

Economic Efficiency and Ethical Behavior: Exploring Ideas on the Creation of Economic Values, the Workings of a Virtuous Market, and the Role of Profit

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Abstract:

This paper takes a brief look into a number of important issues that each requires a much deeper level of inquiry and analysis. The core issue is based on a fundamental assertion that ethics is an inherent component of a well-run economy and successful businesses. In recent years, business has been viewed increasingly as a major cause of social, environmental, and economic problems. This paper questions the sustainability of recent economic and business practices. It argues that the cost of economic crisis, the fallouts from unfair business practices and the emergence of an uncertain future for humans and other living beings on Earth are some of the more obvious costs of the inefficiencies caused by unethical behavior. The issue of profit maximization as a concept that works against its stated objective by bringing a fall in profit in the long term is looked into closely. It also questions the validity of a number of long-held economic principles of neoclassical economics. Finally, this paper looks into some of the existing ideas and practices that can lead to an emergence of policies that envisages the intersection between society and corporate performance through the creation of shared values in companies and societies for a sustainable economy and business future.

Key Words: Ethical Behavior, Working of Markets, Profit, Values, Sustainable Economy, Sustainable Business.

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Introduction:

This paper takes a brief look at three fundamental issues that have been widely argued in economic literature. They are:

- Economic efficiency and its relevance and importance in managing an economy and optimal allocation of resources.
- Creation of values through economic activities. An overview of the merging conceptual framework in a historic perspective with an emphasis on the relevance of postmodernism in economic thinking compared with a traditional neoclassical view.
- Role of profits in economics.

Each of these topics needs thorough research and a much deeper scrutiny than this paper allows.

Economic Efficiency and the Workings of Market-Based Economies:

Efficiency in economics is presented as a logical choice for allocation of resources when societies are confronted with scarcity. It is about deciding how to produce the most for a given amount of resources (scarce resources) or having the least resource cost (minimizing cost of scarce resources) for a given amount of production. It is a complicated concept as it depends on how production costs are defined and measured within a given situation. Those who favor a market-based economy strongly believe that efficiency is observed through the free working of markets and it shows itself in reaching equality between the marginal social cost of production and the price that consumers (buyers of the

products) are willing to pay for it. Price in such an argument is buyers' marginal willingness to pay for the product or the service.

Complexity of Costs Recognition and Calculation in Economics:

A free market assumes that every production decision (to some extent its pricing) is based on inclusion of all costs. In a free market, there is no consideration for externality (cost to the third party) or lack of information (asymmetry of information) for all the parties concerned (buyers and sellers).

The important issue is that we are never sure that: the cost of production includes all the existing and emerging costs; information is free and accessible; and there is always a market for production of a good or service. Production and thus emergence of a market for it emerges when there the prospect of a sustainable profit. These issues are argued extensively in market failure and interventions of various sorts are recommended.

We should also realize that there are two concepts in defining efficiency in relation to production decisions: technological efficiency and economic efficiency. Technological efficiency is an engineering matter which is the direct result of research and development. Given what is technologically feasible, we can decide what can be done or should be done. Economic efficiency depends on the prices of the factors of production. Something what is technologically efficient may not be economically efficient. But something that is economically efficient may eventually be technologically efficient.

Emphasis on Individuals Rather Than Governments:

Economists (mostly neoclassical) generally assume that individuals, not the government, are the best judges of what they want. Thus, the theory of economic valuation is based on individual preferences and choices. What one is prepared to give up determines the cost of what one prefers to have. It is often incorrectly assumed that in a goods market, price measures its economic value. In reality, what a person is willing to pay is, often, far more than what a person ends up paying.

Economic Values and Social Values in the Theory of Value:

The concept of economic values and social values bring considerable complexity into the discussion of values and its measurement and impact on the workings of an economy. This paper intends to bring some of the general contemporary thinking in the discussion of value and how it is viewed in economics. Given the purview of this paper, we introduce a condensed version of this discussion in its theoretical context. The aim is to articulate the role of values in economics during the past and present.

