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Business ethics and organizational architecture

James A. Brickley, Clifford W. Smith Jr. *, Jerold L. Zimmerman

William E. Simon Graduate School of Business Administration, University of Rochester, Rochester, NY 14627, USA

Abstract

We suggest that economics can complement traditional ethics discussions with the respect to at least three basic points. First, economics provides a theory of how individuals make choices; including choices that have potential ethical dimensions. Second business ethics and the internal structure of the organization are inextricably linked they establish important incentives for those individuals who compose the firm. Third, a company's reputation for ethical behavior is part of its brand-name capital. As such, it is reflected in the value of its securities.

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1. Introduction

Ethics is a branch of philosophy that can trace its roots back at least 2500 years. Since the time of Socrates, Plato, and Aristotle a succession of theories has been advanced to provide a set of principles of human conduct. As examples, egoism argues that an act is appropriate if and only if it promotes an individual's long-term interests; utilitarianism suggests that behaviors should produce the greatest balance of good over bad for everyone affected; Kant argued that only good deeds matter – the nature of the act should be judged, not its outcome; ethical relativism holds that moral principles cannot be valid for everyone – people should follow the conventions of their own group. Even a cursory review of major ethical philosophies yields an

* Corresponding author. Tel.: +1-585-275-3217; fax: +1-585-442-6323.
E-mail address: smith@simon.rochester.edu (C.W. Smith Jr.).

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immediate conclusion: Despite considerable effort by some of history's best minds, there is no consensus as to which behaviors are ethical and which are unethical.

In addition to these difficulties in defining ethical behavior for individuals, the problem becomes even less tractable when we address the ethics of organizations like public corporations that encompass large groups of people. A corporation is, after all, simply a collection of individuals. Or more precisely, it is a set of contracts (both explicit and implicit) that bind together individuals with different, often conflicting interests. In this sense, organizations acquire reputations for ethical behavior based on the actions of their employees.

In this paper, we suggest that economics can complement traditional ethics discussions with respect to at least three basic points. First, economics provides a theory of how individuals make choices; including choices that have potential ethical dimensions. In evaluating potential choices, individuals respond to incentives. Managers and other employees can be incredibly resourceful in devising methods to exploit the opportunities they face. This means that when faced with ill-structured incentives, dysfunctional actions likely occur.

Second, business ethics and the internal structure of the organization are inextricably linked. The internal structure of the organization establishes an important set of incentives for those individuals who compose the firm. We focus specifically on three critical aspects of the firm: the assignment of decision rights, the structure of rewards, and the performance-evaluation system within the firm – what we call organizational architecture. [1] To increase the likelihood that individuals will behave in desired ways in their roles as employees and managers, the firm's organizational architecture can be structured to encourage those behaviors. In designing the internal structure of organizations, it is critical that managers anticipate potential responses by employees, customers, or suppliers that might produce undesirable outcomes. Not doing so invites individuals to game the system and can result in the utter failure of well-intentioned policies.

Third, a company's reputation for ethical behavior, including its perceived integrity in dealing with customers, suppliers, and other parties. This reputation is part of the firm's brand-name capital; as such, it is reflected in the value of its securities (just as individuals' human capital is based in part on their reputations for ethical behavior). In this sense, private markets provide potentially important incentives for ethical behavior by imposing costs on organizations and ultimately on individuals that breech accepted ethical standards.

2. Incentives and choices

Economics presumes that individuals can assign priorities to their wants and then choose their most preferred options from among their available alternatives. It does not assert that people are selfish in the sense that they care only about their personal

[1] This framework is not unique to us. See Brickley et al. (1994, 2001) and especially the reference to prior research.

wealth; people care about charity, family, religion, and society. Individuals maximize their perceived well being given their opportunities. The design of the payoffs they receive and the constraints they confront determine the opportunities that individuals face and hence their choices. For example, management can provide incentives to suppliers through supply contracts, to employees through the structure of compensation plans, and to customers through pricing decisions.

