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Ethics, Economics, and Public Policy

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I. INTRODUCTION

Society is increasingly concerned with apparently unethical behavior by the owners, managers, and employees of firms. Often, two features of economic theory are believed to account for the perceived problem. Together, these key features seem to make economics a cold, impersonal, mechanistic, perhaps even totalitarian discipline devoid of personality or interest in anything outside the individual.

The economic emphasis on individual optimizing behavior explicitly or implicitly denies, or seems to deny, a community role in decisions. Critics point out, correctly, the fact that some decisions made under such an approach may benefit individuals while harming the community. The possibility of monopoly profits is a particularly tender point, such seemingly unearned returns bearing many hallmarks of outright theft to some analysts.

Further, the "New Welfare Economics" explicitly rejected interpersonal comparison, apparently denying groups any role in economic decision making (see, for example, Graaff 1957 and Little 1957). If economics can only say that changing to another social state is justified if at least one person would be made better off while no one is harmed, it has little to contribute to intended social improvement. Society is apparently denied the opportunity to improve itself, to pursue a non-efficiency criterion like equality in the distribution of income, or to plan social change. Since it is apparent that society has reached better states of being over time, some view these as unethically misleading denials.

At first glance, neoclassical economics seems to respond to arguments claiming the model is unethical by exclusion. Introductory texts in particular often exclude normative questions from their simplified positive model. On further study, however, economic theory offers an alternative ethical position whose first premise is, indeed, the primacy of individual choice emphasized in Principles courses. In addition, economics includes theories which may account for public choices when externalities or information asymmetries exist and which allow individual choices with ethical content.

Our paper has two parts. First, we examine models offered by noneconomists as substitutes for the new welfare economics and which are intended to provide a more ethical basis for behavior. Buchanan (1985) offered a philosopher's view of the dilemma at the heart of the apparent failure of economic welfare analysis and offered market socialism as a tentative solution. Etzioni (1988, 1990) contended that ethical issues raised by economic theory, particularly the new welfare economics, can be resolved only by expanding economic theory to include the sociological perspective, an approach he calls "socioeconomics." Buchanan's and Etzioni's arguments that the new welfare economics is unsatisfactory, and Buchanan's argument that ethicists and economists would gain from dialogue, were echoed by Sen (1987). He argued that in exchange for the ethical analysis offered by philosophers and others economists could offer increased awareness of efficiency issues, particularly interaction effects. In addition, he suggested that agency theory could be used to expand the scope of ethical analysis within economics.

Next, we consider two economic applications which illustrate the economic role of ethics. First, we examine "The New Public Economics." This theory counters market socialism and socioeconomics by demonstrating that individualistic choice provides a basis for democratic public decisions. Our second application is based on the economics of crime, itself an example of "Economic Imperialism." The model hypothesizes that individuals and firms may include non-pecuniary motives in their decisions

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while searching for maximum utility or profit (Becker 1968; Ehrlich 1974, 1975). In fact, many presumably profit maximizing firms operate extensive programs intended to enhance the ethical content of their actions (Saunders and Brower 1990).

ETHICS AND "THE NEW WELFARE ECONOMICS"

The new welfare economics relies on Pareto analysis, a singularly narrow criterion, and Arrow's impossibility theorem to conclude that economic theory cannot direct social change. Arrow's theorem proved the impossibility of a voting procedure which did not violate at least one of a short list of plausible requirements (Arrow 1970). Buchanan (1985), Etzioni (1988), and Sen (1987) agree that the new welfare economics is inadequate and offer alternative analyses.

A Philosopher's View

Buchanan's discussion includes a capsule review typical of criticism of the new welfare economics. Incomplete citations in this section refer to Buchanan (1985). In particular, he argued that economics "has been dominated by attempts to assess markets solely on grounds of efficiency, to the neglect of ethical issues. Ethicists, (and normative political theorists), on the other hand, have characteristically disdained considerations of efficiency (when they have thought about them at all), while concentrating on the moral assessment of the market, most recently in terms of its failure or success in satisfying the requirements of justice." (1985, 1) Further, he believed that efficiency and ethical arguments might lead to contradictory conclusions about desirable public policies. His central criticism of Paretian efficiency arguments will be familiar to economists; they ". . . may be incompatible with according proper respect to individual persons, who ought not to be regarded merely as contributors to ends which are not their own, including the end of maximizing overall utility" (1985, 9) and he closes by arguing that

