

Chapter 5

Market and Morality



What Follows Why?

To what extent does the market exhibit moral and ethical behavior? Are the results of the market moral and what are the effects of so-called market failures? The market as a framework and a place for economic action will be analyzed in the following chapter, and profit and property will be examined for their morality. What is the system as a whole? Which rules apply in the so-called market economy? And what does market economy have to do with morality? Or in other words, do market forces promote moral ethics or hinder them? We will address these questions in the following.

Learning Goals

You should be able to explain in their own words the extent to which morality complements the market functions.

5.1 Economy and Freedom – A Historical Overview

What did economy and society look like a few hundred years ago? In the middle ages the economic and social form of organization was feudalism. These two forms were interdependent even then, whereby the technological-economic developments determined the social. The societies that adapted to these new developments applied the technological progress and the subsequent productivity advantages the best.

In feudalism the society was hierarchically centrally organized corresponding to the economic structure. The economy was particularly determined by the agrarian sector. Simple tasks were required for agriculture and the distribution of labor was slight. There were few products that had to be produced. The simple tasks to be executed were easy to supervise. Whether or not laborer picked the fields was easy to see. The aristocracy and the church had power concentrated in their hands. The prince assured internal order and external security and there was no separation of

powers. Legislative and executive powers were held by the same person. The individual had to subjugate himself and submit. In the towns the people were unconditionally at the mercy of the prince. In addition to the harsh early rules of the prince, there were also strict moral rules from the church. The punishment for disobedience could reach all the way to eternal hellfire. Life for people at that time was very constricted, there was hardly any individual freedom. The fact that these societal structures were determined by the economy is clear in the saying at the time that “city air makes you free by year and day.”¹

In the so-called free cities it was at least possible to work as an independent handyman or salesman, allowing a certain amount of self-determination in life. The amount possible was determined by the guilds, the self-government of the cities. The guilds embodied the economic order of the time. Within their framework the individual could move freely, be active in the guilds and even participate in determining the city policies depending on one's fortune, such as in a city council. The cities were created with the development of differentiate crafts and the blossoming of trade. Later the manufacturers came and with them a new economic level with the corresponding power. The level of welfare that could then be obtained created power, which the princes repeatedly tried to obtain for themselves over the next few centuries, but which they never could. On the contrary, the new bourgeoisie demanded with the economic power increasing distribution of power in feudalism and ended up stripping the power of aristocracy.² The technology determined the economy, and the economy determined the society.

The economy continued to develop. With technological progress people were increasingly replaced by machines for simple tasks. The people were needed for planning, building and operating. Fewer and fewer people were needed in agriculture. The labor saved by technological progress could then be used to produce new products, which increased the general welfare or could be used as leisure time. The time this freed up allowed a broad populace to achieve a basic education. With the shift in the national economic production from agriculture to the continual industrial manufacturing of new goods, the rules of a market economy gained new importance. Whereas the agricultural system allowed centralized, top-down planning, implementation and supervision, more complex production of an increasing number of goods had to be coordinated. This was only possible through the decentralized price mechanism of the market. More and more markets for more and more products and preliminary products were created and controlled the production, sales, investment and consumption plans of people. The structure of the products and thus their production process were increasingly complex, and the variety of products increased as well. Thus the distribution of labor and specialization also increased. This trend is very visible in new training and study courses.

The tendency towards more complex structures demanded an increasing level of self-responsible behavior from people, thus an increasing level of freedom. The strong incorporation of the individual in the village community and extended family

¹ See Mitteis, Heinrich (1976) and Hühns, Erik/Hühns, Ingeborg (1963), pp.123.

² See Schäfer, Michael (2009).

as well as the subjugation to the power of the prince and the church were replaced over time with more freedom for the individual. After the industrial revolution the service sector rose to the fore, and then came the computer age, which brought new demands for the people in the economic process once again. The tendency moved away from physical activities towards mental activities. If there were still many simple tasks in industry before the computer age, now the manufacturing robots have taken over the simple assembly line jobs. The machines were mostly controlled by calculating machines, the computers. With the progressing industrialization not only the market economy but also the individual had a completely different value. The actions that were simple for supervisors to control, within the hierarchy, became fewer, while being a self-starter and having self-responsibility became more important. The computer age increased this trend. The companies had to grant their employees more space and responsibility. The strictly hierarchical control through supervision of the employees was not as well-suited to assure optimal manufacturing processes. Instead, the companies increasingly turned to setting targets and a sliding scale for wages. Technical progress determined the economic and thus the political development. Thus if an economic system of market and competitive freedom is to function with the level of technology we have today, the individual must be free. A system that tries to separate economic from political freedom will not last, as history has shown. Over the long term economic power has always acquired political power. In the end the economic power makes decisions about the options to politically assert itself. This applies to countries as well. Economically developing countries have always demanded political power abroad over the long or short term. One could compare the foreign policy power of the USA now with 200 years ago.

The decentralized economic activity of the market economy on the other hand, has remained just as important, with a high level of individual freedom. This is why democracy and market economies are interdependent, since democracy promises the maximum possible political influence for the individual as a form of political freedom. For a modern market economy system to function the individual must be free. Technological development determines the economic structure, which in turn determines the societal structure. The stages of economic development and the political system are interdependent if the strengths of the respective economic system are to be realized.

The agrarian sector does not need the individuals involved to develop independently. A feudalistic social system is thus possible and fitting for the organizational needs. Cultivation of fields can be planned and controlled centrally. The optimal economic system appropriate for the modern production technology is the market economy and the appropriate political system is democracy. A centralized, dictatorial system would be contradictory. Considering this the USSR could never have won the arms race because the political system did not fit the economic requirements of the second half of the twentieth century. It was destined to lose for evolutionary reasons. This does not necessarily mean that the society must unconditionally subordinate itself to the economy. The law of economy must be used for the good of humanity, just like the law of nature. Freedom is connected to the possibility for

individuals to gain property through their performance in the market. Owning property is the central motivation in a market economy, although it also contains the respective power of disposal over the resources and thus rights and power.

Market economy needs self-determined entrepreneurs as a personality type, like Schumpeter's pioneer entrepreneur.³ This type of person must be able to develop freely. It is not sufficient to liberate those who are not free. When people grow up in bondage of any kind, no one can expect them to behave creatively and self-responsibly when they suddenly gain freedom. Even if people have a basic tendency to be entrepreneurial, they must reorient themselves to the new freedom and the new market system. Experience in a market economy is only gained through trial and error, which needs time.

The tendency towards the separation of the individual from society induced through technology, thus the tendency towards increasing freedom of the individual from social constraints, still exists. The enlightenment with its freedom and participation demands the consequences resulting from the technological developments that have changed economic and social structures. The consequent application of the market economy rules is also the consequence of the optimal adaptation to the predetermined technical conditions.

How does this tendency affect individual freedom?

In 1989, Kerber found that the young leaders were inclined to opportunism and accepted immoral and often criminal behavior when material success was achieved. Slogans like "Everyone is the next one", "One hand washes the other" or "To achieve a higher goal, sometimes wrong can not be circumvented" were popular. Kerber summarized the trend as follows:

The tendency seems to be a stronger ego-orientation and more attention to success, material goods and enjoyment.⁴

At the beginning of the 1990s there was a trend away from duties such as order, discipline, loyalty, thoroughness and reliability to so-called unfolding values such as independence, self-responsibility, participation and creativity.⁵

A tendency towards individualization has been confirmed by the consulting company Hay Group – in a joint study ("Leadership-2030") with the company Z-Punkt. They also refer to the impact on employee motivation:

Individualization has a strong impact on the loyalty and willingness of employees, who often attach greater importance to 'soft factors' such as recognition, self-development, self-responsibility, value-driven commitment and work-life balance than traditional factors such as payment and promotion.⁶

Many authors see the way into the "post-material evolutionary development" not only positively. They point out that a society can not exist without obligations.

³ See Schumpeter, Joseph Alois (1911).

⁴ Kerber, Walter p. J. (1989), p. 280.

⁵ See Dahm, Karl-Wilhelm (1993), p. 4 f.

⁶ See Hay-Group (2011), p. 8.

Many problems cannot not be solved through self-realization, pleasure, and embarrassment, but would only be talked away.⁷

In modern free society everyone should have the opportunity to develop as he wishes. Everyone should at least have the chance to work their way up to become a millionaire, which is the central stimulus of the market economy. According to the Enlightenment, all human beings are at least equal to their basic rights, which is why a problem-solving approach suggests that the freedom of the individual ceases where the other begins. If left aside, this would be a very idealistic illusion which would lead neither to a functioning nor a humane society. There were only individualists who would maximize their usefulness, their freedom within the boundaries defined by the rights of others. A society as a coherent whole, a community would not exist. No one would do something useful, something charitable, for others. No one would sacrifice himself for his family, no one would nurture or support his parents in old age, or strive to educate his children. Socially necessary honorary offices would no longer be accepted. Politicians would only use their offices to maximize their own benefit. For the benefit of the community, society, the state, or the nation, no one would stand.

Conclusion and Summary

The view that honesty is stupidity seems not only to have established itself in the economy, but throughout the society. “You have to be able to afford morality” and “you have to watch out for your own,” are common phrases. Public spirit and a willingness to make sacrifices have been replaced by a thoughtless benefit maximization. Social education is subject to variations, which we called zeitgeist. If there were ideologies at the beginning of the twentieth century that demanded self-sacrifice for the supposed general good, today the individual and its benefit maximization is the dominant idea. People had the same predispositions over the past few centuries as they do today. Immorality was always rife, and after a time a cultivated civilization developed morally, then often fell back into the middle ages.⁸ Still, there were other, more moral times and societies. How can these moral changes be explained? Morality is above all a social problem, and has always been so, at least since people have been dependent on one another in groups. The church had a monopoly on interpreting morality for the last 2000 years, or at least until the enlightenment. Whether the result was morally irreproachable is another issue. According to Immanuel Kant, enlightenment is a person leaving the nonage they themselves are responsible for. This sounds well enough, like freedom and escaping moral slavery, but it is also like a second expulsion from the Garden of Eden. A shortcoming of the modern age is that people are left to their own conscience, and must make the choice between good and evil on their own. It is the “you mayest” of the American author John Steinbeck, who expresses the ability to choose even as the meaning of life. For an average person this balancing act between good and evil is

⁷ See Leisinger, Klaus M. (1997), p. 144.

⁸ Such as in Germany during the time of National Socialism

almost impossible without help from outside. Leaving the self-imposed nonage has led to a certain loss of orientation.

This disorientation is not unproblematic. It is probably the tree of knowledge in fact, from which Adam and Eve ate the apple. They can distinguish between good and bad actions, which means they have the fundamental aptitude of conscience. The right path is not handed to people without their own effort, however. They must work for it, or to put it another way, people are not born good, but they can improve. This can take place internally through increasing mental maturity or externally. This phenomenon is called socialization, and is the forming of human behavior patterns through rewards or negative sanctions and role models. We could also call this one's upbringing. Parents are not the only ones to educate their children, rather the whole society influences people through these mechanisms.

On the way to total freedom, more and more rules and norms are abandoned, more and more taboos are broken. This trend, however, should be questioned by society, because it is also a way to total individualism. Does this route offer more advantages than disadvantages for society? Does the trend have to be steered into the socially desired pathways? It becomes clear that due to the technically driven economic and social changes, we can assume less and less duty ethics combined with social control. To this extent, we agree to the statement of Homann, but we arrive at other conclusions than the moral economy. It must be the other way round: the greater the freedom of the individual, the greater the morality of man. If the prince and the church no longer sanction men for moral misconduct, if there are little or no pre-determined rules, then the individual must have internalized the socially desirable behavior by inner values, so called ethos. The more modern the economy is, the more important are morality and values for the development of the productive forces.⁹

A total state control of human behavior is both impossible and undesirable, because individual behavioral freedom should be abandoned. This also applies to the control of employees in companies. This gap must close moral, ethical behavior, and business ethics also applies to the economic sector. It has to influence the behavior of the people in the economy in such a way that the company productivity and the common good are maximized.

In conclusion, many authors point to a tendency towards individualism and materialism. It is a question of a "change in values", a neglect of the classical class and profession ethos, as well as an erosion of traditional values such as honesty, justice and solidarity.¹⁰ In the following, we will ask ourselves what business ethics can change in this environment.

Comprehension Questions

1. What is meant by so-called individualization?
2. What are the reasons for this?
3. What is the significance of this development for business ethics?

⁹ See auch Dahm, Karl-Wilhelm (1993), p. 8.

¹⁰ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), p. 327.

5.2 A Free-Market Without Social Rules?

An extreme free-market orthodoxy is considered as one of the causes for the sub-prime crisis. A spoke word of the investment bankers is “rules are for fools”. Greenspan and many U.S. politicians such as Reagan were against rules for the economy. Rather, they wanted to unleash the market forces in order to create more growth. Continental Europe, however, demanded stronger regulation of financial markets. The reason are different conceptions of economics. As Fox points out:

Europeans tend to be less hostile to government as regulator and more sceptical of private cooperation as servant of the public interest.¹¹

In Continental Europe the most spread economic concept is the Ordoliberalism. It does not share the optimism that the market would develop perfectly without state intervention, however, since it might be in the interest of companies to rid themselves of irksome competition, such as price agreements, mergers, vertical restraints etc., and secure profits through a monopoly.¹² The individual freedom in the market is a competition policy goal for ordoliberalism inasmuch as the assumption holds that companies will try to abuse their freedom at the cost of others within competition processes.¹³ Thus a strong state is necessary to channel the behavior of market participants through laws and prevent or remove restrictions to competition through intervention.

Adam Smith was aware that the invisible hand alone is not sufficient to protect the common good from damage by individuals. He stressed the necessity of an economic system and a system to keep order, which did not exclude intervention to protect the common good. An individual enrichment at the cost of the common good cannot be tolerated by a society for several reasons. Besides the damage that is done to the national economy, such behavior has a degenerative effect on the system. Only if the legal system functions well and there is “trust in the sovereignty of the state” can trade on markets develop to the advantage of people, according and create welfare. Smith also identifies the most important components of order to be internal security, jurisprudence, infrastructure, educational institutions and national defense.¹⁴ Adam Smith had already differentiated between an economy and an economic system. The economic system must set the framework for economic behavior in such a way that the invisible hand of the market and competition can develop optimally, meaning that the actions of people determined by their own interests are channeled for the common good. The economic system has the task of setting and implementing the rules for competition and the markets. Adam Smith was thus the first theoretician of order. Unfortunately he did not analyze the importance of the framework for economic order in depth.

¹¹ See Fox, *Eleanor M.* (2006), p. 983.

¹² See Starbatty, Joachim (1983), pp. 570.

¹³ See Starbatty, Joachim (1983), p. 569 and Hildebrand, Doris (2002), p. 160.

¹⁴ See Smith, Adam (1776), chapter III, first paragraph.

The opposite view is represented for instance by Milton Friedman. An extreme belief in the market is expressed for instance in the answer Friedman gave in reaction to the balance sheet scandal in the USA at the beginning of this decade. He said, "Don't do anything, the market will regulate itself!"¹⁵ Is that really the case?

Is it possible that a society develops without any social values, democratic knowledge and economic knowledge? If we are looking for an example to analyze this question we can look at Russia. There can hardly be a more fascinating country than Russia, an empire that determined world politics in the last few decades together with the USA and which is an example for the attempt to find an alternative to the market economy system through socialism and communism. In the end Russia decided to return to a market economy. This transformation policy made Russia in the nineties into an example if not of an ethical market economy.

5.3 The Russian Transformation to an Unethical Market Economy

After Glasnost and Perestroika and after Yeltsin and part of the army held off the communist putsch, there was a historically unique chance for Russia at the end of the 1980s to make a fresh start economically and politically. Russia called in one of the most internationally renown economic scientists, such as the American Geoffrey Sachs, and thus representatives of the quantitative research trend of the period. The USSR was economically finished for good, not least of all because of the arms race with the USA, and discredited morally as a totalitarian system among a large portion the Russian population. Russia thus seemed to be a unique chance to apply economic theory in a practical setting and to create a flourishing landscape with the market system the theorists had dreamt up. Using a quantitative model Sachs found it reasonable to apply the elementary point of departure to Russia, and thus the functional prerequisites of the model, namely private property, contractual freedom and free prices all introduced overnight as a so-called shock therapy. The Russian economy did not develop as the model had predicted however, but fell apart visibly with the raw material sector being the only exception. Per capital real income fell to a third of its previous value. Unemployment, which had not occurred directly in socialism, became a mass phenomenon, and those who were lucky enough to have a job were often not paid. Many of the proud middle class in the USSR, the intellectual elite such as researchers, teachers, engineers and doctors were poverty-stricken or emigrated, as did the employees of the state such as judges and police officers. The educational system, social system and internal security all collapsed, including basic medical care for the population, all of which were quite obviously a public good in the USSR. The UN Human Development Report placed Russia in the early 1990s among the developed nations with a high standard of living. The system

¹⁵ See Schwarz, Gunter Christian/Holland, Björn (2002), p. 1672.

collapse after the shock therapy threw Russia back to the dark ages in a catastrophe of biblical proportions. The average life expectancy for the population dropped from 69.3 years in 1986 to 63.4 in 1994, being just 57.6 years for men. Illnesses that had been long forgotten, such as tuberculosis and cholera appeared again. Alcoholism and other diseases of addiction also spread. More than 2 million children were homeless, much more than during the Russian civil war and World War II. Another 2 million children did not attend school. Criminality increased dramatically, with politically and economically motivated murders a daily occurrence. 10–15% of the population clearly benefited from the reforms, but 60% were made poor. What happened? It had nothing to do with the expected adjustment process to the new market economy framework. Were these the promised benefits of a market economy? Were these the flourishing landscapes?

