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The Ethical Dimension Of Economic Choices

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ABSTRACT:

In general, capitalist countries display sustained growth, dynamism and innovation, and a high adaptability in response to external shocks. Yet in the last twenty years discontent over the notorious drawbacks of capitalism – corporate frauds, corruption, abuses of market power – has grown continually. In this paper, we argue that no remedy to these difficulties can be found if ethical dilemmas are not anticipated and addressed at the individual, firm and economy-wide level. While pro-ethical changes in business regulation would help, government action alone may not be effective enough. Given that the social sciences provide the general framework of reference for human action, better integration of the ethical dimension by these disciplines would bring about additional benefits. In particular, economic theory would gain from developing more in-depth reflection on human end-goals and values.

Key-Words:

- Calculativeness
- Capitalism
- Corporate social responsibility
- Economics
- Virtue Ethics

RESUME :

L'article plaide en faveur d'une meilleure prise en compte de la dimension éthique des choix économiques par les sciences sociales, en tant que moyen d'améliorer le fonctionnement des économies de marché.

Mots-clés :

- Capitalisme
- Ethique managériale
- Responsabilité sociale des entreprises
- Théorie économique
- Valeurs

JEL classification : A11, A13, B41, M14, P17

The Ethical Dimension of Economic Choices

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Radu Vranceanu[1]

Abstract

In general, capitalist countries display sustained growth, dynamism and innovation, and a high adaptability in response to external shocks. Yet in the last twenty years discontent over the notorious drawbacks of capitalism – corporate frauds, corruption, abuses of market power – has grown continually. In this paper, we argue that no remedy to these difficulties can be found if ethical dilemmas are not anticipated and addressed at the individual, firm and economy-wide level. While pro-ethical changes in business regulation would help, government action alone may not be effective enough. Given that the social sciences provide the general framework of reference for human action, better integration of the ethical dimension by these disciplines would bring about additional benefits. In particular, economic theory would gain from developing more in-depth reflection on human end-goals and values.

Keywords: Capitalism, Economics, Calculativeness, Virtue Ethics, Corporate social responsibility.

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Introduction

For a large part of the 20th century, the world experimented simultaneously with two principal economic systems: the traditional free-market system was specific to the Western World, while another group of countries led by the Soviet Union, China and their "satellites" implemented a centrally-planned system. As Friedrich Hayek pointed out many years ago, command economies come with a built-in propensity to suppress individual rights (Hayek, 1944)[2], and sure enough, autocratic regimes and violent dictatorships proliferated in all socialist countries. For years, their governments managed to maintain political order by using terror and violence in response to protests and the popular struggle for freedom. Command economies were also characterized by a generalized waste of resources, stemming from a notorious inability to process information. All this brought socialist systems to collapse almost everywhere in the late 1980s.[3]

Capitalism today enjoys an enviable position as the only reliable *economic model*, despite variations between individual economies in the frontiers between the public and private spheres, the aims and means of state intervention, the scale and nature of income redistribution, market regulation, etc. Regardless of these differences, developed countries owe their economic success to the basic principles of capitalist organization: private ownership of resources, specialization in production, and coordination through markets. Private ownership of property gives individuals enough incentive to behave responsibly, specialization enhances the individual's productivity in the workplace, and the free-market model is a highly efficient way of coordinating many individuals' actions. Voluntary exchange is protected by the law and the legal system sanctions any violent appropriation of resources (fraud, crime, etc.) – when such illegal action is detected. As a system for organizing economic activity, capitalism involves a huge amount of complex human interactions.

Flesh-and-blood models – basketball players, top fashion models, political and religious leaders, "star" CEOs – live under tremendous pressure. With all the spotlights pointing at them, any minor flaw is immediately visible to all – and the initial revelation will be amplified and distorted by a system of echoing. As experience shows, sometimes a single

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[2] For instance, Hayek (1944: 88) wrote: "Most planners who have seriously considered the practical aspects of their task have little doubt that a directed economy must be run on more or less dictatorial lines".

[3] Cuba and North Korea are still pursuing the disappointing socialist experiment.

mistake is enough to bring an idol crashing down, making errors a luxury our role models cannot afford. The same can be said of capitalism in its role as an economic model. During the bi-polar socialism-capitalism period, many of capitalism's notorious drawbacks seemed unimportant compared with the flagrant faults of socialism, but once socialism had collapsed all these difficulties fell under close public scrutiny. Being the dominant economic model implies high expectations, and this entails major risks in the event of any fault, whether serious or merely minor.

Not even the most developed capitalist economies are in practice free of abuses in the economic sphere: stories abound of corporate fraud, theft and information manipulation, abuses of market power and corruption. In more specific terms, how many naïve customers have been abused by dishonest sellers? How many people have naively followed the "buy" advice of a dishonest banker who was hiding information about the high risks inherent to certain financial assets? How many buildings are unsafe because a greedy entrepreneur scrimped on the quality of materials? How many top managers manipulate accounting information for private benefit? How many oligopolistic structures set up barriers to entry, then collude, share markets and charge excessively high prices? How many companies disregard anti-pollution measures and take excessively high operating risks? Over the last few years, public tolerance towards these well-known shortcomings has seriously declined. To fully assume the responsibility inherent to its current role as unchallenged economic model, capitalism must fight a more effective battle against its "traditional" sins.

