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The Production of Business Ethics

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In this article, we outline a conceptual framework for dealing with implementation problems of business ethics. To the extent that implementation consumes scarce resources, it is from the economic point of view a problem of production. As such, it can be analyzed with the customary tools of economic analysis. In our comparative approach, we contrast the production of business ethics with the spontaneous emergence of business ethics in the market process. We also compare it to forced ethics (the imposition of ethical codes of conduct by private parties) and to fiat ethics (imposition by legislation and other authoritarian acts).

Business ethics deals with practical problems of moral decision-making within firms. It has been relatively unconcerned about the systematic analysis of the *implementation* or application of business ethics.[1] Such analysis would have to start at a rather fundamental level, asking questions such as: Why do people choose to adopt *any* ethical orientation in their business? Why and to which extent do they invest any scarce resources to promote such orientation? In a next step, one would have to deal with the adoption of business ethics under the division of labor, asking questions such as: What role does it play whether people agree or disagree on such issues? How can disagreements on ethics be dealt with in firms? What are the possibilities and limits of coercing people to adopt certain ethical orientations?

As these questions show, the systematic analysis of why and how business ethics is in fact put into practice raises problems that transcend the realm of business. We believe that, ultimately, such questions can only be settled on the basis of a general theory of the *production* of ethics, which at present does not exist. However, it might be useful to approach the elaboration of such a theory by focusing, in a first step, on the production of ethics in a commercial context: the production of *business* ethics. This is what we purport to do in the present article, within a comparative theoretical framework.

A number of recent works have dealt with such implementation problems by focusing on the scope of political imposition of ethical norms on business. See for example Paine (2000); Waldkirch (2001); Cuesta Gonzáles and Valor Martinez (2004); Cavanagh (2000, 2004); Izzo (2004); Heath and Norman (2004); and Buchholz and Rosenthal (2004). We will develop these different strands of argument by strictly focusing on positive (rather than normative) analysis and by arguing step by step from basic principles.

We will first study the nature and conditions of the production of business ethics on a hypothetical free market, in which ethical codes of conduct are chosen on a completely voluntary basis. Then we will examine the consequences of the imposition of such codes through legislation or other authoritarian acts.

Business Ethics on a Free Market

Choosing One's Ethics

A free market is commonly defined as social cooperation based on the respect of private property rights (see Hazlitt 1994, 303; Lecaillon 2001). In a *completely* free market, each individual would therefore be free to use his body and his material belongings—but only *his* body and only *his* material belongings—as he sees fit. In particular, he would be free to adopt a great variety of ethics—defined as any set of precepts or "ought" propositions—as an orientation for his conduct. He would be free also to make the respect of his ethics by other human beings a precondition for cooperating with these persons. This concerns especially cooperation in a business setting.

At first glance, a free market seems to be a place of anything goes in ethical terms. If ethics is a matter of choice; if people are completely free, within the boundaries of their property to choose their own business ethic, then there seems to be a natural tendency within such a free market for ethical standards to lose (or never to have in the first place) any larger social validity and to evaporate into the thin air of subjective preferences and desires—into "dust and powder of individuality" (Burke 1999, 96). In particular, firms and other business organizations might then tend to be ethical eunuchs, as seems to be implied in a venerable tradition of economic thought (Mandeville 1989; Wicksteed 1910; Friedman 1970).

However, on a free market, business ethics would not in fact tend to disintegrate. In what follows, we will highlight two mechanisms by virtue of which businessmen and firms come to adopt moral principles as a foundation of their activities. On the one hand, there is here a tendency for the *spontaneous emergence* of a basic canon of business ethics by all market participants and also for the emergence of a specific professional deontology in each branch of business. On the other hand, there are incentives to *produce* business ethics, especially in the form of market-niche specific ethics, as a response to the moral notions that dominate the social environment of the firm.

The Spontaneous Emergence of a Basic Canon of Business Ethics

The very existence of business is premised on certain very basic ethical postulates.[2] In particular, from a legal point of view, the essence of business is to exchange property rights.[3, 4] A businessman *buys* factors of production such as raw materials, tools, and labor services; and he *sells* goods and services to his customers. Now buying and selling presuppose certain agreements between buyers and sellers, and one of the points on which they have to agree—admittedly a point that is so basic that it is hardly ever even mentioned in contracts—is that each party accepts and affirms the ethical postulate of private property rights on the side of the other party. The businessman accepts that his prospective customers are the legitimate owners of their money, and he wishes them to exercise their property right to buy his goods or services. Similarly, he accepts that his employees own themselves and wishes them to exercise their property right by deciding to work for him.

Without agreements on these basic questions, no business could exist at all. The mutual affirmation of property rights is a condition of the very possibility of business. It follows that property rights are a natural point of convergence in business ethics. *Any* businessmen *must* agree on them at least as far as his commercial interaction is concerned. He could hardly attract customers if the latter had to fear being beaten, robbed, or murdered if they came too close to him; neither could he then expect to have any employees or suppliers.

