Notes Business Ethics

Business Ethics (Technische Universität München)

Introduction

1. Why Business Ethics?

1.1 Examples

<u>Example 1:</u>
- In 2018, up to 1.1 m people died from AIDS-related diseases
- 70% of them are from countries of sub-Saharan Africa
- Worldwide HIV could be confined through antiretroviral medication

What obligations do Western pharmaceutical companies have to supply Africa with antiretroviral medications?
The question is who has to pay for it, the government or should the company reduce prices for them.

<u>Example 2:</u>
- In 1981, American Express developed a campaign according to which the company gave 2 cents to charity for each credit card transaction.
- Credit card returns increased by 28 percent.

Can Corporate Social Responsibility become a business case? Some people think yes, other no.

<u>Example 3:</u>
- The Millennial Factor: 86% of millennials consider it a main priority to work for a business that conducts itself ethically and responsibly. In fact, most millennials would be willing to take a considerable pay cut to work for such a business."

Is Corporate Social Responsibility key to attract and retain top talent?

<u>Example 4:</u>
Does the fast technological progress & increasing power of companies demand more responsible self-regulation?

...but do companies have the power to shape technology?

1.2 Traditional views of technology

...but do companies have the power to shape technology?

Technologies' meaning, influence and direction is solely constructed by society and society's desires.
→ technology can be considered as a 'blank slate' or neutral object waiting to gain meaning and values through human interaction (e.g., Drake et al., 2000; Herschel & Andrews, 1997).

"Technology develops as the sole result of an internal dynamic and then, unmediated by any other influence, molds society to fit its patterns" (Winner, 1986).
→ individuals are turned into 'cogs in the machine' (Allinson, 1998) or 'slaves to artefacts' (Ellul, 1962); technomoral artefacts (Vallor, 2015)

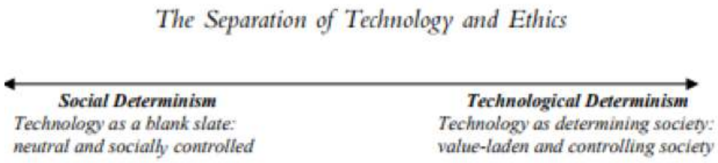


Figure 1. Traditional views of technology.

1.3 Updated view of technology

Yes, companies do have the power to shape technology.

- Technology does hold inherent values but these can be controlled by society.
- Neither technology nor society possess sole dominance over the other, rather they co-shape each other. Companies' responsibility increases: "[T]he controlled development and design of technology becomes paramount within a corporation".

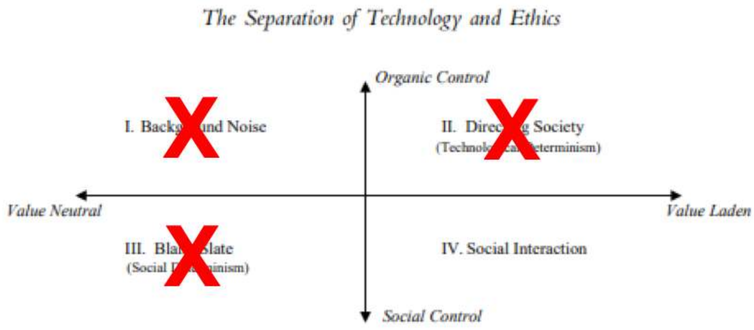


Figure 2. Technology as…

2. General Perception of Business Ethics

2.1 Public perception

Public perception is coined by virtue ethics:
- "Greed": Main cause of economic misconduct.
- Distrust of certain population groups such as bankers, speculators, "grasshoppers", etc.
- Bertolt Brecht: "Bankrobbery: An initiative by the unprofessional. A true professional founds a bank." He thinks that founding a bank is unethical.

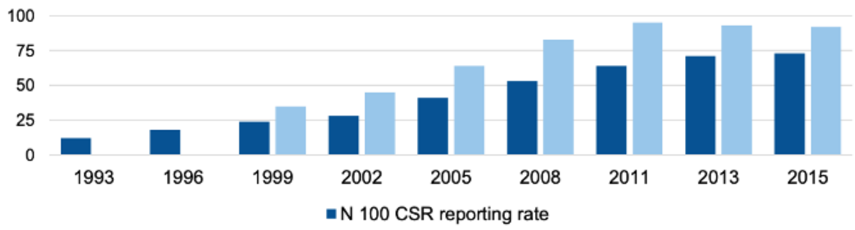
→ Criticism targets involved actors and not structures.

2.2 Some statistics

- Costumers'demand: More ethical practices by companies
- Barclays' study on "Reshaping retail – How ethics and sustainability are changing retail's ecosystems":
  - Around 63% of customers surveyed in the study said they want to see the industry make further sustainable and ethical changes.
  - 52% of consumers said the ethical and sustainable credentials of a business will be an essential factor for them when choosing what to purchase.

2.3 CSR Reporting Development

Has to be done mandatory in the companies.
CSR reporting rate of the 250 biggest companies worldwide: Increase from 35% in 1999 to 95% in 2011.



2.4 Misconduct reporting

- On an individual level (misconduct) reporting rises, too.
- Ethics.org report on ethics and compliance (2020): Around 8 in 10 employees worldwide report misconduct nowadays.
- Examples of the most common forms of observed misconduct included lying and favoritism.
- BUT simultaneously, "there seems to be a growing issue with retaliation in response to employees reporting misconduct": Around 61% of global employees report that they have experienced retaliation as a result.

3. The Ford Pinto Case

3.1 Introduction

- Car of the lower compact class, developed by Ford in the 1960s as a reaction to the first Japanese compact car and the popular German Volkswagen "Käfer"
- Introduction in 1970
- Price 2,000 USD ≈ 11.400 EUR in 2018

3.2 Problem

- Question: where the fuel tank should be placed.
- Finally was placed behind the rear-wheel
    - Thus, damage caused by rear-end collisions at low speed
    - Possibility of leaking fuel, danger of explosion
- Engineers hinted to the problem to the managers. And managers reasoned about the costs.
- The question to Ford: Protecting rubber shell for the fuel tank? This could avoid the problem. But the costs were these:
    - Fitting costs: 11$/vehicle for 12.5M scheduled cars: **137.5 M$.** (Cost of the protecting shell)
    - Costs, if not attached (Calculation of the Ford-statisticians):
        - 2,100 burning vehicles (average time value 700$)
        - 180 dead (official „indication of value" by the US Government at that time: 200,000$)
        - 180 heavily injured (insurance claimed „value" 67,000$): **49.5 M$** (Cost of do not include the protecting shell)

- Decision: No rubber shell
    - In the following years after the decision
    - ca. 60 lethal accidents
    - ca. 120 heavily burn injured people
    - 117 lawsuits were brought against Ford
    - Pinto was withdrawn from the market 1980

3.3 Ethical Evaluation

- No contravention (prevailing rule, tank has to remain intact at the speed of 20 mph was implemented). They were doing everything according to law.
- Pinto was "statistically" as secure as every other compact vehicle (according to Ford)

- Human life is constantly evaluated
- Increased safety measures in traffic, e.g. backfitting of older cars with airbags?
- 11 USD per vehicle are still 0.5 percent of the sales

3.4 Problems for Ford afterwards

- Loss of reputation, especially when the calculation was discovered
- Trial against Ford
    - First US Corporation accused of manslaughter
    - No conviction
    - However: five months after the case, the Pinto production was stopped for good.
- It became a starting point for CSR. It is not enough to be stuck to the rules, ethics need to be taken into consideration.
- Long-term ethics and commercial success compatible.

4. What is the value of life?

NHTSA in 1972

• Future Productivity Losses	173,300	
• Medical Costs	1,125	
• Property Damage	1,500	$ 200,725 in 1972
• Insurance Administration	4,700	≙ $ 1,175,471 in 2017
• Legal and Court	3,000	≙ € 999,354 in 2017
• Employer Losses	1,000	
• Victim's Pain and Suffering	10,000	
• Funeral	900	
• Other	5,200	
	$ 200,725	

Market value of body

• Oxygen (O)	ca. 63%	133.48	
• Carbon (C)	ca. 20%	713.00	
• Hydrogen (H)	ca. 10%	0.02	
• Nitrogen (N)	ca. 3.0%	120.00	€1,022.45 in 2008
• Calcium (Ca)	ca. 1.5%	20.85	≙ € 1,037 in 2017
• Phosphor (P)	ca. 1.0%	13.90	
• Potassium (K)	ca. 0.3%	10.25	
• Sulfur (S)	ca. 0.2%	8.00	
• Other	ca. 1.3%	2.95	
		€ 1,022.45	

<u>Conclusion:</u>

- Some misconducts in the past and the increasing power of companies highlight the relevance of business ethics.
- Additionally, consumers demand and companies acknowledge the increasing importance of corporate social responsibility.
- To what extent business ethics becomes ever more important in the age of globalization will be the next focus in this lecture.

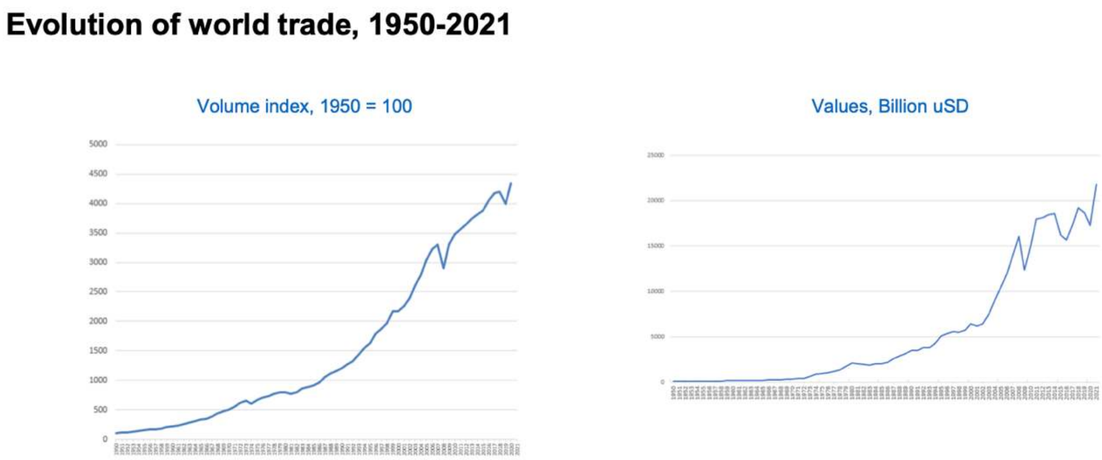
Chapter 1: Business Ethics in the Age of Globalization

1. The phenomenon of globalization

1.1 What is globalization?

- Value-free perspectives:
    - Globalization is “the extension of social relations across world-space.” (Paul James)
    - Other definitions include not only economic but also political, technical and cultural phenomena (Giddens, 1999)
- Value-laden perspectives:
    - Globalization is “a doctrine for the promotion of neoliberalism” (Chomsky, 2006).
    - “A scam perpetrated against everyone by powerful groups.“ (Wallerstein, 2000)

To eliminate potential biases, we take a step back and **define globalization** as: “Increase of commercial and social ties on a global level.”
The ethical judgement of “the increase of commercial ties between different economic actors” depends on the assumed properties and effects of globalization and on the “models of mind” we employ to judge these effects and properties.



1.2 The properties of globalization

- Denationalization: The borders of nation states are becoming more permeable to goods, travel and financial transactions.
- Deterritorialization: Culture (e.g. food, music, fashion) is less tied to geographical areas or nation states.
- Reduction of spatial and temporal distances: New technical developments (Internet, mobile telephony, high-speed trains, air traffic) minimize spatial distances.
- Interconnectedness: People interact across borders and increasingly exchange.

1.3 The first wave of globalization

Milestones of the modern phase of globalization:
- First multinationals (Dutch East India Company; 1602-1799)
- Discovery of mass production (economies of scale) and population growth → increased demand for consumer goods
- Temporary peak of globalization before World War I.
- Implication: We should not regard globalization as a completely unique phenomenon in history, but rather as expression for higher levels of global integration.

1.4 The current wave of globalization

After World War II and in the wake of de-colonialization, the current wave of globalization began:

- Conferences in Bretton Woods and Dumbarton Oaks (1944): Foundation of the United Nations, the World Bank, and the International Monetary Fund.
- Collapse of the USSR (1989-1991) and Economic Opening of China (1978-1990)
- New technological achievements (such as digitization) strengthen the interconnectedness of the global economy ("the extension of social relations across world-space"
- Globalization is a comprehensive phenomenon and rests on economic, political, ecological and cultural pillars.

2. The implications of globalization for business ethics

2.1 Cultural aspects

Cultural Diversity and Globalization:

- Diversity within nation states increases [150 million migrant workers worldwide (ILO, 2003)]
- Diversity among nations states decreases [e.g. increasingly similar business practices, dominance of the English language, global brands such Apple, BMW, Starbucks, Subway (presence in 119 states) etc.]

Implications:

- Likelihood for cultural clashes rises (even within the same national culture)
- Increasing modernization and multi-culturalism might be tougher challenge which developed more rapid than Western countries. →"Overarching values" are likely to play a more pronounced role in future.

Chapter 2: Basic Concepts

1. Problems in Business Ethics as Interaction Problems

1.1 Robinson Crusoe and Friday

Robinson Crusoe alone on an island:

- Daily struggle for survival
- Scarcity as biggest problem. For example, scarcity of time, food, resources, etc.
- Producer and consumer at the same time → "Robinson Economics"

But Friday comes into play. Now he was not the only person in the game.

- Two individuals are competing for limited resources
- Scarcity becoming a problem of social interaction

→ Interaction problem as economic problem.

1.2 Basic Elements of Problems in Business Ethics

Basic problem for economics is scarcity, but only if we talk about interactions aswell. Then, individual problems become social problems. They might share, fight, collaborate to find food, etc. Business ethics starts when Friday arrives, when there is more than one person.

So we need:

- 1st element: At least two actors.
- 2nd element: An environment of scarcity.

Scarcity leading to conflicts

- Focus on interaction of individuals
- Individual problems becoming social problems

- How to respond to conflicts? Possibilities: fighting, sharing, cooperating

Business Ethics begins when Friday arrives on the island.
Morality started when people hunted, then they had to distribute fair the food.

1.3 Cooperation as a Solution to Scarcity Problems

There are two approaches to think about scarcity problems:

I. Criterion of **Distributive Justice**: How should a given cake be split?
   - Existing quantity of goods is given
   - Distribution based on rules
   - Criterion is usually to get a result as equitable as possible

   → Distributional issues treated in isolation, however: problem of scarcity itself is not addressed and persists

II. Criterion of **Allocative Justice**: How can we improve the supply of goods quantitatively or qualitatively to satisfy more demand than before?
   - Best possible allocation of scarce production factors (labor, raw materials, capital, etc.) is crucial, in order to increase yields
   - Determine which scarce production factors should be allocated and used to satisfy demands

     → Gains from cooperation mitigate the problem of scarcity.

1.4 Allocation Problems in Economics

Scarcity problems should be understood as allocation problems to counteract scarcity problem.

It has a connection to economics:
- Interdependence of production and distribution; have to be discussed simultaneously. (Different distribution of "cake" influences its size)
- Shareholders invest in the production of goods or services and anticipate return on their investment.

Efficient allocation of means of production through redistribution that causes little distortions in incentive mechanisms.

<u>Example: Economic policy</u>

Governments redistribute wealth and income by levying taxes and social security contributions including the payment of social benefits.
- Which criteria (equity, equality etc.) do we use to arrange redistributions?
- Which combination and distribution of produced goods does maximize productivity?
- How can we prevent undesired effects such as free-riding or negative externalities?

→ Institutional design determines whether gains from cooperation can be achieved.

1.5 Limits of Individual Moral Actions

<u>Example</u>: The virtue-ethical question "What should I do?" makes Robinson to give up half of his stocks to Friday.
<u>Result</u>: Nobody gets enough to eat.

"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, and never talk to them of our own necessities but of their advantages." (Adam Smith, "Wealth of Nations", 1846, p. 26)

Decoupling of motive and result →morality is interpreted as an unintended result of intentional action.

1.6 Outcome for Business Ethics

Solution: Business Ethics should not be based on actions and their motives, but on the conditions under which actions are carried out.

Reasons:
1. Individual virtues cannot overcome structural problems. For example, corruption cannot be solved by a person.
2. Problems in Business Ethics are by nature **interaction** and **interdependence problems**. We depend on each other, for example in the crisis, it is an interdependence problem of a lot of things.
3. Conditions of the modern world:
- Rising degree of complexity in economic relations
- Prevalence of mutual interdependences between individuals, firms and nation states

2. Ethics and Economics – Definitions and Methodological Deductions

2.1 Classification of Philosophy

- Theoretical Philosophy
  - What does exist? (Ontology)
  - What is the order of the world? (Metaphysics)
  - What can I know? (Epistemology, Philosophy of Science) What is the relation of language and reality?
  - (Philosophy of Language) ...
- Practical Philosophy
  - What should I do? (Ethics)
  - What is the best means to achieve an end? (Economics) What is the best order of society? (Political Philosophy)
- History of Philosophy

Immanuel Kant:

- 1724 – 1804
- German philosopher
- According to Kant, philosophy ultimately aims at answering three questions:
- “What can I know? What should I do? What may I hope?”

2.2 Ethics and Ethos

Basic idea of "ethos":
- "ἔθος" = originally: Space of living, position, horse stables, then also: habit, custom, tradition
- "ἤθος" = Character, disposition, custom, tradition, habit

Aristotle: Triad of politics, ethics and economics.
Since Cicero: Ethos/Conventions = "mores„ →Morality.

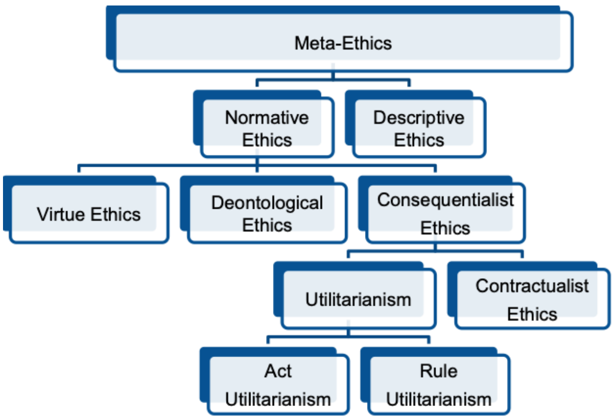
Colloquially often used interchangeably: "Ethics" instead of "morality".

Philosophical usage:
- **Morality** as a complex of rules and norms that determine people's actions in practice
- **Ethics** as theory of morality (reflecting on morality)

Morality definition:
Aggregate of rules of action, standards, norms, values, conceptions of significance that guide or ought to guide the actions of human beings.

- Determines actions or ought to determine actions
- Violation leads to violations of oneself and/or others

Ethics overview:



Ethics is the theory of morality.

2.3 Descriptive, Normative and Meta-Ethics

Descriptive Ethics:

- Description, systematization und explanation of normative systems
- e.g. ethnology, moral psychology, evolutionary biology, behavioral economics

Normative Ethics:

- Ethics is the analysis of human conduct from the perspective of "good" and "bad" respectively "morally right" and "morally wrong“
- Similarly, evaluation of an economic order as "just" or "unjust"
- Different from psychology and humanities

Meta-Ethics:

- Focuses on nature of morality, often relies on semantic analysis of moral judgments. It is the theory of ethics.
- Second-order theory examining the metaphysical, epistemological, semantic presuppositions of ethics such as difference between cognitivism and non-cognitivism (can moral statements be true?)
- Not directly related to content of rules or norms

2.4 Meta-Ethical questions

According to Richard Garner and Bernard Rosen
(1967: Moral Philosophy: A Systematic Introduction to Normative Ethics and Meta-Ethics)

I. Moral Semantics:
What is the meaning of moral terms or judgments?
II. Moral Ontology:
What is the nature of moral judgments?
III. Moral Epistemology:
How may moral judgments be supported or defended?

2.5 Different Levels of Ethics- example

"Human dignity is inviolable."

- Descriptive: According to the German Constitutional Law human dignity is inviolable.
- Normative: No one, not even public authorities, ought to compromise human dignity. (Human rights!)
- Meta-Ethical: What does "is" mean? Does the statement imply a normative meaning? Is an embryo a "human"? What about a corpse? What does "dignity" imply? Can it be reduced to physical integrity?

2.6 Different types of normative ethics

Moral judgements can be based on:

- Action as such.
- Purpose of action. What was the original intention.
- Rationale behind action (means rea)
- Consequences of action
- Utility of action

2.7 Economy and Economics

<u>Economy:</u>
Household. Domain of the discipline economics.

<u>Economics:</u>

Traditionally: science of the domain "Economy"

- Meanwhile it comprises also phenomena such as culture, political offices, elections, education, family, phenomena of addiction, health

Nowadays rather characterized by certain methodology

Definition: Economics deals with the explanation and design of the conditions and consequences of the interactions on the basis of individual benefit/disadvantage calculations.

2.8 Business Ethics

It has 2 concepts:

- Business Ethics as "Hyphenated Ethics"
    - Ethics "for the economy"
    - Just like Medical Ethics, Bioethics, Media Ethics, Engineering Ethics, ...

- Business Ethics as ethics with economic method
  Ethics viewed from a certain perspective: Implementation of norms: transfer of rules into (social) world. Morality is reconstructed by economic means.

Definition: Business ethics is a discipline of practical philosophy that explores which norms can be established and brought to bear under conditions of modern society.

3. Situating Business Ethics in Philosophy

3.1 Theory in Business Ethics

Two options for theory in Business Ethics. → Dualistic vs. Monistic Business Ethics.

What should be done in light of conflicting demands for action? For example, there are conflicting demands between shareholders and stakeholders, shareholders ask something and stakeholders want another thing.

Are there fundamental conflicts between…?
- Morality and Business
  and
- Ethics and Economics

3.2 Dualism

- Calls for decision on one position or at least "mediation" between both positions. You have to decide whether you are in the side of ethics or in the side of economics.
- The final decision is that you should be on the side of ethics, what would be a "domestication" of economy.
- Proximity to everyday intuitions of many if not most people.
- Other examples:
  Are you in favor of …… OR …..?
    - Morality OR Economy
    - Altruism OR Egoism
    - Solidarity OR Competition
    - Ecology OR Economy
    - Common Welfare OR Self-interest
    - Common Welfare OR Efficiency
- Close to perception of human beings (shareholder's benefit from mass dismissals)
- Consequences: Appeals to conscience and postulation of values (prioritization of "moral values")
- Attribution of blame, search for culprits dominates discussion
- Question of norm implementation plays subordinate role

<u>Examples for Dualistic View:</u>

- Karl Kraus (ca. 1920)
    - "You want to study Business Ethics? Then you have to decide on either Business or Ethics!"
- Ulrich Döring ("Allgemeine BWL", FAZ 2010)
    - Making profit is ethical: Shareholder approach is right; morality in the economy is simply dysfunctional
    - "The Stakeholder approach tries to make entrepreneurs act morally via collective decisions at the round table. In business practice the discourse-ethical approach is doomed to fail. Customers, suppliers, investors, staff, and the public have conflicting concerns."
- Erich Fromm (1976)
    - "To Have or to Be"
- Leaving the realm of "possession"; aiming towards an attitude of "being":
    - "True needs of the human being" vs. "Requirements of economy"
    - "Exploitation of nature by man" vs. "Cooperation between man and nature"
    - "Mutual antagonism between man" vs. "Solidarity"
    - "Maximum consumption" vs. "Reasonable consumption" (for benefit of human beings)

Limit of Dualistic Approach: Problem of Implementation

Reason: If actors follow moral appeal, they are vulnerable to exploitation and expect to suffer competitive disadvantages.

