

# Incorporating Business Ethics in Commerce 394

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### **Abstract**

These notes and attached readings are designed to assist instructors of Commerce 394 (Government and Business) in adding a business ethics component to the course. Approximately 1/4 of the course should be devoted to material with significant ethical component. In keeping with the current structure of C394, the business ethics component will also be divided into a conceptual tools section and a set of applications. These notes combine a number of ideas on what material should be used in both sections. I also add a proposed syllabus including a course outline, readings, and class participation activities (debates, cases, trials).

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# Chapter 1

## Business, Government, and Ethics

### 1.1 General Principles

There are three overarching issues in business ethics. The first issue is what ethical principles are available and useful for determining in any specific situation what the ethical course of behaviour is. The second issue is whether profit maximization, or perhaps the well-being of shareholders, should take a primary position in managerial decisions. Finally, independent of the ethical goals of the firm and its employees, there are several important implementation issues.

#### 1.1.1 Useful Ethics Concepts

This section contains a highly selective overview of concepts from moral philosophy that a manager may find useful in analyzing and resolving ethical dilemmas. Before continuing, however, it is worth asking whether this section is necessary or even helpful. Do managers really need to study moral philosophy? Ethical principles are said to be required if the manager is to deduce whether action X is right or wrong. An obvious alternative would be for the manager to let society make such conclusions. Whether X is wrong or not would then depend on whether society (through its various mouthpieces, e.g. religious and political leaders, newspaper columnists, socially concerned actors and musicians) approves or disapproves of actions like X. In defense

of this alternative would be the doctrine of cultural relativism which argues that there are no absolute or universal principles of right and wrong; but rather, social norms of sanctioned and prohibited behavior. Even if one believed that there are absolutes, one might argue that the manager has neither the training nor the natural aptitude to conduct deductive ethical analyses. Certainly, comparative advantage arguments would favor the idea that managers should make widgets and ethicists should be left the task of moral reasoning.

The case against learning ethical concepts becomes stronger if the manager's motivation for behaving ethically is based on the belief that such behavior will promote long run profits. If the firm wants to be perceived as ethical by customers, suppliers and employees, then it need not know whether X is right, but only whether those groups *believe* X is right. This recalls Keynes' famous example of betting on the outcome of a beauty contest. You do not pick the person you find most beautiful; you pick the one that you think the judges will find most beautiful. Similarly, the pure investor in art tries to find paintings that are undervalued relative to the price they will command in the future rather than the ones that are undervalued relative to the investor's own valuations.

Not surprisingly, I find the above arguments unpersuasive. Three considerations challenge the main premise of the anti-first-principles approach. A fourth, perhaps cynical, consideration suggests the knowledge of principles may be quite useful.

- Society does not speak with a single view on what constitutes ethical behavior. Many of the disagreement in popular arguments can be understood in terms of conflict between ethical principles which were developed decades or centuries ago.
- A multinational enterprise operates across multiple standards of ethical behavior. It will often be the case that those standards conflict. However, since the firm is answerable to stakeholders in both nations, it cannot simply adapt to local standards.
- What "society" does say about ethical issues is usually too general or too particular to be of much guidance to the manager. For instance, while the manager absorbs the idea that Exxon was somehow morally culpable in the Exxon Valdez oilspill, the *type* of behaviour

which is disapproved of by society was not clear; hence, it is difficult for other firms to draw conclusions for how society would regard a decision they are contemplating. On the other hand, while our society frowns on certain practices—bribery, deceit, failure to keep commitments—it does not say much about what circumstances, if any, make those actions permissible. For instance, was McDonalds “deceptive” when it failed to label its coffee cups with a warning indicating the high temperature?

- The ethical concepts we will examine have been around for a long time and in part reflect and in part are reflected in our society’s notions of right and wrong. An understanding of the various strands of our ethical traditions is useful to the manager who is called upon to defend an action to shareholders, consumers, a jury, or the general public.

What about the problem that there are rival ethical principles which conflict with each other? Is the manager expected to resolve age-old debates that have occupied moral philosophers on a full-time basis? There are a several possible responses. First, the cautious manager may examine a dilemma from several perspectives and then easily dispose of the many cases where there is no conflict. Second, the manager may choose the principles which justify the action they took or wish to take. Third, the manager may adopt the principles which appear to be the ones that are held dear by the primary stakeholder the manager wishes to accommodate.

At the risk of overkill, I will paraphrase four additional reasons that Fred Feldman provides in the introduction to his book to show why moral philosophy is useful.

1. Moral philosophy can help us to examine our various gut responses to moral issues and figure out what our moral system actually is.
2. Moral philosophy helps us avoid adopting a set of moral principles that are logically inconsistent with each other.
3. Moral philosophy helps us discover the full implications of theories we may have heard of and have an initial response to (for or against) so that we can modify our own views if necessary.