The fact that individuals are clever and creative in exploiting the opportunities they face greatly complicates organizational design. Changing incentives will affect employee behavior, though sometimes in a perverse and unintended manner. Consider two of the Soviet Union's attempts to adopt incentive compensation to motivate employees. To discourage taxi drivers from simply parking their cabs, they began offering compensation based on total distance traveled; to encourage additional production, they rewarded chandelier manufacturers on their total volume of production – measured in kilograms. In response to these incentive plans, some taxi drivers would drive empty cabs at high speeds on highways outside Moscow, while chandelier manufacturers started producing such massive fixtures that they literally would collapse ceilings. (It is less costly to make one 1000-kilo chandelier than fifty 20-kilo chandeliers; manufacturers also substituted lead for lighter-weight materials.) Understanding this individual creativity has important implications for any discussion of business ethics.

3. Organizational architecture and business ethics

An important constraint on corporate policy choice is survivorship. As Charles Darwin noted, competition tends to weed out the less fit – this observation applies to economic systems as well the biological systems Darwin studied. If firms adopt policies that are inefficient, competition places strong pressures on them to adapt; if they do not, in the long run they will close. [2] As Robert Hass, Chairman of Levi Strauss – a company with a long-held commitment to social values – has noted, "you have to have a financially viable business or all the words about values can ring hollow." [3]

Economic Darwinism creates pressures on firms to produce the output customers want at the lowest possible cost. A basic challenge in designing firms is to maximize the likelihood that decision makers have both the relevant information to make good decisions as well as the incentives to use the information productively. The challenge of determining customer demands while reducing costs is complicated by the fact that important information for economic decision-making generally is widely dispersed among many different individuals within the firm. Furthermore, this information often is expensive to transfer. For example, individual machine operators normally know more about how to use their particular machines than do their supervisors. Similarly, scientists are likely to know more about the potential of their specific research

[2] See Alchain (1950), Stigler (1951) and Fama and Jensen (1983).
[3] See Schoenberger (2000).

project than are executives higher in the firm. In each case, communicating such information is likely to be cumbersome – both texture and timelines are lost. Requiring that this information be transmitted to headquarters for approval before it can be acted upon results in many lost opportunities.

A second complication is that decision makers might not have appropriate incentives to make effective decisions even if they have the relevant information – there are incentive problems. For example, a scientist might want to complete a research project out of scholarly interest even if convinced that the project will be unprofitable. Similarly, machine operators might not want to use machines efficiently if this requires them to exert additional effort.

Within firms, there are no automatic systems either for assigning decision rights to individuals with relevant information or for motivating individuals to use their information to achieve the firm's objectives. Organizational architecture is crafted by executives through the implicit and explicit contracts that constitute the firm. In principle, there are private incentives to select value-maximizing forms of organization: by maximizing firm value, there is more to share among the parties in the transactions.

3.1. Formal architecture

A critical responsibility of senior management is to decide how to assign decision rights among employees of the firm. For instance, does the CEO make most major decisions or are these decisions delegated to lower-level managers? Can machine operators deviate from procedures outlined in company manuals?

Within firms tasks are partitioned into smaller blocks and assigned to individuals or groups. Through this design process, both jobs and subunits of the firm are created. Jobs have at least two important dimensions – the variety of tasks and the level of decision authority. [4] For instance, some jobs involve specialized task assignments where the employee is assigned a narrow set of activities concentrated within a single function.

With decentralization many decisions are made by lower level employees. Once the firm grows beyond a certain size, the CEO is unlikely to have the relevant information for all major decisions. Consequently, the CEO faces three basic alternatives in designing organizational architecture. First, the CEO can make most major decisions, despite lacking relevant information. In this case, incentive problems are limited and the development of a detailed control system is less critical. [5] However

[4] Benefits of specialization include exploiting comparative advantage and reducing cross-training expenses; costs include forgone complementarities, additional coordination costs and reduced flexibility. Benefits of decentralization include more effective use of local knowledge, conservation of senior management's time, and additional training/motivation for lower level employees; costs include higher contracting and coordination costs and less effective use of central information.

[5] The CEO still has a contracting problem in motivating lower-level employees to follow detailed instructions. Nonetheless, this contracting problem is likely to be less severe than when the manager gives the lower-level employees broader discretion in making decisions.

without relevant information the CEO is likely to make sub-optimal decisions. Second, the CEO can attempt to acquire the relevant information to make better decisions. This option can enhance decision making. Yet obtaining and processing information can be both costly and time consuming. Third, the CEO can decentralize decision rights to individuals with better information. This choice assigns decision-making authority to employees with the relevant information. But delegating decision rights gives rise to increased incentive problems, which requires that control systems be developed. Another potential drawback of decentralization is the costs of transferring information among the various decentralized decision makers in coordinating efforts across the organization.

