# Introduction

> The two main pillars of art and science are curiosity and criticism.
>
> —JOHN STEINBECK

That business has an ethical dimension, as well as an economic and a legal dimension, is now widely accepted. There is no consensus, however, about the nature of this ethical dimension. Some argue for a *stockholder* view: managers have an ethical duty to increase the returns to the owners. To meet this duty, managers should act only in accord with the impersonal market forces that demand efficiency and profit. Others argue for a *stakeholder* view: managers have an ethical duty to respect the rights or promote the good of all those affected by the firm. Stakeholders can include "suppliers, customers, employees, stockholders and the local community, as well as management in its role as agent for these groups."[1]

The stockholder and the stakeholder views both hold that managers have ethical duties, but they disagree about what those duties are and to whom they are owed. One way of understanding this disagreement is to note that in the stockholder view ethics and economics intersect primarily at the market level, whereas in the stakeholder view ethics and economics intersect at the market, organizational, and individual levels.

Milton Friedman[2] argues for a stockholder view, asserting that ethics and business intersect primarily at the market level. If managers increase profits and use these profits to increase stockholder value, they respect the property rights of the shareholders and promote the general social good. If managers rely on ethics to make day-to-day business decisions, they violate their duties to the owners and interfere with the market's ability to promote the general welfare.

Philip Cochran[3] argues for a stakeholder theory of the firm based on ownership. He argues that there are more models of ownership than Friedman acknowledges. Owners can be employees, consumers, suppliers, and even the community. With the growth of pension funds and mutual funds, millions of people have joined the ranks of owners.

Ethics intersects with economics at the market, organizational, and individual levels because owners have interests that arise at each level.

R. Edward Freeman[4] also argues that ethics intersects with business at all three levels. Businesses and individuals cannot avoid using ethical standards in their day-to-day decisions because business decisions benefit some stakeholders and harm others. The decision to distribute benefits and harms in one way rather than another is an ethical one. Managers need to respect the rights of all stakeholders because they are human beings with intrinsic value.

Each of these theorists uses ethical, economic, and legal reasons to support their view of the ethical role of management.

**Ethical reasons.** Friedman cites the property rights of the owners and the tendency of efficient markets to promote group welfare; Cochran cites the way ethical duties follow property rights; Freeman cites the duty of managers to respect the rights of all stakeholders.

**Economic reasons.** Friedman cites competitive market forces and the need for firms to make a profit; Cochran cites the need for all stakeholders to get a return on their contribution; Freeman cites the need for stakeholders to work together to generate profits.

**Legal reasons.** Friedman cites the legal status of the corporation and the fiduciary duties of managers; Cochran cites how law creates and enforces the ownership structures of firms; Freeman cites the legal contracts between labor and management and case law that supports the rights of nonowning stakeholders.

To evaluate these competing views we need to understand the institutional infrastructures in which business occurs. According to Douglass North, "Institutions are . . . humanly devised constraints that structure political, economic and social interaction."[5] These infrastructures are normative; they tell us what we should do. This "should" typically has ethical, economic, and legal aspects.

We will begin our examination of the institutional infrastructure of business by examining a case, S and R Electronics (A), in which managers must make a decision in an institutional environment with conflicting values. Parts I and II use the S and R case to explore the ethical, economic, and legal aspects of the institutional frameworks of business. Part III contains cases and articles that elaborate on and test the institutional view of business presented here.

## A UNIFYING CASE STUDY: S AND R ELECTRONICS (A)

The CEO and CFO of S and R Electronics need to decide whether to move production facilities overseas. S and R is embedded in multiple institutions that have ethical, economic, and legal features. There is the town in which S and R is located, the relationships with labor and suppliers, case and statutory law that stipulate the relationships between managers and owners, the court system that disgruntled stakeholders can use to influence S and R, and the international trade regimes that set many of the rules on which S and R will rely if they move overseas. The two managers themselves are embedded in multiple institutions that guide their behavior in their jobs, marriages, divorce settlements, parenting, and charitable activities.



# PART I: MARKETS, ORGANIZATIONS, AND INDIVIDUALS

## Chapter 1: Market Institutions, Organizational Practices, and Individual Decision Making

The first chapter contains three articles that set the stage for the more detailed presentations in Part II. The first article, "Institutions," is by Douglass C. North. According to North,

> Institutions are . . . humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange. Together with the standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity.[6]

Institutions, then, are social mechanisms that use ethical, economic, and legal rules and principles to coordinate behavior, as summarized below.

**Ethics.** Institutions tell us what we should do in particular situations. If we have borrowed money, we should pay it back. If employees have done their job, they should be paid. At a more specific level, institutions specify how houses are bought and how trades are executed on the New York Stock Exchange. These economic institutions are *partly constituted* by ethical rules that require us to tell the truth and keep our promises.

**Economics.** Institutions "create order and reduce uncertainty in exchange," allowing economic actors to plan for the future. If the future is uncertain, economic actors will not invest in long-term projects. Without long-term projects, business as we know it would not exist.

Institutions also determine how business is organized. In Cuba, for example, citizens cannot form corporations or even hire employees. If a person has a product or service, such as repairing bicycles, and needs more help, the only choice is to bring in people as partners.[7] This contrasts with the United States and most of the rest of world, where the legal status of the corporation makes it the standard way to organize production.

**Law.** Law is an institution that affects business behavior in many ways. On the institutional view, law is a social institution that reinforces and clarifies other social institutions. For example, much of contract law is based on the institutional practice of promising. We need contract law for at least two reasons. First, it provides the context that makes complex promises possible. Second, it provides an incentive for people to fulfill their contracts when they do not want to.

In the second article, Lynn Sharp Paine argues that organizations are guided by internal institutions[8] that have ethical, economic, and legal features. She describes several companies whose internal institutions encouraged unethical decision making. These decisions resulted in substantial economic loss and legal problems. She goes on to describe