4. Moral philosophy helps us to evaluate new Gurus of Business Ethics. We will be able to analyze their statements and find out whether they have just unearthed old discredited theories and supplied them with new jargon.

**Cultural Relativism** Moral codes differ from society to society. “Morality...is a convenient term for socially approved habits.” (Ruth Benedict in *Patterns of Culture*)

**Conventionalism** Do what the widely held norms of your society dictate. Or, “An act is morally right if and only if it is permitted by the conventions of society.”

**Consequentialism** The rightness of an act depends on its (expected) results. Whatever the intrinsic goods are—candidates would include physical pleasure, friendship, the appreciation of art, the salvation of the soul—acts are good if they have the consequence of increasing such things.

**Hedonism** Happiness, the presence of pleasure and the absence of pain, is the one ultimate good and everything else is desired as a means to that good.

**Egoism** Each person ought to do whatever will best promote his or her own happiness.

**Utilitarianism.** Each person ought to promote increases in the sum of all happiness experienced. Or, as Mill put it, “According to the Greatest Happiness Principle, the ultimate end, with reference to and for the sake of which all other things are desirable (whether we are considering our own good or that of other people) is an existence exempt as far as possible from pain and as rich as possible in enjoyments.

**Categorical Imperative I** “Act according to the maxim by which you can at the same time will that it should become a universal law.” Moral duty consists in following rules that we would want all people to follow in all circumstances.

**Categorical Imperative II** “Act so that you treat humanity, whether in your person or in that of another, always as an end and never as a means only.”

**Contractarianism** Our duty is to act according to the rules that rational, self-interested people can agree to establish for their mutual benefit.

1. In Prisoner's-Dilemma problems act according to the contract, which, if binding, you would sign with the other player. Or (as an implication), take the action, that if taken by the other player, would maximize your combined welfare.
2. Act in accordance with the moral code that would be chosen in the original-position (Rawls).

Now let us consider some of these terms/theories in more detail.

Regarding Cultural Relativism, it is undoubtedly true that different societies have held different ideas about right and wrong. Anthropologists have documented these differences but it is not clear what they imply about whether conventionalism is correct. One damning argument against conventionalism is the so-called Reformers Dilemma. Suppose you arrive in a society in which people guard their property, including their entire front lawn so zealously that is perfectly acceptable to shoot (to kill) someone—whether intoxicated, retarded, or just disoriented—who happens to stray into that property. Many people would argue that society is in need of moral reform. However, moral reform for a society is impossible under conventionalism because good behavior lies in obeying conventions, no matter what they might be.

Utilitarianism is a common and plausible view that combines consequentialism and hedonism, but unlike egoism, insists on *impartiality*. That is utilitarianism insists that every instance of happiness count equally. More precisely, it should not matter who feels a sensation of pleasure but only its duration, intensity, and (according to Mill) quality. In mathematical terms suppose  $W = \theta_1 U_1 + \theta_2 U_2 + \theta_3 U_3 + \dots$ , where  $U_i$  is the level of happiness for each individual  $i$  and  $\theta_i$  is the weight given to that individual. Then egoism says if you are person 1 you should set  $\theta_1 = 1$  and  $\theta_2 = \theta_3 = \dots = 0$  and maximize  $W$  whereas utilitarianism says that all of the  $\theta_i$  should be equal and everyone should maximize the same  $W$ .

Is egoism defensible? Some would argue that if everyone looks out for their own well-being then society as a whole will be better off than if everyone is busy worrying about whether



their actions will make other people happy. If what the person means by “better off” turns out to be happier, then this argument is just a closet utilitarianism. The arguer has implicitly accepted that the correct goal is to maximize total happiness and is just claiming that egoism is a good means. There is some merit to this point of view under certain conditions, that is what the “invisible hand” theory shows. However, it is almost certainly not a universal truth independent of other characteristics of society. Another argument for egoism is based on the notion that it is the only realistic view of human nature. This claim is subject to many factual challenges, such as the results from Ultimatum and Dictator games. In any case, what actually motivates people is not the right basis for deciding what principles people *ought* to have.

Is utilitarianism defensible? When most economists analyze government policy they act as utilitarians. We almost universally favor allowing voluntary exchanges because of our belief that such trade make both parties happier. Indeed, most economists favor eliminations of import quotas even though they know that the people helped by the quotas are rarely compensated by the government for their losses. This is because they believe that the gains in terms of increased happiness of consumers exceed the losses in terms of decreased happiness of domestic producers of the imported good.

