Ethics, Incentives, and Organizational Design

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Over the past decade, much public attention has been devoted to the issues of business ethics and corporate social responsibility. Politicians and social critics have deplored the materialism of the ’80s; the media have treated the public to sensational accounts of corporate scandal; and business schools across the country have begun offering courses in ethics.

Many U.S. corporations have responded in recent years by issuing formal codes of conduct, appointing ethics officers, and offering employee training programs in ethics. Such codes and programs cover a wide range of behavior, but most emphasize the following:

- compliance with laws and statutory regulations;
- honesty and integrity in dealings with customers and other employees; and
- the avoidance of conflicts of interest with the company.

While few would quarrel with such aims, equally few proponents of such corporate initiatives have bothered to ask questions like the following: Are such codes and programs likely to be effective in deterring unethical behavior by corporate managers and employees? And, more pointedly, is the behavior enjoined by such codes consistent with the normal incentives of employees or managers, given the current organizational structure of the firm?

Although this is rarely recognized in most public discussions of the subject, corporate ethics and organizational design are strongly connected. If business people are to behave ethically in their roles as managers and employees, corporate reward systems and other organizational “rules of the game” must be designed to encourage such behavior.

In this article, we make four basic arguments:

- The purpose of the corporation is to maximize its value to its owners (primarily the stockholders). Taking care of other corporate “stakeholders” such as employees and local communities is important, but only insofar as it contributes to the owners’ value.
- A company’s reputation for ethical behavior, including its integrity in dealing with non-investor stakeholders, is part of its brand-name capital; as such, it is reflected in the value of its securities. By the same token, individuals’ “human capital”—that which determines their future earnings prospects—is based in large part on their reputation for ethical behavior. In this sense, private markets provide strong incentives for ethical behavior by imposing substantial costs on institutions and individuals that depart from accepted social standards.
- Considerable emphasis in corporate ethics programs is put on misplaced efforts to change employees’ preferences by attempting to persuade them to put the interests of the organization or its customers ahead of their own. Our approach instead accepts people’s preference as given and assumes they will follow their perceived self-interest. We focus on structuring the organization in ways that better align the incentives of managers and employees with the corporate aim of maximizing value.
- Even if ethical guidelines and training programs are unlikely to alter fundamental preferences, they have the potential to add value by explicitly communicating the firm’s expectations to its employees. To be effective, however, such guidelines should be reinforced by sanctions and must be supported by the firm’s performance evaluation, promotion, and compensation systems.

*This material is adapted from our forthcoming book, Management Economics and Organizations (Richard D. Irwin). For much of our understanding of the problems of organizational design, as well as the concept of organizational “rules of the game” mentioned in this paper, we owe a large debt to the work of William Meckling and Michael Jensen on agency cost theory. See, especially, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” Journal of Financial Economics, Vol. 4, No. 4 (October 1976); and “General and Specific Knowledge and Organizational Structure” in Contract Economics, Lars Werm and Hans Wijkander, eds. (Blackwell, Oxford 1992).

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THE CORPORATE MISSION, ETHICS, AND SOCIAL RESPONSIBILITY

Most people have a pretty good idea what they mean when they describe an individual as “ethical.” Most of us feel an emotional allegiance to the “golden rule” that urges us to treat others as we would have them treat us, and we value qualities such as honesty, integrity, fairness, and commitment to the task at hand.

But when it comes to defining the ethics of organizations like public corporations that encompass large groups of people, there is bound to be confusion. A corporation, after all, is simply a collection of individuals—or, more precisely, a set of contracts that bind together individuals with different, often conflicting, interests. In this sense, corporations themselves do not behave ethically or unethically—only individuals do. And if corporate managers and employees are not pursuing their own interests, then whose interests are they serving? Their bosses? The shareholders? The board’s? And what if there are major conflicts among these various interests?