Surely not. Where then, was the mistake? There were two elementary mistakes. The first mistake was that the shock therapy destroyed the existing economic and social institutions and organizations without creating new ones. The reforms were purely quantitative, which means that the specific qualitative conditions in Russia were not taken into consideration. The second grave mistake was to conduct the privatization from a regime that was not democratic. The two mistakes together meant that assets were distributed according the law of the fittest. Power and influence in the political cadres and access to resources combined with unscrupulous brutality set up the new distribution. 40–45% of the capital used to acquire assets is thought to have been from criminal activities.¹⁶ The public legal and security systems were overwhelmed, incapacitated or were corrupt or disorientated due to a lack of political guidelines. New democratic or market economy structures such as institutions and organizations were nonexistent. According to the Analytical Center of Russian Academy of Science, 55% of company capital and 80% of voting rights in the public companies were acquired by Russian and foreign criminals. 85% of public property was sold at a low nominal value. In the end the American consultant Geoffrey Sachs distanced himself from the Russian market reform. In his opinion the Russian leadership had exceeded the worst prejudices of Marxists about the capitalistic system by understanding their function or goal as achieving private enrichment at the cost of the general population. The criminal circles did not hesitate to engage in murder in order to remove adversaries and resistance. We must fear that in the meanwhile large portions of the Russian economy and politics are in their hands. The illegal economy was neither recorded by the state nor controlled by the official economy, and probably accounted for around 40% of GDP at that time. It was impossible for an independent, innovative middle class to develop in this environment. Performance was never established as a criterion for economic success. Within 7 years between \$300 and 400 billion in private funds was transferred to foreign banks. With this background it is not a surprise that in 1997 only 8% of Russians said they were better off than before the economic reform. When asked what was responsible for the “new Russians” doing so well, 39% was speculation,

¹⁶ See Yurlov, Felix N. (1999); Åslund, Anders (2007) and Weigl, Tobias (2008).

34% theft from state assets and 17% the use of criminal funds.¹⁷ This is what one would call predatory capitalism, an anarchistic capitalism at its extreme.

Tests for the success of the market economy reforms thus came back with disastrous results. The market economy system and so-called neoliberalism have not only been discredited, but have a negative association and not just since the sub-prime crisis. As a result of the unethical and disastrous Russian transformation they have been equated with social injustice, mass poverty, exploitation, hunger and impoverishment. Russia's experiences with a market economy were not seen in isolation, but have been transferred to the discussion on globalization. The idea that the market, competition and liberalism are able to bring welfare to everyone was doubted. The representatives of liberalism have been dubbed market fundamentalists by their new critics.¹⁸

Of course it is easy to criticize something after the fact. On the other hand, we would always be repeating the same mistakes if we were not prepared to learn from them. One of the main reasons for the failure of market economy reforms is the lack of attention given to the initial cultural and social situations, in other words the qualitative factors. What was the qualitative situation? Firstly, a functional market economy was as nonexistent in Russia as was democracy. There was thus neither a middle class that had arisen out of the enlightenment and industrial revolution, nor was there practiced market economy and democratic behavior available as human capital, which would have come from knowledge of market economic functions and individual behavior optimally adapted to market economic conditions or social capital¹⁹ such as the function and practice of common behavior among supply and demand on markets. This may sound banal, but is it not banal in any way. When one must present themselves to an employer in competition with others, the way one must strive to attract customers, what customers should expect from a seller, that one must compare and deal over prices and quality are not abilities one is born with. A moral code for delivery and payment must also be learned. Paying bills on time is in principle a difficult thing for any customer, but he must learn that if he does not pay on time he will have to pay additional fees or face a lawsuit. This is necessary in the market economy system, since the supplier would otherwise have liquidity costs or might even go bankrupt, leaving other creditors all the way down to the employees without compensation. All of these examples are human experiences, rules of behavior that must be learned through practice in the market economy. These games must be played over several rounds so that people can see how they must behave in the market economy. The invisible hand of Adam Smith must be practiced. Behavior in economic freedom must be learned as much as behavior within political freedom.

The same applies for the system of political freedom, democracy. Market economy and democracy presuppose the existence of active, self-confident and

¹⁷ See Lapidus, Gail Warshofsky (1995), Åslund, Anders (2007), Marsh, Christopher (2005) and Yurlov, Felix N. (1999), p. 5.

¹⁸ See Yurlov, Felix N., (1999), p. 5

¹⁹ For the expressions individual capital and social capital see Sect. 6.4.

responsible citizens, and democracy also demands an active, selfless political participation. Those people driving the economy and citizens must be informed and know what they want and actively work towards achieving it based on that information. Even an optimal market economy and democratic system as institution and organization will not inspire the desired behaviors in people, at least not at the beginning. First people have to learn the rules of the game in order to follow them, and they will not immediately behave in such a way in the newly created organizations that they would carry out their assigned functions optimally. To fully develop the productive forces the human capital in a market economy is required beyond just the organizations and institutions. Democratic human capital is necessary for a functioning democracy. There was no human capital for the market economy in Russia, which is why the transformation to a market economy had to fail as shock therapy. The same applies to the transformation into a democracy.

Because Russia was lacking both political and economic frameworks as well as human capital, the old social structures have taken hold in a new guise, the same structures that formed people during the time of the Czars, and which only nominally changed power holders during Communism. A small group of beneficiaries surrounded a dominant leader who got rich ruthlessly at the cost of the Russian people. At least under Communism the people received basic provisions. This is still no longer provided and the difference in wealth gets constantly larger. If this continues a new socialist revolution may result. Neither is the social situation endurable for the population, nor the distribution of assets acceptable, since it is based on immoral behavior instead of performance. The only chance for the new upper class, the so-called “new Russians” would be to create a new social market economy based on the existing property distribution and hope that the people forget the where the distribution originated. A functional tax system without a shadow economy, with which public goods such as education could be socially redistributed and financed would be a basic prerequisite.

To bring it all together we want to look for the lessons to be learned from the greatest national economic experiment of all time. A much-discussed and fundamental question of transformation theory is whether shock therapy or gradualism is preferable. The question can now be answered. A shock therapy, the short-term changes to all institutions and organizations from planned to market economy, or Socialism to Capitalism, can only work in exceptional cases such as after German reunification where an economically and politically stable country economically controls and socially cushions the change of a smaller country. In all other cases only gradualism is an option, as seen in the context of Russia’s example. In fact Russia’s experiences may well have moved China to decide in favor of a gradual release or changeover in its economy and ownership structures. Russia would have been better off importing human capital, in particular executives on a large scale from a country in considered suitable, as Peter the Great did in his reforms. This human capital, appointed to the most important political and economic functions, would have provided a gradual but constant dissemination and implementation of the necessary knowledge behind market economies and democratic systems.

If Geoffrey Sachs had predicted this development he would have given a different consultation, or perhaps none at all. Admittedly a consultant cannot be held responsible for a development over which he has no influence. Be he is responsible for the advice he has given. The project to transform Russia will always be connected to his name. A consultant always has the option of distancing himself from the project if his advice is not followed, but this only applies if the action is not taken at the important crossroads. The quantitative American line of research was simply overwhelmed due to its simplicity and was not qualified for a consultation on a practical economic and political order.

Geoffrey Sachs is a phenomenon who represents the current state of national economic science. He was and is one of it's largest figureheads. At 30 he was already a Professor at Harvard and meanwhile receives a salary from three departments at Columbia University in New York. Having been brought up and educated in a mathematical form of thought, it was easy for him to reach clear statements and recommendations. The models have another advantage in that they can be applied to any countries. Mathematics and econometric models are universally applicable and transferable. A model has variables, which can take on the respective quantitative country values. This is how Sachs managed to advise at least 75 countries. Did he know any of them? In Russia he later said that the corruption "was surprising" for him and that he had underestimated how much Russia was hindered by the lack of a functioning citizenry. Today he expresses doubt about the dominant economy, the standard education "has little use" and hardly any connection to the public.²⁰

Admittedly the economic performance has improved in Russia. From 1999 to 2005 Russia's economy experienced an average rate of 5.5% real growth and the per capita income more than doubled from 2001 to 2005 to around \$5250. Be that as it may, it could have been quite a different story. This economic growth is mostly due to the significant increase of raw material prices. The raw material price index CRB increased by around 81.6% from 2001 to 2005 and the price of oil by around 90%. Distortions caused by ruble to dollar conversions mean that we can only make approximations for the share raw material price developments had in Russia's economic upswing. For example, the oil price increased by 40% in 2005, but real oil production only by 2.2%. The CRB increased by around 23% in 2005, and Russia's exports in dollars increased by around 33% to approx. \$241 billion, whereby raw materials comprised 67% of this, or around \$161 billion. The exports minus imports were \$36.8 billion, which increased GDP by around 4.8% to \$766 billion. If we also consider the multiplier effects for the Russian domestic demand due to increased income from the higher raw material prices, we may conclude that the Russian growth is at least mostly due to the raw material price increases.

What is more, the majority of the population has barely profited from the positive development. We should wish for Russia that it finds a way to use the billions earned from raw materials for social security and education for the general population,

²⁰ See Heuser, Uwe Jean: Die Wandlung des Jeffrey Sachs, in: Die Zeit, no. 38, 2003.

which would provide a step towards long-term stabilization of a modern national economy.²¹

Conclusion

The subprime crisis has shown that a market system without rules and controls can not function. Although capitalism or better to say the market economy is responsible for many crises, it remains with its growth and individual freedom the best of all possible economic systems. Crucial is much more that rules and controls exist to prevent damaging individual behavior. The regulatory concept of ordoliberalism has prevailed against the laissez-faire liberalism. Additionally the society has to implement moral responsibility in order to get a functioning market system.

5.4 How Does the Market Economy System Work?

The market economy is described by many authors as being driven by common sense, using morality, social values and even solidarity. Starbatty contradicts Dietzfelbinger that morality and market economy have different rationalities, that is, the market can be immoral, but he believes that these are two ethical designs. Molitor sees the market economy as a moral institution, because it has the prosperity of all as its goal and it achieves best results. Here, he compares the pure market economy with the central administration economy. For him the higher productivity and the higher degree of freedom for the individual are an ethical advantage of the market economy. He sees the central social ethical justification in its orientation to the wishes of the consumers, as the prosperity of all. The market economy is considered to be ethically superior to alternatives such as a planned economy (central administration).²² In principle, the Catholic Church is in favor of this assessment:

At the national level of the individual nations as well as those of international relations, the free market appears to be the most effective instrument for the creation of resources and for the best satisfaction of needs.²³

However, the Catholic Church does not see the market economy as sufficient to satisfy all human needs. For a Christian ethic, the basic statement of the pastoral autonomy of the Second Vatican Council is that man is the author, the center and the goal of all economics. This essentially corresponds to Kant's rules for reasoning.

²¹ For details about the Russian transformation see Weigl, Tobias (2008); Åslund, Anders (2007); Lapidus, Gail Warshofsky (1995); Grabrisch, Hubert/Holscher, Jens (2007); Javlinskij, Grigorij A. (1994), *Der Spiegel*, no. 39, p. 82 and Yurlov, Felix N., (1999), p. 7.

²² See Molitor, Bruno (1989), p. 71ff.

²³ See Max, Reinhard/Wulsdorf, Helge (2002), p. 290.

5.4.1 *The Picture of the Perfect Market in the Welfare Economy*

The allocation model for the happiness of the greatest number as demanded of the utilitarianism market and competition is shown here.²⁴

The resources of this world are limited and we humans have unlimited needs. Even if we are no longer concerned about survival, we still find new needs. We catch ourselves in the fact that if we have a product we have long desired, we finally have to think about what we want to have. In this sense, people are not actually made for happiness. On the other hand, this has the advantage that we never rest in our pursuit to improve our existence, which drives technological development.

The economic activity of man is necessary. The individual strives to produce enough goods for his survival and a good life. As a society, we must try to produce as many high-quality goods as possible from scarce resources. To maximize welfare, we must strive to produce products that maximize benefits to society. Our goal is the so-called allocative efficiency, whereby we use resources in the form that they bring the greatest benefit to society. Thus the term “economic” also indicates optimal use of resources. We define economically or efficiently as a method of reaching a given goal with the minimum effort for maximum return. In terms of resources, we maximize output to maximize the value of society. This so-called productive efficiency is the human goal independent of state form and era. Science is the result of people striving to produce the maximum quantity of goods for their own needs satisfaction with limited resources.

Our goal is to increase the benefits of all people to the extent that they cannot be increased without benefits to other people being reduced. We are therefore aiming at the so-called Pareto efficiency. We do not go beyond this consideration as economists. Increasing the usefulness of people at the expense of others is a social decision and not an economic one based on voluntariness.

In the market economy, welfare is achieved through voluntary exchange. People exchange their goods or services through markets, until no one can increase their utility without reducing the utility of another. In this way, Pareto efficiency is achieved. It is exchanged until the pareto-efficient state has been reached. This depends on the initial distribution of income and wealth, however. The more income or wealth a person has, the more goods they can acquire. If you buy a good for money, the benefit from this good must be higher than the alternative benefit from the consumption of another good (opportunity benefit).

Fraud is reduced in terms of the welfare system, because the benefit expected of the deceived exchange partner are not achieved after the exchange, and thus Pareto efficiency is not achieved. Moral behavior, on the other hand, would guarantee Pareto efficiency (Fig. 5.1).

In Fig. 5.2, A and B have different combinations of goods and therefore they can also be found on indifference or iso-utility curves that are different from the origin.

²⁴ See Fritsch, Michael/Ewers, Hans-Jürgen/Wein, Thomas (2011), pp. 30.

Fig. 5.1 Exchange optimum in the Edgeworth box

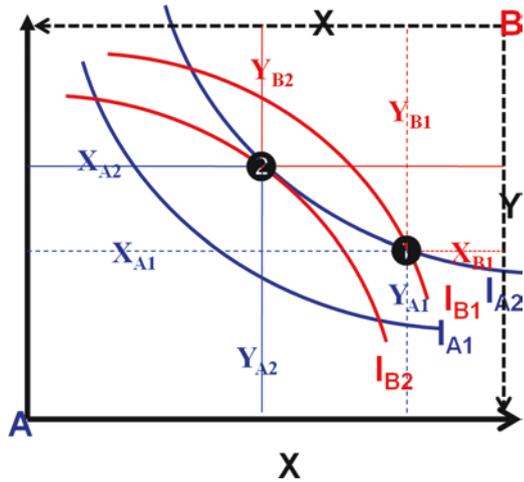
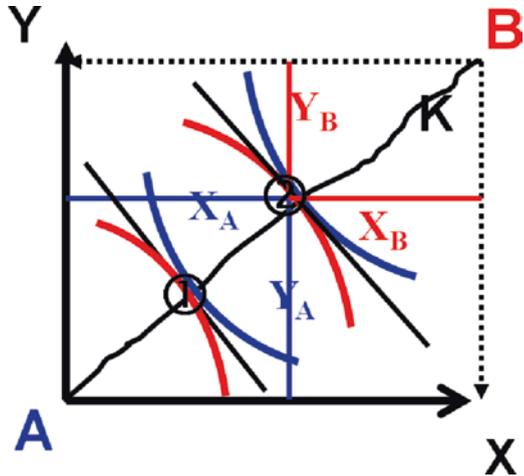
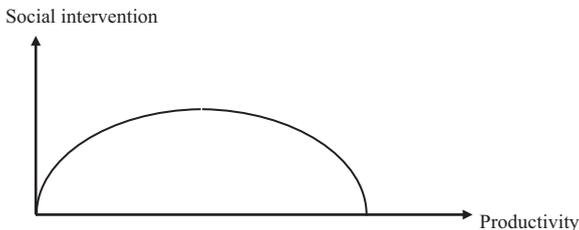


Fig. 5.2 Paretoefficient optima



❶ The utility of B can be increased with the same benefit to A, if A of good X is B, and B gets more Y. It comes to an exchange. In ❷ there is a Pareto-efficient state, since the utility of A cannot be increased without decreasing that of B and vice versa. There is therefore a voluntary exchange: both have advantages (free lunch) until the Pareto-efficient state is reached. Here the indifference curves of A and B are affected. The utility of A can not be increased without the benefit of B being reduced. This corresponds to an efficient exchange: both have exchanged goods for as long as both can no longer gain an advantage through a swap. The tangent at the point of intersection then has the substitution dY/dX as the slope the marginal rate of the exchange.

Fig. 5.3 Social intervention and productivity



However, this does not say anything about the distribution of benefits between A and B. From Pareto combination 1, B has a relatively higher benefit than for A and 2 is better for A than for 1, and vice versa for B (see Fig. 5.3).

Fraud deceives by promising a benefit to the other party in a voluntary exchange, which turns out to be non-existent afterwards. Thus the pareto-efficient optimum cannot be achieved.

The ethical result of the market economy can be attributed to competition functions.²⁵ The market provides the basis for the elementary competition functions with the price signals and the market mechanism. Prices indicate scarcity, costs, profit potentials and benefits (opportunity utilization). Without market competition, however, the market does not provide any allocation-efficient results.