Whether economists are right or wrong to embrace utilitarianism as a guide for good government policy does not, of course, tell us whether it is a good guide for personal or corporate ethics. While it seems reasonable, and there is even a Star Trek movie where Spock sacrifices his life on the grounds that the greatest good for the greatest number is what logic dictates, people should be aware that there are several classic criticisms.

### *Problems for Utilitarianism*

1. Failure to distinguish between things we ought to do, and things that are good to do but we would not be considered morally lacking for not doing. That is there is duty and there is that which is “above and beyond the call of duty.” For instance suppose someone has swam out into the ocean and is caught by a rip tide and appears almost certain to drown without help. It would clearly be wrong to do nothing. But many people would agree that you have done your duty if you run down the beach to look for a lifeguard.

Risking your own life to swim out and attempt a rescue would be heroic but not required by moral duty. The utilitarian would make a different calculation.

2. Keeping promises. The *Lonesome Dove* example. At the end of the book Gus McCrae is dying from gangrene in Montana because he refuses to allow the doctor to cut off his one remaining leg. He asks his close friend Woodrow Call to promise to take Gus' body back to a grove of trees in Texas where Gus spent some of his happiest moments. Woodrow makes the promise and keeps it. Was that the right thing to do? Utilitarianism would probably say no. Call has just started a ranching operation and the ranchers depend on his leadership. The trip to Texas will thus be very costly to Call and to his associates. Since Gus is dead he will not realize any benefits. Thus the conclusion that breaking the promise is what Utilitarianism demands seems inescapable. However, many would say that the moral thing to do is to keep the promise. The general point is that since acts are judged right or wrong according to the consequences and not by whether they adhere to certain moral rules ("Keep Promises"), the decision to break a promise is in not fundamentally different from the decision of whether to brush your teeth or not after a meal. In both cases you sum the effects on yourself and others and proceed if the sum is positive and refrain otherwise.
3. Unjust Sacrifices. Three examples: Sacrificing-the-Hobo, Churchill's dilemma, Punish-the-innocent. The utilitarian theory of punishment holds that punishment has three potential benefits: deterrence, rehabilitation, satisfaction of the desire for vengeance. Suppose the true perpetrator of a crime is known by the police to have escaped capture permanently (perhaps by fleeing to another country or perhaps by suicide). This removes the rehabilitation motive. Now suppose the victims of the criminal will feel great pleasure upon knowing the criminal has been caught and is being punished. Finally, the capture and punishment will deter other potential criminals. If these considerations are strong enough it is certainly conceivable that they would justify the frame-up, conviction, and possibly execution of an innocent person. This would be rejected by non-utilitarians who

might argue individuals have a right to not be subjected to unjust punishment; innocents may not be sacrificed.

The last issue is perhaps the one that people consider most damning about utilitarianism. Many people put it slightly different. They say many times utilitarian calculations would cause us to violate someone's "rights." But what are rights? And where do they come from. What criteria can we use to determine which of the many rights that have been proposed (see examples from the United Nations Declaration of Human Rights) are truly rights and which are just hopelessly impractical or even pernicious items on someone's wish list?

Why is cheating on taxes wrong? A utilitarian might say because other people will observe you cheating and if you get away with it they will imitate you and eventually cheating will become so widespread that the government won't be able to fund any of the services that we want government to provide. Then society will be worse off.

However, this seems suspicious. Suppose you kept it an absolute secret that you were cheating and you did it in such a clever way that no one ever found out *and* the amount was small enough that it had no effect on the government. Would that make it OK? Many people would say no. Nor would they just say that cheating is "wrong" and leave it at that. Instead they would say, "if everyone were to cheat like that, the government would soon go broke. It is obvious that you wouldn't want everybody else to cheat so how can you justify making an exception for yourself?" This is an appeal to *universalize*. It is used to criticize someone who doesn't give to any charities or to someone who walks across a patch of newly seeded grass. This sort of argument is the heart of the Categorical Imperative (version 1).

Feldman provides a good description of the Rawl's original position:

Rawls lays down some rather severe requirements concerning the information available to those in the original position. In the first place, although each person in the original position know general facts about human nature, none of them knows anything about his own particular circumstances in life. Thus, if you were in the original position and were forced to select a moral code for a society in which you would live, you would have to make this choice without any information about the

social status, wealth or prestige you would have in the society. This “veil of ignorance” is designed to assure that your selection of a moral code will not be biased in favor of your own future interests. If there were no veil of ignorance governing these matters, each of us might be motivated to select a code that would favor our own future interests over those of our fellow citizens. For example, if you knew that you were going to be a very rich person in that society, you might incline toward a moral code allowing the rich to retain, protect, and enlarge their wealth. The veil of ignorance eliminates such biased choosing.