One source of confusion is the concept of “corporate social responsibility,” which is often used interchangeably with corporate ethics. In 1969, Ralph Nader and several other lawyers launched their Project on Corporate Responsibility with the following statement:

Today we announce an effort to develop a new kind of citizenship around an old kind of private government—the large corporation. It is an effort which rises from the shared concern of many citizens over the role of the corporation in American society and the uses of its complex powers. It is an effort which is dedicated toward developing a new constituency for the corporation that will harness these powers for the fulfillment of a broader spectrum of democratic values.1

As Nader’s statement suggests, the aim of advocates of corporate social responsibility is nothing less than to change the “objective function” of the corporation. Financial economists have long argued that the primary goal of corporate management is to maximize the market value of the firm—or, what amounts to the same thing, the net present value of future cash flows distributable to the firm’s investors.2 By contrast, the corporate social responsibility movement seeks to make management responsible for upholding “a broader spectrum of democratic values.” Corporate support for such values could take the form of philanthropic activities, the provision of subsidized goods and services to certain segments of the community, or the use of corporate resources on public projects such as education, environmental improvement, and crime prevention.

In the view of Nader et al., the corporation is to be transformed from a means of maximizing investor wealth into a vehicle for using private wealth to redress social ills.

A COALITION OF PUBLIC-INTEREST GROUPS RECENTLY charged that four leading telephone companies are engaging in “electronic redlining” by bypassing low-income and minority communities as they begin to build advanced communication networks. These groups asked the Federal Communications Commission to clarify its rules and issue a policy statement opposing discrimination in the building of such networks. By raising charges of redlining, these groups seek to persuade the firms to provide service earlier to, and thereby subsidize, less profitable markets. A spokesman for one firm pointed out that to achieve its plan of “wiring” half of the state of California by 2000 “without raising rates,” the company “must [first] bring the network to areas where it will generate some new business and revenues, so ultimately we can bring it to everyone in the state.”3

The conflict between Nader’s and economists’ views of the corporation is not quite as pronounced as it might appear. Corporations intent on maximizing firm value often find it in their interest to devote resources to non-investor stakeholders such as employees, customers, suppliers, and local communities. For example, a company with a large plant in an inner city might decide that investing corporate resources and personnel to improve area schools leads to better trained workers and eventually lower-cost products. Giving money to the local university might benefit the firm by improving its R & D and increas-

2. This assumes that any important “externalities” have been addressed by regulation.
ing its access to top graduates. Improving the environment lowers the company’s legal exposure to damage claims and might also lower its wage bill to the extent a cleaner local environment makes it easier to attract skilled workers.

Maximizing firm value, in fact, means devoting resources to members of each important corporate constituency to improve the terms on which they contract with the company, to maintain the firm's reputation, and to reduce the threat of restrictive regulation. More precisely, it means allocating corporate resources to all groups or interests that affect firm value—but only to the point where the incremental benefits from such expenditures at least equal the additional costs.

This economist’s standard of corporate social responsibility was set forth by Nobel laureate Milton Friedman as follows:

In a free-enterprise, private property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society. ...

What does it mean to say that the corporate executive has a “social responsibility” in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example... that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment...

[The problem in this case is that] the corporate executive would be spending someone else's money for a general social interest... [when] the stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so.4

Consider the issue of corporate philanthropy. There are a number of reasons why it is more efficient for the corporation to focus on creating wealth and to let its shareholders, employees, and customers choose the beneficiaries of their charitable contributions. By maximizing their shareholders’ or owners’ wealth, corporations effectively maximize the size of the pie available for distribution; and, in so doing, they enlarge the pool of individual (non-corporate) resources available for charity.5

The experience of the '80s, incidentally, is consistent with this argument: During this decade of large shareholder gains, total charitable giving—which includes individual, corporation, and foundation contributions—expanded in real dollars at a compound annual growth rate of over 5%, a growth rate over 50% higher than in the previous 25 years. Moreover, private donations rose from an historic low of 2.1% of national income in 1979 to 2.7% in 1989.6

Also important, there is unlikely to be complete agreement among all corporate stakeholders about which charities should receive corporate donations. Customers, employees, or independent sales agents objecting to the firm’s choice of charities may take their business or services elsewhere. The net result could be that firm value—and, hence, the size of the pie that can eventually be distributed to charities—is reduced.