This universal *practice*, as far as the world of commerce is concerned, cannot fail to reflect on the *thinking and mentality* of businessmen. By the very nature of their activities, businessmen are inclined to consciously endorse the legitimacy of private property as an ethical postulate—lest they would have to live with a basic contradiction between what they practice and what they preach. Thus, there prevails in business communities a tendency for the spontaneous (freely chosen) convergence of all persons toward such an ethics, a tendency that would exist even if there were no common moral authority or institution that would steer or coordinate the convergence process.[5]

However, the spontaneous business ethics of the market that results from the practice of business is not limited to the legalistic respect of property rights and to related virtues such as honesty and justice. Doing business also stimulates the adoption of moral attitudes and orientations that facilitate cooperation. It encourages the spirit of cooperation, the habit of keeping one's promises, and the readiness to take risks. It rewards prudence, science, foresight, frugality, and efficiency.

In short, the basic canon of business ethics that is likely to emerge on the free market is one of traditional or bourgeois morality.[6] It follows that business is an important driving force for developing, spreading, and preserving this type of morality as a universal basic model of ethical conduct throughout the world (see Schumpeter 1942, chap. 11; 1954, pt. 2, chap. 3, sec. 1). Everyday experience in our age of the global economy confirms this: On the planetary scale, there is no true consensus among the different business communities concerning a great number of ethical issues such as the reality of environmental threats or democracy in the work place. However, there is a common basic outlook on what it means to cooperate and to be a decent business partner. Apart from the arts and the sciences, no international community is as tightly interwoven as the business community. Historically as well as financially, business precedes the arts and sciences.

To sum up, business is not a moral no-man's land. It *does* stimulate the development of a certain number of human qualities that are commonly regarded as virtuous.

Now one could argue that this is a one-sided presentation of things because business *also* encourages vices such as greediness and cold-heartedness. However, even if business were the root of certain vices, it would still not be morally neutral. It would still have a definite moral nature combining as it were a mixed bag of virtues and vices. Moreover, by its very nature, business confines its vices, whatever they are, within fairly narrow limits. The basic fact is that whenever entrepreneurial greed or indifference comes at the cost of an employee, a supplier, or a customer, it cannot fail to create a bad reputation for the malefactor. It then tends to reduce the willingness of potential victims to cooperate with the perpetrator, and thus profit margins dwindle and revenue falls. Business *incites* businessmen to cultivate their virtues—and tough competition *forces* them to do this. Business punishes their vices as soon as other people are negatively affected and therefore acts, as a tendency, against such vices.

One could also object that business thrives at the expense of its competitors and that it therefore does not encourage, as we have contended, a spirit of cooperation but a spirit of strife and rivalry. However, as long as private property rights are respected, competition cannot come at anybody's expense in the sense that it destroys physical property. Competition can merely reduce the *market value* of the products of the less successful competitors (see Hoppe and Block 2002). It is true that such reduction can entail losses and bankruptcy, but this does not imply physical destruction and death, as in a jungle setting. Rather, bankruptcy entails a reshuffling of industrial organization. Labor and other factors of production formerly used in the now defunct firm are employed—at lower prices—in *other* firms or industries. Thus, cooperation continues in an open-ended process of creative destruction (Schumpeter 1942, chap. 7; Mises 1998, chap. 15; Acton 1993, 73; Cahuc and Zylberberg 2004). In other words, competition-induced bankruptcy by its very nature is a *transitory* phenomenon. The *usual* social relationship, both within firms and among firms, is to cooperate with one another.[7]

The basic canon of business ethics is not necessarily applicable in all its elements to other strata of social life. It is certainly not sufficient as the sole moral foundation of society. The fact remains, however, that business by its very nature stimulates the development and preservation of a *certain number* of ethical notions. These in turn correspond to a certain number of traditional virtues (Acton 1993, 56) and facilitate peaceful human coexistence even outside a business context. There is more to human life (and more to ethics) than basic business ethics, but this falls outside of the scope of our present concern.

The Spontaneous Emergence of Specific Canons of Business Ethics

For reasons very similar to the ones we have just discussed, there is a tendency on the free market for the spontaneous development and adoption of a specific professional canon of ethics in each line of business. In fact, the *quality* of any particular product or service depends on specific moral virtues. For example, a teacher will be good at his job to the extent that he has (1) the ability and willingness to understand the individual personality of his students, (2) thorough command of one or several fields of knowledge, and (3) the ability and willingness to rouse interest—even enthusiasm—for learning. Similarly, a soldier will be good at fighting to the extent that he has (1) a thorough command of military techniques, (2) the ability and willingness to obey commands even under severe duress, and (3) bravery and vigorousness in the presence of personal danger. In short, different professions excel by cultivating *different* ethical codes. Because customer choice depends on quality or excellence of the service rendered, there is on the market a tendency to reward those producers who live up to the ethical code most useful in their particular field of activity and to weed out those who do not. Scholars who care for their students tend to get jobs as teachers; indifferent morons do not. Brave men with a high presence of mind and independent judgment have a higher chance to become generals than do sleepy cowards.

As in the case of the basic canon of business ethics, the moral canons specific to each line of business do *not necessarily* come to be adopted through the conscious efforts of the persons involved. Even if no such effort were made, there would still be a tendency for those specific canons to emerge spontaneously. The reason is that the market process acts as a filter separating the better from the worse producers. Those who survive in an industry for any significant period of time probably have the moral disposition it takes to be successful in that industry. Additionally, because practice is likely to reflect on consciousness, all members of a profession are likely to agree on professional deontology—on a set of moral principles that promotes quality in their field.