*Ethics Illustrated: The McDonalds Coffee Case*

1. Who is morally responsible for Stella’s third-degree burns?
2. How would a Utilitarian analyze McDonald’s decision of how hot to serve its coffee?
3. How would a Utilitarian analyze McDonald’s decision of whether to put a warning on each coffee cup?
4. What would a Contractarian (of the Rawlsian variety) say?

*Ethics Illustrated: The Ford Pinto Case*

Several descriptions of this case are available. We use Shaw and Barry (1991) which has the advantage of being (1) short and (2) cheap. There is also a Harvard Case (#383-129), Jennings (1993, 218–225), and Viscusi (1991, 111–116).

Some questions to raise to the class.

1. What criteria would Ford usually employ to decide whether a redesign of some feature of a car was worthwhile?
2. When safety issues arise do companies have ethical responsibilities to surpass government-mandated standards?
3. Is your answer influenced by the fact that Ford lobbied government officials to persuade them not to adopt more stringent requirements?

4. Do the competitive pressures Ford faced in the 1970s in the small car market affect the ethics of Ford's decision?
5. What was missing and what should have been excluded in Ford's calculations of the costs and benefits of modifying the gas tank?
6. Does it matter whether Ford would pass the cost savings per car on to consumers or give it to shareholders?
7. Suppose there were no immediate fix to the gas tank problem. If delays associated with redesign result in lost sales to the Japanese manufacturers should this be counted as a cost?
8. How would you propose to value life?

### 1.1.2 Valuing Life

See discussion in Brander (1992:337–338) and Viscusi (1991, 107–116).

### 1.1.3 Game Theory and Ethics

Consider the coordination game (row player's payoffs, column player is symmetric):

Table 1.1: A Coordination Game

		column player	
		In	Out
row player	In	5	-10
	Out	-2	0

There are two nash equilibria [In, In] and [Out, Out]. [In, In] is certainly preferable but would it be chosen? The more risk averse the players are, the more likely they would be to choose Out. Now suppose they can talk. Clearly, they would be able to agree on [In, In] but

without full assurances, risk averse players might still choose Out. The role of ethics in this game is to ensure that promises are both believed and kept. Trust and reliability can thus make the market perform much better than would otherwise be possible because they facilitate the types of complementary upfront investments which the coordination game can be seen as representing.

Now compare the coordination game above with the Prisoner's Dilemma.

Table 1.2: A Prisoner's Dilemma Game

		column player	
		In	Out
row player	In	5	-10
	Out	7	0

This game (the only change is that Out, In now has a payoff of 7) has a single dominant nash equilibrium: Out, Out. Note that as before Out, Out is Pareto Inferior to In, In. Suppose that playing Out in this game were considered unethical. Note that in many interpretations, there is an ethically charged label for this choice: “fink” or “chisel” is contrasted with verbs like “cooperate.”

A society in which moral codes had a binding effect on behaviour could achieve higher average levels of welfare because its moral code would strictly prohibit the choice of Out.. Reputations and infinite repetitions (with punishment strategies) would be alternate ways to reach In, In. Which is more feasible seems to be an empirical issue.

Note the unfortunate implication that while people would agree that this sort of situation is a justification for teaching ethical standards such as the “golden rule” (do unto others as you would have others do unto you), parents would face the ironic situation in that they would want every other parents’ children to receive substantial moral instruction but they would want to exempt their own children since the best of all outcomes in the above game is to make “suckers” of the other players and play In while they play Out.

Ethics is not the only way to achieve the In, In outcome. In both of the above games, if the parties had access to enforceable contracts with adequately structured penalties for breach, they alter the payoffs such that self-interest would make In, In the dominant strategy. The question is whether such faith in contractual/litigation-based mechanisms is warranted by the experiences of countries (such as the U.S.) which have made heavy use of formal (rather than implicit) contracts and lawyers.

### *Examples of coordination games*

Coordination games involve some form of complementarity. Consider the following examples.

**Business cycles** . What caused the recession of 1990-1992 or the Great Depression in the 1930s. Similarly, what caused the recoveries which followed them? There is no shortage of potential explanations. However, a number of macroeconomists are exploring the idea that “coordination” failure might be the problem.<sup>1</sup>

**Real Estate Markets** . Somewhat related are coordination problems associated with thick and thin markets. A real estate bust could come to a city in which there are many people who are happy to sell and many happy to buy but since there are no current listings, no one wants to go to the trouble of looking and putting their own house on market.

**Traffic** It is best to for everyone to drive the same speed. If all cars are driving slow it will be very difficult to move to the superior equilibrium where everyone drives quickly.