Of course, CEOs can choose a mix of these basic alternatives. For example, executives are likely to choose to retain some decisions while delegating others. The optimal choice depends primarily on the business environment and strategy of the firm as well as the specific expertise of the CEO. In some cases – especially in smaller firms in relatively stable industries – senior managers are likely to have most of the relevant information for decision making, and thus decision rights are more likely to be centralized. In other cases – especially larger firms experiencing rapid change – senior managers and their corporate staff often will not be in the best position to make a broad array of decisions. And, in such cases, decision rights are more likely to be decentralized, with corresponding control systems adopted and implemented.

Through the delegation of decision rights, employees are granted authority over the use of company resources. Employees, however, are not owners: They cannot sell company property and keep the proceeds. Therefore, employees have fewer incentives to worry about the efficient use of company resources than do owners. To help control these incentive problems, managers develop control systems. That is, managers structure the other two basic pieces of the organization's architecture, the reward and performance-evaluation systems that help to align the interests of the decision makers with those of the owners. In the firm, an optimal control system depends on how decision rights are partitioned in the firm, and vice versa.

The structure of rewards within the firm is designed with at least two important objectives (1) to attract and retain qualified employees and (2) to motivate employees to be more productive. While some think narrowly of bonus or stock option plans in providing incentives, any aspect of employment that rewards employees for good performance or sanctions poor performance can be considered incentive pay; thus, promotions, titles, office location, perquisites, and layoffs are each components of the reward system.

Identifying employees that perform well or poorly requires a performance-evaluation system. Thus the firm's reward system uses as an input the firm's performance-evaluation system – the two systems are linked. The internal accounting system is at the center of most firms' performance evaluation systems; it is complemented by employee performance-review procedures.

This discussion indicates that the CEO plays a major role in framing the basic architecture for the firm. Organizational decisions, however, are made by managers throughout the organization. For example, when the CEO delegates a set of decision rights to divisional managers, these managers must decide what decisions to make

themselves and what decisions to delegate to their subordinates. These subordinates then are faced with similar organizational questions. The overall architecture of a firm is determined through this process, ultimately involving managers throughout the organization. [6]

3.2. Ethics programs

Many US corporations have adopted formal codes of conduct, appointed ethics officers, and offered employee-training programs in ethics. Such codes and programs regularly emphasize the following:

- Employees must obey the laws and observe statutory regulations.
- Customer relations in terms of the reputation and integrity of the company are of great importance.
- Employees must support the company's policies to customers.
- Conflicts of interest between the company and the employee must be avoided.
- Confidential information gained in the course of business must not be used improperly.
- It is improper to conceal dishonesty and protect others in their dishonesty.
- Advice to customers should be restricted to facts about which the employee is confident.

Corporate ethics programs have the potential to provide an effective method of setting and communicating expectations among employees for their dealings with customers, suppliers, and other employees. [7] Corporate managers and employees cannot be automatically expected to know the appropriate decision that promotes the interests of the organization. In many cases, managers' and employees' uncertainty about ethical standards – or how to live up to them in practice – may well be a greater corporate problem than their failure to work hard or to act in accordance with standards that are well established and clearly defined.

One potential source of confusion resides in the variability of ethical standards. What might have been acceptable behavior 10 or 20 years ago may not be so today. Social changes such as those brought about by movements as divergent as civil rights and women's rights, on the one hand, and corporate restructuring, on the

[6] See Brickley et al. (1995).

[7] Adopting a corporate code of ethics also helps the firm defend itself against charges of illegality. Sentencing guidelines issued by the US Sentencing Commission in November 1991 strongly encourage corporations to establish and communicate compliance standards and procedures for employees and other agents through training programs and publications. For example, when an individual is found guilty of wrongdoing, the organization might be vulnerable to federal fines. These penalties can be reduced by more than 50% simply by demonstrating that the organization has a compliance program that meets the Sentencing Commission's standards. These federal sentencing guidelines thus have blurred the line between legal and ethical issues. See Gilbert (1994), Boatright (2002) and Bear and Maldonado-Bear (2002).

other, clearly have altered conceptions of socially acceptable behavior. Moreover, the progressive globalization of corporations is increasingly forcing corporate employees to recognize and adapt to differences in national or regional cultural expectations.