This paper suggests that no suitable social response to the economic drawbacks of the capitalist system can emerge if the ethical perspective is disregarded; unfortunately, in the past, decision-makers at various hierarchical levels have all too often tended to neglect that dimension. To some extent, this may be connected to their general education, which chiefly targets effectiveness. Related to this fundamental goal of waste reduction, economics – seen as a theory of choice – plays a central role in the global ideology of capitalism.[4] Over the last two centuries, the neoclassical view has imposed itself as the dominant paradigm in economics. This school of thought takes its inspiration from the problem-solving approach of engineering: building on quantified objectives and the constraints of the various economic agents, it seeks the most efficient way to achieve these targets, either in a single-individual context or taking interactions between individuals into consideration. While this approach helped decision-makers to effectively fight waste, and thus fostered growth throughout the

Western world, the obsession of modern economics with what Williamson (1993) called *calculativeness* – seen as a tendency to quantify, measure and formalize – can prevent researchers from understanding the ultimate goals of human action and may even help pave the way for the proliferation of unethical behavior in the business environment. Yet there is no tragedy pending. Over time, the neoclassical paradigm has displayed an extreme ability to incorporate concepts and methods from other research fields: physics and engineering, sociology, management, biology, statistics, etc. The time has come for a closer dialogue between economics and business ethics. Both fields would gain from such an exchange, in terms of both structure and insight. In an optimistic perspective, this interaction could lay the foundations for developing a new paradigm for economic decision-making as required by behavioral economists in the last few years.

The rest of the paper is organized as follows. Section 2 points out the essential ethical dimension of economic choices in capitalist societies, and paints a brief picture of the main ethical perspectives. Given that firms are the main vector of economic development, Section 3 focuses on ethical issues at the corporate level. In Section 4, we address the question of whether neoclassical economic theory – which provides essential guidance for business decision-making – would gain from including a systematic reflection on human values. The last Section presents the conclusion.

Ethics and the capitalist economy

Choosing a suitable ethical perspective

In the economic sphere, people are constantly striving to push the limits of resources ever further back. To achieve this goal, they analyze, make choices and act. On his desert island, Robinson Crusoe struggled to survive in a rough and hostile environment. From Aristotle's perspective, insofar as Robinson was concerned with "doing good for man", his choices had an ethical dimension. However, ethical principles take on their full meaning in a social context, since they work their effects through interactions between people. Ethical behavior should thus be seen essentially as "doing good for people".

Because economic activity involves a complex nexus of interactions in production, exchange and consumption, economic choices have an essential ethical dimension (Brickley

[4] Kohlberg (1981: 231) defines ideology as a "very general pattern or structure of beliefs that defines evaluation

et al., 1997, 2002). The early social thinkers of the seventeenth and eighteenth century were fully aware of the very close ties between the two spheres; most of them actually studied both ethics and political economy, to mention only Jeremy Bentham, David Hume, John Locke, John Stuart Mill, or Adam Smith.

Following a line of thought that can be traced back at least to the Ancient Greece of Socrates, Plato and Aristotle, leading scholars including Immanuel Kant, Jean-Jacques Rousseau, John Stuart Mill and Adam Smith have drawn up definitions of good conduct in society and attempted to provide a set of guiding principles for everyday human action. These reflections set the basis for a theory of morals which broadly addresses the Socratic question: "How should one live?"

It might initially appear that such an essential question should receive a clear, straightforward answer. Yet within the realm of philosophy, Ethics seems to be the field where controversies are the most acute. The simple remark that one individual's actions bear consequences for others begs the questions: "what is a good person?", "what is a good action?", and "what consequences can be considered as good?" The various ethical theories attach differing degrees of importance to each of the answers.

For instance, utilitarian thinkers, in the line of Jeremy Bentham and John Stuart Mill, focus on social consequences. In their view, a "good" action is one which brings about the largest balance of good over bad for all the agents concerned. In a more general framework, utilitarian ethics aims to evaluate not actions themselves, but the rules that individuals follow in choosing their actions. From this utilitarian perspective, any rule which creates personal gain at the expense of others can be considered unethical.

Deontological theories emphasize the goals that motivate human actions. In *Foundations of the Metaphysics of Morals* (1785), Immanuel Kant states that good deeds are all that matters; one's action should be judged by the underlying intentions – which are probably unknown to the external observer – and not by the consequences of the action. This goal dominance recommends that individuals should follow duty-based universal rules like the Golden Rule: "Do unto others as you would have them do unto you".