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TAKE THE CASE OF PIONEER HI-BRED INTERNATIONAL, the world’s largest seed company. The company provided financial support for Planned Parenthood of Greater Iowa. But when right-to-life groups voiced strong objections in the farming communities where the firm does business, the company was forced to withdraw its sponsorship. As the Wall Street Journal reported, “We were blackmailed,” declares Pioneer chairman and president Thomas Urban. But, he says, “you can’t put the core business at risk,” even though the company concedes that canceling funding probably upset as many farmers as it appeased and the boycott didn’t end.7

People who advocate ever larger corporate contributions to charities and social causes such as retraining displaced workers and environmental clean-up (without consideration of their own long-

run profitability) are effectively calling for higher implicit taxes on corporations. If all companies are so taxed, the taxes are ultimately borne not only by shareholders in the form of lower returns to capital, but also by workers in the form of lower wages, and customers in the form of higher prices. Thus, ironically, the likely social consequences of such an increase in corporate social responsibility are lower rates of economic growth, lower corporate values, higher unemployment, and overall reductions in charitable donations—that is, reductions in donations by individuals that more than offset the increases in corporate giving.

**THE PROBLEM OF AGENCY COSTS**

Most financial economists, then, are inclined to endorse Milton Friedman’s prescription that the social mission of the corporation is “to make as much money for its owners as possible while conforming to the basic rules of society.” As we noted, some companies will find it in their shareholders’ interest to “invest” in social causes of various kinds; but corporate investments that systematically fail to provide adequate long-term returns to private investors are wealth transfers that end up reducing social as well as private wealth.

In this sense, the “problem” to which the corporate social responsibility movement addresses itself is really not about ethics. Most corporations, however, do face an important management problem that some might consider a problem of ethics, but it’s one that economists tend to view as a problem of organizational design.9 The problem is known in the economics and corporate finance literature as “agency costs,” and it has to do with the difficulty in making evaluative behavior—activities which are themselves time-consuming and costly.

Perhaps the most straightforward way to make an agent behave like a principal is to make the agent into a principal—say, by giving the restaurant manager (or corporate manager or employee) an ownership stake in the business. But this solution is likely to be only partly effective (since partnerships are also liable to shirking by partners) as well as quite costly (in the form of dilution of ownership).

A perhaps more common, and often more cost-effective, solution is to devise an incentive compensation contract specifying the agent’s duties, the performance measures by which the agent will be evaluated, and the compensation for performing them. And, to the extent the performance measure accurately reflects the principal’s interest, the incentive compensation contract reduces agency costs by aligning the interests of agent and principal. For example, in the case of a corporate division manager, a profit-sharing arrangement awarding the manager a stated percentage of the division’s profits might be a cost-effective way of reducing agency costs in a large, diversified corporation.

For most corporate employees, however, it is impossible to structure perfect contracts, in large part because of the difficulty of devising objectively verifiable measures of performance that are perfectly aligned with the interests of corporate owners. In the absence of such precise and objective measures, one must resort to other means of monitoring and evaluating behavior—activities which are themselves time-consuming and costly.

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8. The primary aim of economics is to describe and predict human behavior, not prescribe it. Classical economics begins with the assumption that people follow their perceived self-interest, weighing the expected benefits against the costs of alternative courses of action, and then choosing the course whose net benefits appear greatest. Ethical considerations enter into this personal calculus. For most people, violating one’s code of self-conduct imposes a “cost” in the form of lost self-esteem. And even if one’s sense of self-worth is not bound up with a personal code, the regard of one’s friends and colleagues surely acts as a restraint on unethical behavior.

To illustrate agency problems that can arise with performance evaluation and monitoring, take the case of hiring someone to paint your house. Especially in performing tasks that are hard to monitor such as surface preparation (sanding, priming, etc.), the painter has incentives to shirk—or, at least, to do a job that may not be as thorough as you might like. Of course, this same painter will also be prompted by other considerations to do a good job. It may be a matter of private conscience; that is, the painter’s sense of self-worth might be tied up with the quality of the workmanship, and violating such a self-imposed standard would impose major “costs” in the form of a tarnished self-image. Or the painter may be constrained by the desire to maintain his commercial reputation (and, though it might take some time for a poor job of surface preparation to show its effects, the quality will eventually reveal itself). As we noted earlier, reputation is an important contributor to one’s “human capital,” or the capitalized value of one’s expected future earnings.