5.4.2 *Functions of Competition*

As the example of Russia shows, the twentieth century was the century of competition between systems. Different economic systems were attempted. The market economy was able to establish itself as the basic principle of order. Socialism seemed to be the answer to many ethical problems created by the industrial revolution at first. Here we should mention the pauperization of the working class or the lower classes that were poorly educated or impoverished. Market and morality were considered opposites. Socialism considered the basis of the evil to be distribution of wealth via the central function of capital in the market economy as well as market mechanisms felt to be unfair and held responsible for the inequity of needs met. By removing private property and with the central coordination of production plans in the planned economy, a method was devised to better satisfy the needs of the society. Socialism, or Communism, was unable to develop the productive forces. The gulf in the standard of living between the capitalistic and socialist countries grew until it caused the socialist system to collapse. What remains however, are several questions about the market economy system that have gone unanswered. We have examined company crises and the errors in company organization. A lack of moral values or a code of ethics was determined to be a central cause for the crises as much as the one-sided focus on figures or quantitative facts. We have also analyzed Russia

²⁵Zu den Wettbewerbsfunktionen See Conrad, Christian A. (2005), pp. 23.

as an example for an unethical market economy and an example of quantitative economic consultation. What comprises the system as a whole? What rules apply in the so-called market economy? What does market economy have to do with morality? Or, to ask it a different way, do market forces encourage or hinder moral and ethical behavior? We examine these questions in the following sections.

Because of its various forms, there is no generally accepted definition of “competition.”²⁶ The core of the market economy competition could be seen as at least two market participants who compete with each other on the supply side and the demand side. In a market economy the decentralized decisions are made by individuals and coordinated via the market. Each participant is responsible for their own economic plans and decisions, and is then rewarded or punished by the market. The strength of the market economy is that all the productive forces of individual people are stimulated and coordinated. The limit is only human potential and their creativity or inventiveness and their level of education. The basic prerequisite for the development of market economic forces is competition with transparency in what is offered on the markets. Private property and the improved economic situation it brings for the individual is the main incentive of the market economy. Markets and competition fulfill various functions together.

There is no universally accepted definition of competition because of the many forms it can take.²⁷ The basic character of competition in a market economy can be understood as the contention between at least two participants on the supply side and those on the demand side. Competition forces the companies to be adjust their supply to correspond to the wishes and needs of their consumers (*steering function*). In a national economic system the desire to maximize profit produces the dynamic in which the raw materials with the best value are used in production. As we have already seen, striving to maximize profit guarantees that the raw materials to offer the best quality for the lowest price are the ones used (*1st allocation function*). In addition, the most cost effective company has the highest demand and can attract more production because it has the most room to maneuver with its prices (*2nd allocation function*).²⁸

Companies achieve optimal success when their costs equal the profits from an additional unit of production. When he has enough influence, in other words a lack of competition such as in a monopoly, the entrepreneur will set a price far above his costs. Competition forces prices down towards the production costs through dispersed market power. Lower prices are then charged for a higher quality product, both for finished products and raw materials. This increases consumer profit in the case of finished products and the international competitiveness of a country for raw materials, thus indirectly also affecting employment. Competition guarantees that over the longer term only companies using their resources efficiently (*productive*

²⁶ See Herdzina, Klaus (1984), p. 9.

²⁷ See Herdzina, Klaus (1999), p. 9.

²⁸ According to empirical estimations, in a polypoly – as opposed to a monopoly – the static welfare gains in one period alone constitute 10% of the GDP. This is assuming there are no secondary effects. See Scherer, F. M. (1996), p. 11.

efficiency) can stay on the market (*sanctioning function*). Trying to keep a step ahead of one's competitors prevents resources from being wasted and encourages relative prices to be corrected for production factors.

Competition leads to a fair market remuneration and thus provides motivation for good performance, which is in turn the basic requirement for productivity (*distribution function*). The remuneration from the market is often felt to be unfair.²⁹ Competition provides a lot of leeway for those participating in the market to develop their potential. Companies can thus take responsibility for their reaction to decision-making parameters, workers can change their employment, and consumers have the freedom to choose between many different offers (*freedom function*).³⁰ Many suppliers competing for the same consumers automatically limit their economic power, making market-controlling positions impossible (*control function*).

The competition we have described thus far is in reference to a point in time and is thus referred to as static competition. The dynamic character of competition is especially important for the growth process of an economy, however.³¹ Successful companies must also continually try to gain a competitive advantage over their competitors by offering new products and new production techniques (*adaptation function*). Friedrich August von Hayek portrayed dynamic competition as process of search and discovery, through which things are discovered that would otherwise have remained unknown or at least not made use of. Competition is evolutionary for Hayek,³² which applies to both product and process innovation. Innovation can be understood in this context as the economic application of a discovery, in other words invention. In the expectation of above-average rewards from the market an entrepreneur is always searching for cost-effective methods of production and new products for which there is a potential market demand. The entrepreneur conducts risk assessment at their own costs or analyses external research results. The market decides the success of an innovation and thus in the end the consumer or producer that further refines a product has the last say (*innovation function*). Should an entrepreneur decide not to bother with innovation and invention, they will be pushed off the market by their competitors (see adaptation and sanction function). It is clear that the functions of competition and adaptation are closely connected with each other. If companies fail to adapt their products to the demand structures on the market and international division of labor, they will also be sanctioned by the market.

²⁹This is how the scarcity of a good leads to market position gains, or profit without service. Ordinarily those unable to offer good performance would not be rewarded by the market and would therefore starve. This leads to the question of fairness and the acceptance of a neo-liberal economic system. Fairness is a moral and ethical question, thus at once subjective and not a subject for an economic science text, but rather a philosophical or theological framework. The question of acceptance is decisive for the feasibility of any system however, and may therefore not be neglected. This was clear in the hefty demonstrations against the expansion of free trade in Seattle 1999.

³⁰See Berg, Hartmut (1999), p. 233. The Freiburger School sees the equivalent of democracy in individualistically oriented competition, and thus the prevention of a dictator.

³¹See Heuß, Ernst (1968), pp. 29 for the importance of competition for the growth process.

³²See Hayek, Friedrich August von (1969), p. 249 and Starbatty, Joachim (1987), p. 164.

According to Joseph Schumpeter,³³ competition is a process of innovation and subsequent imitation (*imitation function*). The successful innovation on the part of the pioneering company proves a competitive advantage over other companies on the market who have maintained their old production structures. Above-average profits are won from this advantage, which in turn makes other companies want to copy the invention, or even forces them to do so if they do not want to be pushed off the market. This is how the new, resource saving methods of production come about, and thus brings about widespread technological progress and production growth.³⁴ Innovation and sanction functions thus support each other in dynamic competition.

From the perspective of the individual companies it would be positive to restrict competition. For one thing, when a company profits from an increase in its market power, such as those from a monopoly, it reaps the benefits without having to work for it. Competition is also a nuisance, in that it forces companies to constantly better their performance. If they do not adapt to the market and innovate they must face losses or may even have to withdraw from the market altogether.³⁵ The state must protect competition in order to make sure that companies cannot elude the competition functions. Are these functions applicable at the international level, though?

The competition forces companies to continually try to gain competitive advantage through new products or production processes, or at the very least to catch up with the competitors' competitive advantages. On the one hand, this reduces the use of resources and, on the other hand, adapts to changes in the relative prices of production factors,

This principle must be the same internationally,³⁶ though there are country-specific absolute and comparative cost advantages (Ricardo's Theory of Comparative Cost Advantage). According to Ricardo even a unilateral liberalization of foreign trade would give the importing country an advantage. Scarce production factors in individual countries would balance out internationally, which would in turn lead to higher total productivity.³⁷

The largest part of world trade takes place inter-sectorally, which means within a branch and between the western industrial nations that have similar cost and demand structures such as capital and labor provisions. How does foreign trade come about even when there are identical cost and demand structures? This can be explained by the specialization of the producers to various demands. Foreign trade as cross-border competition forces the suppliers to orient themselves to the international

³³ See Schumpeter, Joseph Alois (1911).

³⁴ For an explanation of "Schumpeterschen Unternehmers" See Dürr, Ernst (1987), pp. 245 and Vickers, John (1994), pp. 17.

³⁵ See Drude, Michael (1991), p. 7.

³⁶ Empirical proof of the positive effects from import competition on productivity can be found in MacDonald, Porter, Baily, and Gernsbach as well as in the studies from the EU-Commission on gains in welfare within the European domestic market. See Baily, Martin/Gernsbach, Hans (1995); Commission of the European Communities (1988); MacDonald, James M. (1994); Porter, Michael (1990) and Scherer, F. M. (1996).

³⁷ See Conrad, Christian A. (2003).

demands and or to qualify themselves for a market niche. The broad pallet of products to result from this process is also a gain in welfare. Gains are also possible digressively, in other words with a reduced amount of production within the framework of international specialization. With the increased demand corresponding to the world market, production amounts increase and thus unit costs decrease.³⁸

In principle then, globalization as national markets growing closer together into one national market leads to an overall higher level of welfare. How the benefits are distributed is another question. This is mostly because with changes in international production the jobs are shifted and cause short-term structural unemployment.

Unfortunately the advantages and functions of the market and competition are not public goods, which is surely the main source of the rejection and hate directed at the market, and at the international market in particular. The willingness of states to explain and educate is desperately needed.

Can the market process really regulate everything based on human egotism? Does the market really need morality? Is it really true that the more profit companies make, the more immorally they behave? Do the laws of the market even allow companies to act morally?

5.4.3 *Moral Goals and Market Economy*

The market can not solve all human problems. The solution that the market has developed is that each person pays for the performance they want. The problem creates a demand that creates its own supply. The market only knows the principle “due ut des” as the principle for trade. This mechanism often functions, but not always. The reach of market forces is limited. Superordinate and subordinate relationships have always existed. In every group of apes or humans there is a social order. There are also different mental and physical capabilities and different access to resources, especially in humans, which determines power, dependencies and hierarchies. For example, the resource distribution in Latin America and many developing countries cripples their economic development. Whoever was able to grab something now owns it. Lands and assets have often been inherited within the same family for centuries. Like noble titles, the children of these families have inherited the fortunes of these families without any effort of their own. They have the capital for worthwhile investments, however. Distribution of assets and welfare are therefore set, just like the hierarchical relationships. Anyone without land must work for the others as a dependent employee. In order to change anything in the order and the distribution of wealth, one must have power and even use violence. If this is the case, power through strength or access to resources is a central factor in the social order, which is much stronger than the market mechanism. The given factors of power make the question of whether spontaneous market mechanisms and their ability to fix themselves are sufficient, or whether the state must provide an additional framework

³⁸ See *Conrad, Christian, A.* (Conrad 2005) and *Bender, Dieter* (1992), pp. 419–448.

with its order and even directly intervene in the market mechanism obsolete. The voluntary, mutual, advantageous exchange of goods is more of the exception. The market mechanism can only ever control a small part of the societal exchange process, so it is more of a question really of how much and which system of order, and when the market mechanism is appropriate and when it is not. This question is settled to a large degree by the social framework conditions, as will make clear with the example of Russia.

A lack of property means dissatisfaction, since threatened survival means having to enter into dependent employment, or the rental of one's own time and labor. The distribution of income in a market economy is only oriented towards performance to a certain extent, since the initial distribution of wealth is differently inherited. However a market economy system with the correct conditions provides for a distribution of income based on performance, and thus leads to a more balanced equity distribution with time.

Business ethics places people above the economy, and assumes that the economy should serve the people. There are other perspectives on this, whereby economic success justifies the means. Economics would then be placed above morality. According to Calvinism, economic success is a sign of God's benediction. Economic success is thus not only morally legitimized, but those with success have been chosen by God. There can hardly be a greater incentive to strive to earn more. Hard work and asceticism are then the fundamental characteristics of a successful Calvinistic enterprising personality.³⁹

This idea contradicts the original Christian belief of justified wealth. This has been expressed in sayings such as "it is easier for a camel to go through the eye of a needle, than for a rich man to enter the kingdom of heaven."⁴⁰ Theologians from the middle ages demanded that no Christian work as a salesman, since breaches in loyalty, honor and virtue would result from exchange with the promise of profit in the spirit of greed.⁴¹ Market prices were felt to be unfair (Thomas von Aquinas (1224/25–1274 A.D.) or generally the income distribution of the market, because it was not based only on performance and it completely neglected human needs. The Christian economy was to be a responsible and thus free proposition and establishment of as many individuals as possible for the good of everyone.⁴² Adam Smith (1723–1790), shared this view with his "invisible hand" of the market that led to the benefit of everyone.

The moral expectations confronting economy is ancient. Aristotle (384–322 b.c.) had already differentiated between the art of naturally acquiring or procuring and the art of enrichment (chrematistic) which he condemned because it did not naturally occur but was rooted in the weakness of mankind. Striving after money

³⁹Max Weber had already recognized the source of the positive economic developments in Switzerland, the Netherlands, England and parts of Germany as being from the Protestant or Calvinist influence. See Ulrich, P. (1998), Sp. 1168f and Noll, Bernd (2002), p.166.

⁴⁰See Schwarze, Gunter (2007).

⁴¹See Wilkening, Hans-Rüdiger (2004), p. 61.

⁴²See Beutter, Friedrich (1989), 56–75.

becomes an end in and of itself, which distances man from his natural purpose, namely satisfying the elementary needs for a good life. Aristotle places virtue above economics because man can only achieve happiness by exercising his virtues. The perfect virtue for Aristotle is justice, which serves as a norm for the economy. He does not understand distributional justice as the equity of needs as did Socialism, but rather equal for the equal and unequal for the unequal. According to this principle from Aristotle there must also be a redistributive justice, which balances out unjust distribution results such as those from fraud.⁴³

Moral Property

The human factor as individuals is the central actor in the market economy. In a market economy the market mechanism coordinates the plans of individuals through the market price which matches supply and demand. The basic prerequisite for a total economy to develop optimally is that competition dominates the markets. Private property and its augmentation are the main incentive for individual economic activity. More is required than just the free interaction of supply and demand for such a complex system to function, however. For example, to transform a socialist planned economy into a market economy, allowing free price-setting and creating private property is not sufficient. What good is property if it is not protected or acquiring it is not regulated? The market economy conditions are thus much more extensive than those according to the theory of order from Walter Eucken, and include a functional legal system, among other things. Insufficient attention was given to the necessary conditions in the consultation for the countries leaving Socialism or Communism, as we saw in the example of Russia. With the currently dominant mathematical and quantitative perspective being taught, the market is assumed to function ideally. The human factor is systematically ignored because it cannot be put into deterministic models due to its often irrational nature. People are equal in their rights, but not in their behavior. Thus the market economy could not be successfully established in Russia. People are formed and socialized by their environment from birth. Market economy behavior must be practiced. The market economy demands a different behavior from individuals than planned economies do, such as individual responsibility. An abrupt changeover from planned to market economy is like suddenly demanding a spoiled housecat go catch its own dinner. It is not possible to just switch from a feudal agrarian system or a tribal or clan system to a market economy with individuals that can hardly be controlled without going through an adjustment process.

For the mendicant from the Dominican order, Thomas von Aquinas, all goods are God-given. They are only entrusted to people for their earthly use. Like Aristotle he rejects ownership as an end in itself. Property should serve the good of humankind. He rejects common property as well, since no one would feel responsible for it. According to the idea that “property binds,” those who have possessions should give

⁴³ See Schefold, Bertram (1989), p. 19–55.

some to those in need. Property is generally to be used with consideration for others.⁴⁴

Even without using God as an argument the question of justifying the use of property arises. Property can serve a single individual or the community. If an economy is to serve the good of the community, property may only be obtained through participation in the economic process. Performance on the market, thus evaluated by other people, contributes the most to the general good via the rules of the market and competition. Deceit or theft is obtaining services or property from others without reciprocation, which is usually only possible through devious means or the use of force.

Moral values are expressed e.g. through “fair competition”. This includes the moral demand that the fruit of the market, income, should only be received by those who contribute, in other words those who outdo their competition through an exchange of effort on the market and open competition and not through advantages. Whenever assets are not earned through effort, the community will not accept an unequal distribution. In extreme cases assets are immoral, when they are obtained through theft and fraud. Societal approval as a motivation to perform well disappears in such cases. The motivating model of the American dishwasher who worked his way up no longer has any effect, since effort does not pay off. Property is therefore above all a motivation to perform well. Adam Smith was the one to recognize its importance the most comprehensively. On the other hand, as Smith considers the cause, or driving force, behind the development process to be the constant striving of people to improve their material situation, those who are “satisfied” and those who are hungry but cannot amass assets are hardly motivated to make an effort. The development of productive forces thus requires equitable rewards for performance as the distribution principle for income and assets, which the market evaluates as the location of all material needs of the community.

It is of no importance for the market and the general good whether the performance comes from the necessity to meet one’s basic needs or from limitless greed, glamour and power. The market is only interested in the performance, not the motivation. The individuals bear the consequences, not the community. Each person has just one life and must decide how to invest his energy during his lifetime and for what ends, insofar as conditions allow. However, for the community it can be a problem if too many individuals make egotistical economic gain their life goal, seeing ruthless property maximization as an end in and of itself.

Independent of subjective assessments, the economy may not be its own end, which applies for all instruments used by people to survive since they have existed. The economy must serve people, not the other way around. This statement is always universally valid, including this era of globalization.