3.3 Monism

- "Economics as a continuation of ethics by other means".
- Central normative criterion:
  - Mutual improvement
  - Therefore, all parties can agree on certain rules
- Morality and Economics are considered two sides of the same coin. There is no contradiction between morality and economics.
- Basis: modern understanding of economics
- They believe:
  - Ethics can‘t make individuals work constantly against their own interest.
  - Ethics has to show that acting according to moral rules is in the aggregate (not in an individual case!) more advantageous than breaking these rules.

David Hume:

Correspondence with David Hume's (1711-1776) view: Finally, it is the aim of moral philosophy to show that all its demands are in the interest of the individual.
Only with (general) advantages can one expect people to act according to moral norms in everyday life.

Picture of the iceberg:

- Morality is surface
- (In daily life) ethical phenomena are just surface
- Underneath (mutual) advantages are hidden
- Nine tenth of iceberg are under water surface

3.4 Term “Business Ethics”

German term "Wirtschaftsethik" without adequate equivalent in English

- English:
  - "Business ethics"
  - "Economic ethics„ →very uncommon
  - Corporate Social Responsibility = CSR
- French:
  - "Éthique des affaires"
  - "Éthique de l’économie„→very uncommon

3.5 Ethics and Economics: Example of primary health

Coincidence of ethics and economics can be illustrated with debate over introduction of universal health insurance in USA.

- Ethical argument
    - Right to general primary health care regardless of income
- Economic argument
    - Bad health conditions of working population are detrimental to economy as whole and create high opportunity costs

Both arguments go to the same direction. It can be an example of monism.

3.6 Moral Quality of Economics

- Economics does not maintain its moral quality through individual moral acts – its moral quality is in overall system. If the system is not moral, the actors cannot do a lot to act moral, they are limited by the rules of the game.
- To understand and induce changes in system, actors (e.g., managers) need to be modelled as self-interested beings
- Moral concept of solidarity has to be implemented through suitable order framework. For example, if we want more solidarity, the framework in which we are in has to support it.

3.7 Relevance to Corporate Ethics

- Ideal: Perfect economic condition/ framework (all actions fixed in details) → Business ethics is systemically relevant
- Real: "Complete" framework is practically impossible due to dynamic nature of global markets → Corporate ethics is complementary to business ethics

Theory of Incomplete Contracts:

- Starting point: Assumes that human interactions are governed by contracts, formal (e.g. codified laws) and informal (e.g. promises).
- Problem: These contracts are incomplete in number of ways (for example: performance and consideration are not precisely defined) → Incomplete contracts thus increase uncertainty
- Goal of Corporate Ethics: Recommendations for actions in face of incomplete contracts.

*Oliver Hart (*1948) and Bengt Holmström (*1949): Nobel Memorial Prize in Economic Sciences in 2016*

3.8 Parallelism of Corporate Ethics and Business Ethics

Two important aspects:

1. Business ethics (level of regulation) and Corporate ethics (level of action) must not be in conflict with each other
2. Dualism vs. Monism

What is relationship between profits and morality?

3.9 Risk of a Dualistic Corporate Ethic

Example: Klaus Steilmann (1929 - 2009)

- German businessman who founded company "Klaus Steilmann GmbH & Co. KG" in 1958
- Company evolved due to a strategy of low prices to one of the main players in Europe
- Globalization put the company under strong pressure to lower costs starting from the 1990s
- Steilmann kept his German staff despite their higher labor costs
- Bankruptcy in 2006 could only be avoided because of a take-over by the Italian manufacturer "Radici-Group"

Klaus thought that he was ethic so he didn't want to relocate the production to another country where there was cheaper to produce. In 2006 the company went bankruptcy. What he believed, the ethical part of him, ended with the company. You should take into consideration both, the ethics and the economics.

3.10 Corporate Ethics as Risk Management

<u>Monistic corporate ethics:</u>

Postulate of incentive-compatible implementability. If you want to implement ethical norms, they have to be incentive compatible. Otherwise, people will not follow the rules.

Importance:

- Moral actions have to be reconstructed as self-interested actions.
- Moral missteps can involve high risk for the company's success. Bad reputation.
- Example: Consumer boycotts. Consumer boycotts can change perception of companies. So, morality has to be taken into consideration in the companies, a good manager can employ morality and economy interests.

Result:

- Morality is part of entrepreneurial calculus
- Moral behavior and pursuit of profit become two sides of the same coin

<u>Reputation:</u>

- Goal: Represent yourself as reliable producer/trading partner
- Signaling reliability through collective or individual action.
- Therefore, customer loyalty and maintenance of business contacts in absence of specific contracts
- Reputation serves as check on Opportunism

3.11 Types of responsibility

- **Behavioral responsibility**: Companies are responsible for their actions and resulting consequences. (Compliance, product responsibility, advertising methods, etc.)
- **Regulatory responsibility**: Entrepreneur is obliged to participate in improvement of the social or political order.
- **Discourse responsibility**: Companies are called upon to participate in public discourse on social and political foundations of global society.

Chapter 3: Historical-economic Background: Premodernity and Modernity

1. History Premodernity and Modernity

1.1 Economic Conditions and Moral Norms

The validity of moral norms in business ethics depends (above all) on the prevailing economic conditions

- We can observe a strong change in the economic conditions and structures: Premodern and modern worlds are systematically distinguished from each other
- Ethical concepts from philosophies of the past century are not easily transferable, as the historical developments of the last 200 years are unique
- Earlier ethical concepts were not wrong in themselves, but moral thought could not catch up with developments sparked by technological and economic progress

Premodern societies are characterized by the following structural features:

1. Belief in a predetermined and unchangeable social order.
2. Societal organization according to estates until modern times.
3. Focus on economic survival and not on economic growth.
4. Low degree of social mobility (e.g. slavery, guildes and castes).

1.2 Historical Background

In the premodern world most people were living in small communities, and there were only a few isolate cities. In the small communities you knew each other, you knew the competitors and you could punish them if they were not following the rules.

Until 1000 AD: Only 10 cities with more than 100,000 inhabitants:
- Rome (the largest city around 100 AD)
- Cordoba (around 1000)
- Beijing (from 1500 – 1800)
- London (around 1900)

Low interregional communication options (Lütge, 2005): Interactions mostly among known individuals.
Adherence to moral norms is monitored through face-to-face control, as everybody knew each other.

External factors contributed to a high risk aversion:
- Strong reliance on agriculture for peasants and nobility (cf. Garnsey et al., 2015)
- Objectives of the political economy: Self-sufficiency and protection from natural forces (risk aversion)
- Economy as a private affair (oikos = house; nomos = law)
- Premodernity saw famines with exceptionally high death tolls

1.3 Social Classes in Antiquity

Moral values have supported and reinforced the notion of an unchangeable and predetermined social order:
“All of you in the city are certainly brothers,' we shall say to them in telling the tale, 'but the god (sic!), in fashioning those of you who are competent to rule, mixed gold in at their birth; this is why they are most honored; in auxiliaries, silver; and iron and bronze in the farmers and the other craftsmen.”
(Politeia, 442, a-c)
- Ranking of professions and exclusion of particular groups from political / economic participation (examples: guilds and casts)
- Belief in inherent class differences of human beings by nature

1.4 Economy and Growth in Antiquity

Moreover, the prevailing socio-economic conditions reinforced perceptions of the economy as a zero-sum game (When someone gains something, somebody else lose the same):

- Lack of economic growth throughout antiquity
- Winners of income distributions are either the "poor" or the "rich"
- Static income distribution: "The profit of one is the loss of another‘"
- Political consequence: Distribution struggles and political instability

1.5 Ethics of Behavior

The prevailing conditions of premodernity heavily influenced moral norms:
Prevailing moral norms of premodern society.

Perception of society as zero-sum game, for example:

“By being rich, I make others poor I may not even know." (Giovanni Ruccelai, 1475 -1525)

- Virtue of moderation in consumption (as you might hurt others).
- Risk aversion (dependency on agriculture).
- Pivot to ethics of behavior (as you cannot change society). Society was very stable at that time.

<u>Risk Aversion in Antiquity: Example 1</u>

“It is true that to obtain money by trade is sometimes more profitable, were it not so hazardous; and likewise money-lending, if it were as honourable. Our ancestors held this view and embodied it in their laws, which required that the thief be mulcted double and the usurer fourfold; how much less desirable a citizen they considered the usurer than the thief, one may judge from this. And when they would praise a worthy man their praise took this form: "good husbandman, good farmer"; one so praised was thought to have received the greatest commendation.”
(Cato the Elder, De agricultura)

In the premodern society the business people were the bad guys. They wanted to make money. They were seen as they were trying to exploit others, but this is not the case on the modern society.

<u>Example 2:</u>

A famous example of the ethics of behavior is the story of St. Martin who slices his coat into two parts with his sword, giving one half to the freezing beggar.

- This altruistic act is frequently considered to be the epitome of a good deed
- In the domain of the ethics of actions, this example can be viewed from two angles
  - Altruism is the epitome of a good deed
  - Conceived as improvement of individual's character

Ethics of condition: Problem is not solved on a structural level → both are freezing.

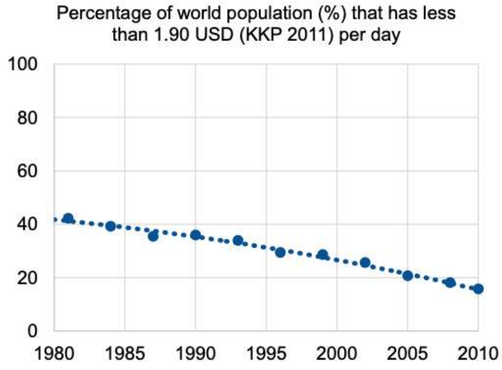
1.6 Changed Structures of Modern World

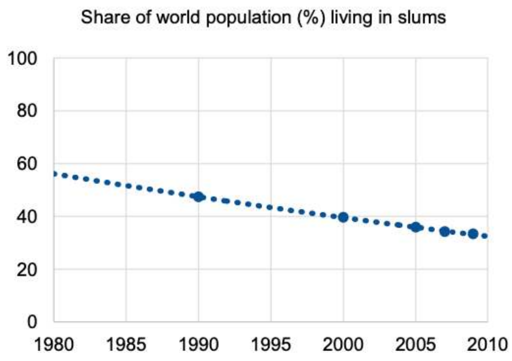
<u>The fundamental differences:</u>

1. People can influence their behavioral conditions (for example: participation in the political / economic sphere), limited degree of predetermined order of things and lack of a universally recognized external authority→ **multitude** of different goals and beliefs, people do not believe the same.
2. Strong increase in individual mobility in geographic, social, cultural, and professional dimensions: **Multiculturism and Pluralism**.

3. The **material wealth of humanity** saw an exponential growth since the Industrial Revolution that has intensified since 1945.

Economic Growth and Extreme Poverty:



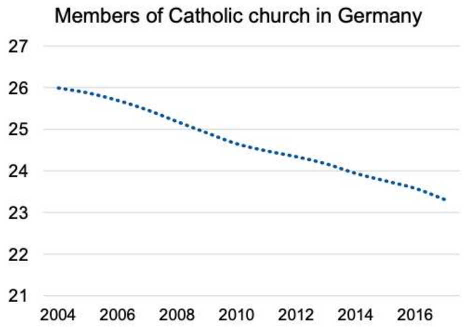


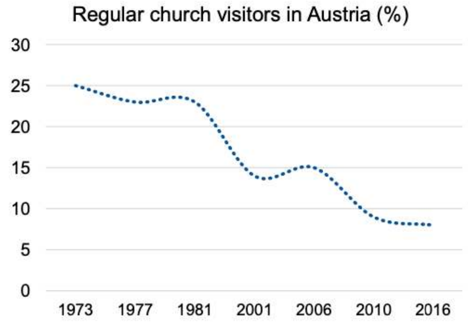
4. Modern society is characterized by the fact that individuals can escape direct "moral" control relatively easily, because social norms are **not enforced by face-to-face control** (excommunication, outlawing, moral appeal). You don't know (personally) every competitor that you have.

Premodern society: Ethics of behavior = improving the behavior of individuals.
vs.
Modern society: Ethics of conditions = improving the conditions for individual behavior.

Change from premodern to modern societies requires a change from "ethics of behavior" to "ethics of order" (Lütge and Uhl, 2021)

<u>Erosion of Traditional "Moral Monopolies":</u>





The members of the church have been declining last years.

1.7 Causes of Economic Growth in Modern Age

This change was sparked by several coinciding factors:

- Technological progress (navigation, steam engine) and gain of scientific knowledge (Galileo Galilei, Isaac Newton).
- Increasing economies of scale by implementing new technologies.
- Introduced competition & increasing international trade.
- Since 1990: Economic transformations in China, India, Russia and Vietnam and the transition to modern market economies → 1 billion people have been liberated from extreme poverty.

1.8 Solidarity and Competition

- Is there a fundamental conflict between **competition** and **solidarity**?
- Modern societies are not zero-sum games, due to economic growth:
    - *"Social interaction for the benefit of all, including the disadvantaged"* (Homann, 2003)
- Competition enables growth and growth increases the size of the cake
- Market economy and competition explain the economic growth after the industrial revolution
- Does competition promote solidarity more than sharing?
  St Martin thought that to promote solidarity the only was sharing, but we can promote it in different ways. We need to look at conditions and rules of competition.

1.9 Economic order

Competition is not "war of all against all".

Conditions and rules of competition:
- Enabling prosperity enhancing competition
- Prohibit certain types of behavior (violence, fraud, tax evasion)

New (ethical) goal: Performance competition
- Preferences of customers must be the focus of the companies
- Quality and cost of the products

→ **Conditions of actions** in focus and not the motivation.

<u>Causes of re-evaluation of competition and individual striving:</u>

1. Elimination of Social Control
- Premodern: Social control via face-to-face mechanisms→ Strong deterrent potential
- Modern: Ever-changing cooperation partners, complex causal connections and effects of actions (externalities)
- Self-control/conscience of the individual leads to competitive disadvantage in competition

2. Self-interest as a "modern form of charity"
- Crucial: Suitable framework promotes prosperity and induces people to produce what benefits their fellow human beings.
- Self-interested action at the expense of others should be prevented.
- Preferences do not only refer to monetary or material advantages. For example, it can be something for animal rights, environmental interests, etc.
- Modern ethics of investment instead of premodern ethic of moderation. If you moderate your behavior, it can bring company out of business. For example, if you want to moderate the gains of the business, it can be bad for the company.

→ Under this view, traditional conflict between "good" altruistic behavior and “bad” egoism is no longer valid.

1.10Ethical Quality of Competition

The following applies if competition takes place in an appropriate regulatory framework:
- Self-interests can be directed in such a way that they bring the greatest benefit to fellow human beings and society
- Exploitation must be prevented by rules. Others should not have an advantage by exploiting.
- Uncertain consequences of enforcing ethical values irrespective of framework conditions are avoided
- Recognizing the complexity of contemporary socio-economic systems

→ Competitive market economy as systemic approach of business ethics

Example of shortcomings of traditional ethics of behavior:

- Burning 105 tons of confiscated ivory in 2016
- Goal: fight against illegal poaching
- Ethical perspective:
    - Poachers hunt for high profits
    - Burning 105 tons reduced supply, so then the prices were increased
    - Demands stay constant, price of ivory increased → higher profits attract more poaching

If systematic connections are overlooked, even well-intentioned acts can often lead to unforeseen and above all unwanted consequences.

2. The Benefits of the Market and Competition

2.1 Competition

What does competition mean?

- Competition is state of "competitive striving".
- "It is merely a metaphor to call competition competitive war, or simply, war. The function of battle is destruction; of competition, construction." (Mises, 1922, p. 291)
- The linguistic distinction between competition and struggle is important
- Struggle: Natural and "without rules"
- Competition: Without a suitable set of rules, competition as an artificial structure can quickly lead to a "ruinous competition." (Hobbes, 1642)

Conceptual history and linguistic usage:
- Latin: competere = "trying to achieve something at the same time„ → abiding by rules vs. concurrere = "collide, converge„ → refers to direct combat, not abiding rules.
- English: Competition = Rivalry → competition comes from competere
- German: Wettbewerb →key concept of liberal economic and social science - put into other contexts (for example: Political competition, biological competition, etc.)

Six that are inseparably linked to the success story of market economies:

1. Market as an instrument for the use of distributed and local knowledge
2. Market as a method of discovery
3. Market as an engine of innovation
4. Market as a control mechanism
5. Market as an instrument of disempowerment
6. Market as an instrument of self-discipline

2.2 The Market as a Method for the Use of Knowledge

The market as an instrument for the use of distributed and local knowledge.

Economist and Nobel Prize laureate Friedrich A. Hayek describes economic relations and human needs as "a complex and spontaneous order". This spontaneous order can have different economic orders:
- **Planned Economy:**
  Describe complex social structures and optimize by way of general laws.
  General production quotas and prices are set. For example, 5-year plan where it says what the factory has to produce to specific prices, after 5 years it can be reviewed.
- **Market Economy:**
  Human needs and conditions are constantly changing.

Market processes dispersed knowledge of all individuals in the price. For example, energy usage is changing every year because the conditions are changing. This year, with the Ukraine war the energy price is higher, so some Christmas lights were not turned on.

Example- Fire in South America:

- Fire in South American copper mine→ interruption of production →supply volume is decreasing → price of copper is rising even there is a steady demand.
- German medium-sized companies using copper can react to this and replace copper with other precious metal that is now cheaper.
- This is an optimization of limited resources.
- The price as an indicator of the shortage of a good contains information that can be reacted to without understanding nature of price changes. The companies react to the price change without the necessity for them to know the reasons of it.

2.3 The Market as a Method of Discovery

- Input: Knowledge of millions of people (swarm intelligence); Output: Unimagined market solutions.
- Competition: the constant exchange of information and the constant pressure of competition
- Creation of goods, concepts, services and convictions that cannot be sensibly controlled
- Findings may not only affect products or services, but also spheres of human coexistence in general
- Competition works as an engine for innovations and improvements in products and services

Joseph Schumpeter (1882 - 1950):

- "Dynamic entrepreneurial type" and genius cult of the 19th century.
- The process of "creative destruction„ → improvement and new development of products. You need to destroy something and create something new. For example, the launch of the smartphones destroyed the Blackberry.

William Baumol (1922 - 2017):

- Rule-based market economy with competition itself brings forth this type of entrepreneur; incentive systems.
- Premodern: competition was often suppressed or obstructed in some way (e.g.: guilds)
- Feedback: innovations and competition results give rise to a feedback effect

2.4 The Market as a Control Mechanism

- Control Mechanism in the Premodern period:
  - Face-to-face control
  - Social control in small communities
- Modern: control function of the market. For example, control by stakeholders and shareholders.
- Cost and duration weaken the effectiveness of legal processes
- Instead: companies are subjected to control from outside and inside
  - Externally: control over stakeholder relations and discipline of the market
  - Internally: Shareholders control mechanism (for example, via the Supervisory Board)

2.5 The Market as an Instrument of Disempowerment

Due to its structural features, the market serves as an important instrument of disempowerment (Limit of the abuse of power):

- Impartiality of the market
- Market mechanisms reward only what meets demand. If people don't want it, you cannot force them to buy it.
- Automatically, limitation of power positions as they are threatened by competition.
- No abuse of power.

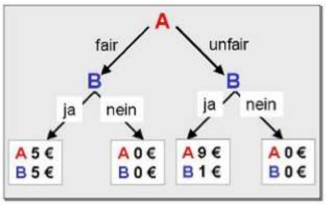
E.g., Microsoft in the late 1990s: Even companies with a large market share and thus a certain power position can never be sure that they will not have competitors.

2.6 The Market as an Instrument of Self-Discipline

- Success is possible only through cooperation with other partners.
- Business transaction occurs if both parties believe that they benefit from the exchange, competing companies need to reconcile their own idea of advantage with that of their future partners.

Does competition generate fairness? (Ultimatum Game)

- Ultimatum Game: (9/1) is rejected, which is irrational under traditional assumptions of money maximization.
  There are 2 players, one makes an offer and the other has to accept/decline it. The A can make a fair or an unfair offer.
  The market can be used as an instrument of self-discipline.
- Empirically: Fair distributions especially among participants from cultures of competition.
- Reason: interaction with strangers; reputation building



3. The Fair Price

3.1 The Fair Price – Antiquity

Economics and ethics from the perspective of Platonic philosophy:
- Main objective: state-sponsored pursuit of virtue (Plato, Nomoi)
- Rejection of profit and utility maximization
- Call for an upper limit on ownership. There was a limit on the things you own.
- Special regulations for economic transactions:
  - A fixed daily price per good. They were not fixed by market forces, it was set for external agents.
  - Profit was only okay in modest margins, as a modest premium on the "value" of a good. Profit
  - Seller knows "value" of goods, does not have to charge premium

Economics and ethics from the perspective of Aristotelian philosophy:
- Theory of Price: Principle of Equalizing Justice:
  - Proportionality of the price depends on need of the product.
  - Assessment of work performance depends on social position.
- Economics and Chrematistic, he made the distinction between these two, while economics is good and chrematistic is bad:
  - Economics (Art of house-keeping) takes place within clear limits and is therefore morally permissible.
  - Chrematistic (The study of wealth) as enrichment at the expense of others is immoral (Zero-sum game)

Cicero's view on the price mechanism:

"During a famine on Rhodes, a trader conveys grain from Alexandria to the island. He knows that more ships with Egyptian grain are under way to the island, but his dilemma is: should he share this information or should he sell at the highest price possible?" (De Officiis, III, 13, 57.)

- Pro argument: The grain belongs to the dealer, he has freedom of action and ownership, so he should sell it at the higher price possible.
- Contra argument: The community of all people forbids exploiting such knowledge. Because there is a "right value" of a good that every person actually knows.
- Objective valuation is typical of antiquity. The value of a good is objective, independent from market forces.

3.2 The Fair Price – Middle Age

Morality and economy in the Old and New Testaments:

- Assumption: The "fair" price is in place: Moses already made the clear demand that no one should "take advantage of his brother" in a transaction (3 Moses 25,14). In the new testament it is said that you shouldn't take advantage of your brother, but from a stranger it is okay.
- An a-priori suspicion: "A merchant can hardly keep himself from doing wrong, or a huckster from sin." (Sir 26.29)
- Gospel of Matthew: "No one should go too far" and take advantage of his or her trading partner. (Mt 6,24)
- Notion of the Last Judgment: Do not endanger security through wealth

Morality and economy for Augustine (354 - 430):

- Theory of Values and Ranking of These Values (De Civitate Dei)
- The purchase price, however, is based exclusively on human needs
- Ranking of human needs from experience: thus an objective value theory
- Augustine does not see trading gains as something bad per se (although he also points out the moral dangers).

4. The Prohibition of Interest and Usury

4.1 The Prohibition of Interest and Usury in Antiquity

"If your brother becomes poor and cannot maintain himself with you, you shall support him as though he were a stranger and a sojourner, and he shall live with you. Take no interest from him or profit, but fear your God, that your brother may live beside you. For thou shalt not lend him thy money in interest, nor victuals for an additional charge." (5 Moses 23,19f)= No taking interest from your brothers, from strangers you can take.