> the strongest case for using the Paretian Principles as criteria for assessing the efficiency of social states is not that they are second-best substitutes for utilitarian comparisons, nor that they are morally neutral or even morally uncontroversial. In the absence of an agreement on a moral theory, the best that can be said about the Paretian principles is that (1) both bear a remote resemblance to the commonsense notion of efficiency as taking the least-costly effective means to one's particular end; and (2) the Pareto principles approximate the principle that social arrangements should be mutually advantageous in the sense that the attempt to achieve a Pareto Optimal state and the choice of a Pareto Superior state over a Pareto Inferior state both acknowledge that advantages for some are to be gained if this can be done without disadvantaging others. However, the Paretian principles are morally uncontroversial only if they are treated as principles for *prima facie* evaluations of social states, subject to the possibility of countervailing moral evaluations. So even if the Paretian principles themselves are not moral principles and hence even if we can distinguish between arguments based on efficiency and those based on moral grounds, the decision of how much weight is to be given to the fact that a particular social arrangement satisfies one of these efficiency criteria is not a morally neutral decision. (1985, 10–11)

As an alternative, Buchanan suggests market socialism, a system which includes several models. Some include markets for labor and consumer goods only while others also include production goods and " 'democratic' worker control over the means of production at the level of the individual firm. . . . 'the worker control model' " (1985, 105–106). His argument recognizes the idealistic components of market socialism and concludes that it is a worthy, if inadequately specified, alternative to market capitalism:

> [E]ven if planned socialism can be rejected as highly inefficient as well as inimical to individual liberty, market socialism cannot be dismissed as clearly unworkable or as obviously inferior—*on grounds of efficiency*—to politically feasible, nonideal, private property market systems. Although market socialist systems will remain seriously incomplete until appropriate theories of bureaucratic, managerial, and worker motivation are developed, market socialism is clearly an alternative to private ownership which must be taken seriously, even if we restrict our view to considerations of efficiency alone. . . . At present the ethical theory of market socialism is considerably more rudimentary than its economic theory, but this situation shows signs of changing. (1985, 117, emphasis in the original)

A Sociologists View

Etzioni, a sociologist in the Harvard Business School, is concerned about the place economics claims in the social sciences. His conclusions on the new welfare economics parallel Buchanan's but he would resolve ethical issues by introducing sociological points of view into economics. Economics, he argues, suffers from hubris and would better serve itself and society by adopting sociological insights. Incomplete references in this section refer to Etzioni (1988); similar points are made in a recent symposium (Etzioni 1990, Swedberg 1990, Stern 1990, Romo and Schwartz 1990).

Etzioni's analysis is based on a dialectical view of Kuhnian paradigms. "[T]he entrenched utilitarian, rationalistic-individualistic, neoclassical paradigm which is applied not merely to the economy but also, increasingly, to the full array of social relations, from crime to the family. . ." now competes with two alternatives.

> One main challenger is a social-conservative paradigm that sees individuals as morally deficient and often irrational, hence requiring a strong authority to . . . maintain order. Out of the dialogue between these two paradigms, a third position arises, which . . . sees individuals as able to act rationally on their own, advancing their self or '*I*,' but their ability to do so is deeply affected by how well they are anchored within a sound community and sustained by a firm moral and emotive personal underpinning—a community they perceive as theirs, a '*We*,' rather than as an imposed, restraining 'they.' (Etzioni 1988, ix–x, emphasis in the original)

The search for economic efficiency, he argues, neglects the ethical issues philosophers address and the group issues sociologists invoke. No indication of the extent of economic interest in totalitarianism is given, although one may presume he thinks it non-trivial. Economics must adopt sociological perspectives and categories because, in particular, they address ethical and social issues which arise from asymmetric power.