Given this large and, in some ways, growing uncertainty about what constitutes appropriate behavior within large organizations, corporate codes of ethics and training programs play a potentially important educational role by effectively communicating corporate expectations to employees and by demonstrating to them how certain kinds of behavior reduce the value of the firm. For example, misrepresentations of products and services to customers might produce short-term gains but reduce the value of the firm by hurting its reputation and thus lowering its brand-name capital. Moreover, in the process of globalizing and thus dealing with customers worldwide, companies might be forced to respond to the increasing cultural differences – or an absence of shared expectations – among their managers and employees by providing more explicit communication of standards and expectations. [8]

Besides issuing a clear set of rules governing employee relations with consumers, corporations also are likely to benefit from communicating guidelines for dealings among managers and employees within the firm. For example, many companies develop their executives by rotating them through a series of jobs. The resulting management turnover can undermine informal agreements among managers and employees. Explicit, corporate-wide communication of expectations can reduce uncertainty about enforcing unwritten agreements and thereby increase internal efficiency.

3.3. Corporate culture

Corporate culture is one of the more frequently used terms in the literature on organizations. Corporate culture usually encompasses the ways work and authority are organized, the ways people are rewarded and controlled, as well as organizational features such as customs, taboos, company slogans, heroes, and social rituals. Our focus on organizational architecture is consistent with this concept of corporate culture. Indeed, our definition of organizational architecture corresponds to key aspects of what frequently is discussed as corporate culture. For example, the architecture specifies how authority (decision rights) is distributed among employees and how rewards are determined. Some dismiss the softer elements of corporate culture (for

[8] Virtually all professions – medicine, law, accounting – have professional ethics codes. Prospective candidates must pass entry exams that test their understanding of these codes. Most professional codes contain detailed descriptions of behaviors that reduce the value of the profession's services. For example, professional accountants are prohibited by their code of ethics from serving on the board of directors of their client firms. Such memberships reduce the appearance of independence of the auditor when rendering an opinion on the client's financial statements. If one accountant is caught not disclosing a known financial fraud, this reduces the value of other accountants' audit opinions. Thus professions, like firms, have incentives to monitor their members for ethical breaches.

example, role models, company folklore, and rituals) as being unimportant. Rather they stress formal architecture as being the primary, if not sole determinant of firm value. Economics, however, suggests that an important role for these softer elements of corporate culture is enhancing communication.

While organization charts, job descriptions, and ethics codes provide the basic outline of a firm's organizational architecture, in most organizations there remains tremendous texture not captured focusing on these mechanisms alone. Most organizations do not attempt to write down all important features of their organizations in detailed procedures manuals. It is too costly to prespecify the entire range of situations that employees might encounter and then stipulate what their appropriate actions might be in each case. Rather, these features typically are communicated to employees in less formal yet frequently more effective ways. Aspects of the corporation such as slogans, role models, and social rituals can communicate organizational architecture to workers in a particularly memorable way. A slogan like *At Ford, Quality Is Job 1* emphasizes that workers are expected to focus on quality and customer service, and that such a focus will be rewarded by the company. Given this slogan and other reinforcing signals from top management, employees at Ford have a reasonably clear idea of how to respond to situations such as dealing with a disgruntled customer, even without formal procedures to follow.

Singling out role models or heroes for special recognition is another way of communicating explicitly what the company values. Consider corporate newsletters; they regularly include articles highlighting recent actions undertaken by particular employees. These articles – along with management speeches and other softer aspects of corporate culture – constitutes a kind of case law within the firm. By publicizing specific employees (for instance, the Nordstrom's employee who changed a customer's flat tire in the store's parking lot) management provides concrete examples of the kinds of activities that it wants to encourage. This process accomplishes several things: (1) it increases the credibility of the firm's articulated policies by providing concrete examples of their application; (2) it adds important texture to the definition of organizational architecture; (3) it communicates these policies in an accessable, relevant manner. [9]

Less tangible features of organizations, such as rituals and role models, can be important in reinforcing and communicating organizational architecture. However, they also can increase the costs of changing architecture. Managers can change formal evaluation and compensation schemes and clearly communicate these changes to the relevant employees. But getting employees to change their heroes, customs, and social rituals is likely more time-consuming and difficult. These features often are created through informal communication channels – they take time to dismantle as well as to create.