- Clear prohibition of interest
- Duty to help among relatives
- Not applied to: behavior towards outsiders

You may charge interest to a foreigner, but to your countrymen you shall not charge interest, so that the LORD your God may bless you in all that you undertake in the land which you are entering to possess." (Deuteronomy 23:19)

→ Moral rule that can be maintained in small groups or face-to-face societies.

4.2 The Prohibition of Interest and Usury in Ancient Greece

In Plato's "Nomoi":

- If there are great assets accumulated through interest = power that can undermine the laws of the state. Business people can get to powerful and this can undermine the state.
- Contrast between state and capital (analogy to Karl Marx)

The State was always seen as highest moral good

- Plato rejects lending money for interest because it can destroy the social order

In Plato's "Politeia":

- General intuition: interest is perceived as evil
- Credit trade increases number of poor in the state

In the Nicomachean Ethics and Politics of Aristotle the profit generated through interest is "unnatural".

- Reason: It does not come from work, but from the money itself. Value can only come from work.

"There are two sorts of wealth-getting, as I have said; one is a part of household management, the other is retail trade: the former necessary and honorable, while that which consists in exchange is justly censured; for it is unnatural, and a mode by which men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of a mode of getting wealth this is the most unnatural."
(Aristotle, Politics)

4.3 The Prohibition of Interest and Usury in Christian Doctrine

Council of Nicaea (325 AD):

- Ban on money lending against interest
- Emperor Constantine translated decisions into laws
- Trading in loans against interest was punished with infamy

Other Councils that emphasized the prohibition of interest:

- Lateran Council 1139
- Council of Lyons 1274
- Council of Vienne 1311

Pope Pius VIII announced in 1830 the lifting of the interest ban.

4.4 The Prohibition of Interest and Usury in Islam

The prohibition of interest in the Qur'an and Sharia:

- Interest prohibition (Arabic: Riba) applies to the demand and the payment of interest
- Interest as non-Muslim, because it is acquired without "achievement"
- Interest is understood as a premium for which there is no consideration, no reason for it.
- "But those who devour interest become like the one whom Satan has bewitched and maddened by his touch. This because they said, "Selling is the same as taking interest." But Allah has allowed selling and forbidden taking interest (Sure 2, Verse 275)
- The waiver of consumption is not recognized as consideration

Islamic banking as an alternative?

- Lender participates in the profit and loss of a credit financed company (equals equity). Bank give money and people pay an interest, and a part of this the people have to buy some equity.
- Profit only if risk of loss is also borne
- Problems:

- No distinction between equity and debt. Borrowing is usually less risky (priority) and therefore important for many companies.
- Many social policy instruments rely on interest.
- All kinds of insurance policies are rejected in Islam according to the traditional understanding if they are not based on donations.

5. Conclusion

- The historical developments of the last 200 years are unique in many ways: Mainly due to technological and economic progress, today's societies are systematically different from those of the premodern age.
- Moral standards, which were originally justified under other socio-economic conditions, are in many ways no longer adequate, and may even have counterproductive effects.
- Moving from premodernity to modernity, a transition from ethics of behavior to ethics of conditions is necessary.

Chapter 4: Foundations and Tools of Business Ethics

1. Philosophical principles and tools

1.1 An overview of ethical theories

<u>Metaethics:</u>
The theory of ethics. Deals with the meaning of ethical terms, the nature of moral discourse and the foundations of moral principles
e.g.:
- What is the meaning of ethical terms such as, right or wrong?
- Are there moral facts? Or are moral judgments relative?

<u>Descriptive Ethics:</u>
Deals with the description, systematization and explanation of normative systems; a form of empirical research into attitudes of individuals
e.g.: ethnology, psychology, biology, economics moral evolutionary behavioral

<u>Normative Ethics:</u>
Deals with criteria of what is morally right and wrong.
Various ethical theories, e.g.:
- Virtue Ethics
- Deontological Ethics
- Consequentialism / Utilitarianism
- Liberalism
- Contractualism

<u>Applied Ethics:</u>
Deals with the application of ethics to real-world problems.
e.g.:
- Business ethics
- Medical ethics
- Environmental ethics
- AI ethics

1.2 Virtue ethics (normative ethics)

The main goal of virtue ethics is the good and happy life → virtuous life

- Goal: Enhancement of certain virtues in people
- Examples of virtues that should be promoted: Wisdom, justice, courage, moderation
- For example: Aristotle
    - Goal: Happiness (eudaimonia) of human beings
    - Virtue as attitude, determined by rationality and educational background / practice
    - Virtuous life = to find a reasonable mean between two extremes
      For example: Bravery as a golden middle way between daring and cowardliness
    - The golden mean is the best, that can be achieved individually.

1.3 Deontological Ethics (normative ethics)

- Comes from → deon = duty or obligation
- "Some choices cannot be justified by their effects [...] no matter how morally good their consequences, some choices are morally forbidden" (Stanford Encyclopedia of Philosophy)
- Action as such is crucial to evaluate it as good or bad (e.g., the intention someone had, conformity with certain rules, duties or rights).

- Calculation of the consequences only additional, not as crucial normative criterion!

Example in a Business context:

CSR example: Corporate marketing and PR measures to give a more social or environmentally friendly image.
Is this behavior ethically positive? Deontologically no, because the goal is pure profit maximization. Profit maximization is the goal and ethical behavior don't focus only at results but also some characteristics of the actions done.

Immanuel Kant (1724-1804):

> *"Act only according to that maxim whereby you can, at the same time, will that it **should become a universal law.**"*

Action is only obligatory if it satisfies the **categorical imperative**: "Act only according to that maxim whereby you can, at the same time, will that it should become a universal law".
You need to follow a rule and not act differently on each problem and that law has to be universal.

Test procedure: May I lie/deceive?

- Do we want "lying" to become a generally morally permissible act?
- Example: A person who seeks to borrow money without intending to pay it back. If it were a universal action, no one would lend money anymore as he/she knows that they will never be paid back.

→ Lying / deceiving is morally unacceptable always.

The **Humanity Formulation of the categorical imperative**:

> *"So act that you use humanity, whether in your own person or in the person of any other, always at the same times as an end, **never merely as a means.**"*

"So act that you use humanity, whether in your own person or in the person of any other, always at the same times as an end, never merely as a means."

- Introduction of the idea of "respect" and "dignity" for individuals.
- Humanity is of absolute value, beyond a price.

Kant says that you have to trat people as an end, not as a mean. That says that you should treat a person as a person, not as an object. For example, a person is different than a chair.

Manifestations in law:

- Legal basis: Right to life and physical integrity (Art. 2 Basic Law)
- Case: Kidnapped plane flying towards a football stadium (evacuation impossible); government has to determine whether or not it should shoot down the plane

Is shooting down the plane ethically justifiable?

NO!	YES!
Deontological: Art. 2 GG must not be violated, no matter how high the damage will be.	**Consequentialist**: minimize harm, life must be balanced against each other.

Drawbacks of Deontological Ethics:

Example: Lying is always morally wrong. Even if a murderer asks about the hiding place of his victim, one is obliged to tell the truth.
→ Imposed duties seem absurd and contradict inner moral compass

Further critique – implementation issues:
- Can put individuals at risk? (e.g., here there is for victim if you tell the truth to the murder)
- Issue of value pluralism; clash of different duties (e.g., do not lie and do not kill)

1.4 Consequentialist ethics (normative ethics)

- (Foreseeable) consequences of actions are crucial to distinguish between good and bad actions: If the consequences are good, the act is right; if the consequences are bad, the act is wrong.
- This theory emphasizes ends over means

Example 1:

Corporate marketing and PR measures to give a more social or environmentally friendly image. Is this behavior ethically positive?
Consequentialist→ Yes, because the measures have positive effects on humans, animals or nature.

→ Consequences are crucial for an evaluation, the reasons (e.g., profit maximization) are irrelevant!

Example 2:

When John tries to rescue a child from a well, a bumblebee is chased up and flies into a cabin of a truck, whereupon the driver loses control and drives headlong into a crowd of people. Was John's attempt to rescue the child immoral?
- Unintentionally, John's action caused more harm than good. The consequences are bad, but they are unpredictable.
- Consequentialism: Only predictable consequences are considered in the evaluation of an action!

Utilitarianism:

It's a variation of consequentialist ethics.

Jeremy Bentham 1748 – 1832:
- English philosopher, legal scholar and social reformer
- "It is the greatest happiness of the greatest number that is the measure of right and wrong."

- Jeremy Bentham and John Stuart Mill as founder of utilitarianism.
- Utility is crucial to distinguish between good and bad actions.
- Utilis= useful; utility here is often defined in terms of well-being, happiness or related concept
- Utility of the "greatest number"; not utility of the individual. Utility not for one individual, it should be for the whole society.
- The best decisions:
  - I. generate the most benefits as compared to disadvantages
  - II. benefit the largest number of people

→ Maximization of happiness: Do the greatest good for the greatest number of people.

A few considerations of Consequentialist Ethics:

What is the target variable or the bundle of targets to be maximized?
- Utilitarianism: Maximization of happiness → But: What is happiness?
- *John Stuart Mill*: distinguishes between different qualities of happiness

- *Peter Singer*: Target variable = preference fulfillment; Action is aimed at achieving certain goals, not cognitive happiness; Goal achievement does not have to lead to happiness.

In what consequences should we be interested in?

- Maximization of favorable consequences for all people living today or for those living today and in the future? →Question of intergenerational justice
- Maximization of human happiness or the happiness of all sentient beings in general?

<u>Drawbacks of Consequentialist Ethics/Utilitarianism:</u>

- Limit on practical implementation
  - How to know/determine the consequences of actions? E.g., long-term vs. short-term consequences? What about (unintended) side-effects?
  - How to compare the happiness and preferences of many different people?
  - How can utility be calculated?
- Excessive demands on the individual
  - Benefit of all should be maximized → Every single decision becomes a moral issue
- Injustice: Happiness of the individual could be sacrificed for happiness of the mass of people
  - Humans as means to an end?
  - Individual and its rights are less important than overarching benefits

1.5 Liberalism (normative ethics)

<u>John Stuart Mill 1806 – 1873:</u>

- English philosopher and political economist
- "That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others." We should not cause harm.
- "On Liberty" 1859 (Mill's book)
  - The freedom of thought and emotion. This includes freedom to act on such thought, i.e., **freedom of speech**
  - The **freedom to pursue tastes** (provided they do no harm to others), even if they are deemed "immoral"
  - The **freedom to unite** so long as involved members are adults, involved members are not forced, and no harm is done to others
- Harm Principle (J.S.Mill): "That no one should be forcibly prevented from acting in any way he chooses provided his acts are not invasive of the free acts of others."

<u>But sometimes norms or ethical paradigms clash...</u>

- Opposing norms:
  - Example: An entrepreneur may be forced to make a choice of either paying expensive bribes in a developing country to win a contract for a large-scale project, or to forgo bribery, thereby jeopardizing jobs in his/her company
    → Violating the prohibition of bribery vs. violating the corporate code (e.g., caring for employees)
- Clash between norms and individual cases:
  - Norm: Certain ethical paradigm that dictates the maxim of action
  - Individual case judgment: value judgment in a real action situation independent on an ethical paradigm
  - Example: Trolley problem

A thought experiment: Trolley Problem:

Moral thought experiment based on publications by Philippa Foot in 1967:
"A tram is out of control and threatens to overrun five people. By moving a switch, the tram can be diverted to another track. Unfortunately, there is another person. Can the death of one person be accepted (by moving the switch) in order to save the lives of five people?"

- General Norm:
  With the utilitarian point of view→ Maximize happiness of all, so the solution would be saving more people and sacrifice one person to save the others.

Vs.

- Individual case decision:
  Not moving the switch to reroute the train.
  Value judgement: You must not consciously decide against a person!

"Now a part from moving the switch you have to throw a person to stop the train"

- General Norm:
  With the utilitarian point of view→ Maximize happiness of all, so the solution would be saving more people and sacrifice one person to save the others.

Vs.

- Individual case decision:
  You don't have to throw the person on the tracks to stop the train.
  Value judgement: You must not push the person down.

Example: Legal situation in Germany

German Aviation Security Act (before 2005): Legal permission to shoot down passenger aircraft in the event of hijacking in order to minimize fatalities.

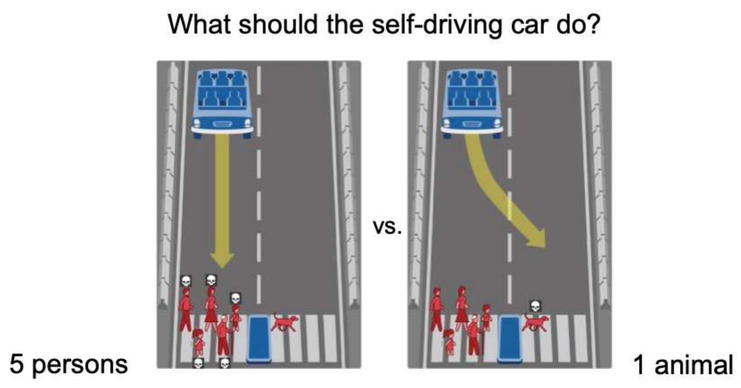
Judgment of the Federal Constitutional Court 2006:
"The authorization of the armed forces to shoot down an aircraft intended to be used against human life by force of arms by direct impact in accordance with § 14 (3) of the Aviation Security Act is incompatible with the right to life in accordance with Article 2 (2) sentence 1 of the Basic Law in conjunction with the human dignity guarantee in Article 1 (1) of the Basic Law to the extent that people on board the aircraft who have not been involved in an act are affected".

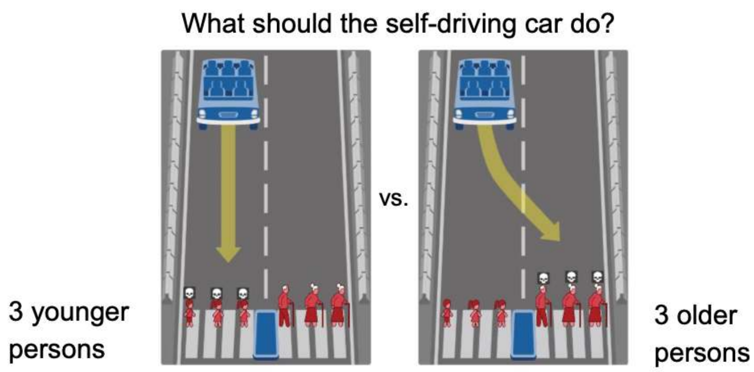
Modern Trolley Problem: Moral Machine Experiment

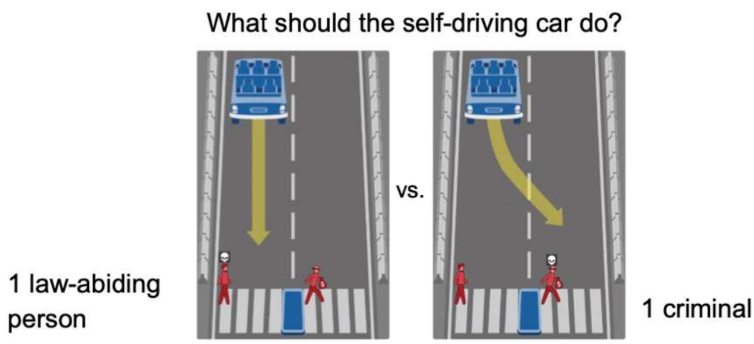
The **Moral Machine** is an online platform developed from a research project at the Massachusetts Institute of Technology (MIT).

The aims of the platform are:

1. Identifying a broad view on how machines should solve moral dilemmas
2. Offering a forum where the public can discuss the collected, potentially morally problematic scenarios.







Results:

- collected 39.61 million decisions from 233 countries, dependencies, or territories
- showed broad differences in relative preferences among different countries
- in general the data indicates that people support minimizing loss of life and protecting children, favoring the fit and wealthy, and sacrificing people who are old, overweight, or homeless.

<u>Ethical Guidelines for Autonomous Vehicles:</u>

Ethics Commission for Automated and Networked Driving of the Federal Ministry of Transport and Digital Infrastructure: World's first ethics guidelines for automated driving, presented in Berlin, June 2017.

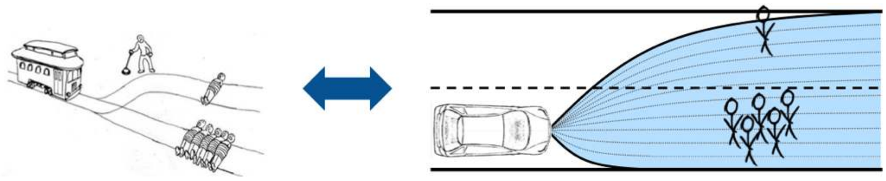
20 Ethics Guidelines, e.g.:

- Personal injury takes precedence over damage to property
- Liability passes from user/owner to manufacturer and operator of software
- General programming to reduce the total number of personal injuries permissible

Guidelines of the Ethics Committee (touching on dilemma situations):

> *7. In hazardous situations, which prove to be unavoidable despite all technical precautions, the **protection of human life** has the **highest priority** in a balancing of legal interests. Programming must therefore be designed within the framework of what is technically feasible in such a way as to accept **animal or property damage** in the event of conflict if this can prevent personal injury.*
>
> *8. In unavoidable accident situations, any **qualification according to personal characteristics** (age, sex, physical or mental constitution) is **strictly prohibited**. A general programming to reduce the number of personal injuries can be justifiable. Those involved in creating mobility risks must not sacrifice uninvolved persons.*

<u>The Trolley Problem & its Practicability:</u>



Benefits of the Trolley problem:

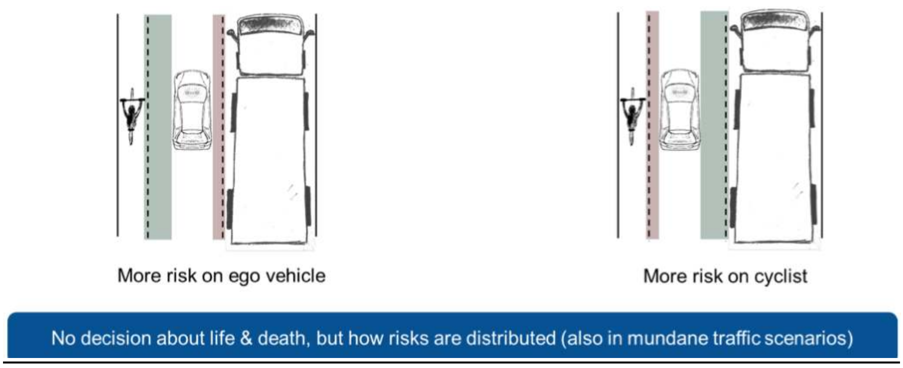
- raises reflection, understanding and awareness of normative theories
- gives insights into societal reasoning and opinions

Shortcomings for autonomous driving:

- postulated consequences as certain event
- limited number of options
- missing contextual information (obligations, responsibility?)

→ Trolley problem is straight-forward (which makes it easy to explain / comprehend issues in autonomous driving ethics) but it is not as relevant in practice!

<u>Reframing the AV Debate Towards Ethics of Risks</u>

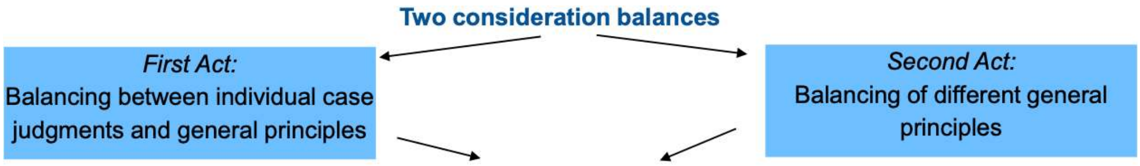


How close should an autonomous car com to a bike or a truck. It's a daily question of IA system in general. To put in action an autonomous car is not just a question for technical issues, also for ethical.

<u>So, what to do when general principles & individual judgments contradict?</u>

John Rawls (1971) suggests that we should try in such cases to brings our norms and one-off judgments into reflective equilibrium in a process of mutual adjustment.

- "**Reflective equilibrium":** is the end-point of a deliberative process in which we reflect on and revise our beliefs about an (moral) area of inquiry. The inquiry might be as specific as the moral question, "What is the right thing to do in this case?" (Stanford Encyclopedia of Philosophy)



→ **Coherence** between intuitions, case-by-case judgments, norms and supreme principles **AND**
→ **Harmonious whole** in which judgments and principles support each other

<u>Weakness: Problem of operationalization</u>

Coherence maybe it's still not right (not a moral truth).

- Coherent system of case-by-case judgments, intuitions, rules and general principles do not need to be right
- Example: Slavery was essential to the social and economic order of ancient Greece. A young man growing up in ancient Athens learned that slaves were not treated with the same respect, much less accorded the same rights as the citizens of Athens. It is not difficult to imagine that such a young man – assuming he brought his beliefs into a reflective equilibrium – could very well have had a coherent system of beliefs that did not grant certain people fundamental rights.

  → Coherence criterion alone is not enough, danger of ethical relativism (= norms and values are time-bound/expression of the respective epoch).

<u>Two Types of Dissent in Modern and Pluralistic Societies</u>

What is a **good life**?

- Urban areas are teeming with millions of people
- Different backgrounds, languages, hobbies, lifestyles
- No consensus on how to live your life

  → Dissent does not lead to problems

What is **morally imperative**?

- Controversies especially in ethical and economic issues
- E.g. fair price / salary? Freedom vs. Exploitation? Markets for blood, organs, sex? Distribution of wealth? To what extend is inequality socially acceptable?

  → Dissent leads to problems

1.6 Three Philosophical Tools for Establishing Norms under Dissent

Goal: generate ethical principles to deal with differences of opinion.

- Contractual concepts
- Democratic majority principle
- Justification and Deliberation (discourse ethics)

1.6.1 Contractual concepts

Basic Idea: moral norms, institutions, and the institutional structures of societies are only legitimate, if they have the **consent of the population.**

Criterion: Instead of maximizing utility via rules → Consent (of all people) to a rule

Ability to consent instead of actual consent: consent can be expected on the basis of interests/preferences.
Hypothetical contracts instead of de facto contracts: Large number of hypothetical contract participants.
→ understand contract-theoretical logic as a kind of thought experiment

Contractarianism vs. Contractualism:

	Contractarianism	**Contractualism**
Traditionally by	Thomas Hobbes (1588-1679)	Immanuel Kant (1724-1804)
Contracting parties	maximizer of one's own utility	morally motivated agents
conditions of use	divergent interests + little moral common ground	Similar interests + common moral basis
	For pluralistic societies with cultural differences	For communities with a strong cultural foundation

In contractarianism people have divergent (different) interests and their goal is to maximize their one's own utility.

Hobbesian Contractual Concepts:

Two insights:

1) Conflict between groups of people had always the potential for war and destruction.
→ peace as a necessary condition for the good life in private life.

2) Peaceful cooperation creates additional value for everyone (specialization, economies of scale)
Example: 10 million families living on 10 million single islands
Cooperation can overcome subsistence economy
→Cooperation creates prosperity

Kantian Contractual Concepts:

Three main differences between Kantian and Hobbesian concepts of a contract:

I. **Modelling of the contract situation:**
additional moral ideal (e.g. Equality, fairness) in initial situation of contract situation
Thus: counteract unequal power relations in Hobbesian contract concepts.
→ starting position of contract greatly determines its outcome.

