous assets traded at competitive prices set by demand; (3) no transaction taxes, costs, or controls on price intervention and factor mobility; (4) complete information symmetry.

Key financial theories, such as the MM model and Capital Asset Pricing Model, rely on this "perfect market" premise. Within such markets, theories on asset pricing and efficiency extend to production, offering insights into production opportunity costs and optimal decisions, thus underpinning three vital mainstream financial conclusions: value maximization, separation of ownership and management, and the MM theorem (Jiang 2007). The "perfect market" assumption characterizes financial theories by assuming external assets and analyzing solely asset prices and cash flow rights, excluding institutions, informal organizations, and culture (Jiang 2007). This framework omits analysis of social costs or benefits caused by corporate actions, focusing instead on corporate-specific factors like asset prices, transaction costs, cash flows, and shareholder returns.

Financial theories rooted in the "perfect market" assumption often overlook the influence of societal factors like institutions on corporate financial decisions, assuming such impacts are negligible. This leads to financial models that ignore the effects of social elements, internal management, and incentive mechanisms on transactions, despite their significant impact on financial efficiency. Guided by this theory, corporate financial decisions may become short-sighted, potentially harming the company's long-term health, such as neglecting social responsibilities or failing to consider investment environments.

Recognizing the importance of factors like information asymmetry, institutional and cultural elements, and the social costs or benefits of corporate actions, the field has begun to shift. The integration of New Institutional Economics into finance has heightened the focus on people, institutions, and culture, introducing tools like financial governance, takeovers, and game theory, leading to the development of Institutional Finance. However, despite acknowledging the importance of institutions and market transaction costs, Institutional Finance has not fully incorporated these elements into its financial behavior framework, leading to a gap between theory and practice.

Stakeholder financial theory proposes maximizing stakeholder interests as a corporate financial goal, emphasizing the importance of their participation in financial governance and management. It suggests mechanisms for shared financial governance and strategic allocation of financial control rights to mitigate opportunistic behaviors, reduce social costs, and decrease financial decision risks. Yet, the challenge of measuring "stakeholder interest maximization" leads to a pursuit of diverse corporate financial goals, including profitability and social responsibility, which could potentially result in a deadlock of serving societal functions at the expense of corporate focus.

To address the limitations of the "perfect market" assumption and enhance contemporary corporate finance theories, focusing on "maximizing stakeholder interests", along with shared governance and adaptive control mechanisms, can indeed steer corporate behaviors towards reducing opportunistic tendencies, fulfilling social responsibilities, and lowering financial decision risks. However, as previously mentioned, establishing multiple corporate financial goals is impractical. In "Innovative Research on Corporate Finance Theory Embedded with Social Responsibility" (2011), the premise of "corporate socio-economic entities" and the concept of an "economic ecosystem" are utilized to propose a financial goal of "maximizing social contribution". This goal encompasses the total social contributions (or costs) generated by the enterprise and those it leads or influences among its stakeholders. The approach to measuring "maximized social contribution" involves categorizing stakeholders into shareholders, collaborators, consumers, competitors and their allies, and government and community, with their respective interests defined as capital appreciation (AV), collaborator income (CI), consumer surplus (CR), competitors and their allies' losses (CL), and government and community gains (GI) . The company's social total contribution (U) is the sum of "AV + CI + CR + CL + GI", with the aim to expand these values significantly beyond stakeholders' minimum expectations, ensuring the company meets at least the minimum return expectations of its shareholders.

A Vision for Integration and Optimization

In summary, modern finance, following a neoclassical paradigm based on assumptions of "corporate legal fiction", "individualism", 'rational economic agents", and "perfect markets", often displaces corporate financial goals with shareholder objectives, sidelining corporate social responsibility (CSR). It overlooks the impact of decision-makers' psychology, institutions, and culture on financial risks. This approach results in a fragmented discipline, where elements like profit, risk, CSR, the financial environment, and governance are treated as parallel yet overlapping areas, leading to confusion.

By shifting these foundational assumptions towards "corporations as socio-economic entities", "individuals within an economic ecosystem", and "economically rational agents with bounded rationality", we can view corporations and their stakeholders as parts of an "economic ecosystem". This perspective simplifies finance to two main elements: governance mechanisms and financial efficiency, framing "social total contribution" and its equitable distribution as the core of financial study. In this framework, traditional concepts like the financial environment become quantifiable as "risk" or integrated into governance requirements, and conventional profit or revenue metrics are viewed as distributions of "social total contribution".

Adopting this refined paradigm could significantly reduce opportunistic behavior and environmental disregard in pursuit of profit, lower financial decision risks due to cognitive biases and information asymmetry, and, through the economic ecosystem's self-stabilizing mechanisms, decrease large-scale economic disruptions and bankruptcies, contributing to societal stability.

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