While values to individuals are relatively straightforward and can be measured in the theory of values and reflected in price as marginal willingness to pay, the concept of social values has not surfaced as a major point of debate in the economic literature up until the early 20th century. In an article published in the Quarterly Journal of Economics by Joseph Schumpeter in 1908, he brings up the discussion of social values as opposed to individual values.

"It is but recently that, in pure theory, the concept of social value came into prominence. The founders of what is usually called the "modern" system of theory, as distinguished from the "classical," never spoke of social, but only of individual value."^[1]

For a long time, economists have thought that values can be observed only through the feelings and preferences of individuals that are capable of feeling and making decisions on what satisfies them. Schumpeter in the same article states:

"It now becomes clear that the same reasoning cannot be directly applied to society as a whole. Society as such, having no brain or nerves in a physical sense, cannot feel wants and has not, therefore, utility curves like those of individuals. Again, the stock of commodities existing in a country is at the disposal, not of

society, but of individuals; and individuals do not meet to find out what the wants of the community are. They severally apply their means to the satisfaction of their own wants. Theory does not suggest that these wants are necessarily of an exclusively egotistical character.”[2]

In further discussions on how the wishes of individuals may serve a higher purpose than own immediate satisfaction, Schumpeter brings up the possibility of individuals wishing to see the happiness of others as a part of their own satisfaction in the form of altruism. He says:

“We want many things not for ourselves, but for others; and some of them, like battleships, we want for the interests of the community only. Even such altruistic or social wants, however, are felt and taken account of by individuals or their agents, and not by society as such. For theory it is irrelevant why people demand certain goods: the only important point is that all things are demanded, produced, and paid for because individuals want them. Every demand on the market is therefore an individualistic one, although, from another point of view, it often is an altruistic or a social one.”[3]

From the former discussion, it is clear that social values are not accepted as a standalone concept that needs to be looked into, measured and considered in decision making and policy formation. In the minds of Schumpeter and many other economists, the concept of social values outside and independent from the viewpoint of individuals was an emphasis that only existed in communistic societies. It is important to realize that while the economists may have rejected the existence of social values in the theory of utility, they considered it as important in other ways. The following quote from Schumpeter makes it clear that social values are important in our understanding of how an economy should function:

“The practical importance of this theory [theory of social value] is obvious. It tends to show that economic forces are not only of the same nature, at all times and everywhere, but also that they lead, under a régime of free competition, to the same results as in a communistic society. Competition and private ownership of productive agents are held to bring about a distributive process quite similar to one regulated by a benevolent and intelligent ruler. This theory attributes, indeed, to the law of social value the functions of such a ruler. Society itself is called upon to sanction what is actually happening, and it is assumed, that, apart from minor grievances, there is little to complain of.”[4]

Whichever way we look at the concept of values in the making of economic theories that explain the workings of markets and their impact on the allocation of resources, it is hard, if not impossible, to avoid the influence of thinking of economics as a science. Many economists would like to think that economics is unlike other social sciences; they build the economic theories on the notion that people have common objectives and are rational. “From this basis we are only a stone's throw away from objective science and highly reliable policy. Our definitive reality is the mechanistic world that is ours to conquer.”[5]

Looking at the evolution of our collective understanding of economics and how it worked, we come across four distinct eras:

Ancient: The ancient understanding of God or gods. God worked out his will on the landscape of the world on which people were placed.

Medieval: The western medieval world view was not much different. However, citizens were responsible to follow the wishes of the God, which were brought up in the natural laws. The world still worked at God's command.

Modern: In this upsurge of ideas we can see the influence of science. Economists began to develop a model of an economic entity with regular patterns of behavior due to common goals and rational abilities.