II. **Rejection of the Pareto principle (ethically inadequate):**
morality cannot be reduced to a mutual exchange of benefits (as merely improving both sides' positions can run counter to essential intuitions of fairness)

III. **Type of communication between contracting parties:**
Hobbesian contract theory: participants discuss the means that would be ebst to promote everyone's means (Question: should one not also deliberate the various aims?)
Kantian contract theory: discussion of choice of means separately (parties have to abstract from their own wishes)
→ not easy

How does one arrive at a fair choice of goal and means? → Asking for justice regardless of one's own wishes and interests.

Rawls' veil of ignorance:

- Moral problems should be discussed behind veils
- Contract participants know neither
    - social status
    - religious / ethnic affiliation
    - mental / physical nature

  We should not know our position in that society. Discussion of impartial observers instead of self-interested individuals.

<u>Veil of ignorance in more detail</u>

- John Rawls 1921 – 2002
- US-American philosopher
- "A Theory of Justice" (1971)
- Though experiment: Imagine you have to found a society. Which five guiding principles would you choose?

John Rawls – "A Theory of Justice"

VEIL OF IGNORANCE
IN THE ORIGINAL POSITION ALL INDIVIDUALS ARE BEHIND THE VEIL OF IGNORANCE, THEY DO NOT KNOW WHICH ROLE THEY WILL PLAY IN THE FUTURE SOCIETY. AGAINST THIS BACKGROUND THEY HAVE TO NEGOTIATE A SOCIAL CONTRACT, EVERYONE WILL AGREE WITH. THE NEGOTIATED RULES WILL BE APPROVED OF, IF ALL INDIVIDUALS IN ALL POSITIONS ARE BETTER OFF IN THE END.

Problem: moral overload of the parties of the dispute:
- Citizens of a society must have certain common abilities or characteristics
- stronger conditions than the Hobbesian contract concepts
- Legal perspective: Ethical judgments are made by impartial judges who have no self-interests

→ Implementation of solutions can be difficult or even impossible

1.6.2 Democratic majority principle

Idea:
- dissent votes on moral questions
- majority opinion as a tool for establishing standards. What the majority believes.

Serious problems:
- Discrimination against minorities possible (e.g. majority prohibits catholicism/ cars/ same-sex marriages)

→ Majority principle can lead to suppression. It needs additional normative regulations (e.g.: fundamental rights).

1.6.3 Discourse Ethics- Consensus as a Goal

The ideal of Discourse Ethics:
"No speaker shall be prevented from exercising (his) established rights by coercion within or outside the discourse." The norms have to be accorded to a discourse, where everyone can talk, equal participation.

Essential principles:
- "Equal participation in the discourse"
- Securing "rule-free discourses". There's no end of the discourse if someone has an argument to say, until they don't have arguments, they don't finish.
- Only the better argument counts
- Possibility to put yourself into the position of the opponent

→ Aim of Discourses: Consensus Finding: But is that really realistic in practice?

<u>Three difficulties for reaching a consensus:</u>

According to discourse ethicist Peter Ulrich (2008):
- Fundamental reasons
    - some affected of a moral norm are in principle excluded from discourse. People are discussing of norms that are not affecting them, the people who are affected are not sat in the table discussing.
    - Example: underage, non-born (intergenerational justice!). There are groups excluded in the discussion.
- Pragmatic reasons
    - Number of people affected is too big to involve everyone.
- Motivational reasons
    - Some participants are unwilling to search for a viable solution.

<u>Discourse ethics as a Business Ethic according to Ulrich:</u>

Business Ethics:
"Profit making must be justified in corporate policy deliberation processes vis-à-vis all stakeholders."
Another problem from discourse ethics is once you have reached the better solution, implementing it in the reality is not that easy, you may have to face with many problems.

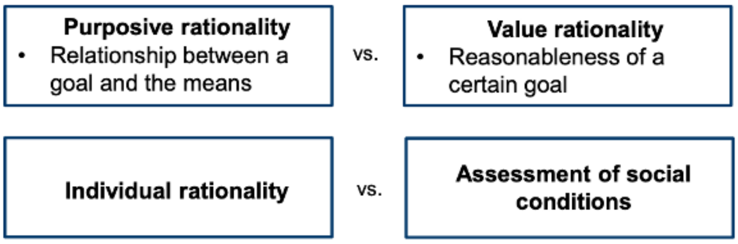
1.7 Conclusion

- There are different ethical theories in normative ethics (e.g., deontological ethics, virtue ethics, consequentialism...)
- These can help determine – based on different criteria – whether an action is morally right or wrong
- Sometimes norms and ethical paradigms clash (example: Trolley Problem)
- There are a few philosophical tools (e.g., contractual concepts, the democratic majority principle...) for establishing norms under dissent
- It is important to distinguish between the consensus concept in contractarianism and the consensus concept in discourse ethics. In discourse ethics there's a lot of preconditions.

2. Economic and socio-scientific foundations and tools

2.1 Rationality

- Max Weber 1884-1920
- Rationality → Derived from Latin "ratio"
- Translated as "calculation" or "reason"
- Max Weber made two distinctions in rationality:



- **Purposive rationality**: you have a goal and you look the means to achieve the goal.
- **Value rationality**: questions →should we achieve this goal?

2.2 Instrumental Rationality and Value Rationality

Instrumental rationality:

- Goal-Means-Relationship:
  - Goal is exogenous
  - Hypothetical Imperative: „If objective A is to be achieved, then means B fulfills this purpose.“

- Efficiency:
  - " are things done right in order to achieve a goal?". For example, to reduce climate change.
  - In relation to a certain predetermined goal

Value rationality:

- Reasonableness of a certain goal:
  - Goals have to be justified
  - Correctness of the goal dependent on e.g. moral, religious or aesthetic beliefs
- Effectiveness:
  - "right things are done"
  - Correctness dependent on criteria

2.3 Interdependency between goals and means

There is an interdependency between Goals and Means.
Homann 1980: no consideration in isolation possible!

- Permanent feasibility study:
  - Feedback between goals and means is consequently necessary “Ought implies can“
  - Focus only on instrumental rationality not enough for economics

→ No strict separation between instrumental rationality and value rationality. No strict separation between considering means on the one hand and goals in the other hand.

Sometimes we don’t have the means to achieve a goal.

2.4 One Concept of Advantage in Economics

Stigler/Becker 1977: “matters of taste cannot be disputed “. They meant that in economics what should be discussed is not preferences, but situational restrictions.

Question: What should be the subject of scientific research? Preferences of people & Situative restrictions.

Preferences

- Actions can be explained by changing preferences of people. For example, prices of laptops go up is because people want to buy them, preferences are changing.
- But there is a lack of theory on development of preferences.

→ Methodologically sufficient to consider preferences as exogenous and stable.

Situative Restrictions

- Objectively observable across individuals. For example, actions can be explained by situative restrictions, for example the war in Ukraine.
- Allow an interpretation of corresponding behavioral conditions

→ Methodologically meaningful subject of investigation.

2.5 Methodological Individualism

Question in background: How can social phenomena be explained? Every analysis of a society begins with the individuum.

What it is NOT: A statement about true nature of man/concrete form of human behavior (= ontological individualism).

→ Methodological individualism makes statement about how to develop good theory about social phenomena.

2.6 Methodological Collectivism/Holism

Contrary to methodological individualism→ Starting point of holism: Every individual behavior is based on social circumstances.

Macro phenomena cannot be explained by individual behavior.

Example: System Theory (Luhmann) – systems as a whole have certain peculiarities and a certain internal law that does not merely result from the aggregation of entities.

Important to remember, economics is trying to explain social phenomena by individualism, by looking on the artificial model of the individual.

2.7 Subjective Concept of Advantage

- Economics is using a Subjective concept of advantage, which means:
  Value of a good depends on individual advantage it brings to the respective consumer.
- Gossen's First Law: The marginal benefit of a good decreases with increasing consumption.

Anticipation of the marginal principle in John Law, 1705:

“Goods have a Value from the Uses they are apply'd to; And their Value is Greater or Lesser, not so much from their more or less valuable, or necessary Uses: As from the greater or lesser Quantity of them in proportion to the Demand for them. Example. Water is of great use, yet of little Value; Because the Quantity of Water is much greater than the Demand for it. Diamonds are of little use, yet of great Value, because the Demand for Diamonds is much greater, than the Quantity of them”.

2.8 Classical Paradox of Value

Why is a diamond more expensive than water?

	Exchange Value	vs.	**Value of Utility**
Water	low		very high
Diamond	very high		low

Already Adam Smith saw no direct connection of both value concepts.

Why is a diamond more expensive than water?

Labor theory of value

- Objective value theory
- The value of a good can be explained by amount of working time spent on it

↓

Unable to solve the classical value paradox

Marginalism

- Subjective value theory
- Individual use of a good is directly dependent on its available quantity

↓

Solves the paradox

→ Exchange value of water in desert high, in a city rather low.

2.9 Theory of Revealed Preferences

Using this theory (Revealed Preference Theory), utility functions can be constructed from the actor's observed choices.

Example: Decision maker has choice between good A and good B or good B and good C.

- One observes, following preferences:
  A is chosen over B
  B is chosen over C
- Revealed Preferences:
  Good A is preferred to good B
  Good B is preferred to good C

So, we have to assume that there’s Transitivity.

Criterion of Transitivity:

Derivation of complete order of preferences:

Two revealed preferences (A > B and B > C)
+
Assumption of transitivity: if A > B and B > C → A>C

Result: Decision maker prefers good A to good C. Order of preference: A > B > C
IMPORTANT: Last preference itself was not observed!
It is an indirectly revealed preference
We assume that there is transitivity, that is not always the same.

2.10 Instrumental use of utility functions

- Wrong interpretation: one decision maker prefers one good over another because it maximizes his utility.
- A utility function is merely a formulation of consistent individual choices
- Certain consistence requirements must be imposed on the choices, since idiosyncratic behavior cannot be modeled
- Empirical studies that violate axioms pose a challenge to neoclassical theory

→ Descriptions of behavior through utility functions are just an "as if". Success depends on success of the prediction.

2.11 Ordinal utility function

What must be present in order to specify an ordinal utility function?

1. Transitivity
2. Completeness

If we have both we can arrive to an ordinal utility function that says that: Any pair of goods X and Y can be compared. This means: either a good is preferred or one is indifferent between the two goods. Note that indifference (both alternatives have the same value for them) must be distinguish from indecision.

Result: Ordinal order of goods, this means the alternatives can be ranked from best to worst.

<u>Rationality of decision maker:</u>

Sufficient criteria for an ordinal utility function: Transitivity + Completeness.

Additional axioms that can be posed on decision makers as a requirement for rationality, for example:

- Irrelevance of third alternatives
  From a set of alternatives of goods X and Y, preference is given to X. It should not change if you add a third option.
  → Preference relation must not change if a good Z is added

2.12 Homo Economicus

A picture of man ascribing a selfish motive to man?

→ NO!: only a postulate of consistency for decision making

- Open concept of advantage on the example of Mother Teresa:
  - Puts welfare of children above her own
  - Compatible with homo economicus model if behavior is consistent
  - Egoistic action in the narrow sense is due to logic of situation (for example in anonymous markets)

What constitutes a benefit to the individual is up to him!

2.13 Economics as Situation Theory

Falsification of homo economicus by psychology/behavioral sciences?
Economic method is still successful
Reason: its special scope
No behavioral theory, but situation theory

- Reality and world view of the people are hidden
- True motivation of actors irrelevant

→ Actors do not act as homo economici per se, but by situationally accounting for actions of others in their decision

→ Modeling of interaction processes that forces individual actors to adapt behavior based on situational incentive structure.

2.14 Economics and Economic Policy

1st step:
Economics asks for ...
- Actions of individual actors under given framework conditions
- Type, quantity and mode of production of goods to be produced
- Distribution of goods among members of society

2nd step:
Economic policy asks for ...
- Institutions to implement the answers
- Regulatory policy/economic framework
- Process policy to influence process of economic activity

→ Which social condition is desirable? Open concept of utility.

2.15 Hayek 1967: Distributive and Procedural Justice

Respectively: consequentialist vs. procedural theories of justice.

Distributive Justice:
How goods should be distributed. It focuses on the result.

Theories:
E.g. **Utilitarianism**
- Social interpretation of happiness. Happiness has to be maximized.
- Fair sate means: greatest happiness of the greatest number

Exhibited in the context of specific welfare functions
vs.

Pareto-Criterion
- Result-oriented minimum consensus. Take seriously the preferences of the people, what people want.

Procedural Justice:

Look at the process of getting from one stage to the other.

- Equality ideal of formal civil liberties
- Issues of procedural justice, rather than result orientation

Theories:
- Entitlement Theory (Robert Nozick)
- Friedrich A. Hayek: The market as place of spontaneous order

2.16 Distributive justice

How can different social conditions be compared?

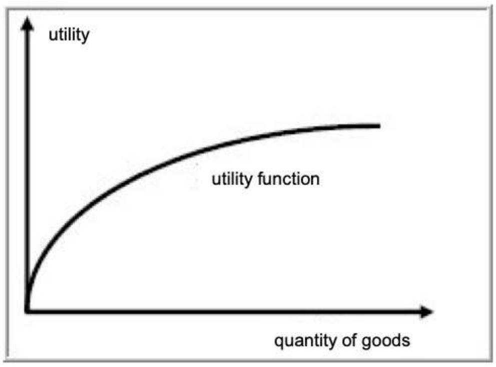
1. Value judgments must be traced back to judgments of individuals
2. Individual value judgments can be described as revealed preferences about utility functions
3. In order for utility levels to be intersubjectively comparable, a cardinal scale level is necessary
4. Through welfare functions different benefit levels can be compared. Depending on choice of welfare function, different results emerge

2.17 Economics and Value Judgments

- Normative individualism:
  Value judgments are attributed to wishes and needs of individuals
- Individual sovereignty:
  Every member of society can judge its own situation
- Methodological individualism:
  There is no superordinate social value that cannot be attributed to value judgments of individual members of society

2.18 Utility function

Concept of **utility function**:
- Individual objectives can be indirectly derived from choice actions
- Revealed preferences can be described by utility functions (assumption: certain consistency requirements).



Only **functional role**:
- Keep metaphysics out of decision theory
- Individuals "have" no utility function.
- Individuals behave as if they maximize function

2.19 Cardinal Utility Scale

Intention is to individualistically substantiate social goals
Question: How can individual benefits be aggregated/compared? → Necessary: cardinal scale level
Distances between the utility values can be meaningfully interpreted
Intersubjective comparability of benefits is ensured.

Examples:
- Temperature in degrees Celsius
- Time

Temperature difference between 10° C and 20° C is the same as between 5° C and 15° C. We need to have cardinal utility to say this.

2.20Utilitarian Welfare Function

$$W^U = \sum_{i=1}^{n} \alpha_i \, u_i(x)$$

W^U : Utilitarian welfare function

u_i : utility for individuum i

α_i : weighting factor for individual i. Special case: $\alpha_1 = ... = \alpha_n = 1$

x : state of society

Social welfare as the weighted sum of the individual utilities of individuals.

2.21Nash Welfare function

$$\boxed{W^N = \prod_{i=1}^{n} [u_i(x)]^{\alpha_i}}$$

W^N : Nash welfare function

u_i : utility for individuum i

α_i : weighting factor for individual i

x : state of society

Sensitive to variations of individual utility (example.: $u_{384} = 0 \rightarrow W^N = 0$). If one utility is 0, the whole function can turns 0.

2.22Rawlsian Welfare function

$$\boxed{W^M = min[u_1(x), \ldots, u_m(x)]}$$

W^M : Rawlsian welfare function based on John Rawls's "Theory of Justice"

u_i : utility for individuum i

x : state of society

Operationalization of maximin criterion: W^M is at maximum when individual of society who is worst off, realizes the maximum benefit. The society should always be in favor of the ones who are worst off.

2.23Problem of Previous Welfare Functions

Assumption: interpersonal comparability of utilities

Example: Utility of a beer = 100 vs. Utility of tomato juice = 10

But: Beer is ten times as attractive as tomato juice is not a meaningful statement

Contemporary utility interpretation: only ordinal statements like e.g. "better"/"worse", distances between utility values are not interpreted. Only makes sense if we say that beer is more attractive than tomato juice, but not in a cardinal way.

→ Cardinal utility concept is rejected today by most economists.

2.24Pareto Criterion

If we don't want to do this interpersonal comparability, we can use Pareto Criterion.

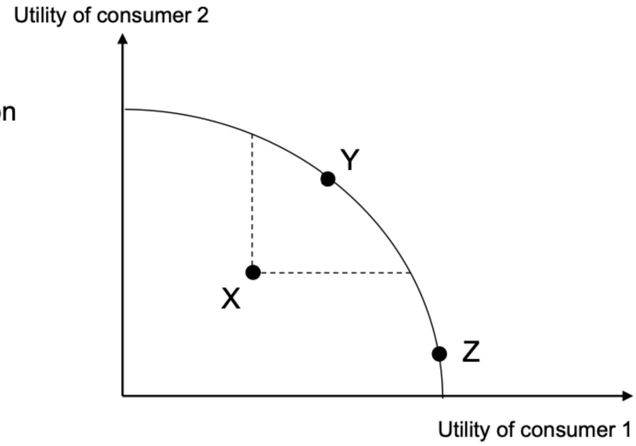
Assumption: Social conditions can only be judged from individual point of view.

Definition **Pareto-efficiency**: State A is Pareto-superior compared to State B, if at least one individual is better off in State A and no other individual is worse off. With this criterion we can classify social conditions.

State X:
Certain utility level for 1 and 2
Under utility-possibility frontier
➡ not Pareto efficient, because better position is possible

State Y:
1 and 2 are better off than in State X
➡ State Y is Pareto-superior in relation to State X

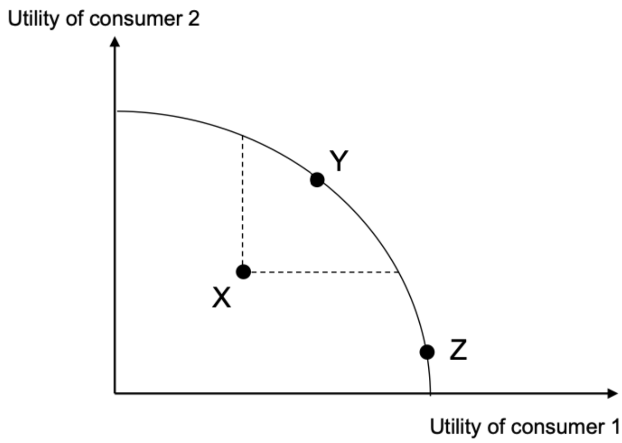
This applies to all points located northeast of State X



Z:
On utility-possibility frontier
No other condition is achievable without discrimination of an individual

➡ From X to Z: from Pareto-inefficient state to Pareto optimum

➡ However: no Pareto improvement
Consumer 1 is improving, but consumer 2's consumption is declining



Pareto efficiency and Pareto optimum:
Movement from Pareto inefficient state to Pareto optimum does not necessarily mean a Pareto enhancement (movement from X to Z)
A Pareto enhancement does not yet imply a pareto-efficient state (movement of X to a point Northeast of it, but below the pareto-efficient curve)

Pareto improvements as a minimum consensus:
Who would object to one side being better off if the other side does not suffer? Most likely no one. Assumption: no envy!

→ Compared to welfare functions: Pareto criterion is normatively more appealing.

Strong vs. Weak Pareto Criterion

When is one social State A preferred over another State B?

- Strong Pareto Criterion:
  In A, at least one individual is better off without another being disadvantaged
- Weak Pareto Criterion:
  In A, all individuals are better off

Counter-intuitive? → Mnemonic: the weak Pareto principle is empirically more difficult to realize

2.25 Buchanan

Critique of Distributive Justice Approaches: Problem with Robinson Crusoe example

- Cardinal economic problem of scarcity must not be described solely in individual case
- Danger thereby: inferrences from individual to society are often problematic. What works for Robinson Crusoe doesn't work for society.
- Leap from individual utility maximization to maximizing utility of society is wrong
- Essential interactions between individuals must not be hidden

→ Economics is essentially interaction economics.

Critique of Welfare Economics:

1. Welfare economics tends towards intervention science
Criteria of outcome justice requires orientation toward theoretical ideal (e.g. Pareto Optimum)
If the ideal is not achieved, there is a tendency for state interventions

2. Efficiency criterion is unrealistic
Efficiency criterion: Any equilibrium that occurs in the complete market is a Pareto optimum
Complete market is a theoretical ideal → Efficiency criterion is unrealistic
Abstract scale, instead of criterion of justice
Economics has lost its orientation function in society
Economics should be re-connected and upgraded in the public discourse

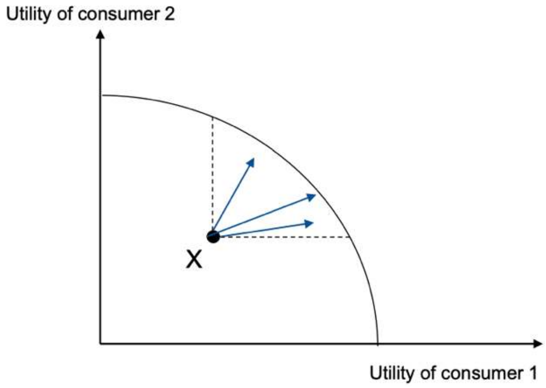
3. Efficiency ideal regardless of wishes of individuals
Pareto Optimum is determined independently of market process independent of desires of individuals
Market as "Calculation Machine" (Samuelson 1954, 388)
Deviation of status quo from Pareto optimum = market failure (market prevented from doing calculative work)
Correction: indifference between democratic process and benevolent dictator
Welfare economics raises efficiency to a normative requirement, which is to be achieved by state control
→ Welfare Economics does not take the actual desires of those affected into account.

Criterion of Consensus:

Buchanan's demand: an **internal and not ideal** criterion, rather than a theoretical ideal for comparing different social conditions.
→ Criterion of agreement/consent: Consistent orientation based on status quo.

Can a situation be established from here and now that everyone agrees to?

- State X as a starting point (status quo)
- Focus on all states that reach a consensus between players starting from State X
  → successive movement in northeastern direction
  → Reference point: status quo and not external Pareto criterion of complete competition



Three key findings/interpretations:

1. A **heuristic** that changes from external perspective of efficiency to internal perspective of political processes (mutual consent!)
2. Market as an **interaction process** for reciprocal improvement through exchange acts, rather than an algorithm whose performance has to be measured against the efficiency ideal
3. Move away from Pareto optimum as distribution criterion and return to Pareto improvement as process criterion → should refer to rules, not individual actions

2.26Example of a Consensual Rule

Criteria:
Rule must be derived from metarules/rules of higher order
These metarules must sometimes be sufficiently general to be unanimously approved

Example:
Establishment of a state with a monopoly on the use of force
End of Hobbes' war of all against all
Generate universal peace dividend

3. Dilemma Structures

3.1 Dilemma Structures vs. Pure Coordination Games

__**Pure coordination games:**__

There are basically no divergent interests between individuals. However, it requires a well-known rule for coordination with each other.
Example: left in UK or right-hand drive in Europe. There is no special interest on driving in the left or in the right. It is a common rule to achieve coordination, if there was no rule a lot of fatalities would happen.

