

DOES BUSINESS ETHICS MAKE ECONOMIC SENSE?*

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Abstract: The importance of business ethics is not contradicted in any way by Adam Smith's pointer to the fact that our "regards to our own interests" provide adequate *motivation for exchange*. There are many important economic relationships other than exchange, such as the institution of production and arrangements of distribution. Here business ethics can play a major part. Even as far as exchange is concerned, business ethics can be crucially important in terms of organization and behavior, going well beyond basic motivation.

1. Introduction

I begin not with the need for business ethics, but at the other end—the idea that many people have that there is no need for such ethics. That conviction is quite widespread among practitioners of economics, though it is more often taken for granted implicitly rather than asserted explicitly. We have to understand better what that conviction rests on, to be able to see its inadequacies. Here, as in many other areas of knowledge, the importance of a claim depends to a great extent on what it denies.

How did this idea of the redundancy of ethics get launched in economics? The early authors on economic matters, from Aristotle and Kautilya (in ancient Greece and ancient India respectively—the two were contemporaries, as it happens) to medieval practitioners (including Aquinas, Ockham, Maimonides, and others), to the economists of the early modern age (William Petty, Gregory King, Francois Quesnay, and others) were all much concerned, in varying degrees, with ethical analysis. In one way or another, they saw economics as a branch of "practical reason," in which concepts of the good, the right and the obligatory were quite central.

What happened then? As the "official" story goes, all this changed with Adam Smith, who can certainly be described—rightly—as the father of modern economics. He made, so it is said, economics scientific and hard-headed, and the new economics that emerged, in the 19th and 20th centuries, was all ready to do business, with no ethics to keep it tied to "morals and moralizing." That view of what happened—with Smith doing the decisive shooting of business and economic ethics—is not only reflected in volumes of professional economic writings, but has even reached the status of getting into the English literature via a limerick by Stephen Leacock, who was both a literary writer and an economist:

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Adam, Adam, Adam Smith
 Listen what I charge you with!
 Didn't you say
 In a class one day
 That selfishness was bound to pay?
 Of all doctrines that was the Pith.
 Wasn't it, wasn't it, wasn't it, Smith?²

The interest in going over this bit of history—or alleged history—does not lie, at least for this conference, in scholastic curiosity. I believe it is important to see how that ethics-less view of economics and business emerged in order to understand what is it that is being missed out. As it happens, that bit of potted history of “who killed business ethics” is altogether wrong, and it is particularly instructive to understand how that erroneous identification has come about.

2. *Exchange, Production and Distribution*

I get back, then, to Adam Smith. Indeed, he did try to make economics scientific, and to a great extent was successful in this task, within the limits of what was possible then. While that part of the alleged history is right (Smith certainly did much to enhance the scientific status of economics), what is altogether mistaken is the idea that Smith demonstrated—or believed that he had demonstrated—the redundancy of ethics in economic and business affairs. Indeed, quite the contrary. The Professor of Moral Philosophy at the University of Glasgow—for that is what Smith was—was as interested in the importance of ethics in behavior as anyone could have been. It is instructive to see how the odd reading of Smith—as a “no-nonsense” sceptic of economic and business ethics—has come about.

Perhaps the most widely quoted remark of Adam Smith is the one about the butcher, the brewer and the baker in *The Wealth of Nations*: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love....”³ The butcher, the brewer and the baker want our money, and we want their products, and the exchange benefits us all. There would seem to be no need for any ethics—business or otherwise—in bringing about this betterment of all the parties involved. All that is needed is regard for our own respective interests, and the market is meant to do the rest in bringing about the mutually gainful exchanges.