Postmodern: In this phase of our understanding of the workings of economic systems, the person's grasp of reality is conditioned by where he is in the scheme of things. The reality is a dynamic concept. In this framework, there is little argument in support of uniformity, homogeneity, and system-wide truths.

The challenge of postmodern science is in its relevance and application to economic science. Moving from one stage to another has been hard. The concept of an ordained world is much easier to pursue and develop economic policies. The same can be said about modern phases of our understanding of the world. Uniformity is a pivotal issue that makes sense given the formation of economic laws and policies, and the outcome may be much easier to explain and defend. So, we need to ask the following question:

Where do we go with postmodernism in economics, economic behavior and policy formation?

There are two questions that need to be considered and answered:

- First is the use of postmodern world view in explaining economic behavior and formation of economic policies.
- The second question is the role of values in postmodern economic thinking.

There are considerable disagreements and even different understandings of how postmodernism applies to economics and explains economic behaviors. Doug Brown presents an interesting connection between the philosophy of postmodern thinking and the realities in the economic world. According to Doug Brown:

"The postmodern drift of capitalism is doing many things, but the production of "social heterogeneity" is the most pressing. The high tech revolution, time-space compression, and the dis-embedding effects of global self-regulation are not only causing greater insecurity and de-centeredness along with the injustices that have always been part of capitalism, but they are producing a social condition in which the ability and means for people to define themselves differently from one another has dramatically increased. The postmodern drift is causing more pluralization, differentiation, individualization, fragmentation, dis-integration and diversity."[\[6\]](#)

The influence of postmodernism in explaining the workings of economic systems and the theory of economics has its own critics who raise issues with the tendency of the postmodern to take the "person" out of economic equations and instead putting in its place "persons". The critics see the negative of such worldview as a movement ignoring the role of individualism as a constructive element of the efficient workings of an economic entity. While avoiding such arguments will be hard, getting into such debates in a meaningful manner is not without a considerable level of difficulty, within a short opinion piece or essay such as the current one.

In the pre-capitalist era, economic activity was embedded into cultural, social, and religious life. Resources were produced and distributed according to one's place in the social order and the religious values of the community.

With modernity came the notion that resources could be allocated efficiently by an invisible hand. This hand did not need to be subject to social values and religious beliefs because it functioned according to laws of the universe that worked in a self-adjusting manner. This brought a high degree of freedom in the ways of thinking about economic forces and meeting the needs of the growing economies.

The problem with such configuration and conceptual understanding showed itself over many years as it drifted from its original understanding of a free market and transformed into a system in which the market is neither free nor functioning according to the laws of universe (even if this ever existed before).

Market-based economies began to show every sign of fatigue and divergence from its predicted path. The frequency of crises and the inability of containing them and solving the problems of human communities over time have reached an alarming level. Somehow, the race towards making profit in the face of its inevitable declining rate pushed the world and its economy into a deadlock. The misuse of technology, ignorance about environmental

constraints, rising chronic and long-term unemployment, political standoffs with little choice for a truly different course of action, fear of the unknown which supports a continuation of the status quo, and the growth of dissatisfaction and distrust of governments brought a bleak prospect toward many economies around the world.

Postmodernism, or at least a version of it, presents a unique paradigm that offers a different interpretation of how economic forces may play out. It shifts the acts committed by individual decision makers and forces that to come from people (persons) rather than individuals. It sees ethical behavior as a sustainable way of doing business and not a randomly selected course of action by a few. It sees altruism and good deeds as an inherent force within the communities. It is true that we still need political processes that make such restructuring possible. We look at such possible changes through the features of the new social bond that many believe are already in motion.