**Location choice with agglomeration externalities.** Suppose there are two areas. One is empty and the other has one manufacturer. Suppose that the empty area is now fundamentally much better, but irreversible investments tie the first manufacturer to his current location. Now suppose two new investors must make a simultaneous location decision.

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<sup>1</sup>A recession is a period where you are not sure if there is demand for your product. If you decide to produce you need to make up front purchases of capital goods and intermediate inputs. If you do not find a buyer that money is wasted so instead you play it safe and hold on to the cash you have. But the firms that would have sold you capital goods have been going through the same process. Hence, there are likely to be occasional periods where everyone is cautious and no one invests.

If they could coordinate they would pick the empty site; however, they would probably play it safe and take the spot which already has one investor.

## **Product Standardization–Network Externalities**

### *Examples of Prisonners' Dilemmas*

**Price-fixing** Consider the example on page 84 of the Brander textbook. Price-cutting is the dominant strategy because usually the increased sales volumes offset the reduction in price, causing an increase in total revenues.

**Pollution Havens** Consider a city which values a healthy environment and the attraction of manufacturing jobs. For concreteness suppose that 5 new jobs are considered enough to compensate one lost life. Each of two towns considers whether to enact and enforce strict [S] environmental laws or to be lax [L]. If S,S get 100 jobs each which is a payoff of 100. If S,L all 200 jobs go to the second town but environment is clean. Hence payoff is 0. If L,S get 200 jobs but also 10 deaths which we “count” as 5 lost jobs each, implying a payoff of 150. If L,L get 100 jobs but also 10 deaths and a net payoff of 50. Thus being lax is the dominant strategy but is pareto-inferior since it results in 20 unnecessary deaths in this stylized example.

**Payment of Dues** Suppose residents along a cul-de-sac want to pay a night watchman to stand at the entrance to their street at night. A letter is sent out requesting a contribution of \$ 50 each. Since this is a multiperson dilemma we will set it up with the two players being “others” and “me.” If others pay then there will be enough people to pay for the watchman whether I pay or not. Hence paying really costs me \$50 independent of others' action and not paying is the dominant strategy. Of course, since each person analyzes the situation the same way, no one pays. Assuming that individuals valued the watchman's services at more than \$ 50 each, this outcome is pareto-inferior.

**Strikes** Striking in order to obtain higher wages may be similar to the payment of dues if workers are good substitutes for each other and happy to take on overtime at extra pay.



Whether I work or stay home will not affect the outcome of the strike which will be the same wage if others work and a higher wage if others strike. Since striking when others work, is called absenteeism and will get me fired, I wouldn't do that. And, working when others strike gets me overtime pay. Hence, working is the dominant strategy and the strike crumbles.

**Fishing Areas** Suppose we can fish an area heavily or hold back this year and allow the fish to replenish their stock. Consider the case of two fish and two fisherman and two periods. If both fish, they each expect to catch one fish now and no more in the future. If both wait, they will expect to catch  $1 + X$  the next period. If I fish while you wait, I get 2 fish now. If I wait while you fish I never get any fish. If  $X$  is 0.5 (i.e. the fish mate and spawn only one additional fish), then Fish,Fish is the dominant strategy. On the other hand, suppose  $X = 2$ . Then Wait, Wait is better than Catch, Wait and we have a Coordination Game.(Of course as the number of fish and fishermen grew, we would get back to something more like the paying dues situation)

Other classic examples of prisoner's dilemmas include the Arms race and the use of tariffs to improve a country's terms of trade (or strategic trade policy).

#### 1.1.4 Does the Invisible Hand obviate the need for Business Ethics?

Three quotations from Adam Smith (from The Wealth of Nations, 1776):

An individual generally neither intends to promote the public interest nor knows by how much he is promoting it... By directing industry in such a manner as its product may be of greatest value, the entrepreneur intends only his own personal gain, and he is in this aim... led as if by an 'invisible hand' to promote an end which was no part of his intention"

By pursuing his own self-interest, the entrepreneur frequently promotes that of society more effectually than when he means to promote it"

It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love.”

The invisible hand theorem asserts that The Profit Motive plus Competitive Markets leads to a Pareto-Efficient Economy. Or, put more loosely, in a world where managers try their best to make profits by charging high prices and paying low wages, if there is competition, the end result will be one where consumers are “sovereign” and workers are compensated for their marginal contributions.

Ethics may be seen as a third alternative solution to market failure problems associated with underprovision of public goods and negative externalities. (i). Public Enterprise (ii). Regulation . (iii). ethical behaviour.

Responsibilities: Shareholders versus “Stakeholders,” The Friedman Argument.