Let us emphasize that these specific canons by their very nature do not contradict but rather supplement the basic canon. They provide ethical specifications layered over the stipulations of the latter. The basic canon of business ethics concerns for-profit cooperation in general, irrespective of the product, whereas the specific canons concern the product. Ethical conflict is therefore unlikely to arise in a business that operates in just one field. However, it can arise in firms operating in several industries that require different, or even opposite specific orientations. Thus, business ethics is a factor in determining profitable industrial organization.

The Production of Basic and Specific Business Ethics

So far, we have argued that basic and specific ethical orientations in business are not necessarily the result of any conscious effort. They *can* emerge, and do tend to emerge, as a mere side effect of the very nature of doing (a certain type of) business. Of course, they can also emerge when the persons involved explicitly desire to promote these ethical orientations by using time, money, and other resources. In this case, we will say that they produce business ethics.

We can define the production of business ethics as the choice to dedicate scarce resources to promote the *acceptance* of the desired ethical orientation by other people (in particular, by other members of the firm) and to promote the *perception* of the firm as being dedicated to this ethical orientation. For example, the production of business ethics is usually part and parcel of professional training, in which the trainee not only acquires intellectual and physical competence but also imbibes the ethical orientations deemed to be important for excellent service. Another standard example would be the development, adoption, and implementation of a code of conduct in which the firm's ethical orientation would be defined (overview in OECD 1999; discussion in Cavanagh 1998, 2004 and in Cuesta Gonzáles and Valor Martinez 2004). We may also think of more unconventional cases. Thus, a firm might also produce some of those basic services that are commonly provided by government, such as security, schooling, or relief for the poor.

The crucial aspect that comes into play with the production of business ethics is the consumption of scarce resources. While the spontaneous emergence of business ethics that we discussed above is costless, its production is costly and thus affects the bottom line. It follows that there is an incentive to manage it. Under competitive pressure, it will tend to be managed according to the principle that also applies in all other activities of the firm: Maximize the monetary return on investment. Money invested in the production of business ethics is no longer available for projects that could otherwise have been realized with those funds. The yield of the former must therefore be at least as great as the latter. Business ethics will therefore tend to be produced only if this production makes a positive contribution to the firm's bottom line. Suppose that a firm considers ethical training of its apprentices in order to improve product quality, with the prospect of increased sales. Then its calculus could look somewhat like this:

+ Additional selling receipts due to higher quality of product or service
+ Reduced expenditure on next-best competing project
– Revenue foregone in next-best competing project
– Additional expenditure on the trainee program to increase its ethical component
= Marginal impact on the bottom line

The modification of the trainee program is worthwhile only if the bottom line in our stylized calculus is positive. Of course the entrepreneur or manager is free to modify the program anyway, even if its net contribution can be expected to be negative. Then, however, he would consume the firm's capital and undermine its future. Only in a noncompetitive market could a firm afford to disregard these constraints (see Barry 2000). Thus, a negative contribution to the firm's bottom line will discourage the production of business ethics (as it would discourage the production of anything else). No productive effort is then likely to take place to promote the basic canon of business ethics or the firm's specific professional deontology. The company will simply have to rely on whatever level of suitable ethical orientation spontaneously exists in its social environment and among its owners, management, and employees.

The Production of Market-Niche Specific Business Ethics

The production of business ethics according to the basic canon of business ethics and to the firm's professional deontology pursues a goal defined by the very nature of business in general and by the very nature of the firm's activities. The entrepreneurial choice concerns only the means: *which* are the best means to pursue these goals, and *how many* resources should be spent on acquiring these means? The production of business ethics can also go beyond these more or less permanent ethical orientations. It can also seek to promote orientations of a more contingent and specific nature. With this aspect, we need to deal now. In the light of very basic economic considerations, we shall argue that more specific types of business ethics can under certain conditions increase a firm's profitability.

In order to explain the production of business ethics beyond the basic and specific canons that we have discussed, it is useful to distinguish two motivations that come into play in human action. On the one hand, the acting person might wish to realize the direct consequences that follow naturally from his action. This is typically—but not exclusively—the case in acts of consumption, such as sitting on the beach, drinking soda, eating ice cream, reading a novel, and so forth. On the other hand, he might not himself desire the natural consequences of his activity, but still engage in this activity to obtain a payment. The payment in turn might be desired for itself, such as when I cut a stack of wood in exchange for a hot meal, or it can be a monetary payment such as ten euros, which I do not desire per se but that I can use to buy things that I desire, for instance, a hot meal.

Action for payment is of course a crucial element of the division of labor and in particular of business. It is what drives virtually all entrepreneurs, capitalists, and employees. Few people if any in the business world act out of pure charity or for the mere enjoyment of their activity. The payment motive or, as it is sometimes called, the profit motive is always present in business cooperation.

However, the omnipresence of the profit motive does *not* imply that it is the *only* motivation in operation. Usually the persons cooperating with or within a firm have other motives as well, in particular, their ethical orientations (see Falgueras Sorauren 2000). Let us see what this implies in the case of consumers, employees, and entrepreneurs.

The product that consumers buy cannot, in most cases, be defined in purely physical terms. Consumers buy a physical object plus an entire package of cultural appeals; some of these are the ethical aspects of the product. The latter can be strong, as it is at present, in recycling paper or fair-trade coffee; it can be weak, as it is now, in carpets or socks; and it can be negative, as it is today in hair spray. In any case, the presence of an ethical appeal, if it is strong enough, can increase payments for the product. As a consequence, there is an incentive for the entrepreneur to produce this appeal; for example, by choosing a suitable corporate ethic for his firm.

