Business Ethics in the Large and in the Small:
A Financial Perspective

George J. Papaioannou

Finance Seminar Series
Finance Department
Frank G. Zarb School of Business

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Setting the Stage

Consider the following aphorisms:

> "Ethics pays"
> "Ethical conduct in the pursuit of economic gain is not ethical at all."
> "We should develop a market ethos." G. J. Papaioannou, *Letter in BusinessWeek*
> "The best management is an ethical management." GJP and others

Research Questions

What is the ethical standard by which individuals and business organizations should be judged in connection to their business decisions and actions?

How can organizations set guidelines so that the decisions and actions of those who serve the organization as principals or agents are consistent with the ethical standard?

Law, Morality and Ethics

- Lawful conduct is prescribed by law. Unlawful conduct, if caught, carries penalties. Penalties are often certain or may vary.
  Even when penalties are uncertain (litigation cases), one can form probabilistic expectations about monetary outlays.
  People refrain from breaking the law for fear of punishment and payment of penalties.

  Due to above characteristics, decision making in regards to legality of actions is easier to conform to guidelines. The accepted wisdom is: make business decisions within the boundaries of the law.

- Moral conduct is motivated by what people consider good or evil, right or wrong. Morality presupposes a conscience. When we break the moral code, even without breaking the law, we are answerable to our conscience. Thus, the penalty is personal and subjective, although the moral rules (what is right and wrong) may not be always subjective.

  > Moral subjectivism: moral rules are set by the individual and thus vary by individual.
  > Moral relativism: all moral codes espoused by different religious or ethnic groups, cultures, etc. are acceptable.
  > Moral universalism: moral rules are the same for all. Based on association of virtue to knowledge - as knowledge becomes common to all, conduct according to virtue becomes universal. According to Plato, knowledge can be common because all forms of good and evil are represented by immutable ideas that humans have to discover through learning (philosophy).

Morality is for human beings not organizations (the latter cannot have conscience the way we mean it for people).

- Ethical conduct is motivated by common beliefs and customs as to what is acceptable and what is not within a social context (local community, national, international). It bears close relationship to morality but differs from it because of the nature of consequences in the case of unethical conduct.

  Unethical conduct exposes the offender to approbation and even rejection by members of its social environment. Penalties can take various forms, all of them likely to reduce the public standing and often the economic welfare of the offender.

  > Ethical egotism: An act is ethical for the decision maker if it maximizes the decision maker's utility.
  > Utilitarianism: An act is ethical if it maximizes utility for all.

The question: “are organizations ethically responsible?”

- Organizations have a social image or character to project and protect.
- Organizations have interests not always identical to the interests of their members. For example, the same person can be a shareholder of mining firm and a resort operator both located in the same area. Other shareholders of either firm may not have cross holdings. The interests of the mining firm may be in conflict with the interests of the resort operator.

- Organization may operate within social environments different from those of their owners or directors.
  Example: Multinational firm owned by US residents but operating in Asia.

- Organizations are social structures/entities whose rights and responsibilities in regards to pursuing their business objectives are prescribed by the economic, social and political values and rules of their environment. Thus they have a stake in contributing to the sustenance of these values and rules through ethical conduct.

Proposition: Organizations are ethically responsible.

Some views for and against:

For:

- Chr. Stone: Organizations are also vehicles for the furtherance of a social interest of higher concern.
- Bear and Maldonado: Organizations function within socioeconomic systems whose preservation is the only guarantor of their existence.

Against:

- Milton Friedman: Only people have responsibilities. Organizations pursue social responsibility for profit not for purely ethical motives.

Business Ethics in the Large

The objective here is to attempt to answer the first question: "What is the ethical standard by which individuals and business organizations should be judged in connection to their business decisions and actions?"

- **The central role of the market as a social good**

  Markets facilitate the efficient allocation of resources and the distribution of goods and incomes.

  Although not all economic transactions are facilitated by markets, their efficient function improves society's economic welfare.

Implication: Because allocational efficiency of scarce resources is importance in maximizing the satisfaction of human needs it emerges as an "ethical good."

Proposition: The ethical responsibility for individuals and organizations within the sphere of business activity is to contribute toward market efficiency.

- **The social and private costs of market failure**

  Market failure can lead to mis-allocation of scarce resources and reduced economic output.

  Market failure can lead to reduced opportunities for individuals and organizations to trade goods including financial claims. In the latter case (failure of financial markets), distortions in the savings-investment process reduces the potential for economic growth.

  Market failure compels participants to engage in costly signaling of their quality or commitment to honest transactions and decisions.

  Market failure can lead to regulation or other state-mandated restrictions that impose costs "of doing business" on both violators of market ethics as well as non-violators.

- **The causes of market failure**

  Information asymmetries: Buyers and sellers do not possess a common information set. Adverse selection problem - the market for lemons.

  - The sellers' full information set; the buyers' full information set; and the third parties' full information set.
  - The market endowed information set.
  - The market endowed information set falls short of the total information set of sellers, buyers and others.