But because the promptings of conscience and the desire to maintain a reputation are neither universal nor constant, it’s impossible for you to know the extent to which your painter is bound by such considerations. You face an information problem: you do not know when hiring the painter the kind of surface preparation you will get, nor will you be capable of ascertaining that until well after the job is done and the bill is paid.

To reduce your vulnerability in such circumstances (which economists refer to as cases of “informational asymmetry”), you will likely ask for a list of references (if the painter has not already provided one). Such references should give you some basis for assessing the painter’s time horizon and the importance he attaches to reputation. The painter might also offer, or you might insist upon, a one- or more-year warranty on the job. (Such common practices as the use of warranties and, as we discuss later, third-party reference and credit checks play an important role in reducing agency costs in the business world.)

But, despite such assurances, some uncertainties about the painter’s level of performance remain. For example, will he be around to make good on the warranty if the paint peels in a year? Perhaps the painter has heavy debts and is about to declare personal bankruptcy. Or perhaps yours will be the painter’s last job before he embarks on a new career painting still-lifes and family portraits.

As a consequence of the possibility of shirking and your own remaining uncertainty, you as the principal effectively reduce the price you are willing to pay. Or, to state the converse of this proposition, if there were some means for the painter to provide you with complete assurance about his level of commitment, you would offer to pay a higher price for the job.

As economists, we would like to make three points using this simple example. First, let’s assume you were able to design a perfect contract; for the sake of argument, let’s say you had a camera that enabled you to observe the painter’s activity at random intervals (and the painter knew you had it), and that you were able to structure a pay schedule based on the observed effort. Even if you were able to devise such a monitoring and reward scheme, it would clearly not pay you to do so. The cost to you of writing, administering, and, most important, monitoring compliance with such a contract would be substantial—probably greater than the value of the painting job itself.

Thus, as this simple illustration is meant to point out, in most cases it does not pay to attempt to eliminate all possible shirking; because of the costs of writing and monitoring compliance with contracts, it pays to leave some slack in the system. In economists’ terms, the optimal amount of shirking or opportunistic behavior by the agent is not zero.

Second, the expected level of opportunism or shirking—which, again, is greater than zero—is priced in the contract. Thus, the principals do not bear the full costs of opportunistic actions by their agents. At least some of these costs are shifted back to agents in the form of lower prices for their services or products.

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Higher ethical standards would lead to a reduction in the level of expected opportunistic behavior and hence a reduction in agency costs. As a result, there would be more transactions (including more jobs created) and higher prices paid to agents by principals (including higher corporate wages).

Third, higher ethical standards among agents, whether corporate employees or participants in market exchanges, would lead (over time) to a reduction in the level of expected opportunistic behavior and hence a reduction in agency costs. As a result, there would be more transactions (including more jobs created) and higher prices paid to agents by principals (including higher corporate wages). This would occur not only because of a reduction in the amount of shirking, but also because the costs of writing and monitoring contracts would fall. Both principals and agents would be better off.

As economist Jack Hirshleifer makes this last point, “Altruism economizes on the costs of policing and enforcing contracts.”11 For a concrete illustration of Hirshleifer’s argument, consider the following testimony by the retired CEO of a small company:

Must of our products were custom-made. Customers called in their orders over the phone. The orders, ranging in value from a few hundred dollars to tens of thousands of dollars, generally required delivery of goods within one or two days. It meant we would usually begin production before receiving a confirming purchase order. (This was before faxes.) The customer’s word alone was enough. In my 20-year stint as CEO, not once did a customer go back on it. Unusual? Not at all. Without such trust, business couldn’t be conducted. Similar transactions happen every day…. (We) learned there are two ways to go: An eye for an eye, or do unto others what you would have them do unto you. In business, the latter philosophy is far more common, simply because it makes things work better.12

The above story makes an important point about the economic consequences of ethics: If we as a society could get everyone voluntarily to reduce opportunistic behavior such as withholding important information, then the resources devoted to monitoring and enforcing exchanges could be used in more productive pursuits.13

THE ROLE OF CODES OF ETHICS IN REDUCING AGENCY COSTS

As economists, then, we view the corporate ethics problem as primarily a problem of reducing agency costs. And, generalizing from the above discussion, there are several potential ways to reduce agency costs. One is to use contracts that better align the interests of managers and the employees they supervise with those of shareholders. Examples of such contracts in corporations are executive or employee stock options, bonus plans, and profit-sharing arrangements.

