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**BUSINESS ETHICS AND THE MARKET
ECONOMY**

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BUSINESS ETHICS AND THE MARKET ECONOMY

It is a depressing commentary on the extent to which business can be misunderstood that the whole topic of 'business ethics' strikes many people as little more than an oxymoron – a combination of hopelessly clashing concepts, and a bad joke fit only to be the starting point for other allegedly bad jokes such as 'military intelligence'. To such people, a market economy is a dog-eat-dog world of exploitation, selfishness and greed, and the only ethical principle in business is that you should do unto others before others get a chance to do it to you.

This is not only a caricature but a dangerous one. Few people who are actually engaged in business would hold to it – and those businesspeople who argue that there are no business ethics usually end up bankrupt or behind bars. And we need to remember that the vast majority of our fellow citizens spend their working lives employed by private sector businesses or running them. Do we really think they adopt ethical standards at work that are basically different from those they practice in their personal lives, or that business morality differs fundamentally from personal morality? And remember also that business does not just comprise the high street, the capital markets and the industrial estate: it includes law firms, medical practices and all those organisations that offer goods and services to consumers for reward. One way or another, business involves practically all of us.

Civil societies have always promoted well-recognised virtues – independence, self-reliance, community responsibility, duty to family, hard work, thrift, honesty, sobriety and so forth. These virtues are important in transacting with others, just as much in commercial settings as they are in non-commercial settings.

I will argue that normal business activity is steeped in ethics, and even encourages the development of many human virtues. Yet even among businesspeople, or those sympathetic to business, there is confusion about business ethics. There are unrealistic expectations about the sorts of ethical decisions businesspeople can legitimately take. These confusions largely arise from misunderstandings about the role of business in our society.

Our current levels of wealth – which by the standards of past centuries are astronomical and unprecedented – are largely due to the activity of profit-seeking businesses producing goods and services that consumers value. Despite its apparent complexity, a modern market economy is based on one very simple principle with enormous ramifications. That principle is voluntary exchange. In every market transaction someone voluntarily gives something to someone in exchange for something else, and expects to be better off as a result. Value is created, and each party to the exchange captures some of that value – or else the exchange would not take place at all. In other words, a market system involves cooperation for mutual benefit. This cooperation may involve people of different races, religions and political views. They may agree on very little other than the benefits they derive from making the exchange.

Much of mainstream economics consists of analysing exactly how and why voluntary exchange of goods and services within a sound legal framework will spread wealth throughout society. The discipline of economics explores how the price mechanism signals consumer preferences and resource scarcities. It explains how the profit motive induces businesses to discover consumer preferences and cater for them at least cost. The search for profits motivates the development of new technologies and the willingness to undertake the investments likely to provide the greatest pay-back to society. Competition between firms to serve the consumer drives down prices and spurs innovation. Market transactions, based on the price mechanism, coordinate the actions of countless people, most of whom will never meet or know one another. In short, the 'invisible hand' which Adam Smith identified over 200 years ago in his classic book *The Wealth of Nations* tends to lead businesspeople seeking profits to serve the wider interests of society far more effectively than the cleverest central planner. Smith's insight is borne out by the success of the Anglo-American market model over the last two hundred years, by the collapse of communism, and by the connection increasingly found between economic freedom and economic growth.

Once we understand that cooperation is fundamental to production, distribution and exchange, it becomes quite implausible to imagine that market transactions can exist in an ethical vacuum. Not only does the ability to do business depend on upholding a range of ethical standards but markets themselves also promote ethical standards more effectively than many other social institutions. We would not expect individuals to be inherently more moral in their business lives than in their

private (non-business) lives. There are no moral policemen keeping immoral people out of business activity. But many features of business activity strongly encourage moral behaviour. One is that markets are based on trust. If two people are to make a voluntary exchange, there must be a degree of trust that both will stick to their sides of the bargain. To be trusted it helps materially that you exhibit good character and ethical behaviour – that you are honest, fair to people, and deal in good faith. Because legal contracts can't cover every contingency and are costly to enforce, reputation and integrity are particularly important in business relationships. Hence the bond trader's saying: 'My word is my bond'.