[9] These are not the only roles played by corporate culture. For instance, social rituals, such as training sessions and company parties, can help to disseminate information by increasing the interaction among employees who otherwise might not see each other on a frequent basis.

3.4. A system of complements

Features of organizations like rituals and role models can be effective in reinforcing and communicating the goals of the firm, and they possess the potential to produce influential aspects of a coherent architecture. Their effectiveness in specific cases has led some management gurus to claim that a productive corporate culture can be molded with no attention to formal evaluation and compensation schemes. Some people – for instance, quality expert Edwards Deming – argue that incentive pay actually is detrimental to a productive organization. Our analysis suggests that it is a mistake to think of these hard and soft aspects of the organization as mutually exclusive or in competition with each other; both can play a valuable role in increasing firm value. The various elements of the organization are more likely to be complements than substitutes.

To create the value-based or consumer-focused organization that many companies seek to become, these less tangible aspects of corporate culture must be reinforced by more tangible actions. That is, the more formal organizational systems that partition decision rights and evaluate and reward performance, as well as sanctions for unethical behavior, must all be internally consistent and designed to encourage firm-value-increasing behavior.

4. Market-based incentives for ethical behavior

Markets impose substantial costs on institutions and individuals that engage in unethical behavior, thus, market forces provide private incentives for ethical behavior. We now examine the nature of these market forces in more detail, how they help to enforce contracts, and transactions where they are most likely to be effective. To focus our discussion, we consider a transaction for the delivery of a product of a specified quality. We examine incentives to reduce costs by lowering quality, rather than supplying products of the promised quality.

The effectiveness of market forces in enforcing contract varies across transactions. Important transaction characteristics include: (1) the cost of ascertaining product quality prior to purchase, (2) the likelihood that behavior in this transaction will affect future sales, (3) the asset/cost structure of the seller, and (4) the specific terms of the transaction.

4.1. Costs of determining quality

For products where quality can be determined at low cost prior to purchase, markets solve this problem easily. If buyers can monitor quality inexpensively, they have strong incentives to do so. In such cases, the product will sell for a price that only reflects actual quality, not promised quality. For example, if a buyer for Kodak is negotiating a purchase of silver, quality can be accurately and inexpensively ascertained prior to purchase by assay.

However for some products, quality is impossible be determine prior to purchase. For example, the quality of an airplane ticket can be known only after the plane has landed, parked at the gate, and the passengers have retrieved their luggage. If quality is expensive to measure, sellers might have incentives to cheat on quality. Yet a rational seller will provide products of lower than promised quality only if the expected gains exceed the expected costs.

4.2. Implications for future sales

Several market forces impose substantial costs on suppliers that cheat on quality, thereby dissuading them from cheating. The potential for future sales provides powerful incentives for contract compliance (see Telser, 1980). So long as the costs of expected future lost sales exceed the gains from opportunistic behavior, supplying products of lower than promised quality will not be profitable.

The costs of cheating on quality are higher if information about such activities is more rapidly and widely distributed to potential future customers. Hence, with repeated transactions between the same parties, likelihood of cheating is lower. [10] For example, in the New York diamond trade, cheating on quality is quite rare. This market is dominated by a close-knit community of Hasidic Jews; thus, information about unethical behavior is rapidly distributed throughout the market.

In other broader markets, specialized information services that monitor the market help insure contract performance. For example, *Consumer Reports* evaluates products from toasters to fire insurance, the *Investment Dealers Digest* reports on activities of investment bankers, and *US News & World Reports* ranks MBA programs. By lowering the costs for potential customers to determine quality, these information sources increase the costs of cheating.

Where quality is difficult to ascertain prior to purchase, potential buyers will reduce their demand prices to reflect the uncertainty they face. Hence, sellers have incentives to provide credible assurance to potential customers that they will not cheat in order to reduce the compensation demanded by customers for bearing this risk. Thus for a firm with an established brand name, entry into related product markets can be less costly. For example, given IBM's position in the mainframe computer industry, they faced lower costs of credibly supplying high quality IBM-branded personal computers. Subjecting both revenue streams to the adverse reputational consequences of cheating faces the firm with stronger incentives for compliance. This implies that this mechanism will be more effective when (1) the products are more closely related and (2) the linkage is more prominently emphasized.