The second is to raise the ethical standards so that corporate managers and employees face higher costs from value-reducing behavior. (Even in cases where such costs are self-imposed, sanctions will also act as a reinforcing deterrent.) Both more cost-effective incentive contracts and higher ethical standards can be expected to lead to lower agency costs, greater corporate efficiency, higher corporate values, and greater social welfare.

As mentioned earlier, many companies and most professions have written codes of conduct; and some companies also have educational programs dealing with ethics for their employees. Most codes and programs emphasize the following:14

- Employees must support the company’s policies to customers.


Consistent with Smith’s analysis, a study of 132 cases of alleged corporate fraud reported that the common stock values of these firms declined by a total of $60.8 million on the two days of the initial press reports of the allegations. This decline in value occurred before the cases were adjudicated. Because only 6.5% of the $60.8 million market value decline was due to subsequent court-imposed costs (penalties and fines), the authors concluded that the majority of the stock price drop was attributable to loss of reputation. See Jonathan Karpoff and John Lott, “The Reputational Penalty Firms Bear from Committing Criminal Fraud,” Journal of Law and Economics 36 (October 1993), pp. 757-802.


14. Note that these codes are not unique to the U.S. For example, similar codes are observed in Australian firms. See Bruce Kaye, “Codes of Ethics in Australian Business,” Journal of Business Ethics, Vol. 11 (1992).
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.

Why have corporations adopted such codes? The most cynical view is that corporate codes of ethics are nothing more than documents that help the firm defend itself against charges of illegality. The new sentencing guidelines issued by the United States 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, a company found guilty of wrongdoing in fulfilling a government contract can reduce its penalties by more than 50 percent simply by demonstrating that it has a compliance program that meets the Sentencing Commission's standards.15

But corporate ethical codes, as we have just argued, also have the potential to perform the economically valuable function of reducing the costs of monitoring and enforcing contracts. To the extent they reduce managerial and employee opportunism, better ethical standards can increase corporate brand-name capital and hence shareholder wealth.

The critical questions, however, are these: Are ethical codes effective in deterring unethical behavior? And if they are, how or why are they effective?

There are two basic ways to view the function of corporate codes of conduct in reducing opportunistic behavior. One way is by appealing directly to employees' conscience and so attempting to instill in them loyalty to the organization and its goals. Economists describe this as an attempt to change people's "preferences."

Now, there is undoubtedly some value to this approach. As we noted earlier, personal codes of conduct, and the guilt one suffers in violating such codes, are undeniably constraints on many people's behavior. In economists' language, conscience and guilt are elements of individuals' "utility functions." As the following statement by Nobel laureate Kenneth Arrow suggests, even concepts as subjective as ethics and morality can be shown to be consistent with the economist's notion of rational self-interest:

Certainly one way of looking at ethics and morality ... is that these principles are agreements, conscious or, in many cases, unconscious, to supply mutual benefits ... Societies in their evolution have developed implicit agreements to certain kinds of regard for others, agreements which are essential to the survival of the society or at least contribute greatly to the efficiency of its working. ... The fact we cannot mediate all our responsibilities to others through prices ... makes it essential in the running of society that we have what might be called "conscience", a feeling of responsibility for the effects of one's actions on others.16

The problem in applying this logic to corporate management, however, is that such "agreements to supply mutual benefits to others" are likely to be too amorphous to serve as a practicable guide to individual behavior in large public companies with diffuse stock ownership. If corporate factory workers are understandably unmoved by serving an anonymous group of "wealthy" shareholders, then who precisely are "the others" whose interests their morality is intended to serve? And what should employees do in those cases, noted earlier, where there appear to be (at least short-run) conflicts between the interests of the corporation and those of its non-investor constituencies. After all, the effective management of scarce resources, as we saw earlier, often means saying no to the requests or desires of some employees, customers, and local communities. Moreover, the entire situation is complicated by the fact that the fundamental goal of the corporation—making money for its owners—is viewed as "immoral" or "unethical" by many advocates of corporate ethics.

Given this confusion about and even conflict between some professed ethical objectives and the goal of the corporation, we are skeptical about corporate attempts to instill conscience or a sense of guilt in their employees—that is, to change employees' preferences. To the extent these corporate ethics programs are aimed at trying to change employees' preferences, they are likely to fail.