> "[*N*]*o exchange occurs among equals* but that one or more parties have a power advantage reflected in the "exchange" ratios (the amount of resources one actor has to invest to gain a comparable unit from another). For example, Mexicans need to work four times as much at the same pace using the same capital as Americans if they are to buy a U.S.-built car. . . . Moreover, far from being limited to economic power, economic actors frequently use political power (their leverage over the government) to advance their economic goals." (Etzioni 1988, xii, emphasis in the original)

An Economist's View and Summary of the Discussion

Sen (1987) agrees with Buchanan that economists and ethicists have much to gain from dialogue and with both Buchanan and Etzioni that utilitarian ethics are inadequate. Economists, in his view, have narrowed their focus by eschewing equity issues in general and interpersonal comparisons in particular but he goes on to specify a potential economic contribution to ethics and, implicitly, other fields including sociology.

At the same time, he argues that non-economists have missed the power of economics as an engineering science to evaluate the efficiency components of ethical and other non-economic issues. General equilibrium analysis, for example, allows complex interdependencies which help to explain some apparently unethical situations. Analysis of famine relief in particular would be improved since interdependencies account, in part, for local famines while world food stocks rise.

Sen's alternative to utilitarian ethics begins by recognizing two aspects of a person. First, individual well being is the means of evaluating individual opportunities and achievements, the relative advantages some have and the degree of justice in their distribution. When welfare economics concludes that it has little to say about relative advantages and the degree of justice, however, he joins Buchanan and Etzioni in asking for more. In particular, he argues that individuals act not only for their direct interest but also as agents for broader interests. The agency aspect of the individual, he argues, is responsible for "valuing the various things he or she would want to see happen, and the ability to form such objectives and to have them realized" (Sen 1987, 59). The analysis retains the economist's focus on the individual while using agency costs to measure and evaluate non-efficiency motives.

In effect, Buchanan, Etzioni, and Sen assumed that economists have simply excluded welfare from their analyses. If true, economists would ignore the obvious interest people have in improving their condition, preclude the possibility of finding any theoretical basis for welfare improvement, and leave the field to critics of economic analysis. Etzioni's concern about totalitarian societies seems most likely if economists, in fact, adopted this position. Fortunately, economists have been more imaginative.

ETHICS AND "THE NEW PUBLIC ECONOMICS"

Atkinson and Stiglitz (1980) favor the new public economics on two grounds. First, society is assumed to apply Pareto analysis and adopt all programs receiving unanimous consent. Thereafter, society and governments must choose competing policies; any analysis which precludes such choices, as the new welfare economics does, is simply inadmissible. Accepting such a limitation would make economics irrelevant to public choices unless efficiency was the only question in a particular instance.

Second, the social welfare function proposed by the new welfare economics can be transformed from an unobservable aggregate utility measure to a set of summary statistics involving the level and distribution of income and other characteristics. If social welfare can be discussed in terms of such observable statistics, economics can provide guidance for social choices. The resulting analysis might not achieve the "First Best" results available when lump sum taxes and transfers with full information are available, but they would allow welfare improvements.

In particular, Atkinson and Stiglitz assume a democratic society with a representative legislature chosen by voting. Elected representatives are expected to reflect their constituents preferences in a legislature which functions as a direct democracy. Society, in the form of its representatives, may then choose a welfare function by combining individual interests politically. The authors suggest Nozick's (1974) minimalist state, Bentham's simple maximization of the sum of individual utilities, and Rawls's (1971) maximization of the welfare experienced by the worst off (the maximin criterion) as alternatives to the utilitarian individualistic criterion. Various egalitarian criteria and central planning are also considered.

The weakness inherent in all of these criteria is their assumption that the benefits of perfect competition are attainable in perfect markets or through planning. When markets fail or information is imperfectly available, Atkinson and Stiglitz recognize that none of these criteria are sufficient, as shown by the failure the new welfare economics. The alternative they offer treats horizontal and vertical equality as constraints on social welfare.

If the degree of horizontal and vertical equity are treated as explicit constraints, society can adopt policies which satisfy them but do not lessen social welfare. Political constraints are assumed to enter the problem in the same way that administrative constraints restrict firms. Individuals may vote strategically and groups may act jointly to influence decision makers. In each case, the individual well being of the people involved determines their level of participation and, ultimately, the content of the decisions made.