Assumptions:
No driver has a preference for driving on the left/right side. All have preference for everyone driving on same side

Coordination:
If achieved, no individual incentive to deviate from rules Equilibrium is self-enforcing. Rule violations do not have to be sanctioned.

Pure Coordination Games: Example

There are 2 players, each of them has to strategies, which are to drive left or to drive right.

$Assumption: a > b$

		Player 2	
		drive left	drive right
Player 1	drive left	I a, a	II b, b
	drive right	III b, b	IV a, a

Assume A is preferred than B. If they drive both left or both right, the utility they achieve a larger utility. If they drive different sides, they achieve a lower utility. No individual has incentive to deviate to the other strategy.

<u>Dilemma Structures</u>

Basic assumption: Theoretically possible and mutually desired gains from cooperation cannot be realized. In theory there are mutually desired gains that you cloud achieve through cooperation but it cannot be realized. The reason of this are behavioral interdependencies, no individual alone can resolve a problem in the society.

Behavioral interdependencies as main reasons:
- No interaction partner can control outcome alone.
- Anyone who acts with respect to common interests risks being exploited. Maybe the other one doesn't stick to the decision taken; you are the only one that do.

→ Pareto-inferior equilibrium: best possible result is not achieved.

Prisoner's Dilemma:

- Description of the situation: Two prisoners are suspected of joint crime
- They are isolated and interrogated in separate rooms
- Maximum sentence for the crime: three years imprisonment
- Both are silent (= cooperation): due to minor offenses only one year imprisonment
- Both confess (= defection): two years imprisonment
- One is silent (= cooperation) and the other confesses (= defection): leniency and thus no imprisonment for the latter, maximum penalty of three years for the former
- High relevance in theory:
  - Patterns of interaction:
    Two persons interact with each other
  - Interdependence of behavior:
    No person can determine result of the interaction alone
  - Mirror-inverted situation:
    Both persons each have two strategies: cooperate and defect
  - No behavioral commitment:
    Crucial: In advance, there was no effective commitment of people to a strategy

		Player 2: cooperate	Player 2: defect
Player 1	cooperate	I 2, 2	II 0, 3
	defect	III 3, 0	IV 1, 1

Both cooperate, both players get a pay-out of 2. If both defect, they get a pay-out of 1. And if only one of them defect, the one defecting would get a pay-out of 3 an the one cooperating a pay-out of 0.
For player 1 is always better to defect. Also it is for player 2.

Situation Player 1 (analogously for Player 2):

- Depending on the decision of Player 2:
    - Player 2 cooperates: Defection maximizes pay off (3>2)
    - Player 2 defective: Defection maximizes payoffs (1 > 0)

So, defection is the dominant strategy→ Both players defect → Quadrant IV (payout: 1, 1)
No player has an unilateral incentive to change strategy: **Nash equilibrium→** Is a set of strategies one for each player, no player has an incentive to change his strategy even with what the other player is doing.

If both players cooperate, payoff would be higher:
- payoff (Quadrant I) = 2, 2 > payoff (Quadrant IV) = 1, 1

→ Pareto-inferior Nash-Equilibrium (mutual improvement is possible). No improvement of the situation by their own effort.

→ Individually rational behavior leads into rationality trap: realization of shared interests fails because of structure of interaction situation.

Dilemma structures: Its application to modern business- Example: Pricing strategy of competing firms

- Two firms sell similar products; each must decide on a pricing strategy
- They best exploit their joint market power when both charge a high price (10 million each)
- If one sets a competitive low price, it wins a lot of customers away from the rival (12 million, 7 million for the rival)
- If both set low prices, the profit of each is 9 million dollars
- In this case the low-price strategy is the prisoner confession. And the high-price strategy is similar to keeping silent.

Relevance of Prisoner's Dilemma:

e.g. Ken Binmore 2011:
Prisoner's Dilemma represents a situation in which dice are as loaded against cooperation as they could possibly be.
Can other dilemmas describe reality better?
Here: prisoner's dilemma as a paradigmatic case that makes cooperation problems salient.

3.2 Stag Hunt

<u>Description of situation:</u>

- Two hunters can either choose to hunt hares (big rabbits) on their own or join forces to kill a stag (larger and most tasty) together.
- Benefits of split stag > benefit of hare
- Hare can be killed alone, stag only in cooperation
- If a hunter breaks the agreement to go hunting together and instead goes hunting hares, other one goes out empty handed
- Generic payoff matrix: $a > b > c$

$Assumption: a > b > c$

		Hunter 2	
		Stag hunt	Hare hunt
Hunter 1	Stag hunt	I a, a	II c, b
	Hare hunt	III b, c	IV b, b

a would be the pay-off if you hunt together and catch the stag.
b would be the pay-off if you catch the hare.
c would be the pay-off if you catch nothing, because the other person breaks the promise.

Compared to the prisoner's dilemma, here defection is not a dominant strategy.

<u>Results:</u>

Two possibilities:

1) Both hunters stick to agreement and cooperate
2) One player does not trust other and goes hunting hare, because he fears to go out empty handed. Possible reasons:

If difference between a and b is low → Slight doubt is enough.
Maximin Strategy → Maximize lowest payout I could obtain.
Situation more cooperation-friendly than prisoner's dilemma, but mutually beneficial cooperation may still not be achieved.

3.3 Battle of the sexes

<u>Description of the situation:</u>

- A couple would like to spend the evening together (main concern).
- Two possible meeting points: Cinema and football stadium
- They forgot to agree on a meeting place
- Woman prefers football stadium, man prefers cinema
- Generic payoff matrix: $a > b > c$

Assumption: $a > b > c$

		Woman	
		Cinema	Stadium
Man	Cinema	I a, b	II c, c
	Stadium	III c, c	IV b, a

A would be they go together to their preferred location
B would be they go together not to their preferred location
C would be they not go together

There is a coordination problem because they didn't remember where to meet.

Two Nash equilibria in pure strategies:

Quadrant I
If woman goes to stadium, it is also best for man to go to stadium

Quadrant IV
If man goes to cinema, it is also best for woman to go to cinema

There is no dominant strategy.

Cooperation fails if:
- Both go to their favorite place OR
- Both want to do other a favor

Interest to coordinate is entangled with a distribution conflict
- No pure coordination game

Clearly diverging preferences regarding coordination solution
- Connection of converging and diverging interests

Incentive structure suits reality: Often we want to get together with others, but have different ideas about specifics.

3.4 Overcoming Dilemma structures

Task of Business Ethics:
- Identify factors that prevent or would facilitate cooperation for mutual benefit.

Constitutional Perspective:
- Buchanan here sees the state as a social institution that is established through a collective act of exchange.

Example: Traffic Offenders

Analysis using Prisoner's Dilemma:
- Situation A:
  - Player 1 (traffic offender) breaks traffic rules
  - Player 2 (other road users) sticks to it
    - → Quadrant III
- Situation B:
  - Constancy of the behavior of others leads to change in behavior of Player 1
    - → Quadrant I

		Player 2	
		cooperate	defect
Player 1	cooperate	I b, b	II d, a
	defect	III a, d	IV c, c

$Assumption: a > b > c > d$

- Result: Consensus of behavioral change fails because
  $Utility\ Player\ 1, Quadrant\ III > Utility\ Player\ 1, Quadrant\ I\ or\ a > b$

  Traffic offender is better off, if he breaks the rules while everyone else sticks to them
  →Therefore, unilateral behavioral changes fail to pass a consensus test

Ability to Approve

Instead: constitutional consensus test asks for ability to approve of rules
Is a general violation of rules preferred over a of general compliance of rules?

Example of the traffic offender: general rule violation = Quadrant IV

$$Utility\ Player\ 1, Quadrant\ III > Utility\ Player\ 1, Quadrant\ IV\ or\ b > c$$

→ Crucial: comparison between general defection (status quo minor) and general cooperation (Pareto-better alternative).

Overcoming Dilemma Structures

More potential solutions – some factors that facilitate cooperation:

- Iteration
- Communication
- Change of payoff matrix (e.g. introduce reward: reduce the cost of cooperation; introduce penalty: increase the cost of defection)
- Non-rationality, non-self-interest of individuals. In prisoner's dilemma it is assumed that the players are rational.

For fun: How individuals communicate & decide in reality→ Example from the game show Split or Steal: The woman chose steal and the man split. The woman gain 1M$ and the man 0$.

		Player 2	
		split	steal
Player 1	split	I 50, 50	II 0, 100
	steal	III 100, 0	IV 0, 0

3.5 Game theory and behavioral evidence

- Game theory could be treated as a normative theory that tells people what they ought to do if they wish to act rational in strategic situations
- BUT there is not always one strategy that can be recommended and assures highest payoffs (for everyone)
- Has game theory indeed helped empirical researchers make new discoveries about human behavior?

3.6 Experimental economic research

- Could be used as method for Business Ethics
- Actual behavior of actors can be examined within context of economic incentives
- No "cheap talk" (like in hypothetical surveys), actual behavior is observed instead of mere statements of intent
- Method to put implementability of desired moral actions under conditions of modern societies to test

Some results from experimental Economic Research:

- Experimental economic research has drawn attention to a number of factors that traditional economics has so far neglected in its theory formation.

For example:

- Fairness considerations in ultimatum game (Güth et al., 1982)

→ Offers of less than one-fifth of the total amount tend to be rejected with a likelihood of approximately 50 % (Fehr & Schmidt, 2001)

3.7 Conclusion

- The concept of rationality plays a central role in economic decision theory.
- There are different result-oriented concepts of justice (i.e., different welfare functions) and process-oriented conceptions of justice.
- The Pareto principle is seen as a prominent test procedure for social conditions.
- Dilemma structures are a central aspects of modern business ethics.

4. Psychological foundations and tools

4.1 Introduction

- When we talk about business ethics, we talk about morality.
- The study of human morality is highly interdisciplinary (Doris, 2013).
- Philosophy as a starting point.
- Psychology: Initially due to mental processes science. Moral psychology becomes an experimental/empirical field of research.
  = Philosophy has been argued to be light on facts, and psychology to be light on theory.

<u>A change in the late 1960s (Doris, 2013):</u>

- On the one hand, morality in philosophy is influenced by naturalism and cognitive science when it comes to epistemology and philosophy of mind.
- On the other hand, psychology sees the end of behaviorism and the rise of empirical research, including towards philosophical topics.

  = In this lecture, we will trace important insights of moral psychology for business ethics.

4.2 The Behavioral Approach to Ethics

Traditional Ethics:

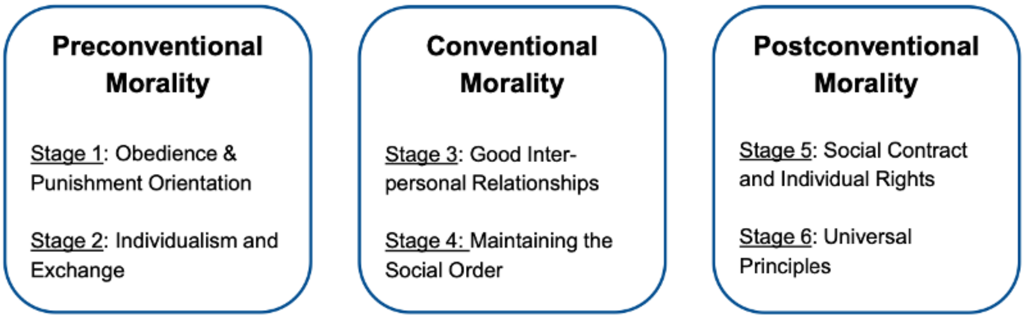
Assumption that once a person has understood what is right or wrong, they act accordingly.
Schwitzgebel (2009):

- Across 31 libraries in the US and UK, ethics books are more likely to be stolen than other philosophical books of similar popularity and age.
- Even more frequent for advanced texts of interest to graduate students and professors.

Thus, there seems to be more to it than simple knowledge, it's difficult to do a decision, it's not just well or wrong. There seems to be a deliberation.

Kohlberg (1984): Stages of Moral Development Theory

- Building on interviews based on 10 moral dilemmas done with 72 Chicago boys ages 10 to 16; 58 of whom were followed up at three-early intervals for 20 years.
- Kohlberg asked the children to give a reason for their moral dilemma decisions. He found that, with age, the reasoning changed.
- He identified 3 stages of moral reasoning development: Preconventional, Conventional and Postconventional Morality.



- Stage 1: 10 to 12 years old. Children don't want to do this because then they are going to be punished or because they were told not to do this (obedience)
- Stage 2: Children recognize there is not only one view. There is more than one way to do things right.
- Stage 3: You think about others, I want to be viewed as a good person. Approval of others.
- Stage 4: The individual becomes aware of the rules of society. So they want to obey the rules to avoid feeling guilty.
- Stage 5: When the child becomes aware that while rules might exist for the good of the greater number, there will be times when they act against a particular individual. Knowing that all things don't apply always to everyone. For example, the protection of life. In certain situations, break the law and protect one's life or do the contrary.
- Stage 6: People have developed his moral guidelines; you think on your own. Maybe you don't fit the law. Example of guidelines: human rights, justice and equality.

- Kohlberg Theory = Morality would develop with age to become a stable character trait.
- Critic from Bazerman and Gino (2012)
    - Normative & prescriptive approach to ethics: how people should act when resolving ethical dilemma.
    - Business ethics: moral evaluation of practices of people within corporations (Bazerman & Gino, 2012)
      = Kohlberg's work is insufficient to understand how ethical dilemmas are actually solved, especially in the context of improving ethicality in organizations.

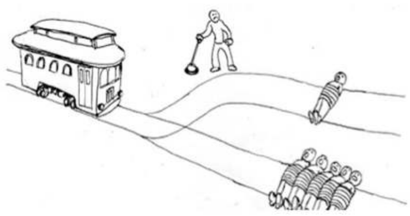
Utilitarian Theory:

An act is considered moral if, compared to possible alternatives, it provides the greatest good for the greatest number of people.

Deontological Theory:

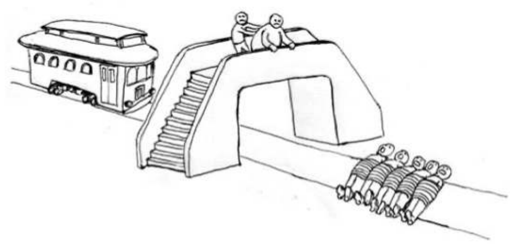
No matter how morally good or bad the consequences, some choices are morally forbidden.
e.g., Kant's categorical imperative that humans should never be regarded as means to an end.
To sum up, deontological is about the action itself, while utilitarianism is about the consequence of the action.

Trolley Problem ("Switch")



A Utilitarian Answer:
The clear majority of respondents feel like it is morally acceptable to use the switch and kill only one worker over five.

Trolley Problem ("Footbridge")



A Utilitarian answer
The clear majority of respondents feel like it is morally acceptable to use the switch and kill only one worker over five.

The deontological answer for the Footbridge: I am not going to throw a person from the bridge as I would be killing a person on purpose. If I do nothing then I am ethical.

Doctrine of Double Effect = Doctrine of Side Effect

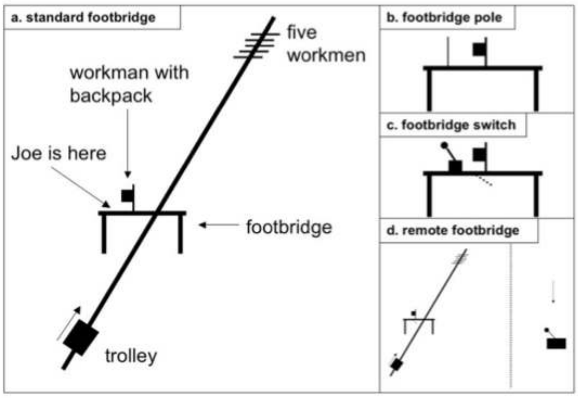
→ There is a line between harm that is caused as a means to an end, and harm that is caused as a side effect.
Footbridge dilemma: without the human to sacrifice on the rail, there would be no trolley stopper.

- Deontological answer (Kant): humans should never be used as a means to an end – **means to an end.**
- Utilitarian answer: there is only one choice: one or five human die – **side effect**.
  = Are any responses to the trolley problems morally justifiable?

Greene (2014): Remote Footbridge

There're some deontological people that in some situations could accept and kill one person, because they don't have to throw somebody from the bridge, instead, they would be in some distance from the bridge, would hit a switch and the person on the bridge would fall.

- A railway worker with a backpack stands on the footbridge under which the trolley will run.
- The bystander is standing at some distance from the footbridge at a distance.
- Hitting the switch will open a trapdoor through witch the railway worker falls onto to stop the train.



- Approval rate of hitting the switch from 31% in footbridge to 63% in remote footbridge.
- If the physical mechanism should not matter ethically, it matters psychologically.

Thus, our intuition in these dilemmas are not only influenced by the ethically relevant means/side-effect distinction that many of us may find reasonable, but also by a distinction of physical distance that most of us probably find rather dubious.

<u>What are factors of a behavioral approach to ethics?</u>

- **Behaviors are prone to incentives:** behavioral ethics looks at how people actually behave, assuming people can act contrary to their best ethical intentions. Thus, it focuses on psychological factors in moral decision-making processes, which are highly situational.
- **Unintentional cognitive drivers** of unethical behaviors explain our inconsistent ethical behavior (Bazerman & Tenbrunsel, 2011). They are predictable patterns that can be understood and therefor addressed. Thus, behavioral ethics regards how people take moral decisions and not how they are supposed to behave in an ideal world.
- **Bounded rationality** in the domain of ethics evaluates unethical behavior that arise without intentionality (Simon, 1997).
- It looks at the ethically problematic behavior that is inconstant with the ethics that the people engaged in this behavior prefer for themselves.
- Thus, it is according the decision maker's own standards, and not the external standards of an observer that the ethical behavior is bounded.

4.3 Dual Process theory

How thoughts can arise in two different ways, or as a result of two different processes, called here System 1 and System 2 (Kahneman, 2011).

System 1 – Intuitive

- Automatic
- Quick
- Effortless
- Emotional

Relates to: impulses, habits, beliefs…

System 2 - Questioning

- Requires Attention
- Slow
- Effortful
- Logical

Relates to: reflection, planning, problem solving…
Monitor and Control thoughts and actions suggested by System 1.

The process of taking a decision can be intuitive or questioning. For example, intuitive can be when we are in the street and somebody behaves wired and we decide to change the side of the street. And questioning, when you have a dilemma and you think about the decision for a time.

The "Bat-and-Ball Problem":
What happens when System 2 is lazy (Kahneman, 2011). "*A bat and ball cost $1.10. The bat costs one dollar more than the ball. How much does the ball cost?*"

Appealing & intuitive answer: 10cents. Correct answer: 5cents.

- If you gave the right answer, you might have been able to resist the temptation to follow the rule of least effort and might have a more active mind.
- If you gave the wrong answer, know that over 50% of participants from Harvard, MIT and Princeton did as well.

Kahneman (2011) concludes:

- People trust their intuition too much and find cognitive effort more than unpleasant. Our brains are lazy.
- Understanding the relevance of System 1 for our thinking is important, and can sensitize us for logical and ethical errors.
- Moral heuristics to ethical problems: System 1 intuitive responses to moral problem.
- Acknowledging the role of our intuitive responses for moral judgement is central to behavioral ethics.
- People trust their intuition too much and find cognitive effort more than unpleasant.
- Understanding the relevance of System 1 for our thinking is important, and can sensitize us for logical and ethical errors.
- Moral heuristics to ethical problems: System 1 intuitive responses to moral problem.

  →Acknowledging the role of our intuitive responses for moral judgement is central to behavioral ethics.

4.4 The social intuitionism model to Moral Judgement

The Rationalist Approach (Kohlberg, 1969; Piaget, 1965; Turiel 1983)

⇒ Moral judgement are reached by reasoning + reflection.

- Moral emotions may feed into the reasoning process.
- Reject the idea that emotions are the direct causes of the moral judgement.

Weighing of right vs. wrong, benefit vs. harm, fairness vs. unfairness. → Reach a well calibrated judgement.

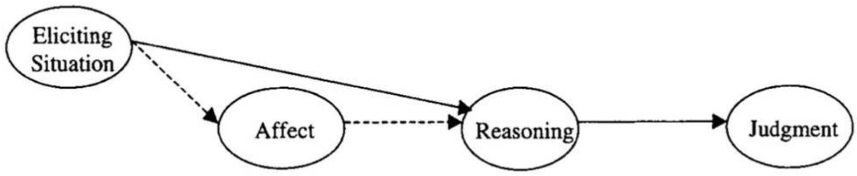


Figure 1. The rationalist model of moral judgment. Moral affects such as sympathy may sometimes be inputs to moral reasoning.

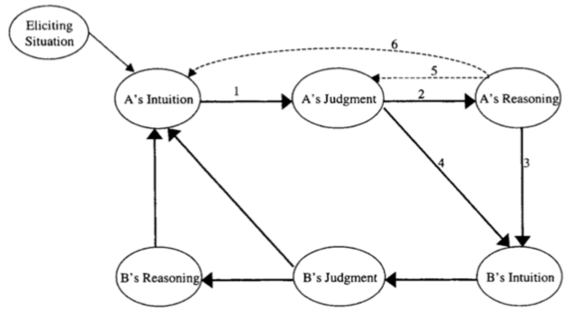
The Social Intuitionism Model (Haidt, 2001)

⇒ Emotional reaction precedes moral reasoning. All of the decisions are made in emotions.

- Emphasizes the importance of social and cultural influences on moral judgement.
- Deemphasizes the role of private reasoning done by individuals.

→ Intuitionist because moral judgements are generally the result of quick and automatic (intuitive) evaluations. Those are followed by slow ex post facto moral reasoning.

The numbered links drawn from Person A only are (1) the intuitive judgement link, (2) the post hoc reasoning link, (3) the reasoned persuasion link, and (4) the social persuasion link. Two additional links are hypothesised to occur less frequently: (5) the reasoned judgement link and (6) the private reflection link.



Conclusions:

- Rationalists' models made sense in the 60s and 70s when the cognitive revolution thought about moral judgement as a form of information processing.
- Since then, evidence show that most cognition occurs automatically, and moral judgements happen outside of our consciousness.
- People usually cannot explain how they really arrive at a particular moral judgement.

4.5 The limits of reason for Moral Judgements

Reasons to doubt the causal importance of reason for moral behavior (Haidt 2001):

- There is evidence supporting **dual process models in moral judgement making**. In this case, System 1 is involved based on automatic processes. Regarding first sight impressions (Albright et al., 1988), people seemed to keep a constant attitude towards a specific group from first sight to later on (Ambady & Rosenthal, 1992).
- The problem of **motivated reasoning** suggests that a post hoc reasoning is more important than a reasoned judgement and a private reflection. People would thus be more likely to arrive at their desired conclusion, while this ability is constrained by their ability to come up with reasonable justification (Kunda, 1990).
- People, post hoc, generate **causal explanations** out of a priori causal theory, such as social norms culturally transmitted supporting the evaluation of other people's behavior. For example, you don't like a group of people because you believe they always behave like this in society. This doesn't mean that they are right.
- The final reason relates to focusing on moral behavior instead of moral judgement. Strong evidence on psychopaths who understand harmful consequences of actions but do not care highlight that moral reasoning matters less for moral actions than **moral emotions**. Behave the right way but you don't believe the right way.