  Examples of acceptable causes of information asymmetry:

  - Firms have legitimate reasons to avoid full disclosure of their tactics and strategies in order to preserve the value of their investments. (Ex. Firms maintain capital structures that helps avoid the scrutiny of public markets.)
  - On other occasions, firms undertake actions to maximize information

transparency because that enhances their value. (Ex. Multiple listings.)

....And examples of unacceptable causes of information asymmetry:

- Information acquired due to insider status privilege vs. information acquired by spending private resources.
- Acting as principal on inside information is generally considered unethical (and unlawful).
- Acting as agent on inside information is unethical. It violates fiduciary responsibility toward buyer-client or seller-client who transacts as principal. (Example: Merrill Lynch investment banking had "negative" information on Enron fund raising activities but analysts did not passes the information to the investor-clients of Merrill Lynch.)
- Acting as agent on private information is unethical when the client-principal is made to expect full and fair disclosure. (Example: dot.com financial analysts are accused of withholding private negative information from clients in order to boost prices and secure deals for their firms.)
- Acting as principal on private information is ethical. Expected gain is reward to private production of information. (Example: informed investors who have positive information on the value of IPO are not ethically obliged to reveal it without compensation.)

Moral hazard: Acting in one's interest even if that imposes costs on someone else to whom the first party has a fiduciary responsibility. Moral hazard affects market efficiency by:

Contributing to information asymmetry. (Ex. As in analyst-investor case above.)

Imposing "transaction" costs on principals that may lead to misallocation of resources. (Ex. Creditors may withhold credit due to fear of wealth transfers.)

The potential for adverse selection and moral hazard forces market participants to reach for second-best solutions, thus reducing economic efficiency.

- **Conflicts between the interests of the individual/organization and the interests of the market**

Ethical egotism favors a resolution in favor of the individual/organization. (Ex. An egotist who has inside information in a country without insider trading laws will trade and gain at the expense of others even though this undermines trust to the market. Observed often in less developed markets.)

"Kalikles: The best life is enjoyed by the man who lets his desires and passions grow as ravening and insatiable as they can, and takes care that he has always present the means of gratifying them.

Socrates: Compare the soul of such a person to a sieve, because this kind of soul cannot hold anything and thus can never be full with a finite and limited amount of things." (Plato's Gorgias)

"Rich is not one with great wealth but one with few needs; and poor is not one with little wealth but one with many needs." (St. Augustine)

Ethical utilitarianism favors a resolution in favor of the market. (Ex. A utilitarian will not act as the above individual.)
"Even above your father and mother, hold your country (meaning the city-state or polis) as a holier and more honorable idea."(Socrates) (I.e., the good of the whole takes precedence over the good for the individual.)

- **Breaking the impasse between egotism and utilitarianism**

  The normative approach: "Do what you consider to be ethical (i.e., good for the market) without regard to external gain." (Dobson, FAJ, 1993)
  - No resolution: An ethical egotist who switches to utilitarianism motivated by personal gain from serving the market interest is not ethical.

  The positive approach: "Act in the interest of the market because everybody, including you, gains."
  - Ethical utilitarianism (hence acceptance of the market as supreme good) wins if evidence shows that "respecting" the market is generally beneficial to the decision maker.

Proposition 1: Aligning individual and organizational behavior with the interests of the market requires acceptance of the positive approach to business ethics. "What is good for the market is good for all."

Proposition 2: Conflicts of interest between the individual and organization, on one side, and the market, on the other, can be resolved by a cost-benefit analysis to determine net impact on market efficiency. Actions that harm the market are to be avoided.

Proposition 3: The private markets can recognize unethical behavior (by the market standard) and can impose costs on the offending individual or organization. (Brickley, Smith, Zimmerman, 1994)

- **Critique of the cost-benefit utilitarian principle**

  Difficulty in measuring benefits and costs; not all benefits and costs are priced.
  Actions that are beneficial to the market may still be unethical. Conversely, actions harmful to the market may be ethical.
  (Steven Kelman: "Cost-benefit analysis: An ethical critique")
  If all behave ethically in the interest of the "internal good", market integrity will be preserved. Thus, instead of encouraging ethical behavior in the interest of market integrity (efficiency), encourage ethical behavior for its intrinsic value. (Dobson, FAJ 1993)

- **Defense of the cost-benefit utilitarian principle**

  "The benefit-cost criterion is a useful way of defining "hypothetical consent" for

centralized decisions affecting individuals with widely divergent interests."
(H. Leonard and R. Zeckenhauser: "Cost-benefit analysis defended")
Moral (normative) philosophers will accept the demise of the business (read market) if the motivation behind the act is ethical. What is moral does not have to be impractical. The purpose ought to be to set clearer guidelines that reconcile business interest with ethics.(A. Stark, HBR 1993).

Another view

- The disagreement comes from failing to distinguish between ethical behavior in business and the moral code in general.
- Ethical behavior in business governs only decisions and actions which are strictly business and economic in nature.
- As such, business ethics needs to have its own standard.
- I have contended that serving market efficiency is that standard.
- Therefore, judge ethical behavior in business by that standard.

