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Comments on Wempe: Conditions for ethical business

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Introduction and overview

In his contribution Wempe addresses the ethical behaviour of business organizations and their agents. He criticizes a reaction to perceived unethical behaviour which he calls the "compliance view", and which he claims is based on a too simplistic analysis of ethical misconduct in organizations and of the underlying social problems that cause the perceived ethical misconduct. He argues that a "plurality of values" lies at the root of many cases of alleged organizational misconduct, and that the 'compliance view' cannot offer solutions to the value conflicts and the social problems which stem from this 'plurality of values'. His aim is to show how business organizations and their agents (professionals, managers) may cope with these value conflicts and social problems and how they may contribute to solving them. In the comments below I will first address the 'compliance view' and what Wempe has to say on that. I will indicate where I agree and also where I disagree. I will then comment on Wempe's views regarding how businesses can deal with the problems arising from conflicting values in society. I will next present my own analysis of a large class of potential ethical misconduct of business organizations, namely cases where business organizations cause environmental damage or other kinds of harm and nuisances which are called 'negative external effects' in the science of economics. Against the background of this exposition, which will include a discussion of Prisoner's Dilemmas, the role of consensus and liability, I will make some final comments on Wempe's view on the social responsibility of business and its agents.

The 'compliance view' of unethical conduct in business organizations

The 'compliance view'

Those adhering to the 'compliance view' of ethical behaviour are trying to reduce ethical misconduct in organizations to the unethical behaviour of a limited number of evil people who need to be warned louder and hit harder in order to make them comply with laws and rules. Hence perceived cases of organizational misconduct are met with a plea for more rules, more control and more punishment. This response disregards the fact that it may not always be clear that executives accused of unethical behaviour actually did break formal rules, and also that there are usually many more involved in the misconduct than just a few key figures at the top. In addition, Wempe claims that the 'compliance view' is inadequate because it does not take into account the plurality of (conflicting) values that is in the background of many cases of alleged

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ethical misconduct of organizations. Because of these conflicting values the issue of what companies should and should not be doing gives rise to ethical dilemmas for businesses and their agents, as conflicting requirements are imposed upon them.

Organizational and institutional failures

I agree with Wempe that reactions to unethical behaviour of organizations are often simplistic and misleading. Often it is suggested that after a few 'bad guys' ('rotten apples') have been removed, all problems have been solved. One may call this the anomaly or incident approach to organizational misconduct. Implicitly or explicitly it is assumed that the contested behaviour was an isolated case, an incident, caused by anomalously behaving individuals. This disregards the possibility of systemic causes for misconduct, either rooted in the organization itself or in the social, legal and political context in which it operates. A similar disregard may be observed in many, notably American-based textbooks on engineering ethics (see Zandvoort, Van de Poel and Brumsen 2000). A related phenomenon can be observed in the analysis of technological accidents. For a long time it was custom to attribute the causes of accidents that could not easily be narrowed down to plain mechanical failures to 'human error'. Such accidents were attributed to e.g. the failure of an operator, who was hence the one to blame. An example would be to lay the exclusive cause and blame for the *Herald of Free Enterprise* disaster with the assistant boatswain who failed to shut the bow doors as he had fallen asleep (for details and background see Van de Poel 2003). Only recently this way of looking at technological accidents has given way to the view that many or perhaps all technological accidents must be considered *organizational* failures. The accident with the *Herald of Free Enterprise* is an example, as the accident could only occur because of persistent inadequacies in the safety procedures and general operation of the ship (for details and a plea for the organizational approach see Dien, Llory and Montmayeul 2003). Organizational failures may ultimately be caused by inadequacies in the social institutions such as law and collective (political) decision making that provide the conditions for organizational behaviour. In this case an even more appropriate term is institutional failures. The analysis of organizational failures pertains to organizational misconduct in general, i.e. including ethical misconduct.