The same mechanism comes into play once we turn from consumers to the suppliers of the firm and in particular to employees. As any human resource manager knows, employees do not only wish to get a paycheck for some abstract activity out of context. The paycheck and the activity come in an entire package of related features, such as the location of the workplace and the character of the coworkers. One part of this package deal is, again, the ethical appeal of the job, which can be strong, weak, or negative, as in the case of the consumers' good. The stronger the ethical appeal, the lower can be the monetary remuneration of the job; in fact, many people volunteer to work for charitable institutions or for organizations such as Greenpeace. The weaker the ethical appeal, the higher the salaries must be to compensate the employees for accepting the job despite its ethical repulsiveness. Entrepreneurs therefore have an incentive to produce a strong ethical appeal for the jobs they offer.

However, this incentive needs to be balanced with the nature of the firm's business. While all specific canons of business ethics are natural supplements to the general canon, there is the possibility of ethical conflict between specific canons if the firm operates in distinct industries that require different—potentially incompatible—virtues to be successful (a military base running a kindergarten; a fashion house operating a quarry). Such conflict becomes much more probable in the case of ethical catering to market niches. Here, the ethical preferences of the firm's social environment have to be layered over the basic and specific canons of business ethics. Yet, there is no reason why these ethical orientations should necessarily reinforce one another or be, at least, complementary. For example, the policy of firing at will without notice might be perfectly ethical from the point of view of the general canon of business ethics, while the firm's customers and employees despise it.

The Production of Ethical Cohesion Within the Firm

We have seen that conflicting value judgments adversely affect the bottom line through their direct impact on contracts. Now we need to analyze how they affect the bottom line in a more indirect way, namely, through their impact on the efficiency of cooperation *within* the firm.

If the people within the firm—owners, management, and employees—have antagonistic ethical orientations, then they will tend to cooperate less smoothly and, therefore, less efficiently. Internal strife and even sabotage might result from the antagonism between nationalists and cosmopolitans, statists and anarchists, Catholics and Muslims, feminists and paternalists, nonsmokers and smokers, and so on. The result in all cases is to increase the per-unit cost of output. Thus, conflict within the firm tends to reduce the bottom line below the level it would otherwise have reached.

Good management will try to counter such antagonism in various ways: by avoiding perceived troublemakers early on in the hiring process, by education toward greater tolerance, by mediation in case of open conflict, or by common social activities that increase the internal cohesion of the company. The least costly strategy seems to consist in hiring only such people who fit into the ethical profile of the company. In any case, the production of internal cohesion is costly.

These considerations suggest that there are significant disincentives for a firm to produce a corporate ethic that would commit it to take a strong stance on a widely contested ethical question. Firms will tend to endorse only those ethical precepts that are (1) part of the basic business canon, (2) part of their specific professional deontology, or (3) widely accepted within society. Thus, to the extent that there are changes in business ethics, these are likely to reflect the changing ethical orientations of society in general, such as nationalism in the 1930s and feminism and environmentalism in our day.

Ethical Preferences of Business Decision-Makers

What about the capitalist-entrepreneurs themselves? They might have strong ethical convictions, in which case they would put their money into projects that harmonize with them, even if they could expect to earn a higher return on their investment in another, less ethically appealing project.[8] Or they might not have any strong ethical convictions, in which case the profit motive would have a relatively stronger impact on their choice. However, in the long run, the personal preferences of the entrepreneurs are comparatively unimportant for the choice of a firm's ethical identity—for its business ethics. The reason is that market competition operates as a selection process to the advantage of the most profitable business ethics. Suppose, for example, that an entrepreneur considers increasing the ecological profile of his company by a suitable advertisement campaign highlighting his donation to the World Wildlife Fund. Then his calculus looks somewhat like this:

+	Additional selling receipts from customers honoring the WWF donation
+	Reduction in salaries of employees cherishing the firm's greater ecological profile
-	Lost selling receipts from customers opposed to the WWF
-	Increase in salaries of employees disliking the firm's greater ecological profile
-	Expenditure on the advertisement campaign
-	Donation to the WWF
=	Marginal impact on the bottom line

Of course our entrepreneur is free to pursue the campaign anyway, even if its net contribution promises to be negative. Again, in this case he would consume his capital and thus undermine the future of his firm.

Things appear to be somewhat different in corporations. Here, the managers enjoy a relatively great amount of discretion because they are only loosely controlled by shareholders. They could therefore afford to pursue personal ethical goals at the expense of capital profitability. However, even in corporations, there is still the ultimate threat of an unfriendly takeover. Managers who use their power to pursue projects of their own liking against shareholder interests turn their corporation into a sitting duck for takeover and restructuring (Manne 1965, Jensen 1988). As long as shareholders have the power to appoint their managers, the mere threat of takeover is likely to reign in any serious attempt to pursue ethical objectives that are not also profitable.[9]

The Optimal Production of Business Ethics

We have underlined that business ethics, because it is a factor of production, *can* be produced and in fact tends to be produced under the impact of competition. Now we need to stress that any type of production—because it is costly—is subject to the law of diminishing returns. There is therefore an optimal amount of resources for each firm that it can invest into the production of its ethics and that maximizes the bottom line. Moreover, there is for each firm an optimal balance of producing very different—and sometimes opposite—ethical orientations.