Perceptive commentators have long noted the link between the demands of successful commerce and the encouragement of moral behaviour. For instance, the London stock exchange of the eighteenth century impressed the French Enlightenment thinker Voltaire who wrote:

Go into the London Stock Exchange – a more respectable a place than many a court – and you will see representatives of all nations gathered there for the service of mankind. There the Jew, the Mohammedan, and the Christian deal with each other as if they were of the same religion, and give the name of infidel only to those who go bankrupt. There the Presbyterian trusts the Anabaptist, and the Anglican accepts the Quaker's promise.¹

There was very little formal regulation of the stock exchange at that time. But the Presbyterian still trusted the Anabaptist because he knew the latter had a strong incentive to keep his word.

A feature of many markets is that they involve repeat transactions. If you break your word on one occasion there will be an erosion of trust, and in future you will find it more difficult to convince others to do business with you. A few fly-by-night operators will try to evade this logic but they cannot evade it for long: lasting success in business requires a reputation for honesty and commitment to one's customers, and constant efforts to maintain it. Even if a firm's business is such that individual customers return only infrequently – as in the case, say, of a seller of consumer durables – reputation does not cease to be important. A free media, the power of word of mouth, consumer groups and the variety of other organisations that advise consumers together ensure that a firm's good name remains crucial. That is why many businesses invest so much in the establishment of brand names.

¹ Quoted in Norman Barry, *Business Ethics*, Macmillan Press, London, 1998, p 91.

Anyone doubting the importance of reputation should consider the case of the US securities firm Salomon Brothers, which was found to have been involved in illegal bids for Treasury bonds. The fallout from that scandal in the form of legal sanctions against Salomon was minor in relation to the effect on the firm's share price. The damage to its reputation led to a far greater part of the fall in the expected value of Salomon's future profits. Reputable people try to avoid doing business with people whose reputation is dubious, or to deny them trust when they have to deal with them. Both these responses promote civil behaviour.

Another cardinal virtue of business is honesty, and a high proportion of the business scandals that do erupt involve lapses of honesty. A business needs to be honest to the various parties who rely on its word – to its employees, its suppliers, and its consumers, and to the capital market through the integrity of its financial reporting. But there are other ethical virtues that commercial businesses have every incentive to display. They will be encouraged, for instance, to treat people and other organisations on their individual merits. A truly profit-maximising business will not be racist, or sexist, or xenophobic, because to act in these ways will hurt the bottom line of the company – unless it is shielded by government interventions which enable it to exercise its prejudices without cost. Thus an ethical business will choose a supplier on the basis of its ability to fulfil orders of the right quality, at the right price, with the right consistency. It will not choose a supplier, or a partner for a joint venture, just because its chief executive went to school with the firm's own chief executive, or on grounds of race, or gender, or nationality, when these features are not relevant.

Similarly with employees: an ethical business will hire and promote applicants who are best qualified to do each job, and will pay each person according to the value they contribute to the organisation's goals. It will discriminate only where there are good business reasons to do so – such as merit. Not only will it refrain from indulging in blind prejudice against classes of people but it will also not succumb to the politically correct temptation to put in place quotas for minority groups, because doing so would simply be another way of treating people unfairly. Again, good ethics is good business.

Moreover, since markets involve inter-personal cooperation, they also encourage the development of characteristics that smooth human relationships, such as courtesy, friendliness, good humour, thoughtfulness and kindness. It is no wonder that perceptive social critics such as David Hume in Britain and Alexis de Tocqueville in

France long ago noted the role of commerce in civilising the manners of those peoples who embraced it.

But while markets may encourage many virtues, the relationship is by no means one-way: business also draws crucially upon the cultural capital already in society. Markets work best when there is a sustaining tradition of personal integrity, honesty, trust, foresight and civil cooperation. This cultural capital is maintained and strengthened when key institutions in society are all successfully doing their work. In western societies the conditions for successful markets took centuries to evolve, and in some parts of the world they are weak at best, even to this day.