The new social bond has several important components:

- There must be an interest in moral philosophy as a guide to what is important in economic life. This is already in motion through the growth of civic societies, consumer activism and grassroots political movements (even though many have not been so successful for the time being. Nonetheless, they are getting stronger and learning from their mistakes).
- The spiritual and religious center of being human must not be ignored in the areas of economic thinking and by economists. We already see this process through growth of spirituality versus institutionalized religions.
- We must understand that technology should be driven by societies for their needs, rather than be an autonomous driver. It may be hard to find a practical model for how to move forward, but this is an effort worth paying attention to and working on into the future.
- One way to look at the issue of technology and its role in our societies is to look deeper and be wiser about technology as a constant input in a production function and look into it in relation to its impact on social processes involved for its development and use. In other words, we need to look into the social costs and benefits of the use and the development of technology much deeper.
- Our societies are too fragmented and we are so isolated from one another, which provide a fertile breeding ground for seeds of suspicion, divide, conflict and wars. The new social glue must contribute to an increased sense of homogeneity among people. Breaking out of the vicious circles of distrust and demonizing others who are different from us is difficult and it becomes more difficult when societies live in economic disorder, political upheavals, and isolation in its multiple dimensions.
- People must feel as they belong to a primary group of some kind in their work and in their leisure. We have lost the identity of an extended family, and technology is also fragmenting occupational identity.
- The emergence of social media and virtual environments that surpasses boundaries of political and economic divides (to some extent) may help us to bridge the gaps. We must protect and strongly support the existence and expansion of such environments at all costs.
- We must resist all the efforts aimed by government and non-governmental forces that would like to limit access to such environments.
- The new social glue must include a coherent explanation of the method of economics. Some (Steven Shuman)^[7] consider economics another form of communication, an ongoing conversation conducted in terms of metaphorical allusions, established conventions, appeals to authority and other rhetorical devices. There is a way to distinguish between analytical substance and argumentative rhetoric.
- Analytical substance specifies a function and often rhetorical arguments come along and bring with them a violation of the function.

- Finally, the new social glue must integrate the social and natural worlds into a more holistic framework.
- The lives of every living entity (human, animal, and plant) are totally interwoven in the tapestry of life on Earth.
- Evolutionary process is a formidable force that brings equilibrium and harmony on Earth and the equilibrium can have life in it, or not. Human beings can prolong the process or shorten it, but the cosmic dance will go on regardless of the choices that we will end up making.
- Creation, environmental integrity, and the role of people in the world need to be an important concern of the economists.

Role of Profit in Economics:

There is so much debate about profit and its contribution to the well- or ill-functioning of an economy. One way to look into profit is to start with its simple definition.

- Profit is a part of cost of production that is paid to the owner of capital.
- In a capitalist economy, the owner of capital is the decision maker on what to invest. Profit is therefore the primary, and in the long-term, the sole determiner of what to invest in and how the investment should be done (choice of technology, location and other prevailing circumstances).
- According to the proponents of profit, profit presents payments for the beneficial use of capital and fulfillment of the demands of consumers. [8] They believe that a business must earn profit in order to exist and therefore profit is the primary and for some the sole determinate of an investment decision.
- According to the supporters of the supremacy of profit, "profits are a social good—that profits are the fuel which makes the wheels of industry turn efficiently, the furnaces burn efficiently, the assembly lines hum efficiently—all contributing to the creation of profit, employment, production and, collectively, to the material betterment of society generally." [9]
- Proponents of profit see any attempt to limit the earning of profit will inevitably lead to emergence of inefficiency and threaten the creation and maintenance of a competitive environment which is the essential element of having progress and protecting the wellbeing of a society.
- Proponents of profits, often, see government as a nonproductive element and any attempt to nationalize will create inefficiency, a lack of progress, and may lead to the emergence of a politically restrictive and undemocratic environment.

While the rhetoric on the importance of profit is fierce and claims are high, the evidence to support such claims over time is not clear. So the question is how to differentiate between the positive and negative impacts of profits or argue under what condition profit seeking may entail a positive outcome for the economies and when this may not be true. What separates profit as a positive motive for betterment of economies and what may bring the opposite consequences?