In other words, entrepreneurs, precisely because they are entrepreneurs, cannot afford to be ethical purists.[10] They can, of course, refuse to provide products such as meat and furs to people who wish to buy them. They cannot, without being punished by the market, invest indefinite amounts of resources into eradicating deviations from an ethical ideal. They cannot, for example, afford to crusade against corruption no matter the costs in terms of time and money. At some point, further ethical investment will be discontinued because its marginal impact on selling receipts does not justify the additional expenditure. Similarly, they cannot pursue just the one ethical orientation cherished by its social environment if this comes at the cost of product quality; or, inversely, just apply the ethics needed to improve the product while disregarding the (possibly opposite) ethical sensibilities of its customers and employees.

The particularity of business is that it can balance all these different ethical needs with the help of the monetary calculus. Conflicting ethics can be reconciled, in any case for the firm, on the bottom line.[11] Moreover, the same calculus can be used ex post facto to evaluate the decisions of the past. Profit and loss provide an objective criterion for judging whether the right balance in business ethics, from the point of view of the firm, has been found.

It is true of course that there is no reason why ex-ante monetary calculation should be an infallible guide to finding the right balance in business ethics. By its very nature, the production of a corporate ethic is a more or less long-winding process, and its parameters are therefore shrouded in uncertainty. Our entrepreneur does not simply have to consider the present-day ethical sensibilities of his customers and employees but also those of the customers and employees of the future. The presence of uncertainty makes it impossible to predict a priori which corporate ethics would be suitable for which firm. Entrepreneurs have to test the market for corporate ethics by trial and error. The selection process of the market then operates as a "discovery procedure" that will reveal, ex post facto, which corporate ethics worked and which did not (Hayek 2002).

Forced Business Ethics

So far, our analysis was predicated on the hypothesis that the private property rights of each market participant were scrupulously respected. Now we will drop this assumption to study the consequences that result when the endorsement of an ethical orientation is forced upon one or more market participants. Let us first consider an example to illustrate the meaning of forced ethics.

Smith is the employee of a firm run by Green. At the end of the month, when he comes to pick up his paycheck, his boss tells him he will hand the check over only if Smith publicly recites three times a Hail Mary (publicly thanks Allah the Almighty, publicly condemns Jesus for his blasphemy against Yahweh, and so forth). If no such action were stipulated in the contract between Smith and Green, then Smith would be the rightful owner of the check even if he refused to do what Green demands. The latter therefore violates Smith's property rights.

Clearly, such burlesque cases are imaginable but in practice are exceedingly rare. The reason is, of course, that Smith could enforce his legal claim against Green with the help of the judiciary and the police. As long as law enforcement—the production of security—works only somewhat efficiently, Green could not get away with his refusal to pay Smith according to their contract. Moreover, Smith is not likely to long remain an employee of Green. The latter has tarnished his reputation by attempting to withhold property belonging to his employee. His attempt to impose the respect (or even endorsement) of his personal ethical orientation on Smith is likely to permanently increase his costs of production. Henceforth, people will tend to make deals with him only if he offers better conditions than before, thus compensating them for the risk of exposure to Green's latent authoritarianism. As a tendency, therefore, Green must sell at lower prices and pay more for the factors of production, in particular, higher salaries for his employees.

Forced business ethics of the sort we just considered therefore tend to be ruinous for its perpetrators. It is for this reason unlikely to play any large role in society.

Government and Business Ethics: Fiat Ethics

Things are very different in the case of fiat ethics. Here the government, usually through legislation, imposes on firms the obligation to take action (spend money and use other scarce resources) to facilitate the attainment of goals that are justified in the name of a distinct ethical orientation. Not only is the firm forced to do things that it otherwise would not have done, but there is also no recourse against this imposition—after all, government is by definition the monopoly provider of security services. In what follows, we first analyze its consequences for morality in business. Then, we will deal with its costs and the limitations implied therein. We will conclude with a discussion of its benefits.

Fiat Ethics and Business Morality

Fiat ethics can seek to promote the realization of basic and of specific codes of business ethics. In this case, it would prescribe a higher level of production than would have occurred on the free market. Examples would be laws against insider trading or laws against discrimination in hiring decisions. Fiat ethics can also compel the pursuit of specific ethical goals that the capitalist-entrepreneur would not have pursued at all. This could for example be the case when the law imposes certain measures to protect the environment or to live up to certain standards of employee protection.

The law is a factor shaping national mentality and the institutions of the market, a fact with which lawmakers are perfectly familiar and of which they take due account. It follows that the law can be a vehicle to shape the ethical orientations of the population. For example, if the law prescribes measures to protect the environment, then the goals of environmentalism have greater prominence than they otherwise would have had, which, in turn, cannot fail to reflect on the mentality and decisions of people, both inside business and outside of it. The greater prominence of those more specific ethical orientations implies, in turn, that the relative importance of the traditional morality enshrined in the basic code of business ethics declines. The same holds true for the relative importance of professional deontology.[12] In the long run, the ethical orientations created by the law may then go so far as to bring about distinct types of capitalism. Thus, today it is customary to distinguish Anglo-American capitalism from Rhineland capitalism and from the Japanese model of capitalism (see Albert 1998).