Wempe on conflicting values and the social responsibility of business

Conflicting values and social problems

According to Wempe, the problem that lies at the root of typical cases of (alleged) unethical behaviour of and in business organizations is the plurality of (conflicting) values in society, as this implies that there is typical disagreement on how a certain social problem should be solved and who should do (or abstain from doing) what. Often, Wempe says, genuine dilemmas exist, consisting of fundamental value conflicts. In such cases it is impossible to decide what *the* correct answer to a certain social problem is. I agree that conflicting values frequently occur. Thus, some people think that Schiphol airport should get a fifth (sixth, seventh) runway whereas other people think that this should not be done, and there may even be people who think that Schiphol should be closed down. However, I find it very unclear what Wempe has to say on the methods or procedures that may be used for 'reconciling' such conflicts of values, and hence I fail to see how his recommendations could result into solutions of social problems. Wempe says that the distribution of costs and benefits (of e.g. a fifth, sixth, seventh Schiphol runway?) should be "just" or "as

proportional as possible", but he has nothing to say on how this should be determined and by whom. Similarly, he does not clarify what "identity-determining values" are and in which special cases and how "a more than proportionate weight must be ascribed to such identity-determining values". Also, Wempe does not explain how "tensions between values" (that may be related to "fundamental value conflicts") may be "a source of value creation" and what the latter means. In addition, it remains unclear why *the business sector* might be successful in reconciling the conflicting values in society, whereas the political institutions apparently fail. He does not say anything on the role of politics or public choice.

Introduction to the next sections

By discarding the belief in market mechanisms and by discarding the 'compliance view', Wempe also seems to discard the rational actor assumptions underlying economic theory as a basis for regulating the behaviour of private organizations and of persons working in those organizations. I am not ready for that, but I do believe that the legal conditions under which the mechanisms of the market, competition and technological innovation currently operate, make it impossible to expect outcomes that are beneficial or represent progress, in an objective, non-arbitrary way. In the following sections, I will vindicate the claim that a main cause of ethical problems associated with the activities of business organizations is inadequate legislation. As in a democracy legal change must be achieved through the mechanisms or institutions for political decision making, it is here that the 'root cause' of at least some of the problems discussed by Wempe must be localized. My analysis pertains primarily to organizational behaviour relating to environmental damage, sustainability issues, and all (other) kinds of nuisance, harm and risks from technology. This covers a very important portion of the ethical problems relating to business organizations, but I do not claim that all of Wempe's examples can be placed in this category. I will discuss negative external effects stemming from market activities, and how these effects may be internalized into the decisions of actors. I will also analyse these negative external effects using concepts of game theory. Notably, I will introduce the concept of a solution to a Prisoner's Dilemma situation. Like any adequate measure for the internalization of negative external effects, such a solution requires consensus among all involved regarding the rules that govern activities that may affect others. I will argue that stricter liability is a means for securing or at least promoting such consensus, and also that liability should always be strict for activities lacking such consensus.

Negative external effects and the need for consensus regarding market conditions

Invisible hand

The science of economics implies that free markets and competition are to the advantage of all, provided that certain conditions are satisfied. It is to the advantage of the baker to bake bread and sell it to his customers, as it is to the advantage of the customers to buy the bread rather than to bake it themselves. The customers will have more time for other activities (production or consumption) while the baker may enhance the efficiency of baking by exploiting scale, mechanization and other innovations. Everyone involved acts on his or her own interests. There is no organized, centralized co-ordination. Nevertheless the result of all this individual,

selfish conduct is beneficial for all, as if led by an invisible hand. Two elements are central to this idea, which was first put forward by Adam Smith in his book *The Wealth of Nations*, published in 1776. The first is that specialization yields efficiency gains. The second is that everyone determines for him/herself which transactions make him/her better off, as every one engages freely into his/her economic transactions. Because of these two elements it is assumed that free markets and competition lead to Pareto improvement, if not for every single market transition, then certainly in the long run. Here, a Pareto improvement is a transition from one situation to another, making at least one person better off and no one worse off.