Caveat: If business nature of decision or act is ambiguous act by the moral standard.

Business Ethics in the Small

The objective here is to answer the second question: "How can organizations set guidelines so that the decisions and actions of those who serve the organization as principals or agents are consistent with the ethical standard?"

- **From market and economic efficiency to firm value maximization**

  In efficient markets value maximization is the outcome of efficient allocation of resources.

  Organizational behavior consistent with value maximization becomes ethical by the market standard.

  Organizational guidelines must set the standard of value maximization as the yardstick of all decisions and actions by its members.

- **Conditions leading to the demise of value maximization as the organizational standard for ethical behavior**

  Once more, informational asymmetry

  - Misinformation about firm conditions can result in excess value for "bad" firms and lower value for "good" firms.

    Implication: Value increases for "bad" firms do not signify efficient allocation of resources.

    Example: Enron's value was higher than justified by the quality its investment-financing decisions.

    Example: Value of dot.coms exceeded their intrinsic value due to pumped-up reports by financial analysts.

  - Failure of the market to discriminate between "good" and "bad" firms even in the absence of intentional misinformation.

    Firm response: "Good" firms will attempt to signal their quality and separate themselves from the "bad" firms.

- **The delegitimatization of value maximization as an organizational goal consistent with the ethical standard: the deleterious effect of value destruction.**

  Conflicts of interest between the firm and various stakeholders.

  - The firm's managers or owners reject economically efficient investments (NPV>0) that do not have positive value for firm insiders.

    Example: Inside owners (majority shareholders) avoid certain risky but profitable investments because they are not as well-diversified as the outside, minority shareholders.

    Example: The owners reject economically efficient investments that do not increase their equity value despite the beneficial impact on the value owed to the firm's creditors.

- The firm's managers and owners adopt operations that maximize the firm's value but reduce the value of resources to others.

  Example: The firm rejects environmental-protection expenditures. Decline of environmental quality deprives others the opportunity to engage in efficient economic activities.

The breakdown of fiduciary responsibility within the firm

- Managers and directors are personal welfare maximizers not value maximizers.

  Example: The managers reject investments that increase the overall risk of the firm for fear of jeopardizing their income stream.
  Example: The managers avoid economically efficient investments if they incompatible with their skills and expertise for fear of being upstaged by others.

- Are transfers of wealth (unfair enrichment of one party at the expense of another party) due to conflicts of interest harmful to the ethical standard of market efficiency?

  Condition 1: Assume that wealth transfers do not affect optimization of resource allocation. I.e., economic efficiency is maximized as in the absence of wealth transfers.
  Implication 1: Wealth transfers are neutral to the standard of economic efficiency.
  Implication 2: They affect, however, the distribution of value among stakeholders. Negatively affected stakeholders will impose penalties on offending firm. It is most likely that firm's value will decline.
  Implication 3: A declining value disables the firm from pursuing all feasible economically efficient operations.
  Proposition: Wealth transfers are incompatible with the ethical standard of market and economic efficiency.

  Condition 2: Assume that wealth transfers do affect optimization of resource allocation. I.e., economic efficiency is not maximized as much as in the absence of wealth transfers.
  Proposition: Actions that cause wealth transfers violate the ethical standard of market efficiency.

  Proposition: Wealth transfers violate the ethical standard.

- **Conditions for rescuing the legitimacy of value maximization: the power and value of reputation**

  The firm's future cash flows valued not only for size and risk but also for sustainability through reputation and ethical responsibility. The "ethical

premium" in firm value. Supporting empirical evidence.
The personal reputation of principals and agents is priced in the market.

- **Ethics, social responsibility and value maximization**
  Firm agents exercising social responsibility with organizational resources
  - Rule: Social responsibility should not have a negative net effect on value.

- **A critique of the stakeholder theory**
  The stakeholder theory: The purpose of the firm is to serve the interests of its stakeholders. (Evans and Freeman)
  What is wrong with this theory?
  - The interests of stakeholders are subordinate to the interests of the market. Hence, from a normative or positive view, serving the stakeholders's interests cannot be the ethical standard for organizational behavior.
  - If value maximization is compatible with serving the market-based standard, then to serve the interests of the stakeholders becomes meaningful only as a means of achieving value maximization.

Final Conclusion

The best management is an ethical management. An ethical management is the pursuit of value maximization by achieving economic efficiency.

Epilogue

Early warnings on the perils of asymmetric information and the value of reputation and certification (from The Art of Living: Socratic Reflections from Plato to Foucault by Alexander Nehamas.

> Socrates: Hippocrates, you cannot carry learning away in a jar. Once you have paid for it, you must accept it directly in your soul, and having learned it you must leave with the harm or benefit already inside you.

> Plato: Do experts on ethics exist at all? And if they do, how are they to be recognized? Unless we know what ethical or virtue is how can we recognize that what the expert will teach us is ethical? But if we know what ethical and what virtue is, why do we need the experts on ethics.

Bottom line: Do not believe what I have told you without putting it to the test of your reason!