However, the impact of fiat ethics on the ethical orientations of the population must not be naïvely supposed to go hand in hand with any positive impact on the morality of the population. Empirical studies show no positive impact of compulsory ethics education on cognitive moral development. The author of a recent study concluded that “whoever coined the phrase ‘you cannot legislate morality’ was probably correct, as it seems that the ‘force-feeding’ of ethics education does not work either” (Izzo 2004, 237). Other authors argue that imposed ethics tends to make people indifferent to ethical questions. It is, in fact, impossible to speak of genuine morality if the law prescribes a certain conduct (see Barry 1998).

Notice also that the shift in the relative weights of possible moral orientations goes hand in hand with a contradiction between the basic code of business ethics and fiat ethics. The former revolves around the respect of private property rights; whereas the latter by its very nature is premised on (at least partial) infringements of private property. Fiat ethics is a product of the law, and the law is backed up with the power of the state, that is, with the threat of physical punishment and expropriation. It is not possible to avoid this conflict through industrial reorganization or other adjustments. This leads us to our next topic.

The Costs of Fiat Ethics

The production of fiat ethics by its very nature tends to be unprofitable. The reason is straightforward: If the level of production imposed by the law were profitable, then it would be in the entrepreneur's self-interest to do it anyway. The very point of forcing the production of business ethics with the help of the law is that this production would not otherwise take place. The firms (whether rightly or wrongly) do not perceive it to be in their own interest.[13]

This basic fact needs to be qualified in one respect: The law does not usually have the same impact on all firms. For some, the level of ethical production prescribed by the law might be just what they would have chosen anyway; others might actually go beyond the stipulations of the law and do much more to realize its goals. Still, it would be the case that at least some firms would be negatively affected by the law.

This implies on the aggregate level that fiat ethics by its very nature tends to diminish production and thus to reduce the living standards of the population.[14] Moreover, there is a monetary incentive for the firms that would be least harmed by any fiat ethics to lobby for its imposition, hoping thereby to gain a competitive edge over other companies (see Stigler 1971). This political rent-seeking produces an impoverishing effect: More resources are dedicated to changing the law rather than producing goods and services for consumers. There is also a redistribution effect: Payments to lawmakers, lobbyists, lawyers, and so on will increase, whereas disbursements to people employed in production for consumers will decrease.

To these direct costs of fiat business ethics we have to add an additional amount related to the enforcement of the law. Monitoring the implementation of fiat ethics necessarily involves hiring additional people (for example, a workplace security officer or an equal-opportunity officer) or setting up government agencies entrusted with this mission. Moreover, each new law entails a higher volume of litigation and thus still more resources consumed in the judicial process.

Finally, in the long run, fiat ethics may increase the costs of adjusting the structure of production to new circumstances. The differences between the various capitalist models spring at least to some extent from the fact that these economies are subject to different legal systems, which in turn emanate from country-specific fiat ethics. Ethics enshrined into the law may hamper fast changes in the structure of production; for example, by opposing the discontinuation of labor contracts or by urging subsidies for insolvent firms.

Because of its costliness, fiat ethics creates an incentive for capitalist-entrepreneurs to evade it, for example, by moving operations to a different country. If no better investment alternatives are available abroad, the capitalist could simply diminish his investments and consume a greater share of his income; or he could discontinue any further investment, allow the existing facilities to depreciate, and then close up shop.[15] In any case, the overall result is to reduce the capital base of the country, thus further impairing economic growth and wage rates. There would then be a similar incentive for workers to quit the country and follow the capital abroad.

The Benefits of Fiat Ethics

From a deontological perspective, the benefits of fiat business ethics would consist in the very fact that an ethical goal is being produced—in the present case, through imposition by law—irrespective of its costs and of other consequences this might entail. The discussion of its benefits would then only concern two questions: One, are the recommended means (the concrete actions imposed on business by the law) suitable to attain those ethical goals? Two, do those goals themselves make sense, that is, can they be rationally justified? Let us address these questions in turn.

It is a frequent error, widespread even among people with training in economics, to focus the discussion of public policy entirely on the *goals* that are to be attained; for example, higher wages or the eradication of corruption. One also has to examine whether the proposed means (in our case, the concrete measures imposed on business by the law) are in fact suitable to attain those goals. This examination might very well lead to the conclusion that the means are unsuitable and should therefore be rejected, even by those who favor the goals themselves. For example, current legislation against insider trading has made it more difficult for certain people to profit from asymmetric information. Arguably, though, it has not changed the fact of asymmetric information per se and has not made it impossible to legally profit from it.[16] Another example would be minimum-wage laws, which are often justified with the moral goal of assuring living wages. Basic economic analysis shows that, while such laws can benefit certain individuals or groups, they cannot increase the wage rates for all employees, and they tend to reduce the overall number of employed persons.