The interesting picture that emerges from a number of studies and research in the last two decades show that the issue of profit by itself is not the sole determining element for the positive or negative impacts in an economy, but it is the manner in which companies conduct their business for the sake of earning profits. The existing researches also indicate that having an ethical business is more likely to reduce costs and increase profits and make the business more sustainable. Here are some of the findings:

- In a 2003 survey by Wirthlin Worldwide, 80 percent of people said they decide to buy a firm's goods or services partly on their perception of its ethics.

- Investments in unethical firms earn abnormally negative returns for prolonged periods.[10]
- Employee fraud costs firms \$600 billion a year, or six percent of the U.S. GDP.[11]
- Companies without a code of ethics do worse. In one study, they generated significantly less economic value added (EVA) and market value added (MVA) than those with a code, experienced more P/E volatility, and showed a decline in average return on capital employed, while those with a code of ethics showed a 50 percent increase.[12]
- Firms not explicitly committed to ethical dealings had worse profit/turnover ratios, 15 percent lower than others.[13]
- Workers less generous with their time are less productive. Others help them less and they have lower social standing.[14]
- Unethical behavior worsens communications: In the 2003 National Business Ethics Survey, 39 percent of employees at firms with no ethics programs reported misconduct when they saw it. By comparison, 52 percent did so in organizations with ethical standards alone, 67 percent with standards and either ethics training or an advice line/office, and 78 percent in firms with all three.
- Unethical behavior worsens retention and recruiting and adds to the employees' turnover cost. In the 2000 National Business Ethics Survey, 79 percent of employees said their firms' concern for ethics was a key reason they remained. Overall, ethical firms have lower turnover, so they tend to hold onto important skills and waste less time training new employees. They also attract top-tier talent more easily. Companies with the highest employee retention have the highest customer retention.[15]

A mere focus on profit without attention to ethical behaviors and social responsibility can be very costly for an economy. There is a body of research that strongly supports such notions:

- Child labor
- Lack of attention to environmental sustainability
- Excess payment for CEOs and top executives
- Commercialization of universities
- Profit driven healthcare, which has brought less productivity and efficiency
- A range of unsavory corporate practices, such as manipulation of earnings reported to shareholders
- Corruption and political manipulation of governmental system for business gains and profits
- Practices that resulted in lack of work safety, product safety, cultural evasion of societies, negative political developments, displacement of population, and worsening of income distribution.
- Senseless wars and destruction of human lives, environment, and properties for the clear purpose of ill-defined and misrepresented economic interests of nations that in reality serve the gains of only a few, and cause loss to many.

Concluding Remarks:

This essay presented a myriad of economic and social issues in a cursory fashion. The idea was to stimulate arguments for examining the status quo with a desire to question what may have worked in one time may not continue to work in the same way forever. Life on Earth is an evolving phenomenon, and so is the way we should be thinking about our economic structure and its function.

Traditional economic theories, while intellectually appealing, need to be relevant, meet the test of time, be pertinent to the emerging living and working environment, and respond positively to the needs of people. Assuming that

making more profit is an indicator of a better economy is outmoded and has no empirical support. Believing in an unrealistic world of free competition and the workings of a miraculous invisible hand does not have any substance. In the recent economic crisis brought about by the mismanagement of the financial sector in the USA, the profits of major companies did not fall for a long time. However, the slow recovery and long-term unemployment is still going on. Increased productivity only benefitted some of people in the U.S. and many other countries.[16] The trend of wages falling behind productivity is alarming and in many ways an unwanted structural change that is likely to change the balance against all people, regardless of where they are in the long-term. A healthy balance between wages and profit and the levels of wages within an economy is pivotal to the sustainability of the existing economic system.[17]

Postmodernism, although controversial, presents a different interpretation of how economic forces interact. It explains that acts committed by individual decision makers are the reflection of the desires and wishes of people (persons) rather than individuals. This acknowledges that societal forces bring about the change even if they are viewed as decisions that were made by the individuals. It sees ethical behavior as a sustainable way of doing business and not a randomly selected course of action by a few people. It sees altruism and the good deeds as an inherent force within the communities. It is true that we still need political processes that make such restructuring and rethinking possible. We look at such possible changes through the features of the new social bond that many believe are already in motion.