In modern economics this Smithian tribute to self-interest is cited again and again—indeed with such exclusivity that one is inclined to wonder whether this is the only passage of Smith that is read these days. What did Smith really suggest? Smith did argue in this passage that the pursuit of self-interest would do fine to motivate the exchange of commodities. But that is a very limited claim, even though it is full of wonderful insights in explaining why it is that we seek exchange and how come exchange can be such a beneficial thing for all. But to understand the limits of what is being claimed here, we have to ask, first: Did Smith think that economic opera-

tions and business activities consist only of exchanges of this kind? Second, even in the context of exchange, we have to question: Did Smith think that the result would be just as good if the businesses involved, driven by self-interest, were to try to defraud the consumers, or the consumers in question were to attempt to swindle the sellers?

The answers to both these questions are clearly in the negative. The butcher-brewer-baker simplicity does not carry over to problems of production and distribution (and Smith never said that it did), nor to the problem as to how a system of exchange can flourish institutionally. This is exactly where we begin to see why Smith could have been right in his claim about *the motivation for exchange* without establishing or trying to establish *the redundancy of business or ethics* in general (or even in exchange). And this is central to the subject of this conference.

The importance of self-interest pursuit is a helpful part of understanding many practical problems, for example, the supply problems in the Soviet Union and East Europe. But it is quite unhelpful in explaining the success of, say, Japanese economic performance *vis-a-vis* West Europe or North America (since behavior modes in Japan are often deeply influenced by other conventions and pressures). Elsewhere in *The Wealth of Nations*, Adam Smith considers other problems which call for a more complex motivational structure. And in his *The Theory of Moral Sentiments*, Smith goes extensively into the need to go beyond profit maximization, arguing that "humanity, justice, generosity, and public spirit, are the qualities most useful to others."⁴ Adam Smith was very far from trying to deny the importance of ethics in behavior in general and business behavior in particular.⁵

Through overlooking everything else that Smith said in his wide-ranging writings and concentrating only on this one butcher-brewer-baker passage, the father of modern economics is too often made to look like an ideologue. He is transformed into a partisan exponent of an ethics-free view of life which would have horrified Smith. To adapt a Shakespearian aphorism, while some men are born small and some achieve smallness, the unfortunate Adam Smith has had much smallness thrust upon him.

It is important to see how Smith's wholeness tribute to self-interest as a motivation for exchange (best illustrated in the butcher-brewer-baker passage) can co-exist peacefully with Smith's advocacy of ethical behavior elsewhere. Smith's concern with ethics was, of course, extremely extensive and by no means confined to economic and business matters. But since this is not the occasion to review Smith's ethical beliefs, but only to get insights from his combination of economic and ethical expertise to understand better the exact role of business ethics, we have to point our inquiries in that particular direction.

The butcher-brewer-baker discussion is all about *motivation for exchange*, but Smith was—as any good economist should be—deeply concerned also with *production* as well as *distribution*. And to understand how exchange might itself actually work in practice, it is not adequate to concentrate only on the motivation that makes people *seek* exchange. It is necessary to look at the behavior patterns that could sustain a flourishing system of mutually

profitable exchanges. The positive role of intelligent self-seeking in motivating exchange has to be supplemented by the motivational demands of production and distribution, and the systemic demands on the organization of the economy.

These issues are taken up now, linking the general discussion with practical problems faced in the contemporary world. In the next three sections I discuss in turn (1) the problem of organization (especially that of exchange), (2) the arrangement and performance of production, and (3) the challenge of distribution.

3. *Organization and Exchange: Rules and Trust*

I come back to the butcher-brewer-baker example. The concern of the different parties with their own interests certainly can adequately *motivate* all of them to take part in the exchange from which each benefits. But whether the exchange would operate well would depend also on organizational conditions. This requires institutional development which can take quite some time to work—a lesson that is currently being learned rather painfully in East Europe and the former Soviet Union. That point is now being recognized, even though it was comprehensively ignored in the first flush of enthusiasm in seeking the magic of allegedly automatic market processes.