4.6 Boundedly ethical decision making

The ability to make ethical choices is limited because of external factors.

<u>Bazerman & Tenbrunsel (2011): in-group favoritism</u>

- A professor at a prestigious university gets a call from a long-lost friend and is asked to introduce the friends' child to the director of admission. The outcome is usually that the professor will follow through due to the unpleasantness to tell a friend it is impossible to help them.
- Most of us are intuitively comfortable with doing favors for those with whom we identify with. It is not the result of an immoral intention, but the result on focusing on being "nice" to those who are like us.

Decision Making Process:

- The "want/should" distinction explicitly captures the intra-personal conflicts within a human mind (Bazerman et al., 1998) and thus justifies the idea of multitude of self conceptions triggered in different contexts when it comes to decision making (Kivetz & Tyler, 2007).
- The "Should" is based on prediction and remembrance. The should is my guidelines and my wants is what I am going to do.

Before
Possible Misperception: Misprediction

During

After
Possible Misperception: Misremembrance

Before the Decision: Prediction Error

- **Prediction errors** is the human tendency to make inaccurate predictions about how one will behave in a future situation. Humans underestimate the impact that visceral factors (emotions, drives, and cravings) have on future behavior (Lowenstein).
- **Hot-to-Cold Empathy Gap**: tendency to consider our desires in emotional states as being more stable than they actually are. An intense desire to act in the moment might evaporate after a "cool off period".
- We have a tendency to predict our behavior as **more compatible with our ethics** than it will actually be, leading to prediction error. Interestingly, this does not apply to our estimation of other peoples' behavior (Epley & Dunning, 2000). If you know people well, you can predict what the person will do. We are good in prediction for other's actions, not for ours.

During the Decision: Ethical Fading

Ethical fading – should/want (Tenbrunsel & Messick, 2004):

- The "want" takes over and the decision-maker is unaware of ethical implications of their decisions which leads to the neglect of ethical criteria for the decision.
- When judging others ethical behavior, the "should" activates over the "want", and we think we might have acted differently than the person. For example, comparing ourselves with a president and think that we would have done it better (any action).
  → Our predictions of our own ethical behavior are bad because we predict according to the "should" (abstract concepts, moral reasoning) but the "want" (visceral response) usually wins.

After the Decision: Selective Memory

Being "revisionist historians" (Bazerman & Tenbrunsel, 2011):

- When evaluating the ethical implications of our actions, we take distance from the want and base our moral reasoning on the should.
- If faced with a mismatch between our self-image and our unethical behavior, our memory can become selective to describe best the self-depiction we desire.
- We find ways to spin the unethical behavior by rationalizing our role in a given situation, interpreting our actions in a more favorable light, or by redefining what is ethical.

Omission Bias (Tenbrunsel et al., 2010):

- Tendency to believe acts of omission to be morally superior to acts of commission.
- In a context of injustice, we predict that we will have the courage to speak up against injustice, but when the time comes, we often remain silent.
- When recollecting such lack of action, we allow ourselves to believe we were not unethical because we did not create additional harm. For example, in the trolley problem, we weren't unethical because the 4 people that died, died not because of us. Doing nothing was the ethical decision for deontological people.

Before

The Should

- Prediction Error
- Hot-to-Cold empathy gap

During

The Want

- Ethical Fading

→ When judging others behavior, the "should" takes over.

After

The Moral Reasoning

- Revisionist Historian
- Omission Bias

The should: What we imagine to be the ethical thing.
The want: When we are actually doing.

4.7 Bounded ethicality in organizations

The normative approach: Traditionally, the study of business ethics has been based on what managers and employees "should" do. This reflects in the popularity of companies' codes of conducts and moral guidelines (De Cremer & Tenbrunsel, 2011).

- The assumption that people behave rationally and purposively and are aware of their actions' implications means that business scandals are the result of few bad apples. This misses the impact of the **circumstances** and **psychological processes** underlying an ethical behavior.
- Designing environments in which behaving ethically is easier would probably work better than banning unethical behavior (Dana et al., 2011).

4.8 Diffusion of Responsibility

- People have a preference for **sharing responsibility** in **an ethically difficult decision** (Dana et al., 2011).
- Unethical behavior does not occur because people want to be unethical, but because they want to be truly ethical and go through the costly process of behaving unethically when no-one but themselves would punish them.
- Sharing responsibility allow people to take actions that they would eschew if they were acting unilaterally.

→ People have a preference for sharing responsibility in an ethically difficult decision (Dana et al., 2011).

Vertically

When intermediaries exist and may take over the "dirty work".

Ex: Outsourcing certain functions to a subcontractor that pays its employees wages below standard firm.

Horizontally

When people fail to behave ethically, because they count on others to do so on their behalf.

Ex: Bystander Effect in which people fail to help another person when others are present but do not do so when alone.

You have 2 ways of sharing responsibility: vertically, horizontally.
Vertically means picking someone to do the work for you. Horizontally means waiting for someone else to do that.

Principal Agents Relationships – Vertical (Hamman et al., 2010)

- Principal agents repeatedly decide how much money to share with a recipient or hire agent to make sharing decisions on their behalf.
- When hiring agents, the sharing was usually reduced.
- Principal agents in this case would not feel like having taken unethical decisions because they were simply hiring people to take the decision for them.

Horizontal Diffusion (Dana et al., 2007)

- Two decision makers had a binary choice between a fair outcome for themselves and a possible bystander, and an inequitable outcome that benefited the two decision makers but harmed the third party.
- The inequitable outcome was implemented only if both decision maker choose it. Thus: if one decision maker choose the "fair" outcome, this could be implemented unilaterally. But if choosing the "unfair" outcome, responsibility was split between both actors.
- When given the choice, twice as many decision maker decided to go for the "unfair option".

4.9 The Influence of Unethical Others

- In social contexts, such as organizations, other people's behavior will influence our own ethical conduct (Shu et al., 2011).

Gino et al (2009) define three ways in which other's unethical behavior can influence our own ethical behavior:

- Changing our cost-benefit analysis of the unethical behavior. Becker (1968) posits that in observing other people get away with unethical conduct may change our beliefs regarding likelihood of getting caught and the cost of such behavior. Thus, leading to assume benefits for the behavior, making it more attractive.
- Attention on Internal Standards of Honesty: Mazar et al. (2008) lead an experiment in which an experimental group is being reminded of moral principles before making a decision, while the control group isn't. When making the decision, the experimental group reduced significantly their level of cheating for financial gains as compared to the control group.
- Norm-focus Theory: Cialdini et al. (1990) state that two types of norms will impact ethical behaviors: injunctive norms, which make specification on how one ought to behave, and descriptive norms, specifying what is actually done. Both can exist simultaneously.

4.10 Crowding-out Effects Through Organizational Measures

The Hidden Cost of Control:

- Tenbrunsel & Messick (1999) report that weak sanctions intended to increase ethical behavior actually reduce it. The ethical behavior is "crowded out".
- Falk & Kosfeld (2006) show that implementing minimum performance requirement induces the agent to reduce performance.

Example: implementing fine in daycare when picking up children late (Gneezy & Rustichini, 2000). The decision to arrive late went from an ethical to a business decision because of the financial aspect of the transaction. The number of parents coming late did not reduce.

Transactional Behavior vs. Ethical Behavior:

- Samuel Bowles (2016) argues that people's preferences are not always stable. They are dependent on the frame put around them: ethical to financial for example.
- When successful, incentives can lead to crowding-in of ethical behaviors.

4.11 Fighting Our Unethical Behavior

Recommendations on Improving Ethical Behaviors (Bazerman & Tenbrunsel, 2011)

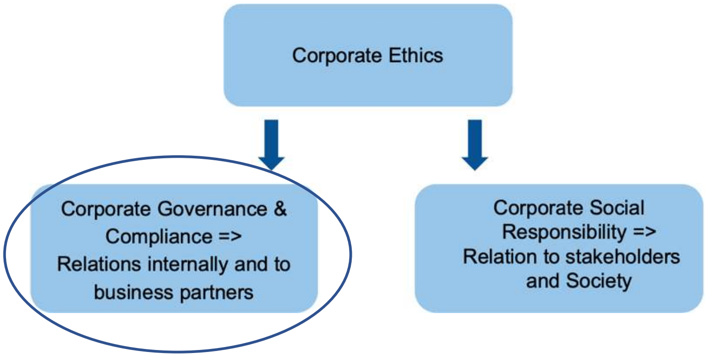
Use System 2 (reflective) and anticipate that the "want" self will exert pressure at the time of our decision:

- Using **self-control strategies** to curb that influence (Bazerman & Tenbrunsel, 2011); e.g. commitment devices such as publicly committing to a decision.
- Train the abstract thinking by focusing on the **high-level** aspect of a situation.
- Have **more than one-option choices**, as the multitude of options induce more reasoned decision (Bazerman et al., 1998).
- **Avoid uncertainty, time pressure, and short-term horizons** type of decisions as those factors facilitate ethical fading (Bazerman & Tenbrunsel, 2011).

4.12 Conclusion

- Simply knowing about ethical theories is not enough for ethical decision-making and behavior; this lecture session highlighted the importance of moral psychology for ethics.
- (Ethical) Thoughts are a result of two different processes, called System 1 (automatic, quick etc.) and System 2 (logical, slow etc.).
- The ability to make ethical choices is limited because of external factors.
- Therefore, various forms of boundedly ethical decision-making can emerge by individuals and organizations.

Chapter 6: Corporate Ethics



1. Bookkeeping fraud

1.1 Introduction

Bookkeeping fraud: Manipulation of annual financial statements in order to give shareholders and the public an incorrect impression of the financial health of a company.

- The Smartest Guys in the Room (documental) believing they could game the system.
- Enron and Wirecard: Examples of fraud which was revealed. There could be numerous other cases which remain undiscovered.
- Good corporate governance mitigating risk of incompetence, wrong incentive structures, bookkeeping fraud, corruption, cartels etc.
- Good corporate governance created transparency, which is not always in the interest of management.

1.2 Case example: Enron

1985: Founded by merger between gas pipelines Houston Natural Gas and Internorth
1990: Chairman Kenneth Lay hires CEO Jeffrey Skilling and CFO Andy Fastow
1992: Largest gas trader in North America. Beginning of mega-project in India
1996: **Beginning of bookkeeping tricks** "Mark-to-Market Accounting “

- "Mark-to-Market Accounting": the current value of future long-term revenue is counted as present revenue → 2000: $10.78 billion in revenue reported, but only $6.27 billion actual revenue. They though that the value of the money invested in the future would be greater, but it turned into 6.27$, less than the money they invested.

1999: Founding of trading platform "Enron Online“.

They started losing money. Losses were covered up by mis-representation in the book keeping.

CFO Andy Fastow created ”partner” companies (Special Purpose Entities, SPE) which enabled Fastow to transfer $30 Billion losses to these fictive companies.

The audit firm Arthur Andersen assisted Enron in building this structure. Arthur Andersen was auditing the company. Arthur Andersen had the interest to do this because they were selling consulting services.

They were recording profits and exporting losses to SPEs.

2000: Stock price reaches all-time high: $90.56

Oct 16, 2001: Enron admits that accounting rules have been violated; profits were corrected down by 20%

December 2, 2001: Stock falls to $0.26 => Enron filed for bankruptcy. $ 60 billion lost. 20.000 employees lost their jobs and their savings, because they invested their savings in Enron stocks.

2002: Collapse of accounting firm Arthur Andersen LLP due to involvement in Enron scandal Arthur

Andersen provided both auditing and consulting => conflict of interest

2006: convictions of Kenneth Lay, Jeffery Skilling, Andy Fastow and other managers

Consequence: One of the consequences was the change on legislation→ Sarbanes –Oxley Act from 2002 (SOX).

- Also known as: "Public Company Accounting Reform and Investor Protection Act", and the "Corporate and Auditing Accountability, Responsibility, and Transparency Act".
- It was an investor protection.
- It was a code of corporate governance making management responsible for audit, so the management had to sign the audit documents.
- Incorrect financial report is a criminal offence.
- Financial reports must certify that the statements truthfully represent the company's financial health, no untrue statements or mis-leading omissions.
- Auditors should be independent => no conflicts of interest
- Auditor rotation

Dilemma of management:

- CFO Andy Fastow served a six year sentence: 2019 speech:
  "Every single deal I did as I was CFO of Enron was approved by Enron's accountants, the outside auditors of Arthur Andersen, Enron's attorneys, Enron's outside attorneys, the bank's attorneys and Enron's board of directors."
- Dilemma due to obligation of management towards the shareholders: Use the full legal framework for the benefit of the corporation and at the same time be sensitive towards potentially criminal constructions

Ethical aspect:

Principles of Sarbanes-Oxley act are principles which ought to be taken for granted
Cases like Enron demonstrate:

1) Business person under pressure => make use of the entire legal spectrum, every act which is not forbidden will be perceived as legal
2) Temptations to make money can weaken ethical sensitivity

British businessman Sanjay Shah involved in cum-ex, a dividend tax fraud scheme

- € 2 billion of Danish tax payers money lost
- Logic: Possible and not explicitly illegal, therefore morally justified

2. Definitions, concepts and risk mitigation

2.1 Definitions Corporate governance

- The system by which companies are directed and controlled => setting the goals and controlling the implementation of these goals. (Cadbury Report 1992)
- System of rules, practices and processes by which a firm is directed and controlled (Investopedia.com)
- A **set of relationships** between the company's management, its board of directors, its shareholders and other stakeholders which **provides the structure** through which the objectives of a company are set, and the means of **attaining** these objectives and monitoring performance. It helps to define the way **authority** is **allocated** and the way corporate decisions are arrived at and executed. (www.lawinsider.com)

2.2 Central concepts

- **Code of corporate governance**: Recommendations on how to govern a corporation in accordance with general standards
- **Compliance:** Acting in coherence with legislation
- **Corporate Integrity**: Shared corporate values as foundation for strong compliance culture
- **Integrity / compliance management**: Practical challenges of ensuring law abiding culture in corporations

2.3 Corporate Governance as solution to issue

- Issue: Separation of ownership and control in publicly listed companies
- Mature listed corporations: professional management versus a more or less anonymous group of shareholders/investors
- Principal-Agent problem: One party (the agent/management) agrees to work in favor of another party (the principal/shareholders) => challenges of incentivizing agent
- Owners do not control the company, therefore incentive structures of management need to be aligned with interests of shareholders

3. Risks of bad corporate governance

Reduced profitability, Reputational risks, Heavy fines and imprisonment, Loss of public contracts.

3.1 Profitability risk

- Good corporate governance organizes management processes systematic communication
- Increases efficiency, checks and balances and clear distribution of responsibilities
- Systematic communication, transparent lines of command and transparent distribution of responsibility mitigates the risk of mistakes being made or mistakes remaining undiscovered
- Lower risk of informal power structures
- Informal power structures can decrease profitability because personal ambitions collide with the need for transparency

3.2 Reputational risk

- Incompliance makes firms vulnerable to public criticism
- Internet, social media and NGOs (e.g. Greenpeace)
- Loss of control over company's communication in mass media where perception is reality
- Strong public focus on corporate misconduct and general distrust of elites, in particular of managerial elites
- Requires monitoring of online activities
- Risk depends on line of business =>
    - Known brands like VW, H&M and Zara are sensitive to reputation because consumers have many alternatives. This increases the risk of consumer boycotts
    - Amazon, well known with high exposure to consumers, but low willingness to use alternatives makes them less sensitive to reputational risks
    - Anonymous corporations who move beneath the radar of public attention => lower risk
- Difficulties attracting talent
    - Reduced employee motivation, shame of working for the company
    - Less attractive for investments
        - ⇨ Example: Large asset managers are required to refrain from investing in non-compliant corporations

Example of reputational damage:

- 4th of August 1991 article in the German magazine “Der Spiegel”: “The Death From Ingelheim”
- Claim of Spiegel article: The German company Boehringer Ingelheim contributed to production of a chemical called “Agent Orange”. It was used by the Americans in the Vietnam War (1955-1975) to make the trees in the jungle loose all their leaves
- Agent Orange made it impossible for the communist enemy (Vietcong) to hide. Agent Orange is known to be carcinogenic (causing cancer) and to cause birth defects. According to Vietnam authorities four million Vietnamese have been affected

19 November 2019:

- A medical professor by the name of Fritz von Weizsäcker gave a speech in Berlin. By the end of the speech he was attacked by a man with a knife and killed.
- Reason for the murder: Fritz von Weizsäcker was the son of the former German Bundespräsident (1984-1994) Richard von Weizsäcker (1920-2015)
- From 1962 – 1966 Richard von Weizsäcker was on the management board of Boehringer Ingelheim
- The murderer wanted to revenge the four million Vietnamese victims of Agent Orange, and since the father had died, he killed one of his sons

Reputational risk: Homepage 2023 (32 years later)

3.3 Heavy fines and imprisonment

- Incompliance with codified law (Anti-corruption law, competition law, data protection law etc.)
- Heavy fines which skim off the economic advantage of the company arising from the unlawful act Management accepting violations committed by employees => liability
  Criminal prosecution up to 10 years imprisonment
- Enron: Jeffrey Skilling sentenced to 24 years in prison, released after 20 years
- Siemens: Fines € 1,6 Billion
- Lorry cartel in Europe from 1997 – 2010: € 3 billion

3.4 Loss of public contracts: Public Procurement Law

- Companies need to be law-abiding and trustworthy to be considered for public procurement procedure (especially in construction and defence industry)
- Conviction and fines paid by companies are publicly available in the commercial central register
- If companies are exempted from public procurement, it can end up in a vicious circle (especially if competitors become more active)
- The re-approvement process of companies requires comprehensible confidence-building measures

4. Case example: Wirecard scandal

- German Dax corporation insolvent in 2019 due to fraudulent financial reporting
- Accounting firm EY responsible for audits
- Failed to double check the bank statements =>

- Failed to contact the banks and get an independent confirmation, that the information provided by Wirecard for the financial audit was correct.

The case:

- Wirecard is a payment service, connecting the customer in the shop and in e-commerce and shops
- Founded in 1999. In 2001 after the dot com bubble, - almost bankrupt.
- 2001 Markus Braun joined => offered payment services to dubious websites.
- 2006 Listed on the TecDAX, index of 30 largest companies of technology sector
- From 2007: International expansion
- 2015 Financial Times: "House of Wirecard" –series begins. Journalist Dan McCrum claiming there is something wrong with Wirecard
- September 2018: Wirecard listed on the DAX
  DAX = An Index of the largest and most profitable publicly listed corporations in Germany
- 2018 Whistle blower from Wirecard (Singapore) contacted Dan McCrum from Financial Times who had written about Wirecard in 2016, and told him, he was right.
- 30th of January 2019: Financial Times article claiming that contracts were forged.
- 16 November 2019: Wirecard defends themselves: FT is wrong, and Wirecard is a solid business with 300.000 customers
- Wirecard claimed, that the FT journalists has leaked the story to hedge funds in advance so that they could speculate (short sell) against Wirecard
- Wirecard's claim:
  Wirecard can connect credit cards of customers with their bank world wide.
  In Germany they can act as intermediary bank, but they do not have banking licences abroad, for which reason they need local partners.
- Local companies offer Wirecard payment service against a fee.
- The fee is paid to an escrow account (intermediate account), and kept there as a guarantee in case there is not enough money on the bank account of the individual customers
  => Wirecard has an account with €1,9 billion
- October 2019: Wirecard forced to call for and independent audit by KPMG.
- KPMG: Wirecard did not provide sufficient information, therefore the report is inconclusive
- Wirecard: You see, we have done nothing wrong. And we will improve the documentation.
- April 2020 EY – the official auditor of Wirecard refused to sign the audit.
- The auditor cannot confirm, that the numbers that Wirecard have provided are also correct.
- June 2020: According to EY, the 1,9 Billion Euro which according to Wirecard was placed on fiduciary accounts (but the money belonged to Wirecard, as long as the partner companies did not need to make use of the guarantee) ..... Turn out to be non-existent .....
- € 20 billion Euro lost

Exit plan (if they had succeeded): Operation Panther

- Wirecard taking over Deutsche Bank
- Covering up fraudulent business by merging the statements of Deutsche Bank with those of Wirecard
- 25th of June: Wirecard filed for Bankruptcy CEO Markus Braun arrested
- CFO Jan Marsalek escaped (believed to be in Moscow)
- Court case in Munich from December 2022

EY Failure:

- A company's auditor is obliged to ensure independent confirmation of bank statements
- After having received the information from the client company X, the auditors contact the bank and asks if the bank can confirm that the statements provided by company X are correct
- With Wirecard, EY did not take this precautionary step
- Combination of disregard for principles of corporate governance and lack of auditor diligence

Wirecard 7/7: The Guardian 16.11.2020

EY

Call for three-year ban on EY bidding on public contracts

Anti-corruption group claims 'recurring professional misconduct' should preclude auditor from future business

Simon Goodley

Sun 15 Nov 2020 16.54 GMT

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5. Sliding into fraudulent business

Fraud often starts out as a minor mis-representation for the purpose of buying time to compensate for low performance

Mis-representing high result increases expectation => requires an overcompensation in the following year.

Overcompensating concealed deficit and overcompensating for higher expectations

- Success: minor mis-representation can be covered up. Lack of success=>requires even higher level of mis-representation
- Snowball effect

6. Codes of Corporate Governance

6.1 Deutsche Corporate Governance Kodex

It is a mixture of legislation and recommendations.

Legislation (German code: "Principles"-you have to do them)

⇨ concerning persons or companies carrying out economic activities.

⇨ formal processes of boards of directors

Suggestions/Recommendations (you should do, you have the flexibility to do or not if you can explain it**)**: according to the principle "comply or explain".

"Soft coercion": Compliance with corporate governance rules necessary for being listed on stock Exchanges

6.2 Legislation and recommendations

German code: **Principles** = legal requirements

Principle: The Management Board is responsible for managing the enterprise in its own best interests. (Have to)

Recommendations are soft law (comply or explain) Example:

Corporate planning shall include corresponding financial and sustainability-related objectives. (Comply or explain, if you do not comply)

7. Procedures

Germany →Three bodies:

- Annual general meeting (Hauptversammlung)
- Supervisory board (Aufsichtsrat)
- Executive board / Management (Vorstand/Geschäftsführung)

7.1 Annual general meeting

- Meeting of shareholders, supervisory board and management.
- Enables shareholders to exercise their membership rights, such as ask questions.
- Management submits fiscal statement for all shareholders to read and informs shareholders about the company's performance and strategy
- Shareholders can confront supervisory board and management with questions Shareholders appoint or re-elect members of supervisory board

7.2 Supervisory board

- Shareholders own the corporation and they appoint the members of the supervisory board
- Supervisory board are representatives of shareholders and representatives of employees if applicable (in Germany: over 250 employees: 1/3 of the supervisory board members are employee representatives, over 500 employees: half of the board are employee representatives)
- It oversees the management on behalf of the shareholders
  →Agency problems: Members of supervisory board and managers may have interests which are not coherent with the interests of the shareholders or with the interests of other relevant stakeholders

Supervisory Board (German rules):

- For corporations listed on the stock exchange: The supervisory board members meet at least twice a year (four meetings per year are also normal)
- Private corporations (not listed): Supervisory board can decide to meet only once a year
- Normally, the chairperson calls the meeting
- Important documents should be handed over to members of the board in time for them to prepare for the meeting
- Meeting has an agenda and decisions are made with regard to the points of the agenda
- At least half of the board members and at least three members are required for the board to have a quorum – i.e. to be able to make decisions

Supervisory Board- management board rotation:

- Principle 6: The Supervisory Board appoints and discharges the members of the Management Board; it supervises and advises the Management Board in the management of the enterprise.