The third important perspective in ethical analysis, virtue ethics, places much emphasis on character; it acknowledges that outcomes and actions cannot be dissociated from the person herself. As argued by Aristotle (384-322 b.J.C) in his *Nicomanchean Ethics*, virtuous people can take only good actions, so ethics is primarily about defining *virtues*.

and choice", including both patterns of assumptions about factual matters and assumed moral principles.

Virtue is that trait of character which allows the person to provide the appropriate response in a given context. In the Ancient Greek (Athenian) context, Aristotle listed some twelve virtues, including courage, temperance, right ambition and modesty… and, most important of all, high-mindedness, which can be understood as a kind of self-respect. A few centuries later, St. Thomas Aquinas (1225-1274), in his *Summa Theologica*, praised the intellectual virtues of wisdom, justice, temperance and fortitude (St. Thomas Aquinas, 1485). In the early years of successful capitalism, Adam Smith (1759) recommended prudence, i.e. "wise and judicious conduct", as the "most ennobling of virtues" (Smith, 1759 / 2002: 253). Virtues as good habits are learned by practicing; knowledge is necessary but not sufficient.

Philosophers' interest in Aristotle's view on ethics is rather recent, and special credit should be assigned to the work of Anscombe (1958), who pointed out that the quest of both utilitarian and deontological theorists for universal rules of action might be void, since no rule can be consistent with the huge variety of real life situations. Several scholars argued that virtue ethics might provide the most suitable channel for analyzing ethical issues pertaining to business situations since is able to strike a subtle balance between determinism (i.e. the external constraints on the individual's behavior) and human character (Koehn, 1995; Murphy, 1999; Solomon, 1992, 2003).

Despite the promising and refreshing view brought about by virtue ethics in modern philosophy and business ethics, decision-makers and standard training in economics kept favoring the rule based perspective, and essentially the utilitarian view. This resilience of utilitarianism is somehow puzzling given that neoclassical economics rejects the founding principle (adding utilities makes no sense in modern microeconomics). An explanation might be found on the side of the calculativeness bias acquired through education, which naturally pushes people who have embraced it to seek rules of actions, even if this way of making choices leads sometimes to inappropriate responses.

Four important questions

To further our understanding of the complex relationship between the spheres of ethics and economics, four important questions must be addressed. Firstly, we need to know *whether capitalism needs ethical behavior*. As pointed out by several social scientists, positive social externalities like trust, loyalty, justice in future dealings, and truthfulness, which can all be considered to come under the broad concept of "ethical behavior", are much needed to lubricate the functioning of the market-based economic system (Arrow, 1974; McKean, 1975;

Becker, 1976; Noreen, 1988; Brickley et al., 2002).[5] The opposite implication is also true. There is a broad expert consensus that reneging upon these ethical values would entail major economic costs in the free economy (Chami et al., 2002; Vranceanu, 2005).[6] But it is possible to go a step further: since capitalism *builds on* voluntary exchange as the mode of allocating resources, universal human values (like integrity, prudence, fairness, etc) are a basic precondition for the existence of the system itself (Solomon, 1992). There can be little doubt that generalized theft and dishonesty are obstacles to the proper global functioning of a decentralized economy, since there is no reason to believe that the juridical system in charge with the order enforcement, would not develop the same vices (and thus become ineffective).

The next logical question is *whether the capitalist system is able to support a moral mode of development.* Critics used to claim that since in capitalism every individual can pursue self-interested goals, there is a risk that selfishness, greed and aggressive competition will become dominant social norms.[7] In fact, these fears have been substantiated neither by experience nor by logical inference. Friedriech Hayek's argument is today as true as ever: the *principle of individualism* does not imply that the individual cannot agree on socially valuable goals and cannot choose to take part in socially valuable action. What individualism acknowledges is that: "the limits of our power of imagination make it impossible to include in our scale of values more than one sector of the needs of the whole society" (Hayek, 1944: 59). A free-market environment gives the individual the freedom to pursue his own ends, but does not prevent him from taking collective action. People who live in a free-market environment can adhere unreservedly to universal values: prudence, integrity, fairness, etc. The fact that people are allowed to be egoists does not mean they necessarily will be. In fact, it is highly probable that human virtues will, most of the time and for most individuals, prevail over vices as selfishness and aggressiveness. Capitalism as a society based on voluntary exchange could never emerge if such universal values did not guide human action. For John Locke (1690), self-imposed respect for one's neighbor is the direct consequence of people being equal in the initial State of Nature. As Adam Smith observed two and a half centuries ago in his *Theory of Moral Sentiments*, human beings are born with a moral sense of conscience and sympathy

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[5] This is a *virtue ethics perspective* since we have here a set of virtues, associated by these social scientists with the notion of ethical conduct in business.

[6] For instance, such costs became explicit in the early 2000s when the US Internet bubble burst; at the time, the series of crises undermining trust in the management of large corporations reinforced the slump in the stock market, and contributed to an increase in the cost of raising capital, thus further aggravating the crisis.