Brander summarizes the Friedman arguments on p. 341:

If society does not like pollution, we should tax it, and let profit-maximizing firms respond (as they will) by reducing pollution. Not only would it be naive to expect “voluntary” reductions in pollution, it would also be counterproductive. Firms that adopted less polluting but more expensive methods of production would earn lower profits and tend to decline in relative importance compared to those who did not. The “good guys” would be punished and the “bad guys” would win.

Similarly, according to Friedman, we should not expect or want business executives to decide which cultural activities to support (with money that would otherwise go to the shareholders or to the government in taxes). Business should supply goods and services that people are willing to pay for, not presume to paternalistically decide on social policy.”

### 1.1.5 The “Instrumental” approach to business ethics.

Otherwise known as “enlightened self-interest,” this is the idea that by behaving “well,” firms will achieve higher profits. With respect to consumers, good behavior enhances good will and avoids boycotts. With respect to workers, ethical treatment may be like an “efficiency wage.” If workers are treated well at a particular firm, the cost of being fired rises because workers expect less ethical treatment at other firms. This can induce higher effort levels. Note however, that this argument applies to a relative standard of ethical treatment. Ethics is in the interest of individual employers but not in the interest of the industry in general.

Two issues remain unresolved. First, is there really any strong link between ethical action and profits? Second, if there is, then shouldn’t managers evaluate ethical decisions the same way they are told to evaluate other projects that may be costly now but yield future profits? That is, shouldn’t they use the standard method of Net Present Value analysis. Intuitively, our response is no. One way to justify that is to recognize costs of calculation that may be particularly high in this sphere. For instance, can line managers accurately evaluate the costs of tarnished reputations? If ethical rules can be clearly explicated they may be short cuts, or rules-of-thumb, that yield on average higher results. Finally, there is the notion that ethical action is “habitual.” By instructing managers to choose the ethical route as a matter of habit, one reduces the likelihood that a manager will regard ethical concerns as easily jettisoned in favour of short-term profits. Of course, since question one was not clearly answered in the affirmative, we have little evidence to support the instrumental view.

Related to this is the approach known as “Corporate Social Responsibility.” It argues that ethical management should not respond to current laws and market signals but anticipate trends. In addition to the argument that in the long run the market rewards good behavior, they also argued that ethical behaviour would help to forestall governments from imposing regulations that would be more costly to obey than ethical codes.

### 1.1.6 Standing and Stakeholders

In the above example one might reach the conclusion that playing In in Prisoner's Dilemma games is morally superior. That conclusion is, however, only defensible if the game description contains all the payoff consequences for every party that has moral "standing." In the text it is noted that price fixing is a prisoner's dilemma; few of us think that undercutting is wrong and many would consider price-fixing to be unethical. The reason, of course, is that a price-fixing hurts a prominent group with "standing": consumers.

The issue of standing, or put another way, of whose welfare "counts" and whose does not, is at the heart of many modern controversies: abortion, animal rights, the death penalty (proponents do not argue that this is a normal penalty to be used as a general deterrent for undesirable behaviour, but rather that it should be reserved for acts which change the perpetrator's moral standing), humanitarian aid to foreign countries (where the argument is often heard that "we shouldn't be spending so much on foreigners when there are so many people here at home that are needy"). Despite its importance, the issue of standing does not appear amenable to logical analysis. Organized religions often clearly delineate where standing begins and ends. The most we can probably do intellectually is make sure that, given notions of standing or moral "weightings," they are applied in a consistent manner.

### 1.1.7 Differing Views on Fairness

We have argued that ethical behaviour can be seen as a way to raise a firm's profits (the instrumental approach). The instillation of ethical codes may also allow the market system to operate more efficiently, either because it is a useful solution to market failures (public goods, externalities, informational asymmetries) or it assists in reaching pareto-superior outcomes in game-like situations.

In many cases ethical decisions revolve around issues of fairness rather than efficiency. Returning to the invisible hand issue, absent market failures, self-interested action leads to pareto-efficient outcomes. These outcomes need not meet societal standards of what is fair.

While government intervention—primarily through taxes and income supports—is the economist’s standard recipe for making the distribution of economic welfare fair, individual actions by managers have the potential to contribute. [Lester Thurow points out that although Sweden and Japan have similar distributions of after-tax income, Japan achieves its equality primarily through compressed wage differentials while Sweden relies on government redistribution] But what distribution is fair? When you say that X is fair do you simply mean that it benefits you (as when students inform a prof that the exam seemed fair to them) or that you approve of X? Or are there more objective standards?