To understand the importance of a healthy civil society we need only compare the economic performance of the various ex-communist societies since the collapse of the Soviet empire. Even though they continue to face many difficulties, some countries such as the Czech Republic have made rapid progress with economic liberalisation. By contrast, the Russian economy remains mired in stagnation, and – despite a fair degree of reform – lurches from crisis to crisis. One important reason is that the Czech Republic has a stronger, more resilient civil society than Russia. It experienced a shorter period of time under communism, and retains from its earlier history some of the cultural capital which communism set out systematically to destroy.

The lesson for New Zealand is that providing a setting for a successful, ethical business sector is a task for all of society – for families, schools, universities, news media, churches, other voluntary groups and businesses themselves. New Zealand has an admirable record of low levels of fraud and corruption in business, despite attempts by some to sully it for self-serving reasons. This has regularly been borne out in surveys by Transparency International. To be sure there are lapses from proper standards in business, just as there are in other walks of life, and they should be met by social opprobrium and, in the case of unlawful behaviour, by legal penalties. But even in the case of the events surrounding the worldwide sharemarket crash of 1987, which are often seen as an episode of business conduct which was dubious or worse, the incidence of outright wrongdoing in New Zealand was small, even by comparison with Australia. Mostly it was a story of over-enthusiastic and imprudent entrepreneurs and equally careless and sometimes greedy investors, and of tax and commercial law that had not caught up with the requirements of an open economy, rather than a story of business dishonesty. Most of the property and investment companies that failed would have done so as a result

of the collapse in asset values relative to borrowings, regardless of any wrongdoing in the way they were run.

I have argued so far that good business behaviour is typically good ethical behaviour. But we must guard against a serious mistake – the confusion of the duties and responsibilities of business (and other legal entities) and those of all of us as private citizens. This all-too-frequent error is the source of much ill-informed criticism of business. Often people complain that public companies should display more 'social responsibility' – that the executives or directors of these companies should, for instance, be more generous in donating company money to worthy causes. Yet this idea misunderstands the nature of a public company and attributes certain characteristics to a firm that can only belong to people.

The role of a company's employees is to assist in maximising long-term shareholder value. All their actions, including their dealings with everyone involved with the company, must be to this end. Those running the company are the trustees of the savings of thousands of ordinary people who have invested in it. Sometimes making donations to worthwhile projects can be justified by the favourable publicity or other benefits it generates for the company. Otherwise, it is a simple breach of fiduciary duty on the part of corporate officers. This is true no matter how generous they might be as individuals. As the Australian philosopher Bob Ewin has put it:

It is not that corporate officers *should not* be generous; they cannot, *logically cannot*, be generous in that sort of situation. When they are acting in their personal capacities, asked for a loan by the secretary or for a charitable donation from their own pocket, they can be generous; when asked to take on extra work so that somebody else can have a day off for grandmother's funeral they can, as a personal favour, agree, because that is a personal sacrifice within the corporation and not a sacrifice of the corporation; but in acting *for the corporation* they cannot be generous.²

There is nothing generous or legitimate about giving away other people's money, which is precisely what happens when corporate officers give away shareholders' funds, just as an employee has no right to give away an employer's goods or a bank to give away its customers' deposits. And just as a corporation in the abstract cannot be generous, so it also cannot be selfish or greedy. A corporation can be successful or unsuccessful at increasing shareholder value, but it cannot be selfish. Anybody wanting to apply a label of selfishness must seek out specific individuals

² R E Ewin, *Why Worry about Business Ethics?*, Institute of Public Affairs, Melbourne, 1992, p45.

acting in their own capacity: they must argue that shareholders of a corporation are selfish. But now they are simply saying in effect that a particular John Smith of Palmerston North, who holds shares in a particular company, is a tightwad who never does a good turn for anyone, and should donate money to a local charity.