What role should money play in a market economy as property? Money functions as an exchange and value retention device, as well as a unit of calculation with all of the price signal and competition functions connected with it. Money is of central importance in a market economy. Because of its value retention function,

⁴⁴ See Beutter, Friedrich (1989), 56–75.

money represents purchasing power and thus power. The market mechanism consciously relies upon egotism and the human striving to enrich themselves, and money is the means to do so. Money makes it possible for the market economy incentives and thus Smith's invisible hand to function fully. Money should always be a means to an end however, not as a dominant societal goal in and of itself that replaces other important goals including social morality. For example, if we assume that the end justifies the means, it would mean that every damaging action for other people or the community would be justified. The top manager who sold his stock to others even though he knew his company would do poorly would be a societal role model just because he got rich. Social morality is thus an important corrective in a market economy. If a market economy works for the advantage of the community, the community must condemn immoral, damaging behavior through legal punishments or social exclusion.

For Kant, the market has its limits where dignity is at stake and therefore there can be no price:

In the realm of purposes, everything has either a price, or a dignity. What has a price, in its place can be put something else as equivalent; which, on the other hand, is superior to all price, and therefore does not allow any equivalent, that has a dignity.⁴⁵

For the market and for the general good, however, it is irrelevant whether the service meets a necessity for the satisfaction of basic needs or arises from boundless greed, courage and power. Only the performance on the market counts, not the motivation. Individuals must bear the consequences in this case, not the community. Everyone has only one life and, as far as possible he has to consider precisely towards what goals he uses his life and energy. For society, however, it can become a problem if not only a few individuals, but many see their life purpose exclusively in the selfish economy, that is, in the unqualified property maximization as self-purpose.

Moral values can be found, for example, in the term "fair performance competition". This implies that the moral demand that only those who perform well receive the fruits of the market, the income, that they not disadvantage competitors in the market and that they succeed in fair competition through their own efforts. If assets are not earned through performance, there is also a lack of public acceptance for unequal distribution. Or, in the extreme case, wealth is even immoral if it is acquired by robbery and fraud. Performance motivation, social recognition, then ceases to be effective. The motivating role of the American dishwasher, who has worked hard, is missing. Performance is not worth it. If an immoral success without performance becomes the rule, performance is no longer worthwhile and the productivity of the market system decreases. The same applies if the property acquired through performance is regularly robbed or taxed too high.

Property is therefore primarily a means of motivation. This was recognized as early as Aristotle.⁴⁶ Adam Smith recognized its importance most extensively.

⁴⁵ See Kant, Immanuel (1785), p. 434.

⁴⁶ See Aristoteles (1991), p. 17 or 1263a.

Conversely, when Smith sees the cause or driving force that determines the process of development in the constant striving of man to improve his material situation, people who are “full” and people who are hungry, but cannot acquire property, are little motivated to perform. The unfolding of productive forces therefore presupposes a fairness of the distribution of the income and wealth. It has been shown in Chap. 3 that people demand a fair distribution of the collective gains in order to participate in group performance.

Economically, it is necessary to distinguish between the justice of exchange, the justice of performance and the justice of needs.

Justice of Exchange is often assumed in market transactions to be voluntary. It is assumed that both parties agree only if the exchanged benefits are beneficial for both (free lunch). If both improve their position in the exchange, the welfare of all is improved (Pareto efficiency or overall economic optimum, see Sect. 5.4.1). However, consideration must be given to whether there were dependencies or power positions. Rawls speaks of procedural justice in this context. Economic procedures should lead to fair distribution results. For example, competition on the markets as a procedure ensures a fair result only if it is not limited by monopolies, cartel agreements or the like, or eliminated by corruption.⁴⁷ The competition thus legitimates the market economy as an ethical process. In order to ensure fair competition, there are competition authorities and laws regulating how unfair competition law is regulated, such as misleading buyers about product properties, fraud, and exploiting inexperience, etc..

For example, if the employee is dependent on the employer to ensure his/her survival, it can not be assumed that the “voluntarily” accepted wage is just because it corresponds to the employee’s performance. In this context, the unions are important in order to establish a fair method. They have the task of bundling the interests of employees into a negotiating position, thus balancing the unequal distribution of the economic power of many “small” workers (suppliers) against a large monopolist labor market (bilateral monopoly).

The justice of needs is a contrast to the justice of exchange, since a claim is regarded as just if it is based not on a performance but on a need. For example, Pope Leo XIII said in the social encyclica “*Rerum novarum*” that a worker must be able to earn with his wages, his livelihood.⁴⁸ But we do not find any need for justice in the market economy.

In the case of the justice as regards performance, remuneration is based on the performance as assessed on the market. Productivity is the basis for this assessment. The value added is generated by the employee or the company. This does not depend on the effort made, but on the result and the evaluation by the market, which is measured as demand.

⁴⁷ See Rawls, John (1999), pp. 73 and 240.

⁴⁸ See Papst Leo XIII. (1891), No. 34; Höffe, Otfried (1997), p. 93; Schmidt, Heinrich (1982), p. 225 and Göbel, Elisabeth (2010), pp. 152.

Ultimately justice is considered very subjective. For example, equal pay for equal work was demanded by the East German workers after reunification. Objectively, however, due to the old economic system the East German workers were less productive than the West German workers. The well-known principle of equality by Aristotle is therefore: “The same is to be treated equally and unequal unequally.”

Despite evaluations being subjective, one thing must be said about the economy that applies to all the instruments that have been used by man since his existence to secure his survival. The economy is not self-serving, it has to serve man and not vice versa. This statement is always and universally applicable.

5.4.4 Social Market Economy

The market and competition offer great advantages, expressed in the market functions already described. Other social or humanitarian goals such as a margin of subsistence or the compensation of market power between employer and employee cannot be explained through the market and competition, however. Other institutions and organizations are necessary for such goals, and are incorporated into the economic order. The market only considers interests important if they have market power. An employee who cannot find a demand for his skills on the labor market because of an overabundance of competitors with his job qualifications will not receive compensation from the market. On the other hand, the employer can afford to treat the employees he already has poorly, since they are so easily replaceable, a behavior which would otherwise be punished via the market.

Market sanctions are moody and sometimes unfair. The market rewards luck, such as those who already have a scarce resource with market condition profits, or a scarcity benefit. Real estate speculators for example, count on the real estate supply being limited with an increasing demand. Hard work itself is not a value for the market. Hard work is rewarded only if labor leads to something others are willing to pay for. In other words, without a product for which there is a demand, there is no reward from the market, which can mean starvation. There is no such thing as compensation according to need in the market system. The criticism from Karl Marx regarding the market economy system is thus justified. Charity and sympathy are foreign concepts to the market. Market and competition are instruments to achieve only some of humanity’s goals, and they must be supplemented by other social regulations. This is where the social market economy comes in. It differentiates between primary and secondary income distribution, which closes the gap between economic and social goals. Since there is no intervention in the primary income distribution of the market, such as price or competition-distorting subsidies, the market and competition continue to function. The subsequent control of income created allows a certain amount of social goals to be realized, such as securing a margin of subsistence. Social market economy does not mean interfering in the market mechanisms for social purposes, as it is often misunderstood. Social means

societal, not socialist. Applied correctly, the concept of a social market economy is preferable to all other forms.

This statement may cause objection at first, but it will be understandable when we remember all of the things that the market cannot provide. We already identified securing a margin of subsistence. What would the advantages of this be? The first may be the avoidance of social unrest. A person who fears for their existence may be prepared to do anything including criminal activities. The willingness of market participants to take risks may well be much higher if they know that should their investment or founding of a company fail, their physical survival will still be secure. This would encourage enterprising or innovative behavior. Securing a level of subsistence also guarantees human capital for the economic process. A policy of financed education through redistribution can be justified economically as an investment in human capital. The productivity of those who have been supported increases, thus increasing economic power and income through taxes for the country. A good basic education also strengthens democracy, since citizens no longer believe unbalanced, one-sided arguments so easily. On the other hand, support for primary and university education exclusively through private scholarships will not provide a broad system of human capital. Procuring external knowledge is an alternative for the national economy and for companies. The international competition between states and companies for resources is not just over capital, but also over human capital.

It would be a fallacy to think that the community, the state, could provide for all the responsibilities in caring for people and perhaps even raising children. It must intercede where there are no family members, but the idea that people only behave egotistically and hand over all duties and responsibilities to the state is contrary to human nature and is simply impracticable. Not even the Socialism that existed went so far.

How can we explain that in reality countries that call their form of economy a social market economy, e.g. Germany, are not necessarily superior in economic productivity to exclusively market economies such as the USA? Most countries have a mixed form. Even the arch-capitalistic USA often demonized by socialists is not a purely market economy, since it has social security, even if not very much. An active social education policy is not implemented, but they do use clever lures for human capital, in particular through the elite American universities. Germany refuses to take this path in the belief that an active educational policy is sufficient. Most European universities are no competition for American universities in the international human capital market due to the lower salaries.

Under a social market economy we understand the combination of free market with social compensation (**definition**). This is where the concept of the social market economy begins. It distinguishes between primary and secondary distribution of income, thus balancing between economic and social goals. Since the primary income distribution of the market is not influenced, for example through subsidies which distort prices or distort competition, the market and competition remain functional. The subsequent taxation of income generated can be influenced to a certain extent by social objectives, such as securing the subsistence minimum.

The term “social market economy” was introduced by Ludwig Erhard, who was the first Federal Minister of Economics of the Federal Republic of Germany from 1949 to 1963. The term was first mentioned by Erhard’s comrade-in-arms Alfred Müller-Armack, who was head of the Economic Policy Department in the ministry of economic since 1952, in his book “Wirtschaftslenkung und Marktwirtschaft”.⁴⁹

Social market economy, therefore, does not mean to enter the market mechanism socially, as is often misunderstood. Social is not socialist but societal. Properly implemented, the concept of social market economy must be superior to all other economic contexts because it balances the disadvantages of market and competition through additional regulations.⁵⁰

This statement is likely to produce a contradiction, but becomes understandable when one realizes what the market cannot afford. We have already mentioned the protection of the subsistence minimum. What is the benefit of this? We first think of the prevention of social unrest. A person who has to fear for his existence is willing to do anything in order to survive and will likely not shy even from criminal acts. However, the risk attitude of the market participants is also likely to be higher if they know that in the event of a failure of their investment or business start-up, at least their physical continuity is guaranteed. This should encourage entrepreneurial or innovative behavior. In addition, by simply safeguarding livelihoods the human capital for the economic process is preserved. An education policy financed by redistribution can also be justified economically as an investment in human capital. The productivity of the beneficiaries increases, and thus also the economic power and the tax revenue of the affected country. Good general education also strengthens democracy, because citizens are no longer so easily exposed to unbalanced one-sided arguments. An exclusive promotion of school and university education with private scholarships will not be able to guarantee a broad range of human capital. An alternative here is the acquisition of external knowledge for the national economy as well as for companies. The international competition of states and enterprises for resources includes not only capital, but also human capital.

The main structural building blocks of a social market economy are social, pension, unemployment and health insurance, a free educational system and a progressive tax system.⁵¹ This results in ethical advantages, inasmuch as a benefit is generated for people. A secure existence and health care regardless of income, as well as equality of opportunity through free education, are important prerequisites for a good and meaningful human life according to Aristotle. However, there are

⁴⁹ See Müller-Armack, Alfred (1947), p. 88; Zweynert, Joachim (2008) and Bundesministerium für Wirtschaft und Technologie (2013).

⁵⁰ In a sense, Aristotle already foresaw the social market economy in which he wished to make use of the advantages of private property but also wanted to make private property available to the community: “On the other hand, an order of property which follows the custom and which is characterized by habitual behavior and the Order of proper laws is a great advantage: it should combine the advantage of both orders-by this I mean the advantage of common property and of private property.”

Aristoteles (1991), pp. 17 or 1263a. (author’s translation)

⁵¹ See Bundesministerium für Wirtschaft und Technologie (2013).

also economic advantages. Social market economy pays off. The main economic advantages are:

1. Development of human capital through a government financed education system

Educating the population increases productivity. Employees with better skills earn more. Due to technical progress the demands on the qualification of workers are increasing. A high human capital is once again the prerequisite for innovations, i.e. technical progress. And innovations increase the productivity, competitiveness and profits of the industry of a country. Well-paid jobs are created. This all leads to significantly higher tax revenues. Investment in the human capital of the population thus pays off in many ways.

2. Greater equality of opportunity and thus better economic use of human capital

The education that a person receives should not depend on the income of his parents, but on his abilities. If education has to be paid for, there will always be people whose skills could not be developed because they could not afford the training.

3. Preservation of human capital by statutory health insurance

It makes little sense to invest in human capital and then let it be destroyed by illness. Even well-trained workers can become unemployed. If they can no longer pay for their health care, the human capital is lost.

4. Social peace through a state guarantee of the subsistence minimum and a redistribution in the form of progressive taxation.

Anyone afraid for his existence is ready for violence. A market economy is more likely to be accepted as an economic form if the inequality of the distribution results is mitigated. Not least of all, the distribution results of the markets are not just based on performance and are sometimes perceived as unjust.

The principle of assistance for self-help applies. This principle of subsidiarity derives from Catholic social doctrine.⁵² The social market economy also corresponds to Rawl's principle of justice. Everyone can be freed from their interests by moving into a primitive state, without social differences, in order to ensure procedural fairness when establishing social institutions. Out of a veil of ignorance the citizens do not know their fate and must fend for themselves in the worst case.⁵³ However, if they do not know whether they are born poor or rich or have health problems, they need social security and basic care. They would, therefore, opt for a social market economy with social redistribution as an insurance against the worst case scenario.

But how do we explain that in reality, countries that characterize their economic form as a social market economy, such as Germany, are not necessarily superior to the other almost exclusive market economies, such as the US, in the productivity of

⁵²See Schulte, Bernd (2000) and http://www.uni-muenster.de/Geschichte/SWG-Online/sozial-staat/glossar_subsidiar.htm

⁵³See Rawls, John (1979), p. 158ff and 341, and in the original Rawls, John (1971), p. 10ff, 12, 139 f.

the economy? Most countries are mixed forms. Even the US is not a pure market economy, but has a social security, albeit a small one. An active social education policy is not being pursued, but the skillful abolition of human capital, especially by American elite universities. Germany, for example, renounces this in the belief that an active education policy alone is sufficient. However, due to lower salaries for professors, most European universities are not able to compete with the US in the international competition for human capital. The term “socialized market economy” also applies to Germany as a “social market economy”. On the one hand, a large number of economic sectors were directly involved, with the result that competition and market functions were disrupted. On the other hand, taxation and social protection have been exaggerated to the point where the incentives have been adversely affected. This was at least partly corrected by the Agenda 2010 of the Federal Chancellor Schröder.

Higher productivity as all as social peace arises through the building blocks of the social market economy. In general, therefore, a correlation can be drawn with the Laffer curve⁵⁴: the productivity of an economy initially increases sharply with an increase in the social intervention of the state, but the increase lessens and then decreases from a maximum with increasing rapidity. This is a semicircular-like functional relationship:

Conclusion

As the example of Russia shows, the twentieth century was, among other things, the century of system competition. Various economic systems were tried, but the market economy won the system competition. At first socialism seemed to offer an answer to the many ethical problems that arose during the industrial revolution. In this context, we should mention the impoverishment of the working class or the lower poorly trained and simply poor population strata. Market and morality were perceived here as a contrast. Socialism saw the ethical basis for the unjustly perceived prosperity distribution in the central function of capital in the market economy and in the market mechanism, which was blamed for the lack of justice in needs and distribution.

Summary

The market economy is considered to be ethically superior to alternatives such as a planned economy (central administration economy) because it achieves the moral goal of adequate prosperity with a higher degree of individual freedom. The competition functions lead to an ethical result in the sense of a justice for performance. The social market economy is the ethical expansion of the market economy. It combines the productivity advantages of the market economy with ethical aspects, which can increase the productivity of a pure market economy when properly applied. However, there is a risk that overriding social interventions can severely limit competition and lead to the same problems as in the central administration economy.

⁵⁴The Laffer curve describes the relationship between tax rates and tax revenues.

Planned economy considered the abolition of private property and the central coordination of the production plans to be two tools to better meet the needs of society. But socialism, or even communism, could not unleash productive forces. The prosperity gap between the capitalist and socialist states became ever greater until the socialist systems collapsed. Nonetheless, the social market economy cannot eliminate all ethical weaknesses in the market economy. The greatest damage is caused by market failures, as we shall see in the next chapter.

Comprehension Questions

1. What are the advantages of the market economy as a system?
2. Name and explain the competition functions.
3. Is there a conflict between market and ethics?

5.5 Market Failure

Markets are by no means perfect, since they are created by people. Markets increase economic efficiency, but the idea that markets are always efficient is an unrealistic idea of theoreticians detached from reality. Of course not all information relevant for the market is known, or procuring it is too expensive or difficult. A large part of market failures and crises can be explained by human failure. People overshoot, there are speculation bubbles and pig cycles. If the market were efficient there would be no successful speculators. Most transactions are created out of stocks, since buyers and sellers estimate the future of the stocks differently. Absolutely efficient markets are impossible because the actors in the markets are humans. Humans are fallible. As we have seen in Chap. 3 they are emotional and imperfect, and do not always act efficiently or rationally. Even if humans strive to attain perfection, or occasionally claim to be perfect or have god-like control over nature, they are not. At the very most they are just slightly ahead of everyone else.