Negative external effects

One of the conditions that have to be met, according to standard economic theory, is that economic activities should not produce (too many) negative external effects[1]. Textbook examples include air pollution from factories and smoke from cigarettes. Such effects are not accepted by individuals as elements of voluntary transactions, but rather are involuntarily imposed upon them. A more expressive example may be the following. If a Dutch consumer buys a basket of strawberries in a Dutch store, then there is a chance that these were produced in Spain, on land which has been cleared from age-old pine-tree forests[2]. The negative external effects of this activity include: the loss of pine-tree forests; the loss of natural oil resources used for transporting and cooling the strawberries and of freshwater resources used for irrigating the strawberries, and the production of $C0_2$ contributing to climate change. As free markets and competition spread over the world, so do the negative external effects. Damage to the environment and ecology is taking place on a very large scale, resources are being exhausted, and a variety of obscure but very real and potentially large and far-ranging technological risks is being created. There is no vindication for the claim that the balance is positive; that the result is progress in the unambiguous, non-arbitrary sense of Pareto improvement.

Reducing negative external effects

Hence the following question arises. How can negative external effects be kept within bounds, such that progress, in a non-arbitrary sense, is safeguarded in a system of free markets and competition? The science of economics gives the following answer. First, find ways to internalize the costs associated with these negative external effects in the market prices of the transactions that generate them. An option that has been suggested is to levy an 'eco-tax' upon polluting economic goods or services (see e.g. Baumol and Oates 1988). Another option to be discussed below is to establish liability for damage done (see e.g. Shavell 1987). Second, if the financial translation of the costs of negative external effects which is required for this internalization is for some reason impossible, then the activities causing the negative external effects should be relinquished.

The need for consensus regarding market conditions

How should it be decided *whether* certain costs can be expressed in financial terms, if so, *how*, and if not, which activities may and may not be undertaken? If Pareto improvement is the goal, the only sound answer is this: by *consensus of all involved*. Here, those involved include not merely those who take actively part in the

[1] There are other conditions as well that I will not go into here.
[2] Source H. Piek, Nederlandse Vereniging tot Behoud van Natuurmonumenten, private communication.

economic activities, but also all those who may experience the negative external effects. If such consensus is lacking, then there is no guarantee whatsoever that free markets and competition will lead to Pareto improvement (for more on the need of consensus among all involved regarding measures such as 'eco-taxes' intended to internalize negative external effects of market activities see Zandvoort in prep.).

Prisoner's Dilemmas and their solutions

The tragedy of the commons

It is important to note that even if it is assumed that individuals enter into those economic activities that, given the circumstances, are for the best of their own interest, this is no guarantee whatsoever that the net result, including negative external effects, will be (experienced as) positive. The possibility to the contrary is illuminated by the 'tragedy of the commons'. This 'tragedy'[3] was intended by its author (Hardin 1968) as an analogy for the environmental problems of present-day society. It involves the following. A community has common grazing land where every farmer is allowed to let his sheep graze. As every farmer wants to improve his personal standards of living, each tries to put as many sheep as possible out to graze there. Above a certain limit, for every extra sheep there will be less grass and therefore a lower yield per sheep. Ultimately even the total revenue will decrease: the grass disappears and the sheep grow thin. Everyone would hence benefit from a 'grazing quota' (dividing up the pasture is another possibility) but agreements on that do not develop spontaneously. For each separate farmer it is disadvantageous to invest time in that or to limit the number of sheep he places in the meadow when all the others are spending all their energy on expanding their flocks. The downfall of every farmer thus seems to be unavoidable.

Prisoner's Dilemma situations and game theory

Similar situations occur frequently in present-day society. They are at the basis of many ethical problems related to technology. Such situations have become known as 'Prisoner's Dilemma situations'. A Prisoner's Dilemma (PD) situation involving many persons may be characterized as follows (Zandvoort 2003):

- Everyone would be better off, at least in the long run, if all people were to place certain restrictions on their actions.
- For each separate individual imposing these self-limitations is disadvantageous compared to those who do not subject themselves to the same limitations. Moreover, the contribution to the total negative effect of one or several non-conformers is negligible.