[7] Such criticism has not vanished together with socialism; indeed, over the last twenty years it has been strongly echoed by anti-globalization groups and some trade unions.

(fellow-feeling) enabling them to live together well, without external intervention. For instance, he wrote that:

> "Among well-disposed people, the necessity or convenience of mutual accommodation very frequently produces a friendship not unlike that which takes place among those who are born to live in the same family. Colleagues in office, partners in trade, call one another brothers; and frequently feel towards one another as if they really were so. Their good agreement is an advantage to all; and if they are tolerably reasonable people, they are naturally disposed to agree" (Smith, 1759/2002 : 263).

True, in capitalist societies, competition is the main engine of economic development. In a static picture of economic relationships, competition may be interpreted as rivalry, which has the negative connotation of aggressive behavior. But this analysis ignores the fact that development itself is the basis for better human relations; when the limits of scarcity are pushed outwards, people become more generous, and aggressiveness is attenuated. Anyone who often uses the subway knows that this proposition is true: in general, when trains turn up at a normal frequency, and the station is not crowded, people are polite and board the train in an orderly way (they may even occasionally smile at each other!). But when the train is late, people rush to get a seat; they behave aggressively and with exacerbated self-interest. Scarcity is often the cause of aggressiveness. Many empirical studies have suggested that crime and other deviant behaviors are often concentrated among those living in poverty (Oxoby, 2004).

A third important question is *whether the capitalist system is able to spontaneously deliver the optimal amount of ethical behavior.* Arrow (1974) argues that nothing guarantees this. Given that ethical behavior has all the characteristics of a positive externality, basic economic theory would suggest that the amount privately supplied will be lower than optimal. This may well be the case: everybody prefers to deal with honest, trustful and fellow-feeling partners. Yet, if a favorable equilibrium is in place, the incentives for one isolated individual to deviate may be considerable. Capitalism creates the conditions for emergence of ethical behavior, but does not appear to spontaneously produce the optimal amount. In the Introduction, we called attention to the notorious drawbacks that are part and parcel of capitalist systems. These drawbacks may be indicative of a contemporary *shortage of ethical behavior*.

This leads us to our last logical question: *what should be done?* Several scholars argue that ethics-oriented state intervention (regulation) can help bring about the favorable equilibrium (e.g., Dunning, 2001; Djelic, 2005; Keren, 2005). As Milton Friedman puts it:

> "The existence of a free market does not of course eliminate the need for government. On the contrary, government is essential as a forum for determining "the rules of the game" and an umpire to interpret and enforce the rules decided on." (Friedman, 1962: 15).

The supply of ethical behavior is assumed to increase if these "rules of the game" are inspired by universal moral values. In particular, the government should regulate business in such a way that any strategy requiring unethical behavior is either ineffective or extremely expensive for the player who implements it.

The major criticism of this approach turns on the question of whether the State is able and/or willing to promote ethical behavior. Firstly, to define rules of good conduct applying to a myriad of different situations may be an impossible task. Secondly, despite the usual political discourse covering a wide range of issues, contemporary governments still set output growth as their main priority. In many cases, ethics and effectiveness may be orthogonal goals. Finally, public officials are all too often given to unethical behavior themselves. Political fraud and abuses of privilege are widespread in both developed and developing countries, as is corruption. There are many examples of state officials showing extreme incompetence, or trying to manipulate institutions and information in their own interest. Can we really trust them to support the implementation of ethically-oriented regulation? The answer is probably yes, but only to a limited extent.

This paper claims that there is another channel which can help a pro-ethical business environment to emerge. In the world of business beliefs and behaviors are deeply intertwined. Social scientists in general and economists in particular should become aware of the practical importance of ethical issues, and advocate integrating the ethical dimension into everyday decision making. Practitioners and policymakers would probably listen to them (they be unwilling to admit it, but they often do so already), and try to transpose the theoretical concepts into practice. No matter how difficult it is to debate the concept of ethical behavior, the contribution of these reflections to improving the quality of human interactions should not be underestimated. Neither should the role of ideas in shaping our lives. Of course, this social project is realistic only if, as argued by Argandoña (2003), *ethics belong to a higher order* *than social institutions* which, in the market economy, are ultimately driven by the efficiency goal.

Ethics and the capitalist enterprise

Enterprises are the main vectors of prosperity and innovation in capitalist societies. Despite their significant contribution to economic development, there is constant public concern and even suspicion about the way corporations exercise their power (Rayman-Bacchus, 2004). The time has now come for more in-depth analysis of the ethical foundations of corporate decision-making.

A complex relationship between shareholders and other stakeholders

The size of the contemporary capitalist firm varies, from the atomistic firm (self-employed individual) to the huge multinational employing thousands of workers throughout the world. Why do people set up firms? In general, such hierarchical forms of organizing economic activity emerge when they provide a more efficient way of delivering goods than the market. More precisely, creating a firm and bearing the inherent organization cost may be the best alternative when transaction costs – connected to uncertainty about future outcomes, bounded rationality or imperfect information – are significant (Coase, 1937; Williamson, 1985).