In the market, individuals make their decisions independently. No discourse takes place beforehand, taking into account the interests of all parties involved. For this reason, there is also a clash between individual benefits and social benefits in the markets, which will lead to market failure, as we shall see below.⁵⁵

5.5.1 Market Failure Due to Non-exclusion

Public goods are goods in the national economy whose benefits for society (public utility) exceed the individual, because the utility is freely available and the market participants cannot be excluded from its use. For this reason, public goods are

⁵⁵The unethical effects of so-called external effects on uninvolved third parties are not taken into account, however.

offered in small quantities or not at all through the market mechanism. The fact that the market fails here is widely accepted. Let's take clean air. Clean air can be produced not just for one person, but everyone in the same environment also profits from it. However, using the air does not make it scarce, so there need not be rivalry to use it. Examples of other public goods from which individuals cannot be excluded would be internal and external security. There is an acknowledged market failure in all of these goods. Since no one can be excluded from their use, many would not want to participate in the cost and hope others finance its procurement. In addition, there are high transaction costs and the impossibility of an individually agreed financing, which is why the state has to provide these goods to society through compulsory contributions (taxes).

There are also public goods in the private sector, where there is the problem of free riding. Whenever several people want to purchase an item where the usage cannot be made exclusive, there is an incentive not to participate in the cost and still use the item. Let's take the acquisition of a common television in a student hostel as an example. Moral behavior would preclude such parasitic behavior and every student would honestly admit that he wants to use the television and participate in the cost.

Social morality or better ethics as practiced moral behavior is itself a public good. Everyone benefits by cooperative, considerate, and courteous behavior. Social morality is a public good. The benefit is arbitrarily divisible, thus not competitive and no one can be excluded.

The methods described in Sect. 3.3. Individualism versus collectivism of public goods showed the importance of social sanctions (norms) and learning or socialization.

5.5.2 Market Failures Due to Asymmetrical Information

The model of the perfect market assumes complete market transparency. Market participants have all the information relevant to their decisions.

One speaks of asymmetric information when the parties have unequal knowledge about:

- (A) the properties of the product to be exchanged (Hidden Characteristics)
- (B) the behavior of the partner after conclusion of the contract (Hidden Actions)
and/or
- (C) the intentions of the partner in the Hidden Intentions.

The economic participants have different knowledge and one party can exploit this unethically to the detriment of the less informed. This party then has less value than expected, which leads to a non-pareto-efficient situation.

- (A) Asymmetric information concerning the properties of the product to be exchanged (Hidden Characteristics)

If, prior to the conclusion of the contract, the exchange partners have different information on the objective characteristics of the goods to be exchanged (for example in the market for consumer goods), this favors the process of negative selection. For example, there is a lot of information on the goods on the used car market, which can be unethical to the advantage of the buyer.

The problem of the hidden characteristics is found particularly in anonymous markets, in which buyers and sellers do not know one another, and are not dependent on one another because they will not do business again. The seller can thus deceive the buyer because of the asymmetric information, without having to fear retaliation if the buyer has identified the fraud. One thinks of the itinerant vendors who went from village to village, and so were never accessible. In decision theory, this corresponds to the game with one round. Anonymous markets can be financial markets, but also in big cities people do not know each other and often do not see each other again after buying. This is why, as a rule, crime is higher in an anonymous city than in a village. Despite the cliché of the country bumpkin who gets rolled in the big city, he is not more naive than the city inhabitant; he has simply not had bad experiences and is therefore more trustful.

Another area with the problem of hidden characteristics is personnel management.⁵⁶ For example, when a new employee is hired, the quality of the that person is not directly identifiable. Hidden characteristics are the qualities of the applicant, which are unknown to the employer when hiring, such as the actual degree of qualification, the integrity, the working attitude and loyalty. Hiring external employees therefore entails a high risk of failure assessment due to the hidden characteristics, associating it with high risks. It can only be recommended if no one is available internally at the time of hiring, or if external knowledge can be brought into the company that the company has no other way to access.

Ultimately, the importance of the corporate identity and, in particular, the emotional attachment of the employee to the company has decreased over the last decades. This has aggravated the principal agent problem. In the past, it could be expected that a company's management would have worked hard or at least learned about the most important value-added stages and corporate identity. This not only had the advantage that managers could better assess the impact of their decisions on the company, and they had a stronger identification with the company. Furthermore, the risk of failure due to hidden characteristics was less, because the management had to prove itself in the company for many years. However, the problems of hidden characteristics, hidden information, and hidden actions exist on every level of leadership down to the subordinate decision-making units.

Market Failures can Be Countered by

- Screening: the uninformed person improves his information level by gathering information directly or through advice from specialized third parties.

⁵⁶ See Berthel, Jürgern/Becker, Fed G. (2013), p. 48.

- Signaling: the better informed party provides information, for instance by offering a guarantee.⁵⁷
- Morality: Ethical behavior in hidden characteristics would prevent the better-informed from betraying the worse-informed.

In German literature, there is still the distinction between trust and experience goods. In the case of experience goods, the customer knows the characteristics of the goods after the purchase, not in the case of trust goods. The commercial audit is, for example, cited as the trust good. In the case of trust goods, self-policing is an effective solution, such as by offering a guarantee.⁵⁸

(B) Hidden actions

Since in general the one partner does not know how the other will behave after signing the contract, this favors possible hidden actions. The contract is then not implemented to the advantage of both sides, but the one side betrays the other and the allocation optimum is not achieved.⁵⁹

This problem of moral risk (moral hazards) is seen particularly often in the insurance industry. The behavior of the insured person may change after the conclusion of the contract at the expense of the insurer, because he will no longer be liable for his property. After completion of the insurance policy, the insured person may, under certain circumstances, influence the probability of the loss occurring without the insurance having any influence on this. For example, the owner of a fully-insured luxury car might hope that he can order a new car if he parks it in a dangerous area. Incentives such as refunds can be used to prevent market failures.

There are hidden actions with rental, since the landlord does not know how the tenant will deal with the object after the conclusion of the lease. To reduce the risk, the tenant must provide a deposit. With moral behavior this would be superfluous and he could trust the tenant.

(C) Hidden intentions

The difference between the hidden intentions and the hidden actions is the intention. A contract partner has performed first and now depends on the other for the fulfillment of the contract. There is a one-sided dependency after conclusion of the contract.

Ignorance of the contractor's "covert intentions" can lead to the exploitation of contractual scope for interpretation by the economically stronger person to the detriment of a contract partner dependent on him (hold-up behavior).

This possible exploitation or blackmail could be attempted with a strategy of interest harmonization (incentives, such as profit sharing). Hidden intentions exist not only in leases, but also advance payment. The one-sided dependency is counter-

⁵⁷ See Dillerup, R./Stoi, R. (2011), p. 24; Welge, M./Al-Laham, A. (2008), p. 52 and Fritsch, Michael/Ewers, Hans-Jürgen/Wein, Thomas (2011), p. 263.

⁵⁸ See Ballwieser, Wolfgang/Clemm, Hermann (1999), p. 414.

⁵⁹ See Weisser, J. (2012), p. 53 and Alparslan, A. (2006), pp. 22.

acted here with deposits and guarantees. Risks from Hidden Intentions are also present in joint ventures for market closure, where a company has the know-how. The other partner could try to build his own company as soon as he has acquired the know-how. Here, harmonization of interests can be achieved by a very high participation of the partner in the joint venture. The participation must be so high that it is no longer worthwhile for the partner to build a second company. Again, it helps if one can trust in moral behavior.⁶⁰

5.5.3 *Market Failure Due to Transaction Costs*

If market transactions fail because of their transaction costs, one can also speak of market failures in a broader sense.⁶¹ Transactions can be understood as all transfers of rights to dispose of goods and services.⁶² The transfer of services includes the internal sale of work through an employment contract. The transfers incur costs, such as information, negotiation, control and enforcement costs, as well as transport costs in a broader sense.

We distinguish between direct and indirect transaction costs.

1. Direct transaction costs

Over the past few decades direct transaction costs have fallen very sharply, leading to the formation of numerous new markets. Some factors in cost reduction have been the Internet, new transport techniques and English as an international business language. All together, globalization has been a key factor affecting costs. The world has become smaller because the paths have become shorter and more cost-effective. The invention of the Internet increased market transparency with reduced transaction costs. Prices and services can be compared faster and more cost-effectively. Innovation have been made in the transport techniques like container shipping, large oil tanks and reduced flight costs. The implementation of English as an international business language is comparable to the introduction of a uniform standard (e.g., metric or DIN). Translation costs are thus obsolete as people trade with other cultures, e.g. German and Chinese in a common foreign language. They have to learn only one language through the common standard in order to be able to do business.

2. Indirect transaction costs

If, as with the asymmetric information presented, the fulfillment of the contract is uncertain, there is a risk of loss. This is always the case if behavior after contract conclusion cannot be controlled absolutely. This is relevant for all forms of transac-

⁶⁰ See Dillerup, R./Stoi, R. (2011), p. 25 and Welge, M./Al-Laham, A. (2008), p. 53.

⁶¹ See Williamson, O. E. (1979), pp. 18 and Williamson, O. E. (1985a, b) and Furubotn, Eirik G./Richter, Rudolf (2005), pp. 47.

⁶² See Gabisch, Günter (2003), pp. 56.

tions, which include long-term contract fulfillment, thus also employment contracts. The higher the advance performance and the longer the contract duration, the higher is the risk of a lower counter-performance. This applies in particular to investments by companies in new production facilities, for example. Here, the investment is high but the return is distributed over many periods. These indirect transaction costs can be reduced by an objective and rigorous legal system. A written Code of Law also reduces the risk and is better than a case law because case law builds on precedents. Countries that do not have a reliable law enforcement system have difficulties in attracting direct investment.⁶³

The indirect transaction costs can be reduced by strong morals. Luhmann also sees trust as a means of reducing the complexity of social interactions. If the culture of a country is moral, the contracting party can trust in the implementation of its treaties.⁶⁴ There is no longer a risk of fulfillment resulting from being taken advantage of.

Transactions are completed when the indirect transaction costs are reduced, which can be considered its own business approach. Phrases like “A good name is worth its weight gold” and “My word is my bond” as well as the legal concept “good faith” stand for this approach. The reputation of a person or a company includes everything associated with its name: poor or good performance, moral or immoral behavior, etc. A reputation is formed by acts that are observed and interpreted by people, by the market. This means that every company is responsible for its own reputation.

The honor of the merchant also derives its significance from the elimination of the risk of contract settlement. This honor was institutionalized by merchant guilds. They introduced codes of ethics and sanctioned corresponding rules. Grievous violations were punished with exclusion from the guild, which was equal with the abolition of the entrepreneur’s livelihood, because he lost the trust of his business partners.⁶⁵ Even in Mafia circles there is an honorary code within the criminal organization and their business partners. Thus even criminal circles need a minimum of morality to deal with their business transactions. They also need mutual trust.

Trust

After the Enron crisis nobody trusted the balance sheets of companies. A result of the subprime crisis was that nobody trusted banks anymore, the confidence was lost, and this would have caused the world economy to collapse without state intervention. What role does trust play for people? If people are descended from apes, we may assume they have similar group dynamics. Apes are extremely rarely solitary animals without connection to a group. They must find a place for themselves within a hierarchy and are dependent on the grace of other group members. For example, the gorillas have a “silverback” who leads the group as the dominant male.

⁶³ See Steinherr, Christian/Steinmann, Horst/Olbrich, Thomas (1997), p. 1.

⁶⁴ See Luhmann, Niklas (2000).

⁶⁵ See Beschoner, Thomas/Hajduk, Thomas (2011); Albach, Horst (2003) and Lin-Hi, Nick (2014), pp. 10.

Chimpanzees have displayed political behavior. Only the ape with the strongest faction of followers behind him can dominate the group, thus a relatively democratic majority. The apes must exhibit a minimum of cooperative behavior, which appears coded in human genes as well, otherwise groups would not be created and solitary apes and humans would be common in nature. Reality shows us that this predetermination is not always sufficient to secure cooperative behavior. The incentive to act uncooperatively must be correspondingly great. This comes from the fact that many decisions are made within daily dilemma structures, such as the prisoner's dilemma. The dilemma consists of the fact that the total benefit is greatest for those involved in cooperative behavior, yet insecurity over cooperative behavior from others allows non-cooperative behavior to seem the best choice for individuals. The worst result for the individual would be if he acts cooperatively while the others all act uncooperatively. On the other hand, the additional benefit for the individual is greatest if he is the only one to act uncooperatively. Since everyone is subject to this situation of insecurity, everyone decides to behave uncooperatively, which provides the worst results for everyone. An example from the decision-making situation on the market: a buyer buys a good that he has not tested and does not know. The seller trusts that when he sends a bill he will be paid later, after the goods have been delivered. If neither of them can trust the other one, they will assume that the other one will cheat them. The consequence will be that each one cheats the other in order not to make the purchase worse, that business does not occur at all or that there are high safeguarding costs. In business with unknown foreign business partners for example, it is common to conduct transactions step by step with the guarantee of a bank (e.g. payment only in exchange for documentation or with a confirmed bank credit, letter of credit).

This kind of dependency and dilemma situation is particularly problematic if not all of the actors know each other (on anonymous markets), cannot vote or if there is a one-sided dependency, in which the decision-maker can later punish non-cooperative behavior. It is best if the people acting directly can be trusted. With morality and good manners as a basis for societal trust, cooperative behavior has a foundation, which in turn allows these values to increase productivity.

Trust is nothing more than believing that someone will behave as expected without sanctions. Trust exists in relation to good performance, moral behavior, help etc. Ethical behavior is an elementary prerequisite for human cohabitation. If one wishes to pursue common goals in a marriage for example, such as providing for each other and raising children together, the basis must be mutual trust. Without ethical, moral behavior there can be no trust between the spouses. Behaving ethically in this context, according simply to our definition, means not to damage the other party, or to be of use. Trust for companies is also important. Companies enter into transactions with new, unknown business partners because they have a good reputation. A good reputation engenders trust. As we saw in Chap. 3, if transactions occur only once, and so anonymously that damage to one's reputation is not expected, it would maximize one's advantages to fleece the business partners. The reputation of a person or company includes everything associated with them. Good or bad performance, moral or immoral behavior, etc. A reputation is made up of actions that both

people and the market observe and interpret. Every company is thus responsible for its own reputation.

Citizens can trust in laws, courts and the executive branch. But as we have already mentioned, no system can control and implement the rules 100%, no matter what efforts are undertaken. Rules help in particular when they are clear and transparent, known by all actors, and everyone involved assumes a consistent application of the rules.

Absolute control is impossible, which means that unethical behavior can pay off. Why then, do people generally behave fairly and ethically? How can we explain this “irrational” behavior? Is it deterrence or are people as social animals programmed that way? Both answers are elementary for moral behavior, but there is also the element of socialization, which teaches us how to live in our communities. Socialization as practicing behaviors and beliefs takes place mostly in childhood, but continues throughout our lives as long as people are in groups where they are at least partially in a dependent relationship. Behavior in conformance with the group is demanded of individuals. Sanctions are applied here as well. They can range from a refusal of recognition to exclusion from the group. People generally continue the behavior they have practiced even if the sanction is removed. Moral behavior must be practiced just like driving a car. The traffic laws provide the framework of behavior, and for interpersonal interaction there must also be rules with sanctions. The continued learning of the correct, or socially desirable, behavior begun in childhood creates a conscious value system in people as the foundation of their own goals and actions, which enters into the subconscious through constant repetition. Based on this subconscious set of values, we act as unconsciously as we drive a car, without having to reflect anew. Sanctions become superfluous. For the community this means that values must be passed on and socialization must take place in the youth. Role models are also important. They communicate beliefs that offer an explanation for behaviors. The disposition towards certain types of behavior are inherited, varied and cannot be influenced. If we want to influence people positively with business ethics, we must start with social, economic or business role models for socialization and communicating beliefs and attitudes.

Trust is an absolutely central economic factor both at the level of the individual and the whole economy. Who would want a business partner they cannot trust? How does it help a customer to be consulted by the best bank, the market leader, and have the feeling that all this intelligence and experience is working against him in order to empty his pockets, perhaps even recommending investments that will permanently damage him? The bank could recommend poor stocks still on the books from an IPO that made it a lot of money, and which the bank now wants to get rid of. Or someone could sell him life insurance with large fees hidden in small yields later on. Let's say the customer had already taken out two life insurance policies. What he cannot know is that the bank forces its consultants to sell at least five life insurance policies regardless of whether the customer needs them or not. Loyalty and confidence, or morality and ethics, are thus an important part of any service and a competitive advantage for companies on transparent markets. Once a customer's trust has been violated, if he acts rationally he will change banks, and as soon as he

finds a bank he can trust he will stay there. For the bank that lost his trust he is lost forever, making the profits from the strategy with short-term success much less over the long term. The ethics campaign of Citibank, once the largest and most profitable banks, thus makes sense not just because of the imposed fines, but because the bank recognized that it went too far with its sales methods. It went so far in fact that the damage to its reputation and customer satisfaction could damage its future market position.

We have already discussed the importance of moral values for national economic development. The same applies at the microeconomic level for each company. A company that must operate in an immoral environment (such as in Russia) will have higher transaction costs. It must monitor and protect itself more. This causes inefficiency, since many economic transactions are lost to higher costs and risks. A company acts in a given social framework and recruits its employees from this society. Suppliers, customers, the legal system... everything comes from this society. The possibility for a company to influence a society is very limited, the opportunities for influence are trade associations, thus politics or advertisement. The most important thing for the company is to acquire morally suitable employees, and to hold them to moral behavior, whereby management focused on qualitative goals plays an important role, as we will show later on.