In this way, equity and political motives enter the economic analysis directly. Society may now choose mixtures of direct and indirect taxes, design agencies which determine their behavior partly by reason of effects on themselves and their employees rather than society at large, and concentrate on distributional rather than efficiency effects. Thus, the new public economics offers the opportunity to explain conspicuous violations of social welfare maximization, like the common reversal of peak load pricing recommendations to benefit commuters (Southwick and Brower 1982).

ETHICS AND "ECONOMIC IMPERIALISM"

Economic Imperialism is the self adopted description of models developed by the so-called Chicago School. The approach is noted for its analysis of non-traditional topics like crime (Becker 1969), irrational behavior (Becker 1962), and others. Becker, for example, believes

> that economic analysis is essential in understanding much of the behavior traditionally studied by sociologists, anthropologists, and other social scientists. . . . In other words, I argue that the broad definition of economics in terms of scarce means and competing ends should be taken seriously and should be a source of pride rather than embarrassment to economists since it provides insight into a wide variety of problems. (1971, 2)

Ethics enters Chicago School analyses as a constraint on individual behavior. People choose to commit criminal, or otherwise unethical, acts if the benefits are large enough to cover all costs, including any psychic penalties imposed by religious, moral, or other motives (Becker 1968; Ehrlich 1974, 1975). Government intervention is limited to controlling externalities through explicit taxes and subsidies or vouchers (Friedman 1962). The literature supporting the deterrence hypothesis is now large (see, for example, citations in Ehrlich and Brower 1987); we are interested in the possibility that it reflects actual corporate behavior on ethical issues.

When James K. Baker, Chief Executive Officer of Arvin Industries and the next chairman of the U.S. Chamber of Commerce, and "There is no such thing as 'business ethics.' There's only ethics. What you do over there's no different from what you do over here." (Kidder 1990) he was echoing Peter Drucker (1981). Their argument parallels the economics of crime in putting responsibility for corporate acts where it must ultimately rest, with the people who work for the firm, particularly its managers. They explicitly adopt the deterrence hypothesis; the objective of business ethics programs is to guide individuals in making ethically correct choices, in part through rewards for compliance and penalties for violations.

In a recent study, we found that six surveys of corporate ethics programs and three articles by prominent academic students of business ethics emphasized such individual responsibility (Saunders and Brower 1990). Corporate ethics programs, we found, are statements of underlying values accompanied by specific policies and procedures intended to guide individual behavior. It seems that firms find ethical behavior efficient in practice even if economic theory does not provide a separate analysis of its role as some critics seem to expect. Our conclusions are limited by the samples underlying the surveys; four of the six studies included only very large U.S. corporations.

We found that business and academic discussions of business ethics begin by assuming 1) that people, particularly managers and other employees, are or want to be honest, and 2) that ethics and profit are complementary. At the very beginning, the assumption underlying ethical criticisms of economic analysis, that managers in particular and people in general are dishonest, is rejected without discussion. While the assumption of fundamental honesty is not traditionally required for perfect competition, it seems essential to us. If people are not fundamentally honest, requiring some guidance and help but desiring to act ethically, Etzioni's fear of a totalitarian society seems inescapable. No one could be trusted and everyone would be watched, a monstrous contradiction.

We also found that the components of corporate ethics programs implemented by firms are so similar they amount to a consensus and that the most recent academic recommendation we reviewed (Molander 1987) is congruent with the apparent corporate consensus. Corporate programs are intended to guide individuals through unfamiliar issues and to provide formal means for discussion and enforcement of ethical standards. Lists of sensitive issues are offered as examples rather than exhaustive catalogs; they change with knowledge about ethical and physical hazards and public expectations. Procedures are provided to encourage discussion of ethical issues, reporting of potential ethical lapses, and to give notice of the penalties for lapses.

The second assumption, that ethics and profit are complementary, connects management to employees, suppliers, customers, and neighbors. At the same time, the community issues raised by Buchanan, Etzioni, and others become explicit parts of the economic model. If a firm is ethical, its reputation will attract ethical employees, increase suppliers' and customers' confidence and willingness to do business, and reduce friction with the community. The firm's costs will be lower as internal losses fall and less security supervision is required. The firm pays smaller legal fees, avoid fines, and reduces public interest in additional regulation while attracting customers who wish to buy from ethical suppliers. Molander's (1987) ideal code is very similar to the corporate consensus. His recommendations are abbreviated in the Table, reprinted from Saunders and Brower (1990).