An Illustration. Consider the transfer pricing problem faced by corporations with multiple divisions that buy and sell to one another. The solution to this problem that maximizes firm value is to set the transfer price to the buyer at the seller’s marginal cost of producing one more unit. But let’s assume, as tends to be the case, that the selling or manufacturing division has better information about its marginal cost of producing one more unit than the purchasing division.

In such a situation, to the extent the manager’s compensation is based on divisional profits, the selling division’s manager has the incentive to set the transfer price substantially above marginal cost. In such a case, the manufacturing division’s pursuit of its own profits will come at the expense of total firm-wide profits (because the buying division will purchase less than the optimal number of units).

Now, if the firm’s code of ethics somehow succeeded in inducing divisional managers to reveal their information about marginal costs, units within the firm would be transferred at marginal cost, and firm profits would be increased. But, as long as division managers are being paid based on the profits of their own divisions, they are unlikely to reveal their actual marginal costs.

As economists, then, we generally assume that individuals’ preferences are given and for the most part difficult to change. We thus believe that managers, instead of attempting to change preferences, should structure the organization’s rules of the game to change their employees’ incentives to take certain actions. For example, in the above case, top management should attempt to find a means of giving the divisional manager some stake in the profitability of the division to which he “sells” his product. A common, though partly effective, solution to this problem is to give divisional managers stock options with payoffs tied to overall company value as well as bonuses for divisional performance.

The Informational Role of Codes of Ethics

Even if corporate codes of ethics are unlikely to change preferences or eradicate self-interest, such codes can still play a potentially important role in modifying behavior. Up to this point, we have assumed that corporate managers and employees know what is the “right thing” to do to promote the interests of the organization. But this assumption may not always hold. 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.

We earlier described the confusion about the corporate mission stemming from the aims and actions of the social responsibility movement. Another potential source of confusion resides in the variability of ethical standards. What may have been acceptable behavior ten or twenty years ago may not be so today. Social changes such as those brought about by movements as different as civil rights and women’s rights, on the one hand, and corporate restructuring, on the other, have clearly altered conceptions of socially accepted 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 ethical behavior in large organizations, corporate codes of ethics and training programs can play an 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 for short-term gain can be shown to 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 may be forced to respond to the increasing cultural differences—or absence of shared expectations—among their managers and employees by providing more explicit communication of standards and expectations.

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ON APRIL 24, 1994, THE MIAMI HERALD REPORTED that H. Richard Handley, the president of Citibank Argentina, had sold portions of Citibank’s Argentine assets to some of his friends at “what now look like bargain prices.” Citicorp spokesmen dismissed that talk as “Monday morning quarterbacking,” pointing out that, at the time of the first sales, there was an equal chance that the value of Argentine investments would rise or fall thereafter.
For our purposes, it is not important whether the terms of this particular set of transactions were appropriate or not; they may well have been deals that furthered important business interests of Citicorp in Argentina. What this case highlights, however, are the costs associated with the potential for self-dealing by corporate managers, and the importance of stating and enforcing policies for business dealings on less than an arms-length basis. The structure of this deal has forced Citibank to defend its actions to employees, investors, and regulators.

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

More generally, codes of conduct and training programs in ethics have the potential to contribute to the building and maintaining of a “value-based” corporate “culture.” Like corporate ethics, corporate culture is an ill-defined term, but it generally encompasses things such as the ways work and authority are organized within a company as well as organizational features such as customs, taboos, company slogans, heroes, and social rituals. For example, slogans like Ford’s “quality is our most important product” help communicate the message that employees are expected to focus on quality and that this focus will be recognized and rewarded by the organization. Singing out role models or heroes for special awards is another way of communicating the values of the company. Similarly, social rituals such as training sessions and company parties can help disseminate information by increasing interaction among workers and encouraging discussion of ethical standards. Indeed, the process by which a code of ethics is produced and the training programs through which these standards are communicated are likely to be more important than the code itself in developing and maintaining the desired corporate culture.