- Principle 13: The Management Board and the Supervisory Board cooperate on a trust basis to the benefit of the enterprise. Good corporate governance requires an open dialogue between the Management Board and Supervisory Board, as well as between the members of these individual Boards. Comprehensive observance of confidentiality is of paramount importance in this regard.

7.3 Executive board/management (Vorstand)

- Responsible for managing the company, for developing strategies in cooperation with the supervisory board and for the implementation
- Accountable to the supervisory board
- Responsible for organizing and signing audits

- Responsible for ensuring that employees comply with legal requirements

8. Other national codes of corporate governance

- UK Financial Reporting Council: The UK Corporate Governance Code (Lütge and Uhl p. 198)
- US Corporate Governance Code: Sarbanes-Oxley Act (A Reaction to the scandals of Enron and Worldcom)

9. International corporate governance standards

G20/OECD Standards for Corporate Governance: Help nations improve legal and institutional framework for corporate governance.

United Nations ISAR (International Standards of Accounting and Reporting) International benchmark for:

1) Auditing,
2) Board and management structure and process,
3) Corporate responsibility and compliance,
4) Financial transparency and information disclosure, and
5) Ownership structure and exercise of control rights.

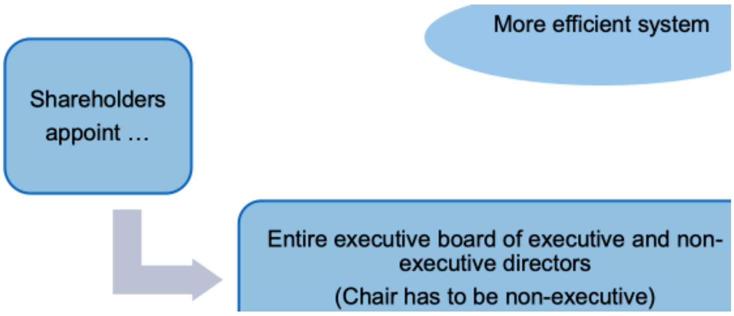
10. Management and supervisory board

National difference:

- One-tier system:
  - UK
  - US
  - South Korea
  - Italy
  - Malaysia
  - AUS
  - SA
  - India

- Two-tier system:
  - Ger, Aut, NL, DK (mandatory)
  - CZ, PL, RU, HU
  - China
  - Japan
  - Brazil

10.1One tier governance system

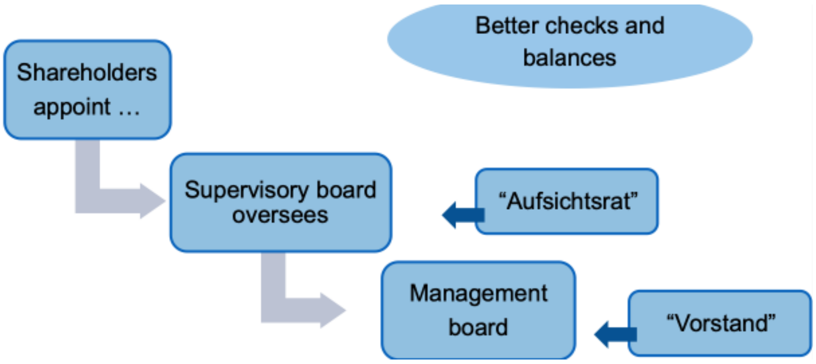


The non-executives are the ones not working on daily management. The executive are the ones working in daily management.
More efficient → better communication with each other.

Example- UK Code of Corporate Governance:

- "Non-executive directors have a prime role in appointing and removing executive directors."
- "Non-executive directors should scrutinize and hold to account the performance of management and individual executive directors against agreed performance objectives."
- "The chair should hold meetings with the non-executive directors without the executive directors present"

10.2Two tier governance system



Example from two-tier system:

German Code of Corporate Governance:

- "The Supervisory Board appoints and dismisses the members of the Management Board."
  it supervises and advises the Management Board in the management of the enterprise and has to be involved in decisions of fundamental importance to the enterprise.

11. Themes of Corporate Governance Codes

11.1Management and supervision

Principle: The Management Board is responsible for managing the enterprise in its own best interests. (Have to)
Recommendation: Corporate planning shall include corresponding financial and sustainability- related objectives. (Comply or explain, if you do not comply)

11.2Conflicts of interests must be disclosed

Lack of board independence from management: Undermines the supervisory function of the board.

Ideally, close personal relations between management and supervisory board members should be avoided

- Supervisory board members primarily support management and not the long term interests of the corporation.
- Risk of mistakes made by management being ignored
- Risk of disproportion between CEO salary (remuneration) and company performance

Insufficient dedication: Lack of independent insight into challenges and issues => uncritical approval of management

Conflicts of interest:

Supervisory board members should be independent of members of management board. Any management or supervisory board member conflict of interest must be disclosed to the chair of the supervisory board.

Members of management and supervisory boards are not allowed to pursue their own business interests as members of the boards (Principle)

Example of conflict of interest: A supervisor board member has an economic interest in one of the company's suppliers. Supporting the supplier in relation to the company would manifest a conflict of interest

Side-line activities of management board members need to be approved by supervisory board (Recommendation)

Conflict of interest example

Remuneration of the Management Board and Supervisory board

Principle: Salaries and bonusses aligned with the corporations long term interest

Example: Bonuses tied to long term performance.

Dilemma: Long term performance of a corporation: six years

Economic bonus to incentivize manager: On annual basis

12. Preventing incompliance

- Good corporate governance reduces the risk of incompliance
- Corruption (Siemens case from 2006)
- Cartels (Lorry cartel)
- Abuse of data

13. Integrity management: Code of Ethics

- Well governed companies => compliance or integrity management system
- Purpose:
    - Inform members of the organization are informed about rules and regulations
    - Make members confirm (i.e. sign) that they have received this information
      →Determine liability in case of misconduct
- Challenge: Prevent information overload => IT based compliance management systems providing employees with relevant information at the right time
- Example: Booking of a flight ticket to high risk nation => the employee receives relevant information and is required to confirm (tick box) that this information is received and understood

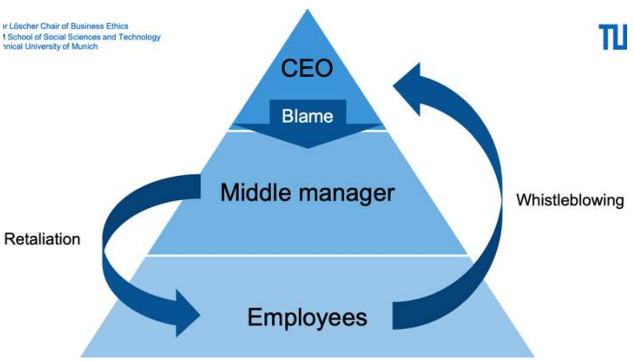
<u>Coherence with culture</u>
- Balance between merit based competitive culture and openness and forgiveness regarding mistakes
- Extremely competitive culture leads to a cover-up-mistakes culture and increases the risk of mis-conduct
- Recent development: Due diligence of business partners and screening of suppliers
- 2023: EU supply chain law

14. Whistle-blower system

Whistle-blower: Person who informs management or board of directors of misconduct in the organization.

Risk: Telling on colleagues => perceived as an act of disloyalty =>Whistle-blower provides information which can ruin careers and – in case of criminal action – lead to imprisonment.

Whistle-blower system give employees a place where they report anonymously on compliance breach and/or illegal behavior without risking retaliation from colleagues



<u>Whistle-blower system legislation</u>

Whistle-blower system required for companies with more than 250 employees

Main purpose: Avoid corruption: Estimated that that corruption adds 15% to the costs of publicly funded projects in EU

Whistle-blower system provides a procedure which clarifies

1) Whom to report to – the responsible person(s) must react within three months.
2) How to ensure confidentiality
3) That whistle-blowers cannot be punished for breaking contracts or confidentiality agreements if they believe they are reporting the truth
4) That they are informed of their rights to legal aid

Channels for Whistleblowing

- Post-box: Requires that a person can report without being seen
- E-Mail: Reporter might want to use anonymous e-mail address
- Ombudsperson: An independent person who can receive reports (can be expensive)
- Digital whistle-blower system: Anonymous communication between whistle-blower and receivers of the reporting

Example of software solution to anonymity

Whistle-blower can create anonymous profile, identify case topic, time, date, location, persons involved. The whistle-blower will receive feedback regarding the development of the case.

Chapter 7: Corporate ethics- Use Cases

1. Introduction

Corruption, cartels and violation of data privacy legislation.
- Siemens corruption scandal: Bribery of foreign government officials
- European truck cartel: Antitrust legislation
- Cambridge Analytica: Abuse of personal data

2. Siemens

2.1 Background Siemens

- Founded in 1847 by Werner Siemens
- 1866: Developed electrical motor on the basis of Faradays invention of the dynamo (The connection between movement and electricity)
- 1870: Build the first telegraph line between London and Calcutta. Reduced communication from 2-3 month to 30 Minutes
- 1900: Tramways and telephone networks
- 1920: Siemens and AEG joins forces with Osram => Production of lightbulbs
- 1945: Rebuilding the company => Main office in Munich and large production site in Erlangen
- 1960'ies: Decentralized organization and production sites India, Africa, South America
- From 1975: Microelectronics and development of overseas production facilities
- 1980s and 1990s: Digital communication systems, microchips, high speed rail and computer technology
- 2008: Siemens divided into sectors
- Energy sector: All kinds of energy production, sustainable as well as based on fossil fuel. (2019: Separate company: Siemens energy)
- Healthcare: Computed Tomography, imaging for radiotherapy, X-ray systems
- Industry Sector: digitalization, electrification, logistics, media, home appliances, lighting, diagnostic imaging, mechanical drivers, and financial solutions.
- Sector Infrastructure and Cities: Rail systems, electricity infrastructure, building technology, intelligent energy solutions
- 2020: 311.000 employees
  - Smart infrastructure
  - Digital Industries
  - Digital mobility
  - Siemens Adventa: Automotive, industrial manufacturing, buildings, oil and gas
  - Siemens Healthineers

2.2 Siemens Scandal (2006)

To understand what happened we have to look at American legislation.

<u>US Foreign Corrupt Practices Act</u>

To understand what happened we have to look at American legislation.
- US FCPA from 1977 => federal law prohibiting US citizens and US entities from bribing government officials in foreign countries.
  Officials: civil servants, political parties
- Germany: Bribery payments to foreign public officials were legal and could be accounted for in the financial statements as "useful expenditures". It was legal for Germany to bribe abroad.

- US Corporations competitive disadvantage (GE General Electric could not compete with Siemens on large infrastructure projects offered to countries with corrupt civil servants). US Corporations had a competitive disadvantage against German ones, as the German corporations could bribe.
- So, US Corporations contacted OECD (Organization for Economic Co-operation and Development).

OECD:
- Founded in 1961: Stimulating economic cooperation and trade between countries who see themselves as liberal democracies.
- 38 Members represent 62% of global GDP
- US pressure on OECD to align national legislation on corruption of foreign public officials
- 1989: Working group preparing the OECD Anti-Bribery Convention signed by Germany in 1999. This convention said that if you signed it, you had to incorporate in the legislation of your country the prohibition to bribe.
- Ratification process lasted till 1st September 2002: Illegal to bribe foreign officials and business partners. From 2002, it become strongly illegal to bribe in Germany.

From legal bribery to illegal bribery:

Siemens didn't know how to continue business without bribing. They decided to continue doing it without telling anyone.
- Culture where bribery was perceived as a legitimate way of making business
- Before 2002: Annual statements: "Nützliche Aufwendungen", useful expenses. They had no idea how the business could continue without bribery
- 2002: Managers met up with loyal employee, Reinhard Siekaczek from the accounting department, told him to open accounts in Switzerland. Midlevel executive Siekaczek organised transfer of 40-50 million Euro through secret Swiss bank accounts
- Complex constructions of front companies and illegal bank accounts for channeling funds for bribing

Bribery illegal from September 2002:

- In Siemens' culture bribery was perceived as a legitimate way of making business
- 1,3 Billion Euros paid in illegal bribery, for example for
  - Power plants in Israel
  - Metro lines in Venezuela
  - System in Argentina for personal identity cards
  - Nigeria: € 10 Million for ministers and civil servants for telecommunication systems. Profit of Project: 600 billion

What happened?

- 15th November 2006: 200 policemen, public prosecutors and tax officials searched the Siemens headquarters and arrested member of management board Thomas Ganswindt
- March 2007. Extra scandal: Manager arrested for supporting trade union alternative to IG Metall
- April 2007: Head of the supervisory board Heinrich von Pierer and head of the management board, Klaus Kleinfeld resign
- May 2007: Peter Löscher new head of supervisory board
- Fines, lawyers and investigations: € 2,5 billion

Consequences

- Centralization of bank accounts => easier to control the cash flows
- Compliance system: Prevent - Detect – Respond. Incompliance => immediate dismissal

- Independent monitoring of compliance behavior (requirement from the US), who participated in meetings and tested the whistle blower system => reports to the Securities and Exchange Commission (SEC).
- In Germany 2009 the former finance minister Theo Waigel was appointed as compliance monitor
- Implementation of compliance processes Compliance training for employees

Siemens Compliance System (internal)

- Zero tolerance: Prevent, detect, respond
- Preventive measures: Training of Employees => information on legal requirements (bribery, antitrust, money laundering etc.), identifications of high-risk areas and guidelines for handling situations (e.g. where bribes are requested)
- Shared compliance policies with business partners based on contractual agreements
- Communication channels: Whistle blower system and ombudsperson => high ranking professional independent of management to whom complaints can be addressed.
- Standardized investigation and resolution procedures

Siemens Integrity Initiative (external)

- $120 m. initiative covering 85 projects in 50 countries.
- Purpose: To contribute to reducing corruption world wide
- Contribute to creating a corruption free environment => level the playing field for competitive market economy

Collective Action

- Cultural problem in countries with high risk of corruption
- Companies faced with choice between paying bribes to win business or withdrawing from market
- Combatting corruption requires cooperation of various interest groups: Companies, governmental organization, NGOs, politicians etc.
- Creating fair marketing conditions for all participants => weakening corrupt cultures => no opportunities for other (competing) firm to take advantage of opportunities of bribe public officials
- Integrity pacts between private and public sector: Contractual agreement on public procurement processes monitored by neutral agent (could be Transparency International)

3. Example from Indonesia

- Cooperation with Indonesian government and local organization to create Indonesian Institute for Independent Judiciary
- The aim of the institute: Assisting regional anti-corruption courts. Strengthening their ability to pursue cases of corruption (gathering evidence, establishing and following procedures)
- Assisting the creation of a coherent legal framework => alignment of processes and protection of whistle blowers
- The product of the project is a 200-page report identifying the development of the judicial system: Challenges of workload and procedures, lack of qualified judges etc.
- Report used by policy makers and NGOs

4. Theory of corruption in organizations

How do organizations become corrupt?

Three processes:

- Socialization: Newcomers are introduced to the practices of bribery
- Institutionalization: Corruption is rewarded, participation in corruption as criteria for promotions. “Rope Teams”: Professional networks of executives loyally supporting each other

- Rationalization: Justifying corruption => "we do it for the sake of the company", "other firms bribe as well"
  Siekaczek (Siemens) in Interview: "We all knew it was illegal, but from the ethical standpoint, we did it for the company. It was about keeping the business unit alive."
  Managers to Sieckaczek: "If you do not participate, you will be endangering jobs".
  Sieckaczek was later told from a loyal manager, that he would serve as scape goat in case the bribery was discovered.

5. Challenge to newcomers

- Evaluating the risk of working for a corporation where you are suspicious of foul play
- The lack of authority due to beginners' standing in hierarchy
- Lack of alternative jobs and fear of losing job and prestige of working for large, successful corporations Working in corrupt culture challenges newcomers' norms
- Confrontation with corrupt corporate culture challenges the moral integrity of employees

6. The Lorry Cartel

<u>Trust as social capital:</u>

- Trust as social capital – societies with high level of trust tend to be more prosperous.
- Trust benefitting society: Increasing willingness to interact professionally with people outside sphere of close relations and reducing transaction costs in business.
- Reliability that business partners will comply with contractual agreements
- Trust increases predictability ad reduces risks of investing time and capital in business
- Fewer cases of costly and time-consuming litigation (court cases)
- Promotion based on merits and not on pre-established social relations (family ties and social network)
- Higher quality of workers at managerial levels
- Higher willingness to enter into professional relations characterized by incomplete contracts

<u>Unwanted relations of trust</u>

- Competition as productive criteria
- Market economy: Competition encourages discipline to produce good quality at a fair price
- "Competition enables growth and growth increases the size of the cake
- Market economy and competition explain the economic growth after the industrial revolution"
- Trust between competing corporations => undermines competition => cartel => inefficiency and exploitation of consumers. Cartel is when companies get together and agree that they are going to control the price.

<u>Antitrust regulation and competition law</u>

- Prohibits cartels: Cooperation between competing parties agreeing not to underbid each other
  - ⇨ Control prices and increase profits
- Most famous cartel worldwide: The international organization of OPEC => Organization of the Petroleum Exporting (Countries => Acting above national legislation)
- Antitrust legislation prohibiting cartels
- Purpose to ensure: "pluralism, decentralization of economic decision-making, preventing abuses of economic power, promoting small business, fairness and equity and other socio-political values."

<u>Antitrust regulation: Historical facts from the US</u>

- 1890: First US Anti-trust regulation in order to avoid monopolies and cartels which undermine free market economy and the advantages of competition. Specifically, an attempt to undermine the market dominance of R.D. Rockefeller's Standard Oil, that they were controlling the oil market.

- Up till 1970s: Strong antitrust regulation is key to competition between firms
  Competition => efficiency and profitability => economic growth
- Beginning debate concerning pros and cons of cartels
  1980s (President Ronald Reagan): Trimming of antitrust law: Policy of only pursuing clear cut cases of antitrust violations
  - ⇨ Easier for corporations to merge => larger corporations => internationally more competitive which makes sense in times of globalization

European Antitrust Policy: Example of current antitrust issue

- Idea of the European Union: To create a single market with fair competition, increasing efficiency and encouraging entrepreneurship
- European Commissioner for Competition
  Margrethe Vestager (she likes to challenge the monopolies of the US)
- EU challenged by monopolies of US Big Tech firms
- Example: Google as search engine
  Amazon as internet trading platform
- Digital Market Act from October 2022

EU Digital Market Act:

- Antitrust law facing new challenges through the rise of Big Tech
- Principle: If you are successful, you grow in market power => grow in responsibility
- Once you reach a certain size (45 million monthly active users and more than 10.000 businesses), you will qualify as gate keeper => obey the to do list and not-to-do list, duties and prohibitions
- List of companies which qualify as "gate keepers".
- "Online search engines, social networking services, certain messaging services, video sharing platform services, virtual assistants, web browsers, cloud computing services, operating systems, online marketplaces, and advertising services."

Amazon 2020 case

- Amazon is a platform for other firms and a retailer of products on its own platform
- Amazon also allows third party sellers to offer products to Amazon consumers
- Amazon collected sensitive data from other retailers using their platform in order to strengthen their own market position. They see what products are sold the most in other companies, and then they incorporate them to his website.
- EU analyzed 80 million transactions and 100 million products and the time of their launch
- Amazon has collected data on the transactions of third-party sellers
  Insight into which products are successful and which were less successful as basis for decisions on which products to launch as a retailer

The lorry cartel case

- 1997 - 2010: Different lorry producers→ DAF, Daimler, Iveco, MAN, Scania and Volvo
- Exchanged information on prices for medium and heavy trucks in order to coordinate these prices
- Enabled them to coordinate gross list prices to avoid underbidding each other
- Coordination of pricing and timing of new technologies
- The EU truck market => "Oligopoly" => 90% of market dominated by few large players
- Few companies made it easy to organize price coordination
- Rationalization: "Crippling competition" between European lorry manufacturers
- In 2010 MAN turned themselves in and applied for lenience "Kronzeugenregelung" (if you are the entity to give the information, you will not be punished).
- European Competition Network Leniency Program

Competition authorities (CA) will grant firms immunity from fines if the firm: "is the first to submit evidence which in the CA's view, at the time it evaluates the application, will enable the CA to carry out targeted inspections in connection with an alleged cartel"

- 2017: Lorry producers (apart from MAN) were fined almost €3 billion. Scania was fined € 880 million
- Statement by commissioner Vestager:
  "... the truck producers discussed the "gross price list" increases they were planning for medium and heavy trucks and coordinated these with each other."
- 2022 Customers who had paid too much for the around 100.000 Trucks are suing MAN, Daimler, DAF, Iveco und Volvo/Renault for 590 million Euro

Lorry cartel from the perspective of MAN:

- Siemens corruption scandal => MAN became aware that disproportionate consulting fees had been paid to business partners in Kazakhstan.
- They contacted to compliance team from Siemens, and the team helped them build a compliance system in MAN
- The focus on compliance made it clear that the close relation to the competitors was not acceptable on a long-term basis
  - ⇨ Decision to inform authorities and cooperate with the authorities

<u>Lessons learned:</u>

Corruption, cartels etc are untenable for two reasons

1) Reputational risks
2) Risks of litigation. FCPA can be seen as a worldwide standard in so far as every business which has anything to do with the United States can be prosecuted by the US. This includes using Dollars and using a US based communication system: Teams, Zoom, WhatsApp, etc.
3) Costs of a compliance system in large corporations: € 10-20 million.

7. Cambridge Analytica

7.1 What is the scandal about?

- Cambridge Analytica assisted election campaigns with micro targeting and psychographic messaging based on information of over 80 million Facebook users. All this people did not agree to provide their data.
- Information bought from researcher from Cambridge University
- Suspicion of influence on the 2016 U.S. presidential election and the Brexit vote.
- A man, whistle-blower, went to the press and said that Cambridge Analytica took private information illegally to manipulate the elections.

7.2 Who is Cambridge Analytica?

- Founded as a subsidiary of Strategic Communication Laboratories (SCL), a UK company based in the US
- Co-founded with Steve Banon and Robert Mercer (Right wing republicans)
- CEO: Alexander Nix.
- British political consulting named "global election management agency".
- Specialized in collecting data on voters => Micro targeting and psychographic messaging

7.3 The Case timeline

- April 2010: Facebook launched Open Graph allowing external developers to reach out to users and request permission to access a large chunk of their personal data, and the one of their friends. Open Graph allowed external developers to put an app on Facebook and took data of the users that allowed it, but also from their Facebook friends of those users (without permission).
- 2013: “This is your digital life” app by academic researcher and founder of Global Science Research (GSR) Aleksandr Kogan is launched.
- The app combines personality test, Facebook profiles and voter records.

7.4 Cambridge Analytica & the Facebook Scandal

This Is Your Digital Life & Aleksandr Kogan:

- Kogan develops an app for Cambridge Analytica which, in turn, arranges an informed consent process for academic survey research for Facebook users.
- The app is allowed by Facebook’s design to collect personal information of consenting participants AND of all people in the FB user’s social network.

This Is Your Digital Life & Aleksandr Kogan:

In total, it is 87 million individuals’ personal data that were harvested from 320 000 initial users.