Most of the time, ethical dilemmas are representative of large companies (by convention, those employing more than 500 persons), which account for about half the GDP of developed countries. These firms finance themselves by their own profits, bank loans, and issuing shares and bonds. In recent years, there has been a clear trend towards increased stock issuance. In particular, the contribution made by many small investors to the development of large businesses has been edging up as new financial instruments have been created and capital markets throughout the world are increasingly deregulated. As a consequence, shareholders' ownership of large firms has kept on increasing in many countries.

Shareholders, being concerned with maximization of their own wealth, need reassurance that the company is generating the largest possible flow of earnings over the long run. Yet managers may pursue self-interested goals quite incompatible with those of shareholders. Corporate governance systems were therefore designed to align these goals and limit the conflicts of interest between managers and shareholders. Over the last decade, structural changes in the financial architecture of capitalist economies have thrown the door wide open to new tensions between managers and shareholders.[8]

The firm as a legal entity raises capital and hires workers, buys input from suppliers, sells goods and services to customers, pays taxes and maintains complex relationships with the regional and national public administrations. After the influential work of Freeman (1984), social scientists acquired the habit of referring to the distinct groups of people affected by the corporation in the pursuit of its goals as the *stakeholders*. In general, the literature designates shareholders, employees, customers, government and the community as the main stakeholders.

Starting from the basic fact of life that sometimes the objectives of the various stakeholders are contradictory, several researchers have claimed that many drawbacks of contemporary capitalist societies stem from management's excessive focus on shareholders' interests and a mirror-image neglect of the other stakeholders' objectives. This point of view is open to debate. True, managers may pursue short-term goals, and this may bring about a conflict of interest between shareholders and the management. But there is no reason to assume that shareholders themselves are victims of the same myopia; as residual owners, their wealth depends on the firm's life-long income flow. And how will a firm that exploits its stakeholders survive in the long run? For instance, how can a company which underpays its staff hold on to the best people and motivate its workforce? And without good people, how can it stay in the market? Can a company which relies on communicating false information about the alleged good quality of its products survive in a free market system?

In fact, shareholders and other stakeholders' interests are generally convergent (see also Carson, 2003). The source of the tensions observed between stakeholders and the management team tends to relate to bounded rationality and imperfect information issues. Fletcher (1966: 114-155) states that "moral choices need intelligence as much as they need concern, sound information as well as good disposition". It may sometimes be very difficult for the manager to have a precise view of how his decisions will affect the peripheral economic players. Like all human beings, top managers can make mistakes. Stakeholder theories make a strong point when they argue that managers should be more aware of the collateral effects of their decision on peripheral players; this change of focus does not imply

[8] For an analysis of the conflicts of interest that occurred during the Internet bubble of the nineties and their ethical implications, see Carson (2003), Donaldson (2003), Healy & Palepu (2003), Sims & Brinkmann (2003), and Vranceanu (2005).

any neglect of shareholders' interests: on the contrary, such open-minded management could be the key to success for a company (and thus serve its shareholders' interests).

Corporate social responsibility – the concept

We can now turn our attention to the important question of *corporate social responsibility*; the concept involves a moral judgment about a company's action in society. In 1962, Milton Friedman wrote that in capitalist economies:

> "…there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rule of the game, which is to say, engages in open and free competition, without deception or fraud" (Friedman, 1962: 133).

His very energetic dismissal of any need for firms to explicitly take the "bigger picture" into account can be better understood if placed in its historical context. Milton Friedman wrote his piece at a period of maximum strain between the socialist and capitalist blocs; at that time, many Western social scientists thought that the command economy might provide a workable alternative to the market economy. Friedman wanted to put across an important ideological message: that free enterprise is a key element of a free society, and worth protecting.

Without denying this essential principle, we know that real-life corporations do not always "stay within the rule of the game". For instance, in the late nineties, several top executives with leading US and some European companies perpetrated huge accounting frauds. The assumption of perfect competition is also problematic. In many sectors, the world market is shared between only a few major companies (oil, airplanes, cars, pharmaceutics, software, etc) which utilize their market power to put tremendous pressure on consumers. This departure from the perfectly competitive market environment can drive a wedge between various stakeholder interests: for instance, a monopolistic company would be able to pay high wages to its employees while also charging excessively high prices, making its clients worse off. Everyone who observes these abuses would agree that a narrow application of the utilitarian principle consisting in maximizing the sum of insiders' utility is inconsistent with what we understood by ethical behavior.