A survey of 500 employees of European companies showed the great importance of trust in ethical behavior. If employees can trust their executives, they are more ethical. Empirical behavioral experiments also confirm this.⁶⁶ The gift exchange game or trust game, which builds on the ultimatum game:

Game 4: Gift Exchange Game or Trust Game

Two students are to split 10 pieces of chewing gum, as they did in the ultimatum game. The first (proposer) receives everything and can determine how much he gives to the second. This amount is then tripled. The second (responder) can then decide how much he will give the proposer.

The Gift Exchange Game or Trust Game is normally played with \$10 instead of chewing gum. Rational behavior presupposes that the proposer should keep all money because, as a rational actor, he also assumes that the responder will give him something afterwards. After all, it is a game with one round. In the games, however, only a small proportion has chosen this strategy. Most of the proposers had confidence in the unknown responder and were rewarded because of the strong correlation between the amount of money transferred and the subsequent responses of the responder.⁶⁷

After the Enron crisis (see also Sect. 4.1) confidence in the company's balance sheets was shattered, and as a result of the subprime crisis no one trusted the banks, while the banks trusted themselves least of all. Confidence was lost, which almost collapsed the global economy. What role does trust play for people? If the human being is descended from the monkey, similar group behaviors may also be applied

⁶⁶ See van den Akker, Lenny/Heres, Leonie/Lasthuizen, Karin/Six, Frédérique (2009).

⁶⁷ See Holzmann, Robert (2015), p. 129.

to man. A solitary existence is a rare exception in the life of monkeys. They have to adapt themselves to predetermined hierarchical levels and rely on the favor of the other group members; this political behavior has even been observed in chimpanzees. The only monkey able to dominate the group must be able to unite the strongest group of supporters, a relative democratic majority. A minimum of cooperative behavior must therefore be applied to monkeys and thus also be a genetic attribute in humans. Otherwise no groups would form, and both monkeys and man would be observable in nature only as solitary individuals.⁶⁸

Reality shows that predetermination is by no means sufficient to ensure cooperative behavior. The incentive to behave non-cooperatively must therefore be correspondingly large. One of the reasons for this is that many decision-making situations in everyday life have a dilemma structure, such as the prisoner's dilemma presented above.⁶⁹ The dilemma is that although the overall benefit from cooperative behavior is greatest for the stakeholders, the uncertainty about the cooperative behavior of others makes non-cooperative behavior the best choice for the individual. The worst result for the individual is if he is the only cooperative player and all others uncooperative. Vice versa, the profit-gain is greatest for the individual if all others behave cooperatively. Since the insecurity in the situation is about everyone's behavior, they all opt for non-cooperative behavior, which is the worst result for everyone (ethical prisoner dilemma, see also Sect. 6.1). Here is an example from a decision-making situation on the market: The buyer buys a product which he has not yet been able to try out, or does not know. The vendor will rely on the buyer to pay for it later, after the delivery of goods. If neither one trusts the other, they will have to assume that they are going to be cheated. The consequence will be that they are also cheating, in order not to suffer from the purchase, so the business transaction is not concluded or high hedging costs arise. For example, in transactions with unknown foreign business partners, it is customary to carry out the transactions step by step with guarantees from a bank.

Dilemma and asymmetrical information are problematic, especially if the persons who are acting are not familiar with one another (on anonymous markets), cannot vote, or if they are dealing with a one-sided dependency in which uncooperative behavior can not be sanctioned later (play with one round). It is even better, then, to trust the active man directly. In the case of morality as a social basis for trust, cooperative behavior can be assumed, which is why these values are productivity-enhancing.

The importance of moral values for economic development has already been demonstrated. The same applies microeconomically to each individual company. An enterprise that has to operate in an immoral environment (as in Russia, for example, due to the uncertain legal situation) will have higher transaction costs. It must control more and secure more. Efficiency suffers, and many economic transactions are avoided because of higher costs and risks. A company moves in a given social context. It recruits its employees from this company. Suppliers, customers, legal

⁶⁸ See Windeler, Arnold (2014), p. 175.

⁶⁹ See Kirchgässner, Gebhard (1991), pp. 51.

order – everything comes from this company. The possibility for a company to influence society is only very limited by economic associations, such as politics or advertising. In the short term, it is also important for the company to acquire morally responsible employees and to educate employees on moral behavior, whereby a quality-oriented management plays an important role, as will be shown later.

Summary

Asymmetric information gives the advantage to the informed contractor over the uninformed and enables him to betray the uninformed contract partner. Reputation, trust, and morality have evolved as a social solution to this problem.

Comprehension Questions

1. What is asymmetric information?
2. What effects can this have on business relations?
3. Give examples of the economy in which asymmetric information exists and possible tools to prevent unethical effects.

5.5.4 Market Failure Due to External Effects

External effects are the consequences of economic action on the welfare of an uninformed third party whose interests are not expressed in market prices (definition), which is why they have an ethical dimension. Negative external effects are immoral because they cause harm. If the state wants to prevent others from being harmed, it must internalize negative external effects through taxes or positive external effects through subsidies.

External effects are thus effects which originate from economic subjects and are not internalized by the market mechanism. As a result, the incentive system is also distorted. Negative effects (negative external effects) are not sanctioned by the market and positive effects (positive external effects) are not remunerated, resulting in a suboptimal resource allocation. For example, environmentally damaging products, such as plastics, are not burdened with the welfare costs that cause their disposal, which is a negative external effect.

Negative external effects (social costs) harm a third party. Some examples are exhaust gases, noise, waste water, damaged the environment and thus the welfare of third parties. The injury is not included in the production costs and thus does not burden the victim. Positive external effects (social benefits) favor third parties. For example, a park in a large city or the maintenance of the buildings increases the value of neighboring buildings. In this case, the positive effect is measurable because it manifests itself in the appreciation of the land value.

External effects cause misallocations because not all costs or benefits are reflected in the market prices. Since the providers and buyers appearing on the market only take individual advantage into account in their decisions, the market profit is not efficient from an economic point of view.

Exhaust gases, mostly CO₂, are produced during the operation of airplanes, damaging the ozone layer. Layers of the atmosphere are destroyed and the level of noise makes life near airports almost impossible. These effects are not included in the operating costs of the aircraft, which leads to a misallocation. Due to the high negative external effects, the flight prices would have to be substantially more expensive. The price does not cover the cost, which is why too many flights are in the air.

The education of the population, on the other hand, has positive external effects. In the long run, education leads to a higher productivity of the population and thus to higher tax revenues, which is why the free education system pays off for the state. Furthermore, as already shown in the social market economy, an educated population is not as vulnerable to opinion manipulation and unilateral extremist slogans, which stabilizes democracy. Overall, there is a higher welfare of the population through education.

There are ethical solutions for external effects. Moral behavior requires that third parties are not harmed. Thus an ethically oriented company would either have to stop the production with negative external effects or at least compensate for the resulting damage. However, if there is no binding regulatory framework internationally, this would mean that moral behavior is associated with major drawbacks, because it entails competitive disadvantages. This places the national governments in a prisoner's dilemma. Environmental pressures in the national market are, at the very least, short-term competitive disadvantages. The uncertainty about the behavior of the others leads to the collective worst case, insofar as no environmental requirements are implemented.

The state has developed external effect standards and sanctioned external effects such as telephoning with mobile phones on the train or smoking in restaurants. Socialization and parenting are key factors here. There are also behavioral guidelines such as "What you do not want to be done to you, do not do to others", which corresponds to the categorical imperative of Kant. It is also possible for people to take care of others, and to try to avoid negative externalities and to support positive ones.

5.5.5 Market Failure Due to Corruption

The market economy generally has a system of rules for playing the game that must be learned and controlled. Especially immoral behavior can damage the system in this context. The most famous example of immoral behavior and systemic behavior is corruption.

Case Study: Does Corruption Pay? The Example of Siemens⁷⁰

1. Discuss the following article in the group. Why is there always corruption and why does it not pay off in the long term? Why is corruption harmful? What measures would you recommend to a company to prevent corruption?

Siemens, as one of the largest exporters of industrial equipment and train systems, maintained a widespread system of corruption. It was decentralized with the tacit approval of the group headquarters. There were a multitude of opaque transactions, insider cliques, and hundreds of accounts abroad in the many divisions and countries of the world conglomerate. The investigations of the American lawyers commissioned by the Siemens Supervisory Board, as well as the Munich public prosecutor's office, showed that between 2001 and 2006, bribe payments of at least 1.3 billion euros had flowed through those bank accounts. The recipient and the purpose of the payments are partly unknown to date.

It turned out that many orders, apparently acquired with bribes, were unprofitable. The Italian energy supplier Enel was responsible for the kick-off of Siemens, although the turbines were scarce and had to be allocated. In Argentina, the governments of Menem and de la Rúa were bribed. However, the announced, and in some cases contractually agreed, major contracts did not come about. Instead, there was blackmail on the part of the Argentinians who were involved in the distribution of orders, as they demanded money for the silence on the bribe payments. Siemens employees in Argentina reported life-threatening difficulties. Thus the seemingly lucrative business became a nightmare and a loss in business.

The US SEC initiated a corruption case against Siemens in the United States, as Siemens is listed on the US stock-market. The Siemens Supervisory Board had then instructed a law firm in the US to investigate the Group and pass the findings directly to the US stock exchange supervisor. It turned out that there were far more questionable payments than the board had initially reported. In the middle of November 2006, the Munich Public Prosecutor's Office carried out a big raid at Siemens. In 2007, Siemens was threatened with the exclusion of public contracts on the world's most important markets, huge image damage and billions in penalties. Siemens decided to make uncompromising reconnaissance and practically exchanged its entire management. At the same time, a comprehensive compliance system was set up. Siemens came away with an asset loss of an estimated 2.5 billion euros, of which were 1.2 billion euros in punitive payments. In 2008, the SEC imposed a fine of \$1654 million on Siemens for the bribery of public authorities in several countries on the basis of the American Foreign Corrupt Practices Act (FCPA), of which \$350 million went to the SEC, \$450 million to the US Department of Justice, and

⁷⁰ Sources: http://www.faz.net/aktuell/wirtschaft/unternehmen/bestechende-grossunternehmen-korruption-rechnet-sich-nicht-12050962.html?printPagedArticle=true#pageIndex_2; <http://www.zeit.de/online/2008/51/siemens-korruption-strafe>; <http://www.sueddeutsche.de/wirtschaft/korruptionsaffaere-siemens-akzeptiert-millionen-dollar-strafe-1.372394>; <http://www.manager-magazin.de/unternehmen/industrie/siemens-zehn-jahre-nach-dem-siemens-skandal-a-1118197.html>; <http://www.handelsblatt.com/unternehmen/industrie/der-fall-siemens-sec-klopft-bei-staatsanwaltschaft-muenchen-an/2805400.html>

\$854 million went to the German prosecutor's office. The CEO of Siemens von Pierer maintained he had not known anything about the bribes. Pierer stepped down from his post. He was not prosecuted under criminal law, but had to pay damages of €5 million. A prosecution against him for neglecting the duty of supervision was suspended for a fine of €250,000. He then worked as an honorary professor and served on a supervisory board.

Private corruption is the abuse of a position in a private organization by using the position for one's own purposes and under public corruption we understand the abuse of a public office (definition).⁷¹

The advantage is difficult to detect and can be hidden behind apparent powers, such as consultancy fees or excessively high prior-day auditors.⁷² Personal contributions are used to influence an individual in his market decisions. Market economy as a system generally has rules, which must be learned and their implementation must be monitored. Immoral behavior can damage the system in this context, and the most well-known example for immoral and system-damaging behavior is corruption. The individual is influenced in his market decisions by personal benefit. The corrupted individual no longer makes decisions according to objective market criteria, which cancels out the market and competition functions, including the invisible hand. The person no longer optimizes in the interest of the whole system, and can thus damage the system and others.⁷³ If, for example, the buyer for a company were bribed by a worse and more expensive supplier he would damage the company, the market economy system and thus the entire community. The company would then have to pay out more for the same amount in preliminary production than if it had bought the objectively better product on the market, the result is production of fewer goods. As a whole the company then produces more expensive preliminary products of a poorer quality and fewer goods. This is damaging for the company, the national economy and the community. Research in 97 countries in 1997 showed a negative statistical connection between corruption and GDP as well as between corruption and growth of the GDP.⁷⁴

There are authors who regard corruption as a voluntary bargaining act, in which both sides win, whereby the redistribution cannot be assessed at the expense of the principal.⁷⁵ Corruption advantages are attested to by the bribe money as so-called Speed-Money. An inefficient situation created by slow bureaucracy uses the money as an incentive to get involved, thus making the situation more efficient. It is either assumed that the bureaucracy is ineffective or that efficiency is increased by corruption.⁷⁶ This implies that the bureaucratic rules are either nonsensical, inefficient,

⁷¹ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), p. 312.

⁷² See Göbel, Elisabeth (2010), p. 300.

⁷³ See Graeff, Peter (2002), p. 295 and Homann, Karl/Blome-Drees, Franz (1992), p. 163.

⁷⁴ Corruption gross domestic product correlation coefficient: -0.80 , statistically significant with a t-ratio of -13.2 . Corruption gross domestic product growth correlation coefficient: -0.32 , statistically significant with a t-ratio of -3.2 . See Jain, Avid K. (2001), p. 90=.

⁷⁵ See Homann, Karl (2003), p. 242.

⁷⁶ See Graeff, Peter (2002), p. 296.

or that the officials would not apply the rules without corruption. Then the state apparatus would be an obstacle to the economy and thus better off done away with entirely. If one presupposes meaningful activity however, corruption creates an incentive to act corruptly. The decisions of the bureaucracy are at least no longer objective when corruption is involved.⁷⁷ They no longer represent the interest of the state or they give preference to companies that pay more, which leads to distortions in competition. We then have to ask who is paying the price of corruption. Bribery only pays off when it offers a greater advantage. As a rule, the damage is much greater than the benefit of bribery. Thus the damage to a bribed official who allows a drug that harms the general public is many times higher than the benefit to the pharmaceutical company.

It is in fact likely that bribery will make bureaucracy more expensive and will not make it more efficient because a corrupt official will try to get the maximum out of an administrative monopoly. A saying from China is “official and rich” and in the Philippines an official was paid up to \$ 75,000 for an item that was valued at \$ 10,000.⁷⁸

Corruption is also partly classified as a voluntary contract, and therefore considered positive. However, the price and the bribe are, as shown above, at the expense of others, which is why corruption is unethical. While it is pointed out in the literature that a relationship of trust is established between the briber and the bribee of the exchange contract, this trust in the benefit, the maximization of the utility, is limited by the bribery. The briber can not usually prove that he has paid for something, and the bribery contract is not enforceable. The immorality in the abuse of trust that the bribed man commits is much easier to prove. A third party (state or company) has entrusted him to carry out a task, paid for it and yet was harmed. The fact that the payment offered was not enough cannot be used an argument, unless bribing was open to the contract between the principal and the agent. The bribee has voluntarily entered into the contract. Corruption is, therefore, first and foremost a breach of trust, and therefore repels many people. For Kant it would be dishonesty, a defeat, and a significant weakness of personality or character. Corruption violates all three Kantian rules of reasoning (categorical and practical imperative as well as publicity rule). Someone who breaks a trust at the expense of the one who trusted him to maximize his financial advantage, can no longer be trusted.

As already described, corruption is the misuse of a position in a private or public organization for one’s own purposes. This includes nepotism, the abuse of the position for relatives or friends. Using relationships for advantageous deals or even name-dropping sound familiar and unproblematic, but the effect can be the same as with financial corruption. It depends on whether the relationship provides an information advantage, a higher transparency for the principal because it gets a person or a product that is better, or whether the person or the product is worse, and can only be accepted because of the relationship. Then there is no advantage for the principal, but a disadvantage through the relationship.

⁷⁷ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), p. 322.

⁷⁸ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), p. 322.

The greatest negative effects of the development of corruption are found in the social impact on the society. Performance is no longer the decisive factor in improving one's own situation, but rather relations allowing nepotism and bribery in daily life, including the purchase of offices. Objective private or state decisions are made impossible by personal advantage and outside influence, which also has a long-term effect by lowering economic power. Foreign investors shy away from countries with strong corruption because they no longer have legal certainty.⁷⁹ Corrupt politicians and officials promote the uneven distribution of wealth as money leads to political power and vice versa. Money becomes the greatest factor in the system, thus displacing democratic decisions at the expense of the population who are excluded from the decision-making process. The distribution of wealth becomes more unequal.⁸⁰ In the Bible, bribery is severely condemned not only by a sense of justice, but also as a purely egoistic behavior against divine human dignity. The individual is enriched at the expense of the public.⁸¹

The unethical effects of corruption lead to the disintegration of the common system. If the acts are not punished, they will soon be imitated. It is always worthwhile for two parties to engage in corruption if they can benefit to the disadvantage of a third party. The incentives of corruption are quite strong and without sanction. There are plenty of arguments that play down damage to the third person and make it easier to avoid a bad conscience. This business, in which both parties profit greatly without much effort, finds imitators and, according to Kant's categorical imperative, multiply until the common system no longer works. That is, the culture is eroded as a basis for a productivity-enhancing division of labor. The damage to third parties is borne by the public through bribed state officials, the expense to the owners of companies as well as indirectly at the expense of all employees, insofar as the company is weakened. Overall, the company has less profit to be distributed.

Corruption is also unethical in the sense that it undermines the advantages of the market economy in the function of competition. The distribution becomes unfair because equals are given unequal reward. Performance is no longer crucial to success.