“Framing” affects perceptions of fairness. For some examples, see Brander p. 333-334.

implications: choosing the way you represent a situation can influence how voters or customers or workers perceive your actions.

distributive justice: outcomes should be fair. people who are “fundamentally equal” should receive equal shares of the final pie.

procedural fairness: the rules governing behaviour should be fair. hence, outcomes are fair or unfair depending on whether fair procedures were observed along the way.

assertion: non-coercive procedures are fair. hence, income distributions that arise from non-coercive interactions (voluntary exchange) are just.

the purse-snatcher example to contrast the two notions of procedural and distributive justice. Next, consider the 100m race metaphor. what is a fair race? Equal starting lines? Each person in own lane. No steroids? where is the real starting line? and where is the finish line? multiple values. e.g. teachers and truckdrivers.

Nozick: Entitlement theory of justice argues that a distribution of holdings is just if and only if everyone is “entitled” to the holdings they possess, where entitlement is established according to the following principles:

1. A person who acquires a holding in accordance with the principle of justice in acquisition is entitled to that holding.
2. A person who acquires a holding in accordance with the principle of justice in transfer,

from someone else entitled to the holding is entitled to the holding.

3. No one is entitled to a holding except by applications of 1 and 2.

Entitlement theory is a historical analysis of justice as opposed to what Nozick calls “current-time-slice” principles.

Rawls: Justice as Fairness. The Veil of Ignorance. Raising the Welfare of the Least Advantaged. Equity as Adequate Insurance.

Table 1.3: Illustration: Which Tax Rate is Fair?

	Tax on “Lucky”:		
	0%	25%	33.33%
Total Income	100	80	60
“Lucky” Person (3/4):	75	45	30
“Unlucky” Person (1/4):	25	35	30

The instrumental view of fairness: Is equity a “public good”?

Examples of intervention on the basis of individual equity:

- unemployment insurance and other public aid programs (ie, Medicare)
- progressive taxation
- public programs of disaster aid
- Berkeley’s food vouchers for “panhandlers”
- “universality” vs means-testing. Which one is fair?

What types of incentive effects associated with these policies?

Examples of intervention on the basis of group equity:

- Legal grounds to sue for damages caused by discrimination.
- Hiring Quotas, Admission Quotas at Berkeley.
- Subsidies/Fellowships to members of disadvantaged groups.

- Does group fairness require desegregation? (vouchers vs busing)
- Malaysia's NEP

group fairness vs individual fairness: “affirmative action”

regional fairness in canada: a crude and inefficient approach to poverty.

the practice of group fairness will frequently benefit the best off members of the worse off group who may be quite a bit better off already than the worst off members of the better off group.

### 1.1.8 Principals, Agents, and Ethics

A firm does not make decisions. Management and employees at almost every level make decisions with ethical components. This raises two important concerns. The first is what is the responsibility of the agent (lower level managers, shop floor workers) in a firm? Is obeying orders a valid excuse? Is there a moral responsibility to be a “whistleblower”? The second is how can the principal (shareholders, the board of directors, senior management) ensure that the agents act according to the ethical standards the principals have set for the firm?

## 1.2 Applications

### 1.2.1 The Ethics and Economics of Safety

Issues of safety arise for consumer products and in the workplace.

Arrow emphasizes the asymmetric information argument (lemons) for why profit maximization may be inappropriate from the point of view of maximizing social welfare. Arrow argues that when the manager has superior information about product safety or the safety of working conditions than the consumer or employee, profit maximization will not yield social welfare maximizing results. The argument generalizes to all forms of unobservable quality but is most relevant to safety since the learning by experience (repeat purchase) mechanism will not be feasible.

Arrow also points out taxes and legal liability as substitute institutions for regulation.

problem with regulation: “The chief drawback of direct regulation is associated with the fact that it is hard to make regulation flexible enough to meet a wide variety of situations and yet simple enough to be enforceable.”

taxation probably appropriate for externality problems but not helpful in the case of product safety.

Litigation can in principal solve the safety problem but it also is problematic:

- if damages per individual are small but aggregate damages are large because of the number of individuals affected, then it may not pay for any individual to incur the litigation costs.
- partial responsibility important in reality but not part of accepted legal practice. instead courts tend to assign total responsibility to one party or the other. (plastic bag example) verification of responsibility is costly and inherently subject to error. tendency is to move towards insurance, even no-fault insurance, which deadens incentives.
- litigation is unnecessarily duplicative for repeated incidents, e.g. pollution, there taxation clearly seems superior.

ethical codes: e.g. medical ethics. Since doctors are valued precisely because they have superior information, the need for some institution to prevent abuses seems clear. This generalizes somewhat to many professions where the basis for their existence is alleged expertise.

Ethical codes can enhance efficiency, Arrow cites example of queue discipline but that case might be better analyzed in terms of Rawlsian fairness.

Question: are ethical codes public goods for firms in an industry? probably, yes. people form impressions of ethical performance of the industry but often the actual individuals are anonymous. furthermore an ethical code about product safety is itself unobservable and unlikely to be believed since it is such a cheap claim to make. Within large firms the same public good issue arises.