Nevertheless, to create the “value-based” or “consumer-focused” organization that many companies seek to become—these less tangible or “softer” aspects of corporate culture must be reinforced by more tangible actions. That is, the more formal corporate rules of the game—rules that include performance evaluation, promotion, and compensation systems, as well as sanctions for unethical behavior—must all be internally consistent and designed to encourage value-increasing behavior.

XEROX’S CEO DAVID KEARNS, IN RESPONSE TO FALLING CORP. EARNINGS AND A STOCK PRICE DECLINE IN THE EARLY ‘80S, ATTEMPTED TO INITIATE A MAJOR CULTURE CHANGE FOCUSED ON CUSTOMER SATISFACTION AND QUALITY. SAYS KEARNS: “OUR CUSTOMER CANCELLATIONS WERE RAPIDLY ON THE RISE, AND OUR RESPONSE TO THE PROBLEM WAS TO TRY TO OUTRUN THEM [BY] PUSHING HARD TO GET ENOUGH NEW ORDERS TO OFFSET THE CUSTOMERS WE HAD LOST. CUSTOMERS WERE FED UP WITH OUR COPIERS BREAKING DOWN AND OUR SERVICE RESPONSE.”

But, after much training, the desired culture change was not occurring. And Kearns came to the recognition that to affect employee behavior, top management had to do more than just cajole and plead; the system of rewards and punishments also had to change. As Kearns says, “UNLESS PEOPLE GET REWARDED AND PUNISHED FOR HOW THEY BEHAVE, NO ONE WILL REALLY BELIEVE THAT THIS IS ANYTHING MORE THAN LIP SERVICE. A WIDESPREAD PROBLEM [WITH IMPLEMENTING THE CULTURE CHANGE] THAT WAS SINGLED OUT WAS THAT PEOPLE SAID WE WERE STILL PROMOTING AND REWARDING EMPLOYEES WHO WEREN’T TRUE BELIEVERS AND USERS OF THE QUALITY PROCESS. THIS WAS CREATING NOISE IN THE SYSTEM AND SENDING MIXED SIGNALS. IT HAD TO STOP.”

Kearns accordingly initiated changes in the criteria for promotions and salary decisions that placed major emphasis on customer satisfaction and quality. Eventually, the culture at Xerox did change and, in 1989, Xerox won the coveted Malcolm Baldridge National Quality Award.17

MARKET MECHANISMS FOR ENCOURAGING ETHICAL BEHAVIOR

As stated earlier, ethical lapses are a manifestation of a conflict of interest, or agency problem; and, in most market exchanges, parties to the contracts have incentives to devise mechanisms to reduce agency costs, thereby raising the prices they receive.

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Codes of conduct and training programs in ethics can help build and maintain a “value-based” or “consumer-focused” corporate culture. But the less tangible or “softer” aspects of the culture must be reinforced by the more formal corporate rules of the game—rules that include performance evaluation, promotion, and compensation systems.

for their products or services. For example, when taking their firms public for the first time, founders of companies typically continue to hold large portions of the stock, and voluntarily impose restrictions on their own selling, to help ensure that their interests are consistent with those of their IPO investors. Such arrangements effectively raise the price investors are willing to pay.

As we also noted earlier, because reputational capital is an important determinant of future earnings, market forces provide incentives for firms and individuals to behave ethically. But the effectiveness of market forces in reducing conflicts of interest and enforcing contracts varies among different kinds of transactions. Among the most important characteristics of such transactions are the difficulty of ascertaining product quality prior to purchase and the likelihood that the transaction will be repeated.

Take the case of a buyer purchasing a product. For products whose quality can be determined at low cost prior to purchase, markets readily solve this problem. If buyers can cheaply monitor quality, they have strong incentives to do so. For example, a buyer negotiating a purchase of silver for Kodak can confidently and cheaply ascertain its quality by assay.

For some products, however, quality is impossible to 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. Although sellers have incentives to cheat on quality when quality is expensive to measure, rational sellers will provide products of lower than promised quality only if the expected gains exceed the expected costs.

Repeat Sales. One important constraint on such cheating is the potential for future sales. Moreover, corporations with established market positions and substantial franchise values face higher costs of cheating and hence are less likely to do so than startup firms. The costs of cheating on quality are also higher if the information about such activities is more rapidly and widely distributed to potential future customers. For example, in markets like the diamond trade in New York, which is dominated by a close-knit community of Hasidic Jews, cheating on quality is extremely rare.