Our review also found evidence that corporate ethics programs are more than paper policies. A study of 222 responses from a sample consisting largely of middle managers and executives was designed to examine managers' ethical awareness. The authors found that "... these managers perceived ethics to be an important aspect of their jobs. Our research indicated that ethics were ranked ahead of many of the job performance dimensions more often considered in management literature." (Mortensen, Smith, and Cavanagh 1989, 259).

DISCUSSION

Our review of criticisms found widespread agreement that economics does not handle ethical issues well. Critics offered no directly implementable specific suggestions intended to improve the situation, however. Buchanan suggested some form of market socialism but he also offered many caveats. Etzioni sought to reverse the apparent gains economists have made in analyzing non-market situations, to concentrate on society rather than the individual as the unit of measure. Sen argued that welfare economics should be expanded to include the agency effects of individual behavior, a potentially measurable extension of traditional analysis.

Buchanan's discussion was thoughtful, particularly his deliberation on market socialism. Many economists would, we think, agree with him that a world of cooperative interaction would be more pleasant and that such a world could only exist if we had much better understandings of political and bureaucratic behavior. We also think that many economists are skeptical of his claim that market socialism would be as efficient as market capitalism. The lack of adequate theory, which he recognizes, and the absence of data precludes an empirical test in any case.

Etzioni's position is important because the issues of community and power he raises are widely discussed by non-economists. He recognizes the potentially totalitarian effect of government regulation based only on efficiency and suggests questions which, perhaps, economists might address more carefully. While Atkinson and Stiglitz and the pattern of activities found among firms suggest that his misgivings may be overstated, economics might benefit from conscious attempts to explicate the role of ethics and community among the benefits and costs swept together in optimizing models.

Sen's argument provides clear evidence that economists are aware of the ethical issues raised by non-economists. His conclusions on utilitarian ethics and the new welfare economics are congruent with those of Buchanan and Etzioni. He differs from them, however, in that his suggested alternative is within economics; agency theory is now applied in numerous areas.

All three of these critics neglect the actual advances economists have made in modeling ethical issues. The new welfare economics and economic imperialism are only two approaches but their contributions are large. Even the issue of monopoly profits and their presumed unethical effects on society is addressed within the economic model. Scitovsky (1990), for example, argues that asymmetric markets offer substantial benefits through non-price competition. Specialists always have more information and can set prices but they also have incentives to offer non-price advantages to non-specialists which increase welfare. He concludes that there is a tradeoff between the benefits of price and non-price competition but that the two cannot yet be ranked.

The socioeconomic analysis is particularly troubling. Etzioni (1988, 1990) and Swedberg (1990), for example, seem to view the relationship between economics and other social sciences as a fight over turf. They seem to misuse economics, as Etzioni did when he neglected the role of comparative advantage in his discussion of the relative purchasing power of Mexican and U.S. workers. In addition, they seem not to have recognized work by economists which addresses the questions they raise.

Swedberg, for example, claims that "[e]conomic imperialism is trying to impose a single-minded vision on the social sciences and is thereby threatening to close the door on the new discoveries that are today becoming possible through the crumbling of the old division of labor between economics and the other social sciences." and asks: "Why not support the socioeconomists who are trying to keep the door open?" (Swedberg 1990, 38)

A review of the economics literature addressed to public questions would have answered the question. Economists have included ethical and community concerns in their models although not, perhaps, in a form familiar to sociologists. To the extent that the new public economics and economic imperialism are successful research programs their accomplishments are based on models which explain and predict behavior. The door is open. If economics has such strong responses to these criticisms, why do they persist and what effect would additional regulations intended to improve ethical analysis have on economics and the economy?

In our view, the most likely reason for continued criticism of economics is asymmetric information. Our review suggests that non-economists' arguments almost certainly reflect the inevitable lag between developments in one field and their recognition in others. Other possible reasons for the persistence of criticisms include skepticism about the validity of the economic models in general, concern about the relative prestige of disciplines, and ideology.