The possible benefits of fiat ethics are severely diminished by the agency problems that arise when it is applied to corporations. In this case, it becomes, in fact, almost impossible to objectively evaluate and monitor the performance of the managers because the latter now have to serve several masters and are evaluated according to different—often contradictory—criteria. They now have a ready excuse for bad performance in any of their missions; they can excuse bad financial results with the necessity to pursue the ethical objectives prescribed by the law, and they can excuse dismal ethical achievement with the necessity of keeping an eye on the monetary bottom line (see Mises 1944, Jensen 2001). Thus, fiat ethics, by exacerbating the separation of ownership and control, makes it less likely that the managers will perform well on any of their objectives (Barry 1998, 77). This was precisely the case with state-run enterprises in the 1960s and 1970s: "Not only were they consistently losing money, but they were often doing a worse job of promoting the public interest, under the explicit mandate to do so, than privately owned firms were" (Heath and Norman 2004, 257). The authors of this study state: "This should be a cause of concern among proponents of CSR. In a sense, the history of nationalized industries in the twentieth century suggests that CSR was tried, and turned out to be a failure" (ibid., 258).

To sum up, to evaluate the suitability of proposed means for the attainment of a given goal we need to rely on prior positive analysis of the nature of business and of its environment. Thus, a deontological perspective on business ethics does not just float in the free air of normative judgments; it needs a foundation in positive fact (see Yeager 2001). This dependence turns out to be even stronger once we realize that the deontological justification of fiat business goals, too, in virtually all cases, depends on such prior positive analysis. For example, the law prohibits insider trading even in those cases in which it would otherwise be expressly tolerated (in labor contracts). This imposition is often based on the notion that market competition is something like a race in sports which, to be equitable, requires equal conditions or a level playing field for all competitors. Now, the very least we can say is that this view of the nature of the market is based on a contestable and contested interpretation (see Mises 1998; Rothbard 1993; Kirzner 1992; Salin 1995). Similarly, the legal limitations on the emission of greenhouse gases are quite essentially based on the view that man-made emissions have produced global warming and that, without legal limitations, continued emissions would jeopardize the fate of the human race, and in fact of the entire ecosystem of our globe. These opinions, too, are contestable and are being vigorously contested by experts in the field (overviews in Reisman 1996; Lomborg 2001; Hulme 2006; Monckton 2006).

We are not here concerned with the pertinence of the positive analyses that underlie the normative claims embodied in fiat ethics.[17] It is furthermore true that what we called above the basic and specific canons of business ethics are also based on positive views about the nature of cooperation and the nature of the different professions. However, in one important respect, the positive analysis supporting fiat ethics is different from these latter cases: While the positive analyses used in business are subject to the more or less direct test of profit and loss, the positive analyses on which fiat ethics is based do not have such a feedback mechanism. It follows that error is more likely to arise and to remain in the latter case. It also follows that the benefits of fiat ethics, if they exist, are particularly difficult to evaluate by the citizens and their representatives.

So far we have considered the benefits of fiat ethics from a deontological perspective. Let us now bring the utilitarian point of view into play, which commends itself for two reasons. One, very few people do in fact adopt a strict deontological viewpoint; therefore fiat ethics is unlikely to enjoy public support if it entails considerable disadvantages. Two, even professional deontologists do not agree about the concrete contents of deontology in general and of business deontology in particular.[18] The public support for the implementation of fiat ethics is therefore likely to depend on its overall consequences, in particular, on their costs. Now, the costs of fiat ethics are certainly out of proportion with their monetary benefits, and they are high by any standard. Furthermore, as we have seen, the very nature of fiat ethics entails cost categories that do not exist in business on the free market, in particular, costs related to political lobbying, monitoring, and enforcement. From the aggregate point of view, this translates into a reduction of living standards and all the indirect consequences that typically follow from it. Finally, there is the fact that any imposition of fiat ethics is likely to increase agency problems within firms, and within corporations in particular, thus reducing both the firms' monetary and moral performance.

Conclusion

In the present article, we have outlined an approach to explain why and how ethical goals are being pursued in business decisions. We have neglected normative considerations and focused on the comparative analysis of various mechanisms through which ethics comes to be applied in business. In particular, we have argued that business by its very nature cultivates a good number of general moral virtues, as well as specific virtues in each branch of business, even if no particular efforts are made in this respect (spontaneous emergence of business ethics). Business is therefore not an ethical eunuch that can be turned into a moral institution only under exogenous impact. Moreover, we have argued that there is such a thing as free-market production of business ethics. This production is not a matter of arbitrary choice of the capitalist-entrepreneurs but an investment to improve product quality and to respond to the ethical orientations prevailing in society, in particular, among employees and customers. It is driven by the profit motive in a competitive environment. The production of business ethics implies that ethical goals can be at least to some extent in conflict with competing (ethical) goals. We have highlighted the specific costs resulting from such conflicts and their implication for industrial organization. We have also stressed that ethical dilemmas need not paralyze business decision-making because a compromise can be found with the help of monetary accounting. Finally, we have discussed the problems of making business more virtuous with the help of the law (fiat business ethics), stressing in particular that fiat ethics cannot be assessed without recourse to prior positive theories of a rather abstract nature.

We see two avenues for the further development of our approach. One, it can be generalized to cover the spontaneous emergence and production of ethics outside of a business context, looking in particular at the production of ethics by churches and similar organizations. Two, it can spell out the analysis of fiat ethics in much more detail, looking for examples of how fiat ethics modifies social relations within the firm and other social settings.