That might be true of some shareholders. However, it is absurd to argue that all shareholders of a corporation will be selfish, or that it is an act of selfishness to invest in a corporation rather than donate money to a charitable organisation. Such an attitude confuses self-interest with selfishness. The savings of individuals help to provide investment capital, which in turn leads to economic expansion and higher

living standards. Moreover, if an investor attempts to get the best risk-adjusted rate of return on her equity capital, she is simply playing her part in the ongoing process of channelling savings into investments that provide the best rate of return for society as a whole. Her action may be self-interested, but it cannot be condemned as bad for society. As we have seen, the self-interested actions of individuals can be justified by their wider, indirect, impact: that is Adam Smith's insight about a market economy. Moreover, all other economic systems are based on self-interest. The difference with a market system is that self-interest is moderated by the disciplines of markets, which do not rely on coercion.

None of this is intended to deny, of course, that giving money for charitable purposes is typically a morally praiseworthy act. But the praise is due to an individual: we cannot get away from the fact that ultimately it is individuals who make moral decisions. Moreover, the sorts of moral decisions they make will influence the type of business sector we have. Critics often lambast business for harming the environment, causing unnecessary suffering to animals, producing various harmful and decadent goods, promoting a culture of mindless consumerism, and many other failings. Yet at the end of the day it is individuals as consumers, acting in their own capacity as free moral agents, who bring about the pattern of goods and services that one sees in a market economy. If there is no demand for particular goods and services, businesses won't produce them.

Thus while only the owners of a business have the right to specify a particular objective for the use of their funds, all of us as individuals can influence business behaviour. As Elaine Sternberg has remarked in her book *Just Business: Business Ethics in Action*:

By choosing whether or not, and to what extent, to support particular businesses with their investment or custom or labour, everyone can contribute to the economic conditions that critically affect business decisions. If, therefore, individuals have views as to how business should be conducted, they should ensure that their individual choices accurately reflect those views. If they find the product or the manufacturing process objectionable, or consider the service or the advertising offensive, or judge the declared values of the board or the management to be misguided, then it is up to them not to support the firm. When each potential stakeholder – otherwise known as every member of society – acts conscientiously in his personal capacity, and strategically bestows or withholds his economic support on the basis of his moral values, then the operation of market forces will automatically lead businesses to reflect those values.³

That might mean refusing to work for a certain business if you believed it was selling a harmful product. It might mean refusing to hold shares in a multinational company if you could not support its decision to invest in a country with an undesirable political regime, or if you believed its marketing techniques to be dishonest. And it might mean refusing to consume goods whose production involved experiments on animals, if doing so conflicted with your convictions on animal welfare. Moreover, if you value non-business ends highly, by directing a large proportion of your spending outside the business sector you will influence the total extent to which society as a whole channels resources to business.

What these examples illustrate is that morality must be about action – not just thoughts and rhetoric. To be genuine, our morality must shape our behaviour. Yet in a free society there is much room for debate about moral behaviour, and there is no shortage of ethical controversies. We should not try to legislate for morality. We must inevitably be prepared to accommodate different views about ultimate values, provided all of us stay within an agreed framework of law. Markets, properly structured, can be a vehicle in which these different views are accommodated.

If we feel offended at some of the outcomes thrown up by the market, the answer may lie in ourselves. To simply ask of business to fix all the ills of the world, while doing nothing on our own account except lambast business as 'greedy', is an abdication of responsibility. It is about as realistic and as ethical as simultaneously demanding lower taxes and more government spending. Just as it is important to have an educated electorate, which knows what it can and cannot realistically require of politicians, so it is important that the wider society understands what it

³ Elaine Sternberg, *Just Business: Business Ethics in Action*, Little, Brown and Company, London, 1994, p 257.

can legitimately ask of business. That is why those educators who associate business with greed, or teach students that markets exploit workers, create confusion about the nature of business ethics. By continuing to peddle long-exploded fallacies, they create a culture suspicious of business and envious of those who are successful. To the extent that they succeed, the whole of society is the poorer.