Since corruption not only affects the national economy, but also the companies themselves, Transparency International has compiled recommendations for companies on corruption prevention.⁸² Transparency generally recommends companies involved in bribery to be listed in an anti-corruption register and to exclude them from the award of public contracts for several years.⁸³ However, this sanction would affect only a part of the companies, since not all of them participate in public contracts.

⁷⁹ See Graeff, Peter (2002), p. 298 and Lambsdorff, Johann Graf (2002).

⁸⁰ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), pp. 322.

⁸¹ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), pp. 324.

⁸² See http://www.transparency.org/whatwedo/pub/assurance_framework_for_corporate_anti_bribery_programmes, http://www.transparency.de/fileadmin/pdfs/Themen/Wirtschaft/Checkliste_Self-Audits_TID.pdf (4.04.2013).

⁸³ See http://www.transparency.de/Stellungnahme_Entwurf-Gesetz-S.2338.0.html

Internationally, there is a trend towards a tightening of corruption regulations. In response to the Watergate scandal, the U.S. issued the Foreign Corrupt Practices Act (FCPA) in 1977, which punished the bribery of foreign public officials by American corporations and citizens internationally. Since other countries did not follow, and Germany partly promoted the bribery of foreign companies to support exports, the FCPA initially had a negative effect on the competitiveness of American companies. In addition, all companies listed in the US are obliged to adjust their accounting to the anti-corruption rules of the FCPA.⁸⁴

In 2008, the SEC imposed a fine of \$1654 million on Siemens for the bribery of public authorities in several countries on the basis of the American Foreign Corrupt Practices Act, a settlement of which is \$350 million went to the SEC and \$450 million to the Ministry of Justice. \$854 million went to the German government. The profit from these transactions, however, amounted to \$1.1 billion for Siemens.⁸⁵

In 1997, the OECD adopted a “Convention on Combating Bribery of Foreign Public Officials in International Business Transactions” signed by all 29 states with an obligation to incorporate the content into national law. This law, however, only regulates the bribery of foreign officials and presupposes that a breach of service duty can also be proven. This law was only ratified in Germany.⁸⁶

The United Nations Declaration against Corruption entered into force on 16 September 2005. It is the first international treaty to fight corruption. The contracting parties undertook to punish various forms of corruption against officials and international cooperation. After persistent public criticism, the Bundestag passed a tightening of the rules of parliamentary deputies in 2014. A convicted deputy will be punished with up to 5 years imprisonment.⁸⁷

Corruption is punishable for individuals, but not for companies. The introduction of criminal liability for legal persons and associations of persons failed to take hold in 1998. If a company commits a criminal offense, this is treated as an administrative offense.⁸⁸

Bribery or attempted bribery in private business transactions is punishable for instance in Germany according to StGB §299 with imprisonment up to 3 years or with a monetary penalty. It also punishes whoever is or is trying to bribe employees or agents of a business enterprise. StGB §344 stipulates the punishment of the bribery or attempted bribery with an imprisonment of 3 months to 5 years.

Since corruption is not public, it is difficult to measure. Transparency International uses the Corruption Perceptions Index (CPI) to measure the corruption perceived in the public sector. However, this is not a direct, comprehensive measurement, but an aggregation of various studies and studies from a number of independent and

⁸⁴ See Pritzl, Rupert F. J./Schneider, Friedrich (1999), p. 329 and <http://www.justice.gov/criminal/fraud/fcpa/>

⁸⁵ See <http://www.sec.gov/news/press/2008/2008-294.htm>

⁸⁶ See Elsner, Ulrike (2012); Keuchel, Jan (2002); Göbel, Elisabeth (2010), p. 300 and <http://www.gesetze-im-internet.de/intbestg/BJNR232729998.html#BJNR232729998BJNG000100305>

⁸⁷ See <http://www.transparency.de> (4.04.2013) and Deutscher Bundestag Drucksache 18/476.

⁸⁸ See Bundesrechtsanwaltskammer (2013).

well-known institutions. The countries are listed according to the degree of corruption in the public sector. According to Transparency International, the CPI is the most widespread corruption indicator in the world.⁸⁹

Conclusion

Corruption acts as a reward for an expected risk, such as moral hazards, thus as incentives directed against the interests of the company or the community. Immoral behavior presents the greatest negative impact for top managers for stakeholders and shareholders. The company's success is jeopardized by immoral behavior. Moral, ethical behavior is therefore very important for the company. The same applies to the companies among themselves and in competition. Only a fair performance competition ensures an optimal allocation of resources and thus an efficient overall economic production. Immoral behavior harms society generally, from market processes, internal business processes and the erosion of culture.

The subprime crisis has shown that a market system without rules and controls cannot function. Although capitalism, or the market economy, is responsible for many crises with its growth and individual freedom, it remains the best of all possible economic systems. It is much more crucial that rules and controls exist to prevent damaging individual behavior. The regulatory concept of ordoliberalism has prevailed against the laissez-faire liberalism. Additionally, society has to implement moral responsibility in order to get a functioning market system.

Comprehension Questions

1. What is corruption?
2. Why is corruption harmful?
3. To what extent is corruption punished?
4. Identify the forms of market failure and explain to what extent morality is necessary here.

5.6 Morality Within the Economic Division of Labor

The decisive question is thus which soft facts are relevant for productivity in a company and national economy and how they can be used. To be more exact, how can the natural tendencies, motivations and desires of employees be applied for the good of the company and other employees? What would this kind of management or company approach look like? First we want to define a company more precisely however, what its functions and special features are. Let us consult academic science. Institutional economics defines a company as "a coalition of resource owners bound by a nexus of contractual relations that is governed by a contract decision and monitoring agent – the entrepreneur."⁹⁰ This definition describes the composition of a company, but does not really address its core. According to Coase, the function of a

⁸⁹ See <http://www.transparency.de> (4.04.2013).

⁹⁰ Quoted from Nowak, Eric (1997), p. 22.

company is to avoid transaction costs. This would make companies a unit that regulates repetitive transactions internally and externally through long-term contracts, which would then save transaction costs. Adam Smith recognized companies as a means of organizing labor distribution and thus taking advantage of the learning process, which simplifies production and using the individual strengths of the employees. Alchian and Demsetz later stress this aspect and identify team production as the main function of a company, as did Wieland.⁹¹

The decisive characteristic of a company is neither long-term contracts nor team production, but organization in and of itself. A company does not have to produce in a team to make profits. A bus company for example, is made up of many individually operating transportation units that are completely independent of one another. There is no team production here. The important value creation in this case is the organization of buses or bus routes. We define organization as the systematic assignment of functions into a whole capable of action (definition). In our example this would be the assignment of routes to the individual buses and drivers, thus assigning functions to people and machines. Within the framework of the company organization the employees receive tasks and decision-making powers. This organization of productive forces provides productivity, from which comes the added value of the organizational form “company.” The art is thus in an optimal assignment of functions to employees and machines. The productive force of the company is hidden here. For example this is why job descriptions in a company (tasks and abilities) must be matched with the capabilities of the employees.⁹²

Why is there human culture? Only because the mathematical principle of $A + B + C = 1 \times (A + B + C)$ is disproved by life in human communities. If a group of people join forces for a common task the result of the common action is greater than the sum of the individual actions (emergence). The sum is greater than its parts, which is a human wonder because it contradicts mathematical law. In the end organizations are nothing else but societal solutions to problems that they have developed in answer to external demands and conditions. Over time social constructs come into being, which create added value through the cooperation of different people. For these people to create an added value cooperatively, several challenges must be overcome. Suitable rules for potential conflicts must be found. In companies this often takes the form of the long-term contracts mentioned. Not only do they reduce transaction costs by regulating performance and compensation between the employer and employee of the long term, which encompasses the social inclusion of the actors in team production, but they also regulate the power to make decisions and thus all internal rights and duties including the distribution of added value created in the company as income.

Social rules are called institutions in Sociology. In contrast to the organization, an institution does not create direct added value, but it is an important requirement to do so. Institutions have been created over time to overcome societal dilemma

⁹¹ See Alchian, A. A./Demsetz, H. (1972); Nowak, Eric (1997), S 19ff and Wieland, Josef (1999), pp. 54.

⁹² See Vahs, Dietmar (2001), p. 62 and Conrad, Christian A. (2010).

structures, such as the state legal system. A social dilemma comes from the fact without a state framework for order, it would be worth enriching one's self at the cost of others. For example, not even a bridge could be built with the guarantee of ownership, because the construction site would be constantly plundered. If only the law of the strongest applied, property would not be obtainable through labor, or at least one could not keep it, which removes a central motivation to work. Without institutions many added social values would not be obtainable.

Another social construction that creates added value is cooperative networks. These are practiced forms of cooperation or generally supportive interactions amongst many people, which create added value. Every team is a cooperative network; repetitive labor is delegated within a team and practiced in cooperation together, for example. Every team member knows what output is received from each partner. The decisive factor is the added value possible through this cooperation. The cooperation between the network members can also include the exchange of information. The added value then comes from decisions made that are more in touch with reality.

Companies are generally made up of several interactively cooperating networks that are included in the organization as an assignment of functions. Cooperative networks also exist outside of companies however. The first such networks was probably founded in hunting groups in the Stone Age. Only together was it possible to herd wild animals or kill a large beast. A soccer team is another example of a cooperative network that is not a company. A soccer team can be created spontaneously, which makes clear that long-term contracts are not imperative for cooperative networks. An informal, mutual agreement is sufficient. Since most cooperative networks are designed to be long term, such contracts are the rule. For all social constructs based on mutuality, at least an informal agreement is required for cooperation. Otherwise the members of the network would not agree to advance concessions with their cooperation, since they are usually expecting compensation. Let us resume: Cooperative networks are social constructs, just like institutions and organizations that have been created in the society over time to create more added value through group cooperation. Cooperative networks are the first level of cooperation if measured by complexity. Organizations give structure to cooperation, putting the cooperative networks in a more complex order and hierarchy, so that more complex processes can be structured securely over the long term. Long-term contracts are necessary for this. Institutions make cooperation possible as rules that provide a framework. In principle this is nothing more than the best possible application of all productive forces, the combination of humans and machines. With this background the necessity for hierarchies is given for purely functional reasons, to coordinate processes from above and to bundle the flow of information from below upwards.

There is no corresponding example in nature for the differentiated labor distribution in human culture. Take the comparison with ants. Ants do not have differentiated possibilities for communication, nor do they have a central decision-making body that can collect and evaluate information in order to make decisions for the group. Despite these differences, the following has been observed in ant colonies: a) they raise and milk aphids, b) they grow trees suitable for their housing by destroying

the seedlings of other trees c) they collectively build bridges over rivers and d) together they build living rafts in case of a flood. These are also repetitive behaviors, yet they are not consciously designed and then practiced. They must be the product of evolution. Certain inborn behaviors offered survival advantages over other species, and with this programming they were able to solve problems in a decentralized manner and were able to gain the evolutionary advantage compared to other insects. All of the estimated ten trillion ants, including 12,000 species, amount to as much biomass as the humans living on earth.⁹³ Recent observations have even led to the supposition that ants have at least a certain degree of cognitive abilities. There is one species of ants for example, in which it was observed that the older ants showed the younger ants the way to food sources.⁹⁴ We can conclude from this that decentralized solutions to complex tasks, or decision-making at lower levels taking superior company goals into consideration is indeed possible without consulting a higher instance. This assumes however, that the employees have a character like that of the ants. This would include knowing the goals of the company and the morality, or better said the willingness to follow them without supervision.

We have now worked out two important components of companies, first cooperative networks that are, second, embedded in an organization. Another important component is the human capital of the employees. If one put together a company with just any employees without paying attention to their characteristics, it would not be functional. Human capital can be understood here as all of the prerequisites and potential for added value creation in which people are involved and incorporated as productive forces. We can differentiate here between social capital and individual capital.

Social capital is all of the prerequisites for productivity a person has, but only in a group, thus social in the sense that they can only be realized within a society. The practiced cooperative and informative behavior of members in cooperative networks is social capital, because it can only provide an added value through the interaction with other people. Another example for social capital is practiced social behavior, including virtues, morals and politeness. The social added value that is only created with others comes from a reduction in the transaction and control costs of all social activities. The so-called honorable salesman used to know the basic principle of "good faith." If everyone behaved perfectly morally, most legal costs and other expenses created by the implementation of rights would be done away with. Of course the problem of defining correct moral behavior and delimitation of individual rights would not be solved. The most extensive certainty of the law coming from moral behavior from individuals would stimulate many economic decisions, in particular investment decisions that would otherwise not be made due to insecurity about the behavior of others and the rights to investment profits. More productive forces would be developed and social product and welfare would increase. Morality as social capital makes decisions that are good for everyone possible, and thus increases the productivity of the company and national economy. For instance

⁹³ See Handelsblatt dated September 14th 2006, p. 9.

⁹⁴ See Handelsblatt dated January 26th 2006, p. 15.

researchers at the University of Bern in Switzerland found out that rats selflessly help even unknown members of their species if they had been helped in their own past. This allows us to assume that a willingness to help proved beneficial to evolutionary goals. The more help the rat had experienced, the more help it was willing to give.⁹⁵ Individual capital on the other hand is all of the prerequisites the individual has in order to produce added value, creating value without the community or third parties. Education as a goldsmith is an example of individual capital.

Each person has various abilities as a social being and individual. An efficient business organization seeks to combine these useful qualities through a structured assignment of function – through the inclusion of real capital, for example by bringing together machinery and patents – to create a greater synergistic whole and thereby the optimal creation of value. Human capital (through individual and social capital) and real capital create for the firm the maximum benefit, or greatest possible combined interaction of assets.⁹⁶

Is social capital created without costs? Of course not. Just like for individual capital, it needs investments over longer time periods. Cooperation for networks must be practiced, for example. This means that every member practices their function in the network and learns who can give them what information or performance, and who to delegate to. Organizations, such as companies whose design and continuation create costs, are also social capital because they assign functions and structure a whole unit capable of making decisions and taking action, including practicing processes. Except for the costs of company excursions, the costs of social capital are not included in the controlling and national economy calculations. In fact, the labor time to create cooperative networks, in other words training cooperation, should also be measured and evaluated. Forgetting this fact, and because it is perhaps only difficult or quite costly to capture it in detail, a value estimate of this capital is neglected. Unfortunately the benefits reaped from the social capital are not attributed to social capital. In general only a small part of human capital is registered, with the corresponding distortions in the allocations of resources. With the costs to build up human capital, just the costs for education or training is registered, but even so, the value created or the individual and social capital do not appear as an asset. An employee who has been trained for a task in a company has human capital, be it more individual or social capital depending on the task envisioned. If the employee is incorporated into the company for this task, additional social capital is created. His “value” for the company is realized when applied for the good of the company, just like for a machine, and corresponds to the cash value of the added value from production minus the wage expenses and the expenses of the job. Human capital in positions filled is taken all too seldom into consideration, although the company is interested specifically in the optimal development of productive forces. Analyses of employee potential, in which the companies identify the maximum contribution an employee can make to value creation are thus invaluable in order to avoid poor resource allocation.

⁹⁵ See Weltkompakt dated July 3rd 2007, p. 25.

⁹⁶ See Conrad, Christian A. (2010).

The costs of the cooperative networks and a large part of the organizational costs for a company are recorded just as little as the company added value, which means that there is de facto no value approach. How can one explain the difference between the liquidation value of a company, thus the value of the net assets (value of the non human capital minus the liabilities) and the present value of the cash flow (or the shareholder value) as the net value creation of a company? Only through the added value that the organization, institutions and cooperative networks create via the productive combination of human and non-human capital. Alternatively formulated, if the cash value of the cash flow drops below the net asset value, it is often because of a poor combination of productive forces. The same applies of course in general for national economic systems as a whole and even for states. The state is also an organization, comparable to a company with branches with a systematic assignment of functions into a functional whole. Organizations, institutions and cooperative networks create added value in states as well, through the productive combination of human and non-human capital. Just like in companies, this added value is the difference between the value of a national economy's capital stock, or assets, and the cash value of the future GDP.

Improving productive forces is about the best possible assignment and structuring of organizations, institutions and cooperative networks. This is a science of order. Seen in this light it is possible to compare order using business science and economic science to find out what combinations of organizations, institutions and cooperative networks have had the best results or which deficits have been found. Human capital varies from country to country and is difficult to capture. This is a decisive factor to develop productive forces however, and therefore for the development of a country as well. These factors are more qualitative than they are quantitative. Despite the unpredictability, at least tendencies can be identified. An ideal order like a blueprint to guide companies or the national economy does not exist, and will never exist. The most that can be hoped for is the optimization of order as a framework for a company or economy and for a certain point in time.

The Incomputability is also the main reason for the previous neglect of qualitative factors. Despite this unpredictability however, there is not only an influence from these factors, this influence is so lasting that it would be negligence not to include it in calculations. Quantitative economic science does not explain why, for example, many Asian countries that were at a similar level of affluence to African countries were able to achieve economic prosperity in the last few centuries and many African countries have been fighting starvation despite development aid. The limited ability to predict and plan macroeconomic indicators is generally made clear by the different development in planned and market economic systems. The differences in the development between West and East Germany or North and South Korea after the war can only be explained qualitatively, thus by comparing the systems of order. On the other hand, Communism and Socialism were able to get many people to work until physically exhausted or to sacrifice themselves. Wages do not exist in these cases as an incentive, and the willingness to sacrifice oneself cannot be explained only through the threat of totalitarian measures of oppression. There must therefore have been an immaterial, intrinsic incentive. Why are there countries

that develop into prosperous and dominant countries seemly out of nothing, increasing their capital stock many fold, just to then become meaningless and poor again without outside influence? Human capital is not a static factor. Also the institutions and organizations change.