If future corporate existence is more uncertain, so are the expected costs of foregone future sales. Thus, firms in financial distress are more likely to cheat on quality than are financially healthy firms. Firms can adopt financial policies that help to

[10] In general, the range of possible equilibria increases with repeated interaction. In the game theory literature this issue has been studied quite formally. This result frequently is referred to as the folk theorem. If the costs of future sanctions are sufficient to overcome the immediate benefits of cheating, it will not be in the managers interest to cheat on quality. See Kreps (1990, Chapter 14).

bond product quality. Since financial distress is more costly for firms that market products where quality is difficult to ascertain, such firms have stronger incentives to adopt financing policies that imply a lower probability of financial distress. Therefore, such firms should have lower leverage, fewer leases, and engage in more hedging.

Specialized credit-information services like Moody's and Dun and Bradstreet perform both a monitoring and an information dissemination function (see Wakeman, 1981). Fama and Jensen (1985) and Mian and Smith (1992) suggest that the existence of such intermediaries provides an opportunity for the firm to guarantee quality. Firms pay Moody's to have their debt rated over the life of the bond issue. By issuing rated public debt a firm lowers the cost to other potential corporate claimholders (including potential customers) to ascertain the firm's financial condition. James (1987) argues that banks have a comparative advantage in monitoring the financial condition of borrowers; thus, the use of bank credit also might help control these incentive problems.

4.3. Seller asset/cost structure

Klein and Leffler (1981) note that the higher the expected future steam of quasi-rents, the less likely the firm cheats on quality. Thus, a firm with an established market position and substantial franchise value faces higher costs of cheating and hence are less likely to do so.

Firms bond quality by investing in firm-specific assets whose value falls if the company fails. For example, Coca Cola's advertising budget represents an investment in brand-name capital that would depreciate substantially if the company were to cheat on quality. This also helps to explain "image" advertising (for example by Xerox or IBM) where there is no discussion of the company's products. Similarly, by choosing a distinctive architectural design for its outlets a firm more effectively bonds product quality. For example, Taco Bell outlets would have limited alternative uses if the enterprise fails; hence, cheating on promised quality imposes, greater losses than if it had erected more generic structures.

4.4. Organizational structure

Incentives to provide high quality products vary across ownership structures. Individual proprietorships and partnerships impose unlimited liability on the principals and thus offer stronger incentives for contract compliance than the limited liability provided through the corporate form. This is one reason why professional service firms like law firms, accounting firms and investment banks are frequently established as partnerships. Fast food firms must decide whether to franchise or own particular outlets. Outlets located at expressway interchanges will receive fewer repeat sales than other locations. Brickley and Dark (1987) argue that these outlets are less likely to be franchised because their managers incur fewer costs of lower sales if quality is lowered They not only predict these locations will be owned, they should be subjected to more intense monitoring from corporate headquarters, as well.

The hierarchical management structure that corporations employ is an important mechanism to guarantee quality (see Fama, 1980). In this structure, top managers have strong incentives to monitor their subordinates. Moreover, competition among managers for these top jobs provides incentives for lower managers to monitor senior executives, as well. This mutual monitoring imposes constraints on an individual manager's ability to cheat on quality.

Oversight of the firm's CEO is the responsibility of its board of directors. Board structure provides valuable monitoring of the internal management team – especially the monitoring by outside board members. This perspective helps explain why many Fortune 500 companies have academics or religious leaders on their boards. During board meetings, proprietary information is discussed and hence the meeting must be closed to shield this information from competitors. Yet closed meetings provide the potential for management and the board to collude; they might adopt a set of policies that make themselves better off, yet reduce the value of the firm. By including an individual whose career choices indicate that maximizing income is not that individual's most important goal, the firm makes a believable promise to focus on value-maximizing policies when the board meets behind closed doors.

The world's largest online auction, eBay employs several mechanisms that reduce opportunism among buyers and sellers: (1) The Feedback Forum is a place where eBay users leave comments about each other's buying and selling experiences. Participants can check the other party's Feedback Profile easily, so for instance, a buyer can check their seller's experience with others before placing a bid. (2) The eBay staff investigates alleged misuses such as fraud, trading offenses, and illegally listed items. Potential resolutions include banning a person from future trading on eBay. (3) Buyers and sellers can use an escrow service in transactions involving expensive items. eBay's escrow partner, i-Escrow, holds a buyer's payment and sends it to the seller only after the buyer has inspected the merchandise and gives approval. Sellers have the same opportunity to inspect and approve a returned item before the buyer receives a refund. (4) Every eBay user is covered by insurance at no additional charge under the terms of eBay's program. If a buyer pays for an item and never receives it (or receives the item, but it was less than expected), eBay reimburses the buyer up to $200, less a $25 deductible.