### **1.2.2 Ethics for International Business**

The MNE Dilemma: Home Country versus Host Country Ethical Standards.

otherwise known as the “when-in-Rome..” problem, or in the language of philosophy, “cultural relativism”

Two issues arise repeatedly. The first is differences in norms for acceptable business behaviour. In particular, when if ever, is bribery ethically permissible? The second issue relates back to product and workplace safety. Is it O.K. to have two standards one with respect to home-country citizens and the other with respect to foreigners? If foreign governments have low safety standards or lax enforcement should that influence the firm’s decisions?

### **1.2.3 The Ethics of Interfirm Relations**

Is collusion ethically wrong? Can You Ever Compete Too Hard? Canadian competition policy addresses the issue “Abuse of Dominant Position.”

### **1.2.4 Ethics, Self-regulation, and financial markets**

A number of interesting issues arise in the context of stock markets such as the Vancouver Stock Exchange. There is the issue of insider trading. There is also the concern of defrauding naive investors.

# Chapter 2

## Syllabus

## 2.1 Outline

Week	Lecture 1	Lecture 2
1	Overview [1]	Canadian Business Environment [6] Useful Economic Concepts[2]
2	Useful Games [5:84]	Useful Ethical Concepts
3	Ethical Concepts (cont'd) The Pinto Case	The Invisible Hand [3:21–27] Market Failure [3:27–30]
4	Fairness [3:30–32, 16:327–341]	Government Failure [4]
5	Government Failure (cont'd)	Class Cancelled
<b>Midterm at 6:00 pm Oct 5</b>		
6	The Zeebrugge Ferry Disaster Social Responsibility	Review of Midterm
7	<i>Debate 1 (Profits vs Ethics?)</i> Trade Policy [7]	<i>Debate 2 (Sanctions)</i> Trade Institutions [8]
8	<i>Debate 3 (Motorcycles)</i> Industrial Policy [7:122-128]	<i>Debate 4 (Logs)</i> Environment [14]
9	Environment [14] “Let them Eat Pollution”	<i>Debate 5 (Agro)</i> Agriculture [12:243-246]
10	Jobs and Growth [15]	Competition Policy, Mergers [9,10]
11	<i>Debate 6 (Nutrasweet)</i>	Collusion, Predation [9,10]
12	<i>Debate 7 (Pharms)</i> Intellectual Property [11:228-233]	Advertising [10:209-211] Regulation [12]
13	Regulated Industries [12]	Public Enterprise [13]

## 2.2 Readings

1. James Brander, *Government Policy Toward Business* (2nd edition, Butterworths, 1992)
2. Business Ethics reading package.

## 2.3 Class Participation Activities

### 2.3.1 Debates

#### 1. Does Ethical Behaviour Really Increase Long-Run Profits?

Define (for the purposes of this debate) ethical behaviour as: "actions taken by management to protect or improve the well-being of customers, workers, suppliers, members of the community, or society at large, which are undertaken voluntarily, i.e. not forced upon the firm by direct competitive or legal pressures"

Consider the following forms of evidence:

- (a) Do firms that are praised in the business press or by books which report on ethical behavior have higher profits or market shares than those which are criticized?
  - (b) Do so-called "socially responsible investment" (SRI) mutual funds perform as well or better than other funds which do not apply ethical screens?
  - (c) Are there prominent examples of firms who made ethically unsound decisions and ended up being punished by the market in some manner? What about the converse?
  - (d) What are the mechanisms which relate good ethics to high profits in the long run? How effective are they in practice?
2. Should Canada permit its businesses to freely trade with and invest in nations that violate their citizens' human rights?
3. Harley Davidson at the International Trade Commission.
- (a) Was HD "materially injured" by Japanese motorcycle manufacturers?
  - (b) Should HD receive tariff protection? Why? How much? How long?
4. Should British Columbia Restrict Log Exports?
5. Agricultural Policy:

- (a) Should BC abolish the agricultural reserve laws?
  - (b) Should BC (and Canada) eliminate marketing boards and import restraints in the dairy industry?
6. Nutrasweet at the Competition Tribunal.
- Was Nutrasweet guilty of "Abuse of Dominant Position"?
7. Should Canada reinstate mandatory licensing of pharmaceuticals?

### **2.3.2 Cases**

- 1. The Pinto Case: Was Ford at Fault?
- 2. The Zeebrugge Car Ferry Disaster.
- 3. Should "Dirty" Industries Migrate to the Less Developed Nations?

Evaluate the three Larry Summers arguments reprinted in the Economist under the title "Let Them Eat Pollution"