Sometimes, different courses of action bring about the same gain in wealth, but have different social consequences. Why should companies (or more precisely, their management team) not reflect on these consequences, and try to choose the most moral course of action? When company abuses are triggered by a shortage of competition, ethical managerial behavior can redress the balance of corporate action in favor of the disadvantaged groups. We do not claim that corporate resources should be devoted to provision of public goods (e.g. schooling, healthcare, service to community); the State is better fitted to fulfill this task. We only claim that in the quest for the largest profit (which in competitive markets is close to zero), management's choices must build on *universal virtues* – respect for others, integrity, fairness, responsibility, wisdom and prudence.[9] Their behavior must be spontaneous, anchored into their intimate convictions and confidential.[10]

When analyzing an episode like the recent Internet bubble, Shleifer (2004) points out that some managers who manipulated earnings by "creative accounting" did so under pressure from both shareholders, who saw the share price going up, and workers, who received better pay since the firm could raise cheaper capital. He suggests that such behavior could be considered as ethical, given that many agents benefited, and adds that a manager who did not implement it would have been thrown out of his job. This line of reasoning points to the limits of ethical utilitarianism combined with ethical relativism. If one follows Shleifer's view and defines ethical norms by reference to practice, any practice can be interpreted as ethical provided it is adopted by "the crowd". In this case, the concept of ethical behavior would become irrelevant for economic decision-making, since no decision can build on a moving referential. Furthermore, as Hayek (1960) pointed out, in a social framework such an ethical perspective is supportive for the worst abuses against minorities.

Virtue ethics provides a sturdier approach to evaluation of managerial practices. If there is such a thing as universal human values – and we believe there is – they should guide managerial actions towards achieving society's long-term objectives, in harmony with the objectives of their own company. They can also protect the weakest persons, within the scope of corporate action, against potentially harmful actions undertaken with a view to maximizing the sum of individual utilities, thus complying with a sound redistributive principle (Rawls, 1971). If in the years to come, managers choose to move further away from universal values

[9] This is not an exhaustive list. Research in Business Ethics has an important say in pointing out the relevant values.

and take a narrow focus concentrating only on effectiveness, there may be more public protest against such conduct in developed countries, due to the divergence between the individual stance, which is largely ethical, and such corporate practices. People want to see the principles that guide their everyday action also guiding the organizations they set up, be they firms or the government.

There is widespread agreement between economists and social scientists that ethical conduct can improve business performance; indeed, it is clear to everybody that unethical behavior comes with significant long-term costs attached, starting with loss of reputation, an important asset in the business world. This instrumental perspective is important, but is far from fully satisfactory; the real debate is whether consciousness of an ethical stance, independently of pecuniary considerations, can be raised in the businesses themselves, as they can for individuals.

As already mentioned, policymakers have responsibilities in the field of institution-building, and developing regulation systems to support ethical behavior. A clear diagnosis of the global business organization should be worked out and the potential conflicts of interests should be identified. The business regulation environment should then be modified so as to make dishonest behavior strategies either ineffective or very expensive (i.e. to block conflicts of interest). The global business environment needs to integrate incentives for managers to behave ethically; for instance, preventing auditing firms from carrying out consulting activities for its audit clients, which would reduce the incentive to provide fraudulent reports. Or obliging managers to accept legal liability for the financial statements, as required in the US by the *Sarbanes-Oxley Act* of 2002, which means there is less incentive to communicate misleading information.

Sanctions and public watchfulness are needed, but may not suffice to bring about the desired outcome. Plato's remark "Good people do not need laws to tell them to act responsibly, while bad people will find a way around the laws" is as true for corporate actions as for individuals. As Argandoña (2004) emphasizes, the government should not aim to impose rules of ethical behavior on every firm. The other possibility would be *to raise managerial awareness of the ethical challenges*. Socially responsible companies would be able to anticipate ethical conflicts, and take preemptive action accordingly. They would be the

[10] This is important because communicating on the ethical orientation of a company may confuse the public, since there are all too many attempts to "buy a conscience" for firms that notoriously pay lip service to ethical principles but abuse market power, engage in corruption, disregard environmental regulations, and so on.

pioneers of self-imposed ethical norms, which could provide guidance for other firms.[11] Research in the social sciences should provide practical men with management tools that assign a more important role to ethical issues.

Neoclassical economics and Business ethics

The development of the capitalist system – with its significant achievements and its ethical dilemmas – cannot be dissociated from the establishment of economics as a major field of social research. Indeed, the influence of economic thinking on human action is impressive. To quote John Maynard Keynes:

> "…the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." (Keynes, 1936: 383)

What is modern Economics about? One eminent textbook provides the generally accepted definition: "Economics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people" (Samuelson & Nordhaus, 1998: 4). Acknowledging the tension between the scarcity of resources and the assumed limitlessness of needs, modern economic theory has focused on effectiveness in production and allocation, *for given tastes*. This textbook has 781 pages. Only one paragraph, on normative economics, contains a reference to the concept of ethics, and then in a rather problematic sentence: economics is said not to be able to supply right or wrong answers to questions that involve "ethics and value rather than facts". This is totally representative of a stylized fact pointed out by Hirshleifer (1977: 23): "modern neoclassical economics has foresworn any attempt to study the source and content of preferences, i.e. of the goals that motivate men's actions".