PD situations have been extensively studied in game theory. Game theory is sometimes described as the mathematical analysis of strategic interaction between people. Strategic interaction is defined as situations where the decisions (and the subsequent actions) of two or more individuals together determine the outcome. Game theory was created by Von Neumann and Morgenstern in their book *Theory of games and economic behavior* (1947). Since then, its concepts and results have been used to model many actually occurring situations of strategic interaction. Some of these concepts and results are used below.

[3] If a tragedy is defined as an *inevitable* course of negative events, as many seem to do, then 'tragedy' is actually not a correct word for the processes that I deal with in the text.

Two-person PD games

The simplest PD situation is a two-person one-off game, where there are only two actors or 'players' who meet each other only once. The situation is often further simplified by assuming that the actors have two options each (called strategies in game-theoretic language). A PD 'game' of this type is defined by the following so-called 'pay-off matrix' that specifies how the outcome for each depends upon the actions of both (see e.g. McLean 1987, chapter 7):

		You	
		Co-operate	Defect
I	Co-operate	3, 3 R, r	0, 5 S, t
	Defect	5, 0 T, s	1, 1 P, p

Figure 1. The pay-off matrix for a two-person PD game

Here, 0, 5 should be read: the outcome of the combination {I co-operate, You defect} is valued 0 by Me, and 5 by You. (Initially, the words co-operate and defect are mere labels for the two strategies that both players have available, but below I will vindicate for repeated PD games the connotations of these words in ordinary language.) The game is defined solely in terms of how the players *order* their valuations of the four possible outcomes, not on quantitative values. Hence, if the outcomes for Me of the four possibilities {we both co-operate}, {I co-operate, You defect}, {I defect, You co-operate}, and {we both defect} are called R, S, T and P, then a game is called a PD game if I order these outcomes as $T > R > P > S$ ($X > Y$ means that I prefer X above Y), and if You order the corresponding outcomes for You as $t > r > p > s$. Hence, any change in the numbers 3, 0, 5 and 1 which retains their ordering renders again a PD game, as does multiplying My (or Your) values with an arbitrary positive constant.

Equilibrium strategy for PD games

Suppose I want to choose the strategy that optimizes My outcome for this one-off game. Then I must consider two possibilities: either You co-operate, in which case it is best for Me to defect; or You defect, in which case it is also best for Me to defect. Hence in both cases My optimal result ensues by defecting. The same reasoning applies to You, and hence if You and I are economical, selfish players, outcome 1, 1 will materialize. This may even remain true for a repeated PD game, which is a situation where the same players encounter each other repeatedly (or continuously) in a PD situation. The tragedy of the commons exemplifies this.

Solution for a repeated PD game

However, for a repeated PD game there is an unambiguous, non-arbitrary solution available, namely a contractual agreement that ties both players to the strategy 'co-operate'. This solution is non-arbitrary or objective in the sense that it leads both players to results that are better than if there were no agreement, for outcome R, r (or rather a series of such outcomes) is valued higher by each player than a series of

outcomes P, p. Hence, for repeated PD games, the strategy labelled 'co-operate' may be associated with socially optimal behaviour, and likewise to 'defect' with socially sub-optimal (or detrimental) behaviour. The non-arbitrariness or objectivity of these definitions rests on the notion of Pareto improvement: socially beneficial behaviour is defined as behaviour that is beneficial for all. (Clearly, if there are negative external effects for parties other than the players, then the agreement should be extended to those others as well.)

Nature and costs of solution

The described solution requires that players reach an agreement on certain rules. That requires organization and effort, that is: costs ('transaction costs' in terms of economic theory). It is the task of politics to design such rules and to secure agreement on these rules (for an introduction to this view on the role of government see Mueller 1989, esp. Chapter 1). If there are many actors involved in the agreement, a system of enforcement will be needed as part of the agreement: an arbiter/controller with the authority to levy sanctions to violators of the agreement. Also such a system of enforcement involves additional costs. (It might be an element of the agreement that these costs be recovered from the sanctions, as these costs would not have to be made if there were no violators.) The costs for settling and executing the arrangement should not exceed the collective gain from the arrangement if it is really to be a solution to the PD situation. This is the case if these costs do not exceed (R-P) + (r-p) in our simplified model.