Notes

1. A number of recent works have dealt with such implementation problems by focusing on the scope of political imposition of ethical norms on business. See for example Paine (2000), Waldkirch (2001), Cuesta Gonzáles and Valor Martinez (2004), Cavanagh (2000, 2004), Izzo (2004), Heath and Norman (2004), and Buchholz and Rosenthal (2004). We will develop these different strands of argument by strictly focusing on positive (rather than normative) analysis and by arguing step by step from basic principles.

2. As the phenomenology of social acts—most notably in the philosophy of language and in legal philosophy—has pointed out, any sort of human interaction is conditioned by certain a priori presuppositions. See Reinach (1989); Searle (1969); Habermas (1995); Hoppe (1989).

3. Ronald Coase (1988) has famously distinguished the firm from the market, arguing that, in the former, human cooperation is coordinated by hierarchy while in the latter it is coordinated through contract. However, this distinction is unsuitable for our present discussion, because, even in firms, human cooperation is only superficially coordinated by command and obedience. *Ultimately* it is coordinated by *contracts* between employers and employees. Thus, there is from this point of view no difference between firms and the market; rather, firms are part and parcel of the market as far as the coordinated-through contract is concerned. See Matthews (1998) and Salin (2002).

4. In the light of stakeholder theory, a firm would be interpreted as a bundle of moral ties between various individuals and groups rather than a bundle of individual contracts. Whatever the merits of this approach, it is irrelevant for the production of business ethics on the market, which is based on private property and individual contracting.

Below, we will deal with the consequences of imposing any ethical theory (and thus, for example, stakeholder theory).

5. The emergence of a basic canon in business ethics as a social institution can be interpreted as a particular case of Carl Menger's (1883) general theory of the spontaneous emergence of social institutions. More recently, Robert Nozick (1974) has applied this approach to explain the emergence of political institutions and of political ethics. Our analysis confirms his point that private property rights are at the center of a spontaneous convergence process. For a critique of Nozick's theory see Childs (1977) and Rothbard (1998).

6. This point has been stressed in particular by economists of the Austrian School. See for example Hazlitt (1994, chap. 30). Mises (1998, 144) even argued that "feelings of sympathy and friendship and a sense of belonging together […] are *fruits* of social cooperation, they thrive only within its frame; they *did not precede* the establishment of social relations and are not the seed from which they spring" (emphasis added). Other scholars have independently arrived at very similar conclusions. See for example Oosterhout et al. (2006) and the literature quoted therein.

7. Acton (1993, 97) insisted: "Competitive cooperation, therefore, is not a contradiction in terms, if we mean by it the working together that takes place without conscious participation in some comprehensive plan. There must, of course, be deliberate cooperation within firms, and between firms that contract with one another, but in a competitive economy the firms are not cooperating to execute a plan agreed between them all or imposed upon them."

8. We here mean only those ethical orientations that do *not* concern the making of money. This is not to deny that making money could be an acceptable ethical orientation too (see for example Rand 1961; Friedman 1970; Sternberg 1994; Hasnas 1998).

9. The margin of managerial discretion is even smaller if the courts hold that managers are contractually bound to maximize monetary profits by virtue of a fiduciary duty toward their stockholders (see Marcoux 2002).

10. Arguably, they can be such purists only in the Aristotelian sense of finding the right middle ground (*Nicomachean Ethics*, bk. 2, chaps. 6–9).

11. This fact is certainly repulsive from the point of view of certain ethical orientations, but any other criterion for striking a balance between conflicting ethical goals would be similarly contestable. In any case, this question falls outside our purview, which is the *positive* analysis of the production of business ethics. Notice in particular that we do not here claim that the production of business ethics, either within a single firm or within any aggregate, is or can be "optimal" from any larger social point of view, as for example in the theory of Pareto optimality. We use the word *optimal* exclusively in the sense that it has from an accounting perspective.

12. Norman Barry (2005, 8) puts this tendency in context with recent business scandals: "All of the persons involved in the business scandals of the recent years had very high moral profiles, they gave to charity (often with company money) and were visible churchgoers. But they were lax in the elementary fiduciary duty of responsibility to shareholders."

13. It is true that, in some cases, fiat ethics might simply reduce the firm's overall profitability without eradicating it. This would still imply that the imposed code of conduct is less profitable than known alternative ways of using the available resources. Similarly, it could be objected that fiat ethics can conceivably increase a firm's productivity. This would be the case if, before the enactment of the law, the entrepreneur had underproduced the good in question and that the law merely forces him to do what is really most profitable for him. For obvious reasons this is not very likely to happen.

14. Below we will deal with the question of whether this tendency can be neutralized or overcompensated by long-run beneficial effects of fiat ethics.

15. A more detailed analysis of these limitations could usefully follow the procedure in Böhm-Bawerk (1914).

16. See Barry (1998, chap. 5). Padilla (2002) argues that insider trading has resulted from government policy aiming at the protection of corporate management against unwanted takeovers.

17. Let us merely stress that each case must be examined on its own merits. It is not sufficient to make sweeping claims according to which the free market would solve all problems. Neither is it sufficient to simply posit the existence of social conflict situations such as the prisoner's dilemma and to jump from there to the assertion that government fiat provides a way out.

18. To give just one example: One important topic in modern deontology is the analysis of the conditions under which ethical agreements can be reached. In this field, two schools following by and large the same approach (speech-act analysis) come to diametrically opposite conclusions. Compare Apel (1973) and Habermas (1995) with Van Dun (1982), Hoppe (1989), and Kinsella (1996).

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