[11] The development of ethical codes and ethical programs could be part of the ethics-oriented management system.

Taking this narrow view, economics has managed to explain many real-life phenomena and helped decision-makers to significantly improve the quality of their choices.[12] In recent years, economics has incorporated new techniques from statistics and game theory, and successfully addressed the issues of imperfect information, credibility, dynamic consistency and incentives as applied to both micro and macro situations, and to specialized sub-fields of economics. In particular, in the seventies and thereafter, economists managed to provide a neat analysis of expectations within the exogenous tastes paradigm. Combined with the assumption of imperfect information, the formal, probabilistic approach to expectations – referred to as the *rational expectation* assumption – brought support to the idea that multiple equilibria and the related instability might be a built-in feature of free-market economies (in particular, those which rely heavily on the financial market to transfer resources over time).

Thanks to econometrics, economic theories can be tested and falsified, so that only those theories which stand up to many longitudinal and cross-sectional verifications will survive. The fact that it is possible to apply such methodology, extensively used in physics, probably explains the high credibility of neoclassical economic theory as compared with other social sciences; in turn, this credibility explains why economics has such a strong influence on the general ideology of capitalism.

However, the tendency of contemporary economics to ignore goals and (human) values is rather puzzling. As emphasized by Sen (1987), at its modern origins in the 18th century, the science of economics was closely related to that of ethics. Solomon (2003) goes a step further and suggests that Adam Smith – who wrote both *The Wealth of Nations* (1776) and *The Theory of Moral Sentiments* (1759) – should be considered the father not only of Economics but also of Business Ethics. Classical economists were at least as concerned about how people *should* behave within the economic interactions as how these interactions are actually organized. This normative focus required judgment regarding the fairness of distribution, and more generally regarding the ultimate goals of the society.

Sen (1987) also argues that it is a mystery why economics gradually shook off its early interest in ethical issues to follow the problem-solving approach of engineering. But the development can be rationalized. Firstly, the intellectual appeal of physics and engineering during the Industrial Revolution should not be underestimated. Secondly, the idea that limits

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[12] Perhaps the main achievement of mathematical economics is the logical demonstration of the theorem according to which an *ideal* free-market system can work properly, as described in qualitative terms by Adam Smith in his celebrated Invisible Hand parable. The formal proof was provided by Kenneth Arrow and Gerard Debreu in the 1950s, following an approach pioneered by Leon Walras in 1930.

on resources could be rapidly pushed back if modern methods were employed in goods production held an exciting appeal. It is hardly surprising if at the time of the Industrial Revolution, fighting poverty took priority over any other considerations.

While carrying out research within these self-imposed boundaries has enabled researchers in the specialized sub-fields of economics to obtain many substantial results, and effectively contributed to the development of the Western World, in recent years it has become only too obvious that such methodological extremism is no longer justified, and may even become damaging. According to Yuengert (2002), over time neoclassical economics has become more and more of a technique, which, like any other technique, can develop with a degree of independence from reflection about the ultimate goals of the analysis. He notes that: "If the researcher's ends are separated completely from the higher ends which direct it, he will either substitute the goals of economics for those higher ends, or risk conducting research that has no intelligible principle guiding it" (Yuengert, 2002: 331).

As already mentioned, Williamson (1993) pointed out that traditional economic theory has developed a methodology which focuses on *calculativeness* – a concept that he does not define, but from his examples appears to be characterized by a strong focus on analytical thinking, formalism, measurement, etc. This calculative approach to *positive economics* could be considered unsuited to analysis of choices driven by personal feelings or emotions, since such decisions cannot easily be transposed to the straitjacket of quantitative goals. In general, economists carrying out analyses of trust, honesty, fairness and altruism have worked within the framework of the standard model for decision making under uncertainty; in this paradigm set up by John von Neumann and Oscar Morgenstern in the 1940s, the individual is supposed to chose the course of action consistent with the highest expected utility. Hence, economists used quantitative measures of satisfaction for the subject to assess the benefits of telling the truth, helping others or comparing with a reference group.[13] In the expected utility framework, prudence may be interpreted as risk aversion. This approach has brought about substantial insights into these problems, and may contribute many more. But how can the intimate decision "to act with integrity" be transposed into the calculative framework? How does a "look on the bright side" attitude to life affect decisions? Obtaining an answer to these

[13] For an illustration of this methodology, see Schelling's Altruist Dilemma. This is a variant of the Prisoner Dilemma, where being nice to others is highly costly to one individual. In the Nash equilibrium, both players behave altruistically, but they would have been better off if they were selfish (Schelling, 1968). See also Sobel (1985), James (2002) or the special issue of *Journal of Economic Behavior and Organization*, 55, 2004.

questions is probably not impossible, but careful, in-depth analysis is still needed to provide one.