An alternative, which we do not pursue, is the possibility that critics have other agendas. As Stigler recognized a generation ago, critics have an easy job if they make "poor use of either empirical evidence or economic theory, so [their] criticisms are founded upon prejudice and [their] reforms are directed by wishfulness." (1964, 99)

Next, we turn to the role of public policy in encouraging ethical behavior. Such regulations have a prominent place in non-economists suggestions for improving social welfare and in economists' recommendations for controlling specific market failures. No one, and no firm, exists in an unregulated state. Existing laws and regulations contain extensive descriptions of proscribed behavior and provisions for penalizing malefactors. Firms survive only by accommodating the social and legal environment since their behavior is controlled by the laws of the chartering state, by regulations affecting many of their activities, and by their customers' and neighbors' tolerance. Boards and managers must satisfy both their fiduciary duty to shareholders and all other requirements imposed by law and society. Firms, and individuals, may therefore find that behavior based on ethical motives is efficient as our review of business ethics programs suggested.

We believe, therefore, that regulations specifically intended to improve the ethical performance of markets are likely to offer little real benefit while increasing the cost of consumer goods and services. Firms are designing and maintaining their own programs to encourage ethical performance; it seems unlikely that a government agency could do as well without sufficient direct supervision to adversely affect the economy at large, reducing Gross National Product and social welfare. Denison (1978) found,

TABLE
Molander's Code

1. Employee Rights: The program should prevent employee manipulation by superiors, favoritism, and discrimination. Appropriate affirmative action programs should be included.
2. The Individual and the Company: The program should consider conflicts of interest between employees and the firm, including specific provisions on the use or theft of company property.
3. Customer Relations: The program should ban false advertising, misrepresentations by sales people, and questionable payments to customers. It should encourage fair pricing and reciprocity.
4. Accounting Standards and Relations with Financial Community: The program should ban manipulation and distortion of financial results.
5. Relations with Suppliers: The program should ban exploitation of captive suppliers, questionable payments to and from suppliers, and fee-splitting.
6. Relations with Competitors: The program should prohibit corporate participation in price fixing schemes while encouraging communications and fair play with competitors.
7. Relations with the Political Process and Government: The programs should address appropriate political contributions, fair dealing with government as customer and regulator, and dealing with foreign governments.

Source: Molander (1987)

for example, that the combined costs of protecting the environment and workers' health reduced the rate of GNP growth by 0.65% per year by 1975. Efficiency losses that produce measurable social welfare gains, as environmental and health regulations arguably do, are desirable but it seems unlikely that additional regulation affecting ethics will offer sufficient welfare gains to justify their cost.

Finally, if business and economics respond as well as we claim to ethical issues, and if society has laws and regulations intended to control violations, two questions remain. Why do unethical events occur and why has society not advanced to still better states?

People are human. Everyone makes mistakes, for a variety of reasons, and some choose to behave unethically or even to commit more or less horrible crimes. Economic models address average behavior, knowing that no theory can account for every action by every individual. For public questions, however, studying behavior by the average individual is an advantage. No policy could address every individual without the totalitarian controls Etzioni (1988) fears. The economic emphasis on individual choice, in fact, opposes totalitarian tendencies as recent events in Eastern Europe and the Soviet Union demonstrate.

The second question assumes the existence of an ideal legal or ethical system. Such a system would guide people to ever better behavior, continuously reducing the number and severity of legal and ethical failures. We believe that such a system must remain a myth simply because no individual or group could hope to have sufficient information to construct it. Only if everyone agrees on specific goals could such a state even be approached but, since unanimous choices are the most easily adopted and the ideal state does not exist, it cannot exist. Society can only advance as fast as its members are willing to accept change. Those who want faster change and those who want slower or no change agree to deplore the actual rate of change, but for opposite reasons. The larger group in the middle proceeds at its own pace, exhorted by both sides.

Economics need not apologize for its handling of ethical and community issues. Instead, the strength of economic models is their ability to accommodate new questions. Rather than ignoring ethical issues, economists have developed approaches which incorporate them into the basic model, improving our understanding of markets and human behavior within the existing framework of analysis. The new welfare economics was flawed but it led to better models. Whether economics, sociology, or some other approach offers the better explanation of behavior can only be determined by their relative ability to predict behavior. In any event, we can be sure that economics, and other disciplines, will be strengthened as they respond to criticism.

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