But what must also be considered now is the extent to which the economic institutions operate on the basis of common behavior patterns, shared trusts, and a mutual confidence on the ethics of the different parties. When Adam Smith pointed to the motivational importance of “regard to their own interest,” he did not suggest that this motivation is all that is needed to have a flourishing system of exchange. If he cannot trust the householder, the baker may have difficulty in proceeding to produce bread to meet orders, or in delivering bread without prepayment. And the householder may not be certain whether he would be sensible in relying on the delivery of the ordered bread if the baker is not always altogether reliable. These problems of mutual confidence—discussed in a very simple form here—can be incomparably more complex and more critical in extended and multifarious business arrangements.

Mutual confidence in certain rules of behavior is typically implicit rather than explicit—indeed so implicit that its importance can be easily overlooked in situations in which such confidence is unproblematic. But in the context of economic development, across the Third World, and also of institutional reform, now sweeping across what used to be the Second World, these issues of behavioral norms and ethics can be altogether central.

In the Third World there is often also a deep-rooted scepticism of the reliability and moral quality of business behavior. This can be directed both at local businessmen and the commercial people from abroad. The latter may sometimes be particularly galling to well established business firms including well-known multinationals. But the record of some multinationals and their unequal power in dealing with the more vulnerable countries have

left grounds for much suspicion, even though such suspicion may be quite misplaced in many cases. Establishing high standards of business ethics is certainly one way of tackling this problem.

There is also, in many Third World countries, a traditional lack of confidence in the moral behavior of particular groups of traders, for example merchants of food grains. This is a subject on which—in the context of the-then Europe—Adam Smith himself commented substantially in *The Wealth of Nations*, though he thought these suspicions were by and large unjustified. In fact, the empirical record on this is quite diverse, and particular experiences of grain trade in conditions of scarcity and famine have left many questions to be answered.

This is an issue of extreme seriousness, since it is now becoming increasingly clear that typically the best way of organizing famine prevention and relief is to create additional incomes for the destitutes (possibly through employment schemes) and then to rely on normal trade to meet (through standard arrangements of transport and sales) the resulting food demand.⁶ The alternative of bureaucratic distribution of food in hastily organized relief camps is often much slower, more wasteful, seriously disruptive of family life and normal economic operations, and more conducive to the spread of epidemic diseases. However, giving a crucial role to the grain traders at times of famine threats (as a complement to state-organized employment schemes to generate income) raises difficult issues of trust and trustworthiness, in particular, that the traders will not manipulate the precarious situation in search of unusual profit. The issue of business ethics, thus, becomes an altogether vital part of the arrangement of famine prevention and relief.

The problem can be, to some extent, dealt with by skillful use of the threat of government intervention in the market. But the credibility of that threat depends greatly on the size of grain reserves the government itself has. It can work well in some cases (generally it has in India), but not always. Ultimately, much depends on the extent to which the relevant business people can establish exacting standards of behavior, rather than fly off in search of unusual profits to be rapidly extracted from manipulated situations.

I have been discussing problems of organization in exchange, and it would seem to be right to conclude this particular discussion by noting that the need for business ethics is quite strong even in the field of exchange (despite the near-universal presence of the butcher-brewer-baker motivation of “regard to their own interest”). If we now move on from exchange to production and distribution, the need for business ethics becomes even more forceful and perspicuous. The issue of trust is central to all economic operations. But we now have to consider other problems of interrelation in the process of production and distribution.

4. *Organization of Production: Firms and Public Goods*

Capitalism has been successful enough in generating output and raising productivity. But the experiences of different countries are quite diverse.

The recent experiences of East Asian economies—most notably Japan—raise deep questions about the modelling of capitalism in traditional economic theory. Japan is often seen—rightly in a particular sense—as a great example of successful capitalism, but it is clear that the motivation patterns that dominate Japanese business have much more content than would be provided by pure profit maximization.