The issue before us is how we can move forward from a theoretical perception of how the economy is working or may work to establishing the institutions and the framework within which the new economy can function freely and reach the objectives which are desired. The modern economic institutions should give support to the following initiatives and polices:

- Keeping the channels of communications open and access to direct communications among the people regardless of their social and economic positions. This requires protection of law, vigilance of citizens and freedom of expressions without any hindrance.
- Strengthening the foundation for support of the following services and goods in the public sector:
 - Education at all levels and beyond secondary based on willingness and ability.
 - Healthcare
 - Protection of law and against any aggression
 - Food sufficiency when people are unable to have access to it (this may be a temporary arrangement and not needed on regular basis)
 - Shelter when people are not able to have access to it (on need and temporary basis when needed)
 - Airways should belong to public
- Freeing universities and institutions of research and development from the pressing dominance and reckless and limited horizon of solely profit-driven business interests and senseless competition for resources.
- Upholding the universal declaration of human rights without any diversion
- Promotion of non-profit entities for production goods and services.
- Promoting and expanding the concept of sharing resources in the emergence of a new and sustainable world.
- Looking for a holistic approach in the provision of education, healthcare, and the construction of the physical environment, recreation, work and leisure.

- Looking for ways that make prosperity possible without economic growth.

[1] See Joseph Schumpeter (1908), "On the Concept of Social Value," Quarterly Journal of Economics, volume 23, 1908-9. Pp. 213-232, <https://www.marxists.org/reference/subject/economics/schumpeter/value.htm>

[2] *ibid*

[3] *ibid*

[4] *ibid*

[5] See Jim Halteman (1994), The Role of Values in Post-Modern Economics, http://www.gordon.edu/ace/pdf/halteman_valuesinpomo.pdf

[6] See Doug Brown, "Doing Social Economics in a Post Modern World," Review of Social Economy vol. L:4, p. 388.

[7] See Steven Shulman, "Metaphors of Discrimination: A Comparison of Gunnar Myrdal and Gary Becker," Review of Social Economy, vol. L: 4, p.432.

[8] See Arnold Johnson (1982), "Functional Role of profit", http://www.fee.org/the_freeman/detail/the-functional-role-of-profits

[9] *ibid*

[10] See D. Michael Long and Spuma Rao, "The Wealth Effects of Unethical Business Behavior," Journal of Economics and Finance, vol. 19, no. 2, Summer 1995, pp. 65-73)

[11] See Association of Certified Fraud Examiners, 2002 Report to the Nation on Occupational Fraud and Abuse

[12] See Simon Webley and Elise More, Does Business Ethics Pay?: Ethics and Financial Performance, Institute of Business Ethics, London, 2003

[13] *ibid*

[14] See Francis J. Flynn, "How Much Should I Give and How Often? The Effects of Generosity and Frequency of Favor Exchange on Social Status and Productivity," Academy of Man

[15] See Bain and Co., cited in "The Success of the Socially Responsible Business and Investment Movements," speech given by Gordon Davidson at the World Future Society Conference, July, 2003

[16] See New York Times: Sunday Review, 2013, http://www.nytimes.com/2013/01/13/sunday-review/americas-productivity-climbs-but-wages-stagnate.html?_r=0 Also see Joao Paulo and John Van Reenen, Decoupling of Wage Growth and Productivity Growth? Myth and Reality, CEP Discussion Paper No 1246, <http://cep.lse.ac.uk/pubs/download/dp1246.pdf>

[17] See Henry Blodget (2013), Profits Just Hit Another All-Time High, Wages Just Hit Another All-Time Low <http://www.businessinsider.com/profits-at-high-wages-at-low-2013-4#ixzz39pTio66A>