- Interestingly, SCL (subsidiary of CA) participated in Kogan’s research. SCL used a million dollar to pay 3-4 $ for each person who would participate in the survey on Kogan’s app asking questions about personality.

Behind the Scene (2014):

- Cambridge Analytica contacted researcher Alexandr Kogan, psychologist from Cambridge, and creator of ”This is your digital life”.
- Kogan set up Global Science Research (GSR) (which has nothing to do with Cambridge Analytica).
- Cambridge Analytica buys a dataset from Kogan’s Company / Global Science Research (GLS) – psycho-demographics + personality from the app Kogan set up on Facebook.

The Case Timeline:

- 2014: In 2014 Facebook realized about the issue of collecting data of friends from people that have consented to be in the app. So, there was a change of rules limiting developer’s access to user data. This change is not retroactive, thus Kogan did not have to delete the data previously acquired.
- 2016: Trump’s campaign team begins investing heavily in Facebook ads, with the service of Cambridge Analytica. Cambridge Analytica knew, thanks to the Facebook data, which groups were their target.
- Alexander Nix (CA CEO) works on the campaign. Trump representants hired Cambridge Analytica.

Summary of the case:

- 2013: “This is your Digital Life” by Kogan, where you consent to give your data, pass the personality test and see your entire digital life.
- 2014: Creation of Global Science Research (GSR) by Kogan.
- 2014: SCL (subsidiary of CA) pays over a million dollar to pay participants to “This is your Digital Life” Survey.
- 2014: CA buys a data set from GSR.
- 2016: CA is involved in Trump’s campaign that uses psychographics to target communication.

- March 2017: Whistle-blower and co-founder Christopher Wylie exposes CA and the harvesting of over 50m Facebook profile data (later estimated at 87m) in the Guardian and the New York Times.
  Wylie explains the data were used to develop psychographic profiles and deliver pro-Trump material to them online.
- March 2017: Zuckerberg reacts a few days later on the social media.
  “We have a responsibility to protect your data, and if we can’t then we don’t deserve to serve you. I’ve been working to understand exactly what happened and how to make sure this doesn’t happen again.”

Consequences of a Scandal:

- 2018: the Cambridge Analytica operation is closed due to the scandal.
- Awareness in regards to data privacy.
- Standards and regulations being enforced such as the GDPR (European General Data Protection Regulation).

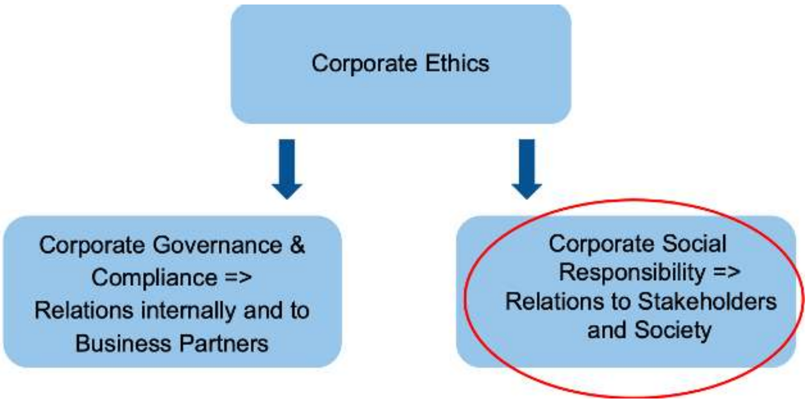
GDPR:

- At the heart is Personal Data. Broadly this is information that allows a living person to be directly, or indirectly, identified from available data.
- Obvious: Person's name, location data, or a clear online username.
- Less apparent: IP addresses and cookie identifiers.

GDPR’s Seven Principles:

- Lawfulness: don’t do anything against law
- Fairness and Transparency: try to be sure not to discriminate anyone. Be transparent in what you do with the data.
- Purpose limitation: what are you going to do with the data
- Data minimization: I take only what I need
- Accuracy: take the data that I say
- Storage limitation: I am removing this data in x time.
- Integrity and confidentiality (security): I will not put your data on internet
- Accountability: if there’s a problem, it’s my fault

Chapter 7: Corporate Ethics – Corporate social responsibility



1. Conceptual development

- Milton Friedman 1970: "The business of business is business"
- Archie B Carroll 1979: CSR Pyramid
- Freeman 1984: Stakeholder Management
- Michael Porter 2011: Shared Value

- Pivotal Question: CSR as descriptive or normative?
  If the descriptive/empirical claim does not hold, i.e. if corporation can be long term profitable as a result of unethical business, then proponents of CSR would have to claim, that corporations have a moral obligation.
  - ⇨ Appeal to individual ethics of business persons, which might be in conflict with incentives

1.1 1970 Friedman: Profit Maximization as Corporate Goal

"The Social Responsibility of Business is to Increase its Profits"- Milton Friedman
- Friedman's essay "The Social Responsibility of Business is to Increase its Profits" (1970) is regarded one of most influential views in Business Ethics
- According to this view, managers have clear and well-defined goal they should achieve: Maximization of profits for shareholders
- "CSR" would be use of resources for goals that are not required by shareholders

Tasks of managers:

- Shareholders employ managers for specific purpose (profit maximization)
  → Use for "moral" purposes (social, ecological, etc.) is thus improper use of resources
  - Managers don't have expertise to make good use of resources in areas outside their area of business
  - Resources will be allocated to achieve certain ends that are chosen by management (non-democratic decision)
  - Costs of this behavior will usually be allocated to customers or employees (forced tax)
- Managers thus undermine ownership rights
  → this is endangering the liberal economic system
- Responsibility for social problems lies with state - not with companies

Goal of companies:

Companies:
- Friedman: Companies emerged from free association of individuals and their property
- Objective and tasks of companies: determined by owner (has the right to do so)

Who determines tasks of company and who bears responsibility? usually managers, employed by owner.

Agent (Manager) → Profit maximization → **Principal** (Owner)

According to Friedman, a company can NOT be responsible for an act because of its nature →"Corporate responsibility" is in fact semantic category defect. The responsible of that is the state.

Social Goals and Corporate Responsibility

Assumption: companies are resource-rich actors → they should be responsible for society
BUT: How can individual know if expenditures of resources serve "social interest" if manager cannot know what "social interest" is?

Through **agent's commitment** to principal, goal of business is to maximize profits (fiduciary duty). Principal can easily judge fulfillment of goal and quality of work of agent via data (≠"Social goals")
→ By complying with legal frameworks and basic moral standards, company is already paying attention to other stakeholders

Friedman's examples of misunderstood forms of "social justice":

1. Forego price increase to meet social desire to avoid inflation
2. Environmental protection beyond legal framework (achievement only by cost factor)
3. Recruitment of long-term unemployed rather than better-qualified workers (social integration)

Criticism:
- Managers, as agents, utilize resources that do not belong to them and are entrusted to them for another purpose
- Risk of shifting decision-making power over social developments → undermine central pillar of free society, namely property
- Only small group (of managers) who neither have the mandate nor the competence decides on social investment
- Incentive problem (no means to audit manager's performance)
- Investment in social projects would diminish profit; it is illegitimate form of taxation of owners (against paradigm of profit maximization)

• Illegitimate: Taxation is not brought about by adequate procedure (checks and balances), but by small group of managers who do not have sufficient competence

Danger of **collectivism through corporate social responsibility**: By emphasizing social responsibility, it is implied that profit motive of companies is wrong
- Assumption of social responsibility as "compensation" for morally dubious profit striving
- If managers do not fulfill claims: "iron fist" by state compulsion (danger for liberal social order)

→ Task of state institutions is to account for social responsibility

1.2 Events after Friedman 1970 article changing the context of business

- 1950 – 1970: Unprecedented economic growth in Europe and the United States. => „The Golden Age“
- 1970s: Economic crisis caused by the Oil Crisis (1973) and early globalization marking the end of the golden age
- 1980s: Decade of economically liberal and right-wing policies favorable to business.
- US President Ronald Reagan: Deregulation (banking sector and antitrust law), tax cuts.
- UK Prime Minister Margaret Thatcher: Privatization of public enterprises and reduction of trade unions influence
- 1990s: World Trade Organization. Accelerating globalization. China joins 2001

Globalization has enabled the growth of multinational corporations => debates on the role and the power of business in society.

2. Demonstrating the increasing significance public opinion

2.1 Introduction

Two case examples: IHC Caland in Burma & Brent Spar from 1995

Both cases demonstrate how corporations can lose control over public opinion and how civil society and NGOs can put corporations under pressure even though their cases might be controversial.

2.2 IHC Caland in Burma

Compliance to legal and self-imposed rules on its own does not protect a company from a loss of image or boycotts (even in the B2B sector).

Burma Mid 90s:
- Bad human rights situation in Burma
- 1997: Clinton issued ban on new investments
- Heineken, Interbrew, HP, etc. then withdrew from the country
- US/NL: Consumers threatened with protests against companies continuing to operate

IHC Caland:
Dutch corporation in the offshore gas and oil industry (formerly also shipbuilding), today: SBM Offshore

IHC (B2B) thought that what they were doing was okay, so they were not going to be the focus of protests.

IHC Caland's investments in Burma:

- IHC Caland's investment in Burma: Signature of a 15-year contract with the Burmese Government in 1998 for an offshore project (volume: several hundred million euros, joint venture)
- Previously, US oil company Texaco had withdrawn, presumably because of US investment ban

Protests against the investments:
- Worldwide protests against the involvement of IHC in Burma
- Allegation: support for oppression of the Burmese people/support of the military regime
- Publication of IHC Caland financial networks by protest groups to identify which investors were indirectly involved in business with Burma

IHC Caland's point of view:

- Business is legitimate as long as there is no NL/EU embargo
- Duty of company is only to act within the legal framework
- IHC referred to its B2B relationships which played no role in moral issues
- Nevertheless, IHC had difficulty financing the project as Dutch banks refused to finance it

Code of Conduct and compromise:

- In 2000, IHC Caland set up code of conduct
- Nonetheless, they wanted to stick to the policy of signing contracts in countries without official embargo
- Another contract with Burma was closed
- Two important shareholders sold their shares
- In 2003, representatives met with Burma's ambassador to discuss human rights issues
- IHC Caland follows OECD guidelines → FNV and CNV check compliance

Further Developments:

- 2003: Stricter sanctions against Burma (President Bush)
- 2013: EU suspends sanctions against Burma

Conclusion:

- Regardless of whether investments by western companies promote human rights violations, IHC Caland case shows that public can also exert considerable pressure on B2B
- It is also in the interest of company to calculate reputational risks beyond legal framework
  → Compliance alone is not sufficient!

2.3 Shell and Brent Spar

- Brent Spar: Oil container for oil waiting to be picked up by boats, off the Norwegian coast.
- 1995: The tank was damaged, and Shell's plan was to sink it in the Atlantic Ocean. Permission granted from British authorities including scientists & wildlife experts. The tank would have created an artificial reef supporting marine life
- Greenpeace: Said the bottom of the ocean is not a dump for industrial waste. Shell just wants to save money! Brent Spar contains 5500 tons of poisonous oil residues*. Shall should bring it to shore and recycle the parts.
- Brent Spar occupied by Greenpeace activists

  *In September 1995, Greenpeace admitted that their estimate of the amount of toxic oil residues in the tank was much too high. In fact, the oil residues amounted to 75 to 100 tons, i.e. about 1.37-1.8% of what was claimed.

- Media attention. Boycott Shell! Employees attacked, Gasolin station burned down
- 20% drop in sales from Shell stations
- Shell underestimated the power of a well-orchestrated campaign encouraging consumers not to buy their petrol at Shell.
- Shell forced to dismantle Brent Spar and the parts were used to extent the harbor facilities of Stavanger in Norway
- 1996 General prohibition on disposing redundant facilities at the bottom of the ocean
- After the initial permission from the relevant UK authorities
  - No violation of law or regulations.
  - Debatable whether dismantling Brent Spar was better for environment

- Assessment of environmental damage: nothing extraordinary; is also undertaken in economic evaluation of environmental protection

Still, a scandal with dire consequences for Shell and demonstrated that corporations can lose control of public communication, even though they have broken no laws.

3. Business and society

- The two cases exemplify public debate on the safety of producing goods and environmental challenges
- They are also symptomatic for a problematic relation between business and society rooted in traditional political conflicts
- Public hostility towards firms – towards the corporate world – can lead to business hostile political developments
- Firms depend on the support of the population => there has to be a certain level of trust between firms and their the and the general population

<u>Symptoms of lacking trust between firms and civil society</u>

Greenwashing: Firms offering green products, which are not really green.

1) McDonald's replacing plastic straws with papers straws. Paper straws cannot be recycled and their sourcing and production have raised questions
2) Royal Dutch Shell committed to reduction of CO2 emissions and at the same time exploring new opportunities for oil and gas production
3) "Coca-Cola Life" as green version of Coca-Cola.

Places the responsibility of environmental pollution on the corporations and corporations reply be engaging in less projects with low credibility

4. Business ethics as Business Strategy: Trust

OECD's definition of trust:

1) A person's belief that another person or institution will act consistently with their expectations of positive behavior".
2) The willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor irrespective of the ability to monitor or control that other party." (Mayer et al., 1995, S. 712, Lütge & Uhl p. 248)

Trust as reciprocal altruism: A is altruistic towards B in the expectation the B will eventually return the altruism.

Trust saves **transaction costs** from economic perspective
Economic perspective on ethical concept of trust: How can trust be built and maintained in modern society? Which risks arise?
"The definition of trust proposed in this research is the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor ".

Trust correlating with prosperity
High level of social trust requires predominantly predictable and law-abiding behavior
Trust has a positive effect on prosperity of a nation for the following reasons:

1) General trust in fellow citizens increases the willingness to cooperate and build business relations with people outside immediate social biotope.
2) Trust and being trustworthy reduces transaction costs by making time consuming contractual agreements redundant
3) Trust reduced the risk of lawsuits because issues can be solved in informal communication
4) Trust as social capital: Trust in multilateral relationships. If A trusts B, then others will also trust B. Multi-lateral trust as social capital requires string institutions who can impose sanction

5. Business Ethics as Business Strategy: Social Capital

Example: **Alumni associations**
Graduates can expect support from each other, even if unknown
Social capital thus facilitates interaction and saves resources: no costly and time-consuming controls

Protection of social capital: By sanctions in case of misuse of trust

- Sanctions can be imposed by contracting party or third parties
- Due to implicit nature of contracts: sanctions of informal nature, such as damage to reputation, public disregard or social exclusion

Even in globalized world, moral misconduct becomes risk factor for businesses (e.g. legal consequences of bribery)

6. CSR as Business Strategy: Social Capital

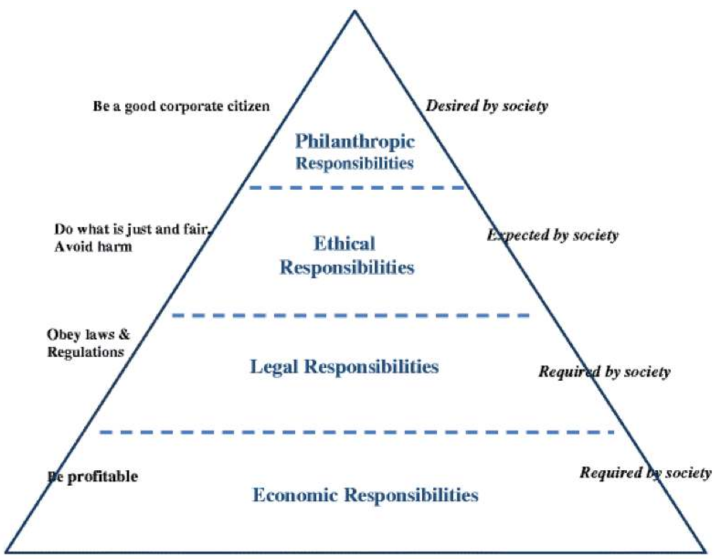
Corporate social responsibility manifesting in relations of trust between corporations and citizens
Theoretical positions described in this lecture describe different manners in which to strengthen trust between firms and citizens, either

1) Strengthen business and free market economy (Friedman)
2) As a company focus on the interests of stakeholders
3) Accept responsibility for finding solution to social problem (Shared Values)

7. 1979: Archie B Carroll: Pyramid

Different levels of responsibility:

- Economic and legal responsibilities as fundamental and preconditioning other responsibilities
- Ethical standards: Expectation exceeding Legal requirements
- Philanthropic responsibilities: Active commitments to promoting the common good



- **Economic** responsibility is fundamental because society expects of companies that they are capable of sustaining themselves. Lack of profitability would drive the firm out of business.
- **Legal** responsibilities: Ground rules as codified ethics. Compliance as condition for license to operate and for an effective economic system. Corruption and mistrust undermines effective business practices.
- **Ethical** responsibility: Living up to normative expectations of society which are not codified in legislation. For example: Global corporations' conduct in countries with more lax regulations
- **Philanthropic** responsibilities: Active commitment to promote good. Example: Encourage employees to participate in charity work

<u>Challenge of Carroll's pyramid:</u>

Ethics and philanthropy are conditioned by profitability. You can only follow ethics if the economic conditions are good.

=> Identifying the level at which a corporation has satisfied its economic responsibility

Significant difference between **the level of profitability at which the public believes** that a corporation has satisfied its economic responsibility
and
The **level of profitability at which the company believes** the economic responsibility is satisfied

From the perspective of company profits should be retained for consolidation
The public would expect higher commitment to ethical responsibility and philanthropy on the basis of lower profits.

8. Stakeholder theory

Expression used by Stanford academics since the early 1960s.

Most importantly in 1984 by: R. Edward Freeman:
Publication →Strategic Management. A Stakeholder Approach.

Stakeholder: Person or group of persons with an interest in the company.

Stakeholder theory emphasizes the common interest of the firm and all the stakeholders.

Friedman: Management of firms are obliged towards all their shareholders.
Freeman's stakeholder theory encourages firms to take into account all stakeholder concerns.

Task of management. To balance a multiplicity of interests of sometimes conflicting interests of stakeholders.
Strategies for balancing interests of stakeholders:

1) Specific stakeholder strategy: Maximize benefit for what is believed to be the most important stakeholder(s).
2) Utilitarian strategy: Maximize benefits to all stakeholders (within means)
3) Rawlsian strategy: Raise the level of the worst-off stakeholder. Maxi-min strategy.

Employees may require higher wages and shareholders' investment in production
Conflict between consumers desire for cheap products and their requirement for a cheap environment

Essential claim of Stakeholder Theory: Firms benefit from taking the interests of stakeholder into account. If they can affect the firm, the firm should deal with them.

<u>Challenge of stakeholder theory</u>

The increasingly critical civil society has often blamed firms for using stakeholder management in particular and CSR in general strategically. Accordingly, it is not real CSR if it benefits the firm.
This creates the following dilemma for businesses

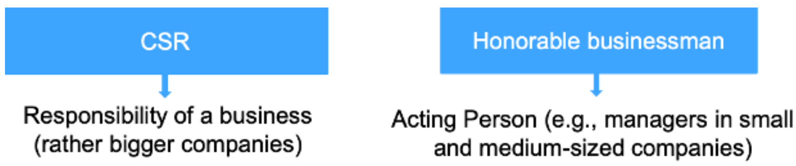
I) As moral obligation: Stakeholder theory as requirement for moral surplus => untenable in competitive market economy
II) Stakeholder theory as empirical claim: Considering the interests of stakeholders beyond legal obligations increases profit – controversial claim
Claim valid in societies with strong civic society and for corporations with high public exposure and replaceable products (VW, H&M, Shell)

Dilemma: If stakeholder management is purely strategic, i.e. only caring about stakeholders because it increases profit, there is no difference between Friedman's shareholder focus and Freeman's stakeholder management.

Freeman in interview: "I actually think if Milton Friedman were alive today, I think he'd be a stakeholder theorist. He would understand that the only way to create value for shareholders in today's world is to pay attention to customers, suppliers, employees, communities and shareholders at the same time."
- If Friedman and Freeman are coherent: Then the theory is in no need of moral surplus.
- If stakeholder management is meant as a moral obligation to take the interests of stakeholders into consideration, Freeman is asking for "Moral Surplus"

9. The challenge of Moral Surplus

9.1 CSR as Moral Obligation: The Honorable Businessman



- Promotion of ethical behavior of legal person (in form of enterprise) →character of entrepreneur
- Individual ethical concept (moral demands on individual)
- Virtue-ethical approach (strong connection to individual character traits and virtues)

9.2 CSR as incorporating the honorable businessperson

Many professional groups have guiding principles, e.g. doctors, lawyers, etc.

Statute on the Provisional Regulation of Law of Chambers of Commerce and Industry
§ 1
"... It is incumbent on them in particular to support and advise authorities through proposals, expert opinions, and reports and to work for the preservation of the decency and customs of the honorable businessman."

There are numerous models in various organizations and associations that define virtues of honorable merchant, but: Principles derived from these virtues are indeterminate and abstract.

9.3 Concept of Honorable Businessman

Lack of a unified basis of concept → historical and conceptual approximation necessary
Businessman (m/w) refers to economic subject who conducts any kind of commerce (purchasing and reselling/production and distribution) with degree of autonomy

9.4 Concept of Honor

- Interpretation of term only possible within social context Which actions are considered "honorable", "venerable", etc.?
- Term consists of Old High German root êre and the Greek term for "good reputation" (emphasizes social character of term)
  →An action is honorable if it is assessed positively by society (e.g. if it meets/ exceeds norms)

Dual concept of honor:

- Internal honor:
  Feelings of individual itself regarding its conscience (recognition of other people necessary!)
- External honor:
  Evaluations of social group (mostly outsiders)

Concept of Honorable Businessman Today

Harvard Business School has issued MBA Oath for graduates to ensure "ethical conduct" in business-related decisions (voluntary signing!)

Commitment to:
- Not promoting their own interest at expense of their company or society
- Rejecting corruption and avoiding business practices that harm society
- Supporting management profession as whole, acting ethically and create sustainable prosperity
- Reinforcing integrity and confidence in oneself through one's own behavior

10. Criticism on individual ethics

External concept of honor: intercultural differences and historical fluctuations in meaning.
- Different markets require different behaviors in order to get social recognition of respective society
- Concept of honorable businessman is not stable
- How can ethical model be implemented against background of value pluralism?
- Divergences in evaluation of actions even within cultural circle

Concept of honorable businessman cannot act as guideline!

Free market economy: Demand for honorable businessman can become superfluous, since companies have vested interest in being perceived as "honorable" and respectful.

Is inner motivation to act with great honor relevant?
- Businessman would not be honorable if he or she did not act out of intrinsic motivation, but do purely instrumentally what is expected from him or her

Trust: trust-based relationships are very important in business ethics

Concept of honorable businessman has fallen out of time:
- ⇨ Concept comes from time, in which economic system was much simpler than today (Late Middle Ages: no large organizations with complex chains of action and responsibility).

Modern world: individual ethics meaningful on conditional level!

⇨ Need to implement ethical values in form of institutions and rules

Plea to individuals to behave ethically are unenforceable unless competitors behave "honorably" as well.

Confidence-inducing performance of businesses essential, but mainly for purpose of creating reputation (investment in future)
→ Concept of honor seems unnecessary, even threatening

Concept depicts company's untimely normative ideal

Honorable businessman suggests a "trustworthy, proper official“

But: Dynamics and entrepreneurship should not be in the background!

Ethics necessary for a modern, dynamic society.