Different commentators have emphasized distinct aspects of Japanese motivational features. Michio Morishima has outlined the special characteristics of “Japanese ethos” as emerging from its particular history of rule-based behavior pattern.⁷ Ronald Dore has seen the influence of “Confucian ethics.”⁸ Recently, Eiko Ikegami has pointed to the importance of the traditional concern with “honor”—a kind of generalization of the Samurai code—as a crucial modifier of business and economic motivation.⁹

Indeed, there is some truth, oddly enough, even in the puzzlingly witty claim made by *The Wall Street Journal* that Japan is “the only communist nation that works” (30 January 1989, p. 1). It is, as one would expect, mainly a remark about the non-profit motivations underlying many economic and business activities in Japan. We have to understand and interpret the peculiar fact that the most successful capitalist nation in the world flourishes economically with a motivation structure that departs firmly—and often explicitly—from the pursuit of self-interest, which is meant to be the bedrock of capitalism.

In fact, Japan does not, by any means, provide the only example of a powerful role of business ethics in promoting capitalist success. The productive merits of selfless work and devotion to enterprise have been given much credit for economic achievements in many countries in the world. Indeed, the need of capitalism for a motivational structure more complex than pure profit maximization has been acknowledged in various forms, over a long time, by various social scientists (though typically not by many “mainstream” economists): I have in mind Marx, Weber, Tawney, and others.¹⁰ The basic point about the observed success of non-profit motives is neither unusual nor new, even though that wealth of historical and conceptual insights is often thoroughly ignored in professional economics today.

It is useful to try to bring the discussion in line with Adam Smith’s concerns, and also with the general analytical approaches successfully developed in modern microeconomic theory. In order to understand how motives other than self-seeking can have an important role, we have to see the limited reach of the butcher-brewer-baker argument, especially in dealing with what modern economists call “public good.” This becomes particularly relevant because the overall success of a modern enterprise is, in a very real sense, a public good.

But what *is* a public good? That idea can be best understood by contrasting it with a “private good,” such as a toothbrush or a shirt or an apple, which either you can use or I, but not both. Our respective uses would compete and be exclusive. This is not so with public goods, such as a livable environment or the absence of epidemics. All of us may benefit from breathing fresh air, living in an epidemic-free environment, and so on. When uses of commodities are non-competitive, as in the case of public goods, the rationale of the

self-interest-based market mechanism comes under severe strain. The market system works by putting a price on a commodity and the allocation between consumers is done by the intensities of the respective willingness to buy it at the prevailing price. When "equilibrium prices" emerge, they balance demand with supply for each commodity. In contrast, in the case of public goods, the uses are—largely or entirely—non-competitive, and the system of giving a good to the highest bidder does not have much merit, since one person's consumption does not exclude that of another. Instead, optimum resource allocation would require that the *combined* benefits be compared with the costs of production, and here the market mechanism, based on profit maximization, functions badly.¹¹

A related problem concerns the allocation of private goods involving strong "externalities," with interpersonal interdependences working outside the markets. If the smoke from a factory makes a neighbor's home dirty and unpleasant, without the neighbor being able to charge the factory owner for the loss she suffers, then that is an "external" relation. The market does not help in this case, since it is not there to allocate the effects—good or bad—that works outside the market.¹² Public goods and externalities are related phenomena, and they are both quite common in such fields as public health care, basic education, environmental protection, and so on.

There are two important issues to be addressed in this context, in analysing the organization and performance of production. First, there would tend to be some failure in resource allocation when the commodities produced are public goods or involve strong externalities. This can be taken either (1) as an argument for having *publicly owned enterprises*, which would be governed by principles other than profit maximization, or (2) as a case for *public regulations* governing private enterprise, or (3) as establishing a need for the use of non-profit values—particularly of *social concern*—in private decisions (perhaps because of the goodwill that it might generate). Since public enterprises have not exactly covered themselves with glory in the recent years, and public regulations—while useful—are sometimes quite hard to implement, the third option has become more important in public discussions. It is difficult, in this context, to escape the argument for encouraging business ethics, going well beyond the traditional values of honesty and reliability, and taking on social responsibility as well (for example, in matters of environmental degradation and pollution).