5. Ethics versus value maximization

Although ethical behavior and value-maximizing behavior obviously are not equivalent, economic theory suggests at least one special case in which ethical problems are resolved efficiently. Consider the benchmark case of a frictionless economy like the one that Ronald Coase (1960) imagined and further presume that there are no wealth effects. Within such a setting, individuals and organizations will exhaust all available gains from trade and the resulting allocation of resources will be efficient. This resource allocation will reflect accurately society's opportunities and preferences – including preferences related to individuals' ethical standards.

Note that within this setting, individuals still may disagree about ethics. (As we argued above, there appears to be no universal standard as to what constitutes ethical behavior.) Thus, it should not be difficult to find specific individuals who might charge that a broad array of value-maximizing corporate policies might violate their individual notions of ethical behavior. But within this setting, such disagreements could be addressed using the same basic mechanisms through which externalities are internalized – side payments from those who want to undertake a given action to those who might have their notions of ethics breached by such actions. [11]

While this benchmark case involves quite a high level of abstraction, we believe it highlights several important issues. First, although managers have a fiduciary responsibility to owners to maximize the value of their firms, unregulated markets create incentives to recognize the ethical standards of employees, customers, investors, and others who interact within the organization. In fact, one of our major points within this paper is that value maximization requires a deeper understanding of ethical standards than the typical economics discussion of short-run profit maximization might suggest. Second, any deviations from this benchmark case logically should be limited by the magnitude of contracting costs. With positive information costs or contract negotiation and administration costs, value-maximizing firms have private incentives to take actions to internalize these considerations whenever the costs of deviation are greater than the contracting costs associated with resolving the issue. Third, changes in the distribution of wealth potentially lead to different efficient policies. For example, some argue that it is unethical to pollute the environment. This view appears to be more strongly held among higher income individuals – clean air and water appear to be luxury goods. With an increase in wealth, the efficient amount of pollution thus would fall. Finally, a legitimate role of government is to enact regulation in order to internalize potential externalities. Yet even after accepting as fact that unregulated value-maximizing policy choices by firms lead them to engage in unethical behavior, thereby imposing costs on others, two questions still must be addressed before concluding that government regulation would help: Can government resolve the problem at a cost lower than that caused by the firm's actions? (After all, government intervention is not free.) Will regulators in fact act in the public interest and focus on restraining ethical breaches or will they employ their discretion under the regulation to act in their own self interest?

6. Conclusions

We have focused on three basic points: (1) Individuals respond to incentives in systematic and creative ways. (2) Within organizations incentives are established through the structure of the firm's organizational architecture. (3) Private markets

[11] While we are comfortable labeling this outcome efficient, we explicitly do not label it "ethical". Deciding whether full compensation for the costs imposed because others actions breech your sense of ethics makes an outcome "ethical" requires a deeper theory of ethics than we can provide.

impose potentially significant costs on individuals and firms that engage in unethical behavior.

Although we would not argue that these market incentives alone are sufficient to ensure ethical behavior, our analysis of these costs helps explain why ethical behavior is so widely observed in markets: ethical behavior frequently is profitable. This is especially important in financial services, where business depends as much on reputation as on performance. (Of course, current performance is the major determinant of future reputation.) We believe that more widespread understanding of these consequences would result in fewer ethical-conduct violations.

Some argue that if competitors have adopted low ethical standards, it would be unprofitable for a firm to adopt high standards. Our analysis suggests this is incorrect. Potential customers discount their demand prices where there is uncertainty about the quality of the product to be supplied. By credibly promising to act ethically, a firm can differentiate their product and increase their demand – potentially by a substantial amount.

Our analysis suggests that a board of directors concerned with the ethical conduct of the firm's employees should spend less time exhorting the human resource manager to search for honest employees (like Diogenes' search for an honest man). They should identify potential incentive problems between the firm and its customers, creditors, or employees. Once identified, managerial attention can be focused on the constructive resolution of the incentive problems.

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