PD situations are omnipresent

In our technological society, characterized by environmental pollution, ecological damage, depletion of natural resources and all kinds of technological risks, Prisoner's Dilemma situations are omnipresent. The human production of CO_2 and its impact upon the climate may be one of many examples. It is very relevant to know whether a certain problem has the traits of a Prisoner's Dilemma situation, for in that case a solution of the type described above is in principle available: a set of shared rules coupled to a system of control and sanctions for violation on which there is agreement. If such solutions are available but nevertheless not realized, this may be blamed on failing political institutions or procedures of public choice, rather than on conflicting values or unsolvable moral dilemmas.

Legal systems and consensus

The solution to PD situations described above amounts to what is commonly known as a legal system. It is important to notice that such systems, including sanctions for violations, can in principle be based on the consensus of all involved. More to the point, such systems *must* be based on that consensus in order to represent a solution to a PD situation in the sense described above. In contrast to this, in the present societies consensus is not required and does not exist concerning the legal conditions that govern economic and technological activities. National political decision making proceeds on the basis of majority rule at best. The qualification 'at best' refers to serious problems with representation in the contemporary democracies. See Mueller (1989) for vindication. In addition, present democracies continually

sanction activities with significant actual or possible negative effects for people living outside those democracies, without having secured their consent[4].

The role of liability

The result regarding the need for consensus on market conditions that was reached earlier above can be obtained more directly and more generally from the ethical principle of restricted liberty, also known as the no-harm principle. In addition, by invoking the reciprocity principle governing situations in which this principle has been violated, the analysis can be complemented with considerations regarding liability. This renders a 'default rule' for liability in the absence of consensus on market conditions. These two issues are the subject of the present section, which draws on work of J.F.C. van Velsen (2000; 2003).

Restricted liberty

The restricted-liberty principle can be stated as follows: *Everyone is free to do what he/she pleases as long as he/she does not harm others.* An equivalent formulation of the restricted-liberty principle is the right to be safeguarded: *Everyone has the right to be safeguarded from the consequences of another person's actions.* An implication is that actions are allowed if and only if either there are no (possible) consequences for others; or those who will experience the (possible) consequences have consented after having been fully informed.

Reciprocity and liability

The principle of reciprocity specifies how violations to the restricted-liberty principle may be dealt with: *He who violates a right of another one will be reacted to in a reciprocal way. That means that somebody who infringes a certain right of another will himself lose that same right insofar as that is necessary (and no more than that) in order to correct the original violation or to compensate for it and in order to, if necessary, prevent further infringement.* Reciprocity implies that anyone not respecting another person's right to be safeguarded and thereby causing another person harm, loses his own right to be safeguarded, in the sense that he may be forced to repair or compensate the damage. Hence the reciprocity principle implies strict, that is, non-conditional liability for activities that lack the prior consent of those who may experience the consequences. In actual reality this is very often not the case (a concise history of legal liability for technological/commercial activities is contained in Zandvoort 2000).

The role of liability

The consent required for activities that may affect others may be provided by a general rule such as a law on which there is consensus among those involved. In order to secure that consensus, it may prove necessary that actors accept liability for

[4] It is sometimes claimed that between states, there is consensus decision-making regarding market conditions. An example that is sometimes quoted is the WTO. But others have stressed that in fact the situation is not one of real, that is, free consent Steger, M.B., 2002. *Globalism: the new market ideology*. Rowman & Littlefield, Lanham. . Nevertheless there seems to be agreement regarding the *desirability* of consensus on the international level regarding market conditions. It is remarkable how few show awareness of the discrepancy of this with that other idea, adopted by very many either explicitly or implicitly but almost always in an entirely uncritical way, namely that *within* nations majority rule would be an adequate procedure for making collective decisions.

negative consequences of their contemplated actions. However, if such consent is lacking, liability should always be strict, in the sense of non-conditional.