The second issue is more complex and less recognized in the literature, but also more interesting. Even in the production of private commodities, there can be an important "public good" aspect in the production process itself. This is because production itself is typically a joint activity, supervisions are costly and often unfeasible, and each participant contributes to the over-all success of the firm in a way that cannot be fully reflected in the private rewards that he or she gets.

The over-all success of the firm, thus, is really a public good, from which all benefit, to which all contribute, and which is not parcelled out in little boxes of person-specific rewards strictly linked with each person's *respective*

contribution. And this is precisely where the motives other than narrow self-seeking becomes productively important. Even though I do not have the opportunity to pursue the point further here, I do believe that the successes of “Japanese ethos,” “Confucian ethics,” “Samurai codes of honor,” etc., can be fruitfully linked to this aspect of the organization of production.

5. *The Challenge of Distribution: Values and Incentives*

I turn now to distribution. It is not hard to see that non-self-seeking motivations can be extremely important for *distributional* problems in general. In dividing a cake, one person's gain is another's loss. At a very obvious level, the contributions that can be made by ethics—business ethics and others—include the amelioration of misery through policies explicitly aimed at such a result. There is an extensive literature on donations, charity, and philanthropy in general, and also on the willingness to join in communal activities geared to social improvement. The connection with ethics is obvious enough in these cases.

What is perhaps more interesting to discuss is the fact that distributional and productional problems very often come mixed together, so that how the cake is divided influences the size of the cake itself. The so-called “incentive problem” is a part of this relationship. This too is a much discussed problem,¹³ but it is important to clarify in the present context that the extent of the conflict between size and distribution depends crucially on the motivational and behavioral assumptions. The incentive problem is not an immutable feature of production technology. For example, the more narrowly profit-oriented an enterprise is, the more it would, in general, tend to resist looking after the interests of others—workers, associates, consumers. This is an area in which ethics can make a big difference.

The relevance of all this to the question we have been asked to address (“Does business ethics make economic sense?”) does, of course, depend on how “economic sense” is defined. If economic sense includes the achievement of a good society in which one lives, then the distributional improvements can be counted in as parts of sensible outcomes even for business. Visionary industrialists and businesspersons have tended to encourage this line of reasoning.

On the other hand, if “economic sense” is interpreted to mean nothing other than achievement of profits and business rewards, then the concerns for others and for distributional equity have to be judged entirely instrumentally—in terms of how they indirectly help to promote profits. That connection is not to be scoffed at, since firms that treat its workers well are often very richly rewarded for it. For one thing, the workers are then more reluctant to lose their jobs, since more would be sacrificed if dismissed from this (more lucrative) employment, compared with alternative opportunities. The contribution of goodwill to team spirit and thus to productivity can also be quite plentiful.

We have then an important contrast between two different ways in which good business behavior could make economic sense. One way is to see the

improvement of the society in which one lives as a reward in itself; this works directly. The other is to use ultimately a business criterion for improvement, but to take note of the extent to which good business behavior could in its turn lead to favorable business performance; this enlightened self-interest involves an indirect reasoning.

It is often hard to disentangle the two features, but in understanding whether or how business ethics make economic sense, we have to take note of each feature. If, for example, a business firm pays inadequate attention to the safety of its workers, and this results accidentally in a disastrous tragedy, like the one that happened in Bhopal in India some years ago (though I am not commenting at present on the extent to which Union Carbide was in fact negligent there), that event would be harmful both for the firm's profits and for the general objectives of social well-being in which the firm may be expected to take an interest. The two effects are distinct and separable and should act cumulatively in an overall consequential analysis. Business ethics has to relate to both.

6. *A Concluding Remark*

I end with a brief recapitulation of some of the points discussed, even though I shall not attempt a real summary. First, the importance of business ethics is not contradicted in any way by Adam Smith's pointer to the fact that our "regards to our own interest" provide adequate motivation for exchange (section 2). Smith's butcher-brewer-baker argument is concerned (1) directly with *exchanges* only (not production or distribution), and (2) only with the *motivational aspect* of exchange (not its organizational and behavioral aspects).