A more fundamental question is whether the object of research in economics is determined by the method (assumed to be invariable), or whether the method itself can evolve so as to increase its analytical power over a given subject. If economics is about studying human choice *for given tastes*, the former applies, because in that case the method defines the object and not the reverse. But if economics is about studying human choice, the latter will be true. Quite obviously, a person’s character (preferences) is the engine but also the result of the ongoing battle against scarcity. As pointed out by Aristotle long ago, in the long run, action will also have a bearing on character. In other words, choice may have a bearing on tastes, and not only the other way round. Several scholars in consumer theory, particularly those who have studied the impact of advertising on demand elasticity or addictive behavior, have already considered this mutual interdependence (*inter alia*, von Weizsäcker, 1971; Pollak, 1971; Cowen, 1989). Could this methodology not be generalized to the study of the impact of choice on human character in general? Interesting analyses at the cross-roads between ethics and economics were also carried out on the interactions between social status and individual welfare (*inter alia*, Frank, 1985; Scitovsky, 1992; Cole et al., 1992; Corneo & Jeanne, 1998; Oxoby, 2004).

In recent years, behavioral economics pointed out several contradictions between the standard model in decision making under uncertainty and actual individual choices (in special cases). Some researchers concluded rather hastily that the concept of rationality dear to neo-classical economists is meaningless; the other have inferred that the standard decision model should be generalized in order to account for these idiosyncratic reactions. As pointed out by Smith (2005), the first conclusion looks inconsistent with the observed domination of the planet by the human specie over several millennia; he embraces the second view, and suggests that economists should pay more attention to the role of contexts in mental processes, as shortcuts for decision making. No doubt, ethical values have an important role in context definition and selection and thus should have a bearing on the choice of the course of action.[14]

From a *normative* perspective, neoclassical economics adopts a relatively low profile. The Pareto principle authorizes the decision maker to improve the well-being of one person if this action does not affect the well-being of anyone else. Yet, in many real life situations, economic actions involve trade-offs; ex-post some persons will be better off, and others

[14] Smith (2005) emphasizes the role of fairness.

worse-off. Neoclassical economics has for long acknowledged that compounding (weighted) utilities is a meaningless exercise, as is the maximization of the sum of utilities as a decision criterion for collective choice. Is there any way to aggregate individual preferences so that the preferred ordering of alternatives should be respected for all individuals? Arrow (1950) proved that this is impossible, under a very restricted set of sensible axioms. Since traditional economic analysis provides decision-makers facing trade-offs with little guidance, they must rely on superior, ethical-based criteria.[15]

In general economists themselves refuse to consider the moral implications of their policy advice. Their usual disclaimer is "I must focus on effectiveness and let the policymaker assess the moral consequences of my recommendations". But a change of perspective might well improve the quality of economic analysis. Responsible researchers should be directly concerned with the ethical implications of their advice. True, those who address ethical issues need an excellent understanding of the social context surrounding individuals and firms. Since time is a scarce resource, some might gain from shifting the balance from learning techniques towards learning facts.

Conclusion

Does capitalism support the emergence of ethical behavior between market participants, or does it on the contrary provide a prolific breeding ground for greed and aggressive rivalry? Can policymakers and society regulate the supply of ethical conduct? Should corporations be concerned with ethical issues or should they focus on wealth maximization only? Should economics broaden the field of analysis so as to integrate ethical considerations? As is usually the case with ethical issues, there is no simple answer to these questions: it may actually depend on the background and personal experience of the researcher. But the co-existence of a range of opinions should not be taken as a disincentive to further research on these topics; if anything it should have the opposite effect.

By allowing the individual the right to behave in accordance with her own principles and values, the capitalist system creates the necessary conditions for the moral development of all people. Yet in a moral environment, there is no guarantee that some individuals will not be tempted to take advantage of this favorable situation and reap personal benefit by abusing

[15] Stiglitz (2002) is extremely critical about the policy reform programs implemented in the eighties by developing countries on the advice of the main international financial organizations, which neglected the social,

others' trust, so the spontaneous production of ethical behavior may be suboptimal in the free-market economy. True, an efficient juridical system may dissuade abuses provided that the "rules of the game" do reflect the ethical dimension. Unfortunately, today's governments still focus excessively on effectiveness and may not be able or eager to pay enough attention to ethical issues. The development of a moral environment for business could instead come about from within, with economic agents becoming more concerned about the ethical challenges and acting accordingly. Businesses would probably improve the quality of their interactions with the public at large if the ethical dimension were to become a fully-fledged component of their management systems in general.

To achieve these desiderata, the social sciences, and economics in particular, would need to reconsider the role of ethics in their intellectual constructions and as a criterion for policy evaluation. One proven strength of neoclassical economics is its high ability to incorporate valuable concepts from other fields. This paper points to the need for closer interaction between economics and business ethics. Business ethics would probably benefit from importing a few methods from economics, while the economics needs business ethics to better identify the higher human ends, to work towards incorporating these ends and values into analyses and recommendations. In the long run, these new research paths may provide useful guidance for less disruptive policy reforms and smoother interactions between market participants in the open society.

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