Recapitulation of the above analysis

A large class of cases of alleged ethical misconduct of businesses relates to negative external effects generated by business activities. If adequate measures for internalizing such negative external effects into the behaviour of actors will not be implemented, such allegations of ethical misconduct of businesses cannot be expected ever to stop. Such measures require the consensus of all involved, i.e. of all those who may experience negative external effects from the activities considered. The same result was obtained from an analysis in terms of Prisoner's Dilemmas. Many situations regarding environmental pollution, the depletion of natural resources and the creation of technological risks apparently have the structure of Prisoner's Dilemmas. Such dilemmas can be solved in a non-arbitrary way, by introducing a set of (legal) rules that have the consent of all involved. If a problem has the structure of a Prisoner's Dilemma, then such solutions exist. If they are nevertheless not identified and implemented, this should be blamed to failing political institutions and procedures (such as majority rule) rather than to conflicting values. The analysis of (internalizing) negative external effects and of (solving) Prisoner's Dilemmas are both based on the concept of Pareto improvement, and on the claim that social progress can be objectively defined only as Pareto improvement. An implication of this is that, if an activity embodies social progress, then that activity can obtain the consent of all who are affected by it. Finally, I have argued, on the basis of the ethical principles of restricted liberty and reciprocity, that liability should be strict for all activities that do not have the consent of all those who may be affected.

The social responsibility of business agents

Wempe's aim is to advise business and its agents as to how they can resolve the value conflicts in society that are at the basis of ethical problems relating to the activities of business organizations. As was explained at the beginning of my comments, I have two main points of criticism regarding his advice. The first point is that I find the methods and procedures described by Wempe very unclear. Hence it remains unclear how and why these methods and procedures can perform their intended functions. I find Wempe's exposition of little help regarding the question: how should situations be dealt with in which people's actions affect other people and where they do not agree on the norms or values on which the actions or their consequences are evaluated? The second point is this. One way in which I can make sense of the proposed methods and procedures for resolving value conflicts in society is that they are an attempt at a(n) (ill-defined) method for creating solutions to PD situations, in the sense explained above. But such a method, even if it would be sound in itself, cannot be executed by business organizations, contrary to what Wempe suggests. Instead, adequate procedures and institutions of public choice and law are needed. I have argued (1) that adequate procedures of political decision making should be based on consensus rather than on majority rule as is presently the case, (2) that the introduction of stricter liability may be a means of securing consent to activities which otherwise would not be consented to, and (3) that as long as actual political decision making is not based on consensus, liability should be strict. Against

this background, I want to end with the following remarks regarding ethical business and what Wempe has to say on that.

The role of business organizations in solving PD situations

Even if business organizations cannot perform the functions of politics and government, it remains a relevant question what the role of business organizations and their agents in political processes should be. In view of the above analysis one would expect that business organizations and their agents who want to perform their activities in an ethical way would actively contribute to the realization of the changes that are required according to that analysis, notably the introduction of liability laws that are more strict than at present, and of political decision making that is more than at present based on consensus. At the very least, one would expect critical and open-minded assessments of the inadequacies of the actual political and legal systems. In practice, very little of this can be observed. This leads me to the following remarks with which I will end my commentary.

Freedom of speech of persons associated to (business) organizations

This freedom of speech is very limited in the organizations that populate the present societies (see Zandvoort in press, for substantiation and for implications). This holds both for business organizations and for government organizations. This effectively keeps many people's mouths shut on a large range of very important issues, including the need for stricter liability laws discussed above. It appears to me that ethical business organizations without the freedom of speech of those working there is almost a *contradictio in terminis*. Unfortunately, Wempe's contribution does not address this subject.

The political responsibility of business agents

The limited freedom of speech mentioned above adds to the ethical responsibility that those who legally speak and decide for business organizations carry for the political outcomes of what they say and do and of what they fail to say and do. Again, Wempe's contribution has nothing to say on the responsibility of business agents (professionals, managers) considered from this perspective.

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