Second, business ethics can be crucially important in economic organization in general and in exchange operations in particular. This relationship is extensive and fairly ubiquitous, but it is particularly important, at this time, for the development efforts of the Third World and the reorganizational attempts in what used to be the Second World (section 3).

Third, the importance of business ethics in the arrangement and performance of production can be illustrated by the contrasting experiences of different economies, e.g., Japan's unusual success. The advantages of going beyond the pure pursuit of profit can be understood in different ways. To some extent, this question relates to the failure of profit-based market allocation in dealing with "public goods." This is relevant in two different ways: (1) the presence of public goods (and of the related phenomenon of externalities) in the commodities produced (e.g., environmental connections), and (2) the fact that the success of the firm can itself be fruitfully seen as a public good (section 4).

Finally, distributional problems—broadly defined—are particularly related to behavioral ethics. The connections can be both direct and valuational, and also indirect and instrumental. The interrelations between the size of the cake and its distribution increase the reach and relevance of ethical behavior, e.g., through the incentive problem (section 5).

Notes

¹Lamont University Professor, and Professor of Economics and Philosophy, at Harvard University.

²Stephen Leacock, *Hellements of Hickonomics* (New York: Dodd, Mead & Co., 1936), p. 75.

³Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776; republished, London: Dent, 1910), vol. I, p. 13.

⁴Adam Smith, *The Theory of Moral Sentiments* (revised edition, 1790; reprinted, Oxford: Clarendon Press, 1976), p. 189.

⁵On this and related matters, see my *On Ethics and Economics* (Oxford: Blackwell, 1987); Patricia H. Werhane, *Adam Smith and His Legacy for Modern Capitalism* (New York: Oxford University Press, 1991); Emma Rothschild, "Adam Smith and Conservative Economics," *Economic History Review*, 45 (1992).

⁶On this see Jean Drèze and Amartya Sen, *Hunger and Public Action* (Oxford: Clarendon Press, 1989).

⁷Michio Morishima, *Why Has Japan 'Succeeded'? Western Technology and Japanese Ethos* (Cambridge: Cambridge University Press, 1982).

⁸Ronald Dore, "Goodwill and the Spirit of Market Capitalism," *British Journal of Sociology*, 34 (1983), and *Taking Japan Seriously: A Confucian Perspective on Leading Economic Issues* (Stanford: Stanford University Press, 1987).

⁹Eiko Ikegami, "The Logic of Cultural Change: Honor, State-Making, and the Samurai," mimeographed, Department of Sociology, Yale University, 1991.

¹⁰Karl Marx (with F. Engels), *The German Ideology* (1845-46, English translation, New York: International Publishers, 1947); Richard Henry Tawney, *Religion and the Rise of Capitalism* (London: Murray, 1926); Max Weber, *The Protestant Ethic and the Spirit of Capitalism* (London: Allen & Unwin, 1930).

¹¹The classic treatment of public goods was provided by Paul A. Samuelson, "The Pure Theory of Public Expenditure," *Review of Economics and Statistics*, 35 (1954).

¹²For a classic treatment of external effects, see A. C. Pigou, *The Economics of Welfare* (London: Macmillan, 1920). There are many different ways of defining "externalities," with rather disparate bearings on policy issues; on this see the wide-ranging critical work of Andreas Papanandreu (*Jr.*, I should add to avoid an ambiguity, though I don't believe he uses that clarification), *Ideas of Externality*, to be published by Clarendon Press, Oxford, and Oxford University Press, New York.

¹³A good general review of the literature can be found in A. B. Atkinson and J. E. Stiglitz, *Lectures on Public Economics* (New York: McGraw-Hill, 1980). On the conceptual and practical importance of the incentive problem and other sources of potential conflict between efficiency and equity, see my *Inequality Reexamined* (Cambridge, MA: Harvard University Press, 1992), Chapter 9.

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