Third-Party Monitors. In some markets, specialized information services monitor the market, certify quality, and help to ensure contract performance. For example, Consumer Reports evaluates products from toasters to automobiles, the Investment Dealer Digest reports on activities of investment bankers, and US News and Business Week rank MBA programs. These third-party information sources lower the costs for potential customers to determine quality and so increase the expected costs of cheating.

IN 1991, RICE AIRCRAFT COMPANY BECAME THE FIRST company in its industry to earn ISO 9002 accreditation, the highly regarded international standard for quality management. This was a significant, highly visible signal of change within the firm. For in August 1989, Bruce J. Rice, CEO of Rice Aircraft, had pled guilty to fraud and was sentenced to four years in prison. The Defense Department forbade its contractors to do business with the company for five years, and annual sales fell from $15 million to $5 million. At this point, Paula DeLong Rice, Rice’s wife, took over and set out to save the company by visibly and radically transforming it. She implemented a total quality initiative and provided classes in statistical process control, time management, and communications for all the company’s employees.

Ms. Rice’s strategy appears to have been quite effective. Profit margins increased from 12% in 1992 to 27% in 1993 without benefit of price increases; order cycle time was reduced by 50%; and on-time deliveries increased 98%. Ms. Rice, moreover, is now in great demand as a speaker on managing for quality.

In credit markets, specialized credit-information services like Moody’s and Dun and Bradstreet perform both a monitoring and an information dissemination function. The existence of such intermediaries provides an opportunity for the firm to guarantee quality. For this reason, corporate issuers 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) of ascertaining the firm’s financial condition.

Capital Structure. Moreover, companies in financial distress are more likely to cheat on quality than financially healthy firms. Some firms can help “bond” product quality by adopting conservative financial policies. Since financial distress is more costly for firms that market products where quality is difficult to ascertain, such firms have incentives to adopt financing policies—including lower leverage, fewer leases, and more hedging—that lead to a lower probability of financial distress.
Disclosure and Regulation. The required level of disclosure in markets can also be important in determining quality. For example, a study of two wholesale used car markets with different levels of required disclosure found that prices in the market with more required disclosure are higher. The ability to “precommit” to disclose information reduces the potential information disparity between buyer and seller and so reduces that discount buyers apply to their demand prices.

Organizational Structure. Incentives to provide high-quality products vary across ownership structures. Take the case of franchise companies such as fast-food and lawn-care firms. Such companies typically franchise some units instead of owning all their stores in order to take advantage of the incentive benefits of decentralized ownership while retaining scale economies in advertising and brand-name promotion.

Outlets that have little repeat business create a special problem. The franchise owners of these stores have an incentive to cheat on quality because they can benefit from a steady stream of one-time sales while hurting the reputation of the entire organization. At these locations the central company is more likely to own the unit than to franchise it, in part because a salaried manager has less incentive to cheat on quality.

IN SUMMARY

There is considerable confusion about the meaning of “corporate ethics.” The corporate social responsibility movement has focused less on raising corporate ethical standards than on transferring shareholder wealth to other parties such as customers, employees, and local communities. While these corporate stakeholders are important, we believe the aim of the corporation is to maximize its value to its owners—a goal which in turn promotes efficient use of scarce social resources.

Thus, the principal challenge for corporate ethics programs should be to complement and reinforce an organizational structure, including performance evaluation and reward systems, that encourages employees to pursue the interests of their shareholders. In this sense, improving corporate ethics is primarily a matter of changing organizational design and employee incentives to reduce “agency costs.”

Corporate ethics programs that attempt mainly to exhort employees to work harder and otherwise change their preferences are unlikely to be cost-effective. But even if such programs do not alter basic preferences, they can help develop and maintain a value-based corporate culture by clearly communicating the firm’s expectations to its employees.

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19. A study involving one of the present writers finds that franchise companies in lines of business with more repeat sales at individual units (e.g., lawn-care and beauty shops) are likely to franchise a higher percentage of total units than franchise lines with less repeat business (such as motels, car rental agencies, and restaurants). See James Brickley and Frederick Dark, “The Choice of Organizational Form: The Case of Franchising,” Journal of Financial Economics (1987).

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