Communism and Fascism are ideologies. Like religions, they give people clear moral values and behavioral guidelines. They give actions a purpose. Human behavior is given a value that goes above and beyond the material value, and it thus becomes a value in and of itself. Apparently many people want to believe in something good, something they can apply themselves to. They want to feel they are part of something bigger than themselves. One's personal benefit is at least partially subjugated to the greater good because individuals define benefit differently, and they feel better because of their activities for the group. Of course ideologies and religions are often abused and there tends to be a danger of being manipulated. We do not wish to preach an economic ideology, just to determine the importance of moral values as motivations for actions and behavior, and thus for the development of productive forces. Values as human capital can also advance societies as well as in particular companies and national economies by stimulating the productive forces of its people.

Humans aren't machines, and almost all of them question the sense in their existence either consciously or unconsciously. Considered in this way moral values are like the oil in the machinery, if we want to stick with the machine metaphore. If the values are lost, the engine grinds. The gears no longer catch for the functioning of the system as a whole, and take on a life of their own. People maximize their own benefit at the cost of the whole system. Such behavior was one reason of the Enron crisis and the subprime crisis. This is not the maximization of one's interests that encourages general welfare, as Adam Smith had in mind. The invisible hand cannot do anything against corruption and embezzlement. Profit and morality are not in conflict, as is often assumed. There can be no profit without morals, either in companies or national economies.

A survey of 400 German executives showed that the majority of problem-solving competencies are seen in self-organizing networks. Because of the collective intelligence, more creative impulses, higher innovative power, acceleration of processes and reduction of complexity can be expected by this organizational form than by others.⁹⁷

Conversely, immoral behavior diminishes the added value of organizational forms. Let us assume that employees are distrustful and do not help each other anymore. If they do not exchange information among themselves or inform themselves wrongly, the added value they can reach through division of labor and cooperation will decrease.

Immoral behavior from top managers has the greatest negative effect on stakeholders and shareholders. The company's success is endangered by immoral behavior. Moral, ethical behavior is thus very important for companies, and the same applies among the companies and in competition. As we have already described, only fair competition for performance assures an optimal allocation of resources

⁹⁷ See Initiative Neue Qualität der Arbeit (2012), p. 7.

and thus an efficient economic production. Immoral behavior damages the society as a whole, beginning with market process, internal company processes and all the way down to interpersonal relationships.

The genetic disposition towards cooperative behavior we have already described is unfortunately insufficient. Hobbes had already recognized that cooperative behavior must be worth it for the individual, and that he must be able to trust in it, because otherwise we would have anarchy. How can this be achieved? Only if society encourages cooperative behavior by rewarding it and by sanctioning uncooperative behavior. Economic laws, courts and supervision are absolutely necessary for this reason. They have the task of acting as referee for behavior in accordance with competition, so they must be able to control competitive actions and sanction missteps. Without controls and sanctions there is no assurance of fair, thus economically ethical behavior. Cooperative behavior is the same as moral/ethical behavior. People will only trust the cooperative behavior of others if they can presume moral/ethical behavior, thus morality as a social standard to measure actions that must be practiced and trained (socialization).

The disparity described somewhat provocatively at the beginning between private, rewarded morality on the one hand and societal and politically unsanctioned immorality on the other hand is a basic evil that need not exist. The society must find appropriate conditions for moral behavior, which must be worth the effort in politics and economics. This is even true for a community of apes, where deceit, such as stealing bananas or beating weaker apes in the group is addressed and usually punished.⁹⁸

Summary

Morality complements the positive effects of the market. The results of the market correspond only partially to our ideas of what is right. In case of market failure, morality ensures that third parties are not harmed. Against this background, the social market economy is entering the market and changing the distribution results. Social morality is an important corrective factor in the market economy. If a market economy is to be an advantage for society, society must discourage immoral, damaging behavior through legal penalties or social exclusion. In addition, it must promote voluntary ethical behavior through the provision of values.

In order for a society to function and to develop its productive forces, there is still the ethics of social capital which has to be in line with the orders, the system, and the economic stage of development. In this context, the attitudes of the people are particularly important for society, thus the community, and social cooperation. The norms, values and morality as well as the attitudes to the political and economic system are important.

Comprehension Questions

1. Define a company. What makes a company and what creates added value?
2. Define organization, institution, human and social capital.
3. To what extent is morality necessary for the functioning of an organization?

⁹⁸ See Handelsblatt, dated 8th December 2005, p. 8.

5.7 The Company in the Market System

5.7.1 *The Company's Objective of Maximizing Profits*

Can the market process really regulate everything on the basis of human self-interest? Does the market really need any morality? Is it true that the companies earn more profit the less morally they behave? Do market laws allow any company to behave morally?

Roleplaying: Concealing of Negative Product Characteristics

Roles in the cigarette game: 1. Cigarette producer, 2. Supermarket salesman, 3. Sportsman with advertising contract, 4. Smoker and 5. Non-Smokers

According to Milton Friedman, there is only one company goal in the market economy, profit maximization:

... and nature of a free economy. In such an economy, there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open and free competition, without deception or fraud.⁹⁹

Is this sufficient? The Ford Pinto scandal demonstrates the consequences of unilateral market profit maximization. Ford maximized the profit in the Ford Pinto by eliminating the inclusion of a plastic buffer at the petrol tank because the cost of \$11 per vehicle was higher than the litigation costs and damage regulations from the fire incidents and the 180 deaths in accidents. In 1977, 9000 victims were killed in the previous 4 years in 20 million vehicles.¹⁰⁰ Market and morality are in contradiction here.

The goal of winning is the basis of a market economy system and as an incentive and sanction (loss) is the basis for the competition and thus for the productivity and prosperity of all. Without a profit there is also no investment in private ownership. No one profits from company losses, neither shareholder nor stakeholder. The profit is a residual income, that is, the amount remaining when the company has settled all period-related claims and obligations. Therefore, profit is ethically a good.¹⁰¹

Even in practice, many managers see profit and ethics as conflicting goals:

I have great doubts as to whether one can always insist on the great moral imperatives. It is not an acceptable idea for everyone to have to carry an ethics handbook with them. The fake morality that we are a moral institution and that we should make profits accidentally disturbs me. This kind of illusion is not my world.¹⁰²

A German chairman of the board said about the conflict of goals:

Concerning the misconduct, I see it as actually only the tip of the iceberg. So I have to say, on the whole, I fear that in our leadership headquarters, I do not want to say an abyss of

⁹⁹ Friedman, Milton (1963), p. 133.

¹⁰⁰ See Wörz, M. (1994), p. 22.

¹⁰¹ See Homann, Karl/Blome-Drees, Franz (1992), pp. 38.

¹⁰² Quoted after Buß, Eugen (2009), p. 17. (translation by the author)

immorality, but in any case a great temptation every day to violate ethics and business ethics.¹⁰³

There are different opinions about the moral responsibility of entrepreneurs in the objective of profitmaking. For Ulrich, the maximization of profit is socially legitimate, if it also serves other people, or society as a whole, thus increasing the prosperity or the satisfaction of everyone. The profit maximization becomes problematic if it conflicts with other societal objectives. If moral behavior leads to profit losses in the company, goods must be weighed. Economic ethics suggests that profit maximization is subject to a legitimacy reserve. It is legitimate if only non-priority goods are injured.¹⁰⁴

Moral economics, on the other hand, frees businesses from responsibility. Homann and Drees attach the legitimacy of the profit goal to the existence of a legal and moral framework that ensures that all legitimate claims of stakeholders are taken into account. Economic actors must also comply with these rules without fail. Profit is socially legitimized by the framework in the form of the democratically adopted laws that do not damage the society or at least the damage has been compensated, leading to a welfare increase (including the environment, etc.).¹⁰⁵ Both authors go even further by seeing the responsibility for ethical corporate policy in the government. It has to create the morally correct incentives. If, for example, child labor is not prohibited, an entrepreneur must also use it because he would otherwise have a competitive disadvantage.¹⁰⁶ Economic ethics is thus a pure ordinance or institution ethics. Company rules must ensure moral behavior.

Even Kant saw the highest good in the connection of morality and (one's own) happiness.¹⁰⁷ Morals are worthwhile. Homann and Blome-Drees, however, go a step further. In the event of a conflict, they place the profit from goods over the ethical goods.¹⁰⁸ If this is only a matter of one's own happiness, it is in contradiction to Kant. For him, his own happiness must never be the chief determinant of action, one can only strive with morality and hope to see that there is no conflict to moral goals to which one must subordinate one's own happiness.¹⁰⁹

We can maintain that there must be a legal framework that is moral, thus ensuring that all legitimate claims of stakeholders are taken into account. The emphasis on the necessity of a morally organized economic order is very important. However, such an optimal order, which is also universally adhered to, is a theoretical construct that can never be that complete in practice. A framework can never regulate all actions in all situations, nor is it always known to the actors, and finally the com-

¹⁰³ Quoted after Buß, Eugen (2009), p. 17. (translation by the author)

¹⁰⁴ See Ulrich, Peter (2001), S. 415. "Legitimate profit-making is always morally limited profit-making." Ulrich, Peter (2001), p. 415. (translation by the author)

¹⁰⁵ See Homann, Karl/Blome-Drees, Franz (1992), pp. 39 and 51.

¹⁰⁶ See Homann, Karl (1999), p. 330 and Homann, Karl/Blome-Drees, Franz (1992), pp. 18 and 36.

¹⁰⁷ See Kant, Immanuel (1788), p. 238.

¹⁰⁸ See Homann, Karl/Blome-Drees, Franz (1992), p. 145.

¹⁰⁹ See Kant, Immanuel (1788), pp. 217, 243.

plete enforcement of such a framework is not possible. There will always be attempts to undermine the framework if there are short-term benefits to the company. The economic regulation cannot therefore issue a moral legitimization license. It is precisely at the international level that there is a conflict between legal profit making and ethics, thus socially legitimate behavior. Below there are a few historical examples listed. The maximization of profits must therefore be subject not only to a reservation of legality but also to a reservation of legitimacy. In the case of company policy, profit as a good must be weighed ethically with other goods. The profit goal cannot be pursued at the expense of the society, but must be used by the society.

Examples

1. VIOXX: US Merck conceals fatal side effects that have occurred in the clinical trials in order not to endanger the turnover from rheumatoid arthritis patients.¹¹⁰
2. Nestlé: Aggressive marketing of maternal milk substitutes in Africa led to death due to the use of contaminated water. Public outrage caused cessation of marketing.¹¹¹
3. NIKE China's sports shoe manufacturing in so-called "sweatshops" paying a pittance led to public criticism, especially by non-governmental organizations (NGOs). Nike then created better working conditions in the supplier companies and accepted the losses in profits.¹¹²
4. Damage to the health of workers in the South American and African flower industry by the use of pesticides, with very low wages.¹¹³
5. Motorola renounced the sales market South America, because business could only be conducted with corruption.¹¹⁴
6. The US mechanical engineer Cummins renounced the sales market South Africa due to the former apartheid regime.¹¹⁵

In order to make the ethical consequences of the profit goal transparent, a qualitative controlling is required.

¹¹⁰ See Frankfurter Allgemeine Sonntagszeitung, dated October 10th 2004, No. 41, p. 69. <http://www.faz.net/aktuell/wirtschaft/unternehmen/vioxx-skandal-risiken-nebenwirkungen-1191252.html> (5.05.2015).

¹¹¹ See Steinmann, Horst/Oppenrieder, Bernd (1985), S. 171 and Spiegel, dated June 1th 1981. <http://www.spiegel.de/spiegel/print/d-14336212.html>

¹¹² See Scherer, Andreas Georg (2003), p. 12.

¹¹³ See Göbel, Elisabeth (2010), p. 161.

¹¹⁴ See Post, James/Preston, Lee E./Sachs, Sybille (2002), pp. 94.

¹¹⁵ See Post, James/Preston, Lee E./Sachs, Sybille (2002), p. 106.

5.7.2 *Weaknesses in Controlling*

Meanwhile, conventional controlling is criticized for the fact that it only provides information on short-term monetary target achievement. Costs, profit and/or profitability ratios are quantitative and do not say anything about their ethical background. Ethically motivated actions generally lead to qualitative, long-term results. This kind of controlling thus creates a barrier for ethical behavior. Göbel asks why a manager should choose an alternative that will bring less profit in the short term, but in the long run a better reputation or a higher motivation of the employees.¹¹⁶ Such tight controlling means that long-term consequences, risks, difficult-to-measure consequences and consequences that occur in other departments of the company are not obvious.¹¹⁷ For this reason, a different focus on controlling has been required for years. In so-called strategic controlling, the long-term, qualitative and indirect consequences are also to be included.¹¹⁸ The most ethical consequences of entrepreneurial activity are long-term and qualitative. A set of short-term quantitative targets can lead to these being achieved at the expense of ethics.¹¹⁹

In the meantime, there are some approaches that complement traditional controlling with ethically-oriented information. Companies can collect the services they have rendered for their employees or other stakeholders in so-called social balance sheets. They are divided into a social report, a value-added statement and a social account. For example, in the social report, company payments or further training measures are listed, the value-added statement shows the company's contribution to the national product and social benefits of the company to society in expenditures for charitable purposes, such as reforestation projects or the like. There are also specific environmental or life cycle assessments. For example, the quantity of waste and its disposal costs can be recorded in the production or, in general, all quantifiable burdens on the environment generated by the company.¹²⁰ Meanwhile, there are also so-called Corporate Social Performance (CSP) figures, which are levied for capital market investors looking for sustainable investments, where ecological, economic and social indicators are determined. The Global Reporting Initiative has developed a guide as a market standard for this type of sustainability reporting.¹²¹

The above steps do not resolve basic controlling problems, however. There are many effects of corporate activity that cannot be quantified and thus cannot be recorded. And why should a company that damages the environment be interested in documenting its activities? This would require state, thus institutional, guidelines

¹¹⁶ See Göbel, Elisabeth (2010), p. 259 and Hahn, Dietger (1997), p. 21.

¹¹⁷ See Fridl, Birgit (2005), p. 288.

¹¹⁸ See Eschenbach, Rolf (1997), pp. 102.

¹¹⁹ See Conrad, Christian (2010), pp. 121.

¹²⁰ See Eisele, Wolfgang (2005), pp. 494; Seidel, Eberhard (1995), pp. 358, 367; Wagner, Gerd R. (1997), pp. 177 and Göbel, Elisabeth (2010), p. 281.

¹²¹ See Bassen, Alexander/Senkl, Daniela (2010).

that would force companies to keep such balances. In order to avoid manipulations, external auditors would also need to review these balance sheets.

In addition, there are ambiguities that make it difficult to record information. For example, a low level of health care costs can be traced back to a good working climate as well as to high pressure and fear of redundancies.¹²²

If measurement of the performance of individual employees is not possible in large corporations, commitment is often measured instead of performance. It can be useful for the employee to stay in the office longer, even if he is not doing any productive work, just to make a good impression with the superiors. These are also unethical incentives. It is worthwhile to make a show of diligence to the boss. Rewarding employees is thereby unfair and the time given by the employee has no advantage for the company.

5.7.3 *Corporate Social Responsibility*

The concept of social responsibility is currently often discussed as corporate social responsibility. According to Milton Friedman's Chicago School, a company has no social responsibility.¹²³ Is this really so? The majority of textbooks name profit maximization as the corporate objective. The shareholder value approach, however, has once again demonstrated how inaccurate profit is as a benchmark for economic performance and the company's success. Ultimately, despite all the textbook specifications, there are no natural company targets with a predetermined weighting. What is clear is that a company must earn more income in the long term than it has expenditures. Otherwise, there is a lot of room for differences in how much profit is to be earned, and what other goals a company wants to pursue. Extreme returns naturally limit the pursuit of other targets. Thus in the age of the industrial revolution some entrepreneurs have financed social institutions from their profits. These were exceptions, but it shows that it is possible to pursue other objectives besides profit maximization without negatively affecting the development of the company as long as the productive processes of the company are not impaired.

Social goals should not be misunderstood as inefficient employment of superfluous employees. It is important that the productive forces of the business process are used to ensure the highest possible added value, which can then be distributed. However, the question arises at what price and at whose cost profit is maximized. Profit can for instance be maximized at the expense of the environment and thus the public. What about employee layoffs? A company cannot oppose market laws because it would risk its existence in the medium term. The above-described

¹²² See Göbel, Elisabeth (2010), pp. 284.

¹²³ "... and nature of a free economy. In such an economy, there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open and free competition, without deception or fraud." Friedman, Milton (1963), p. 133.

functions of market and competition make this clear. If, for example, the demand for a product falls, or it is produced at a lower price elsewhere, the company can no longer employ its workers involved in production without operating at a loss. The employee's costs exceed his value-added contribution in the company.

Against the backdrop of continued technical progress and increasing globalization, mainly due to constantly improved communication and transport techniques, the international division of labor is subject to ever-changing conditions. This in turn leads to cheaper products for the consumer, but also to ever faster changing conditions on the supply and demand side for the companies. This means that the optimal use, the placement of people in the production process also changes more and more quickly.

The company has a responsibility to its employees, as well as the employee to the company. This is also called loyalty. Companies and employees depend on mutual cooperation. There is something like an implied loyalty contract. What a company can contract and control from its employees is far less than a motivated and loyal employee is able to give the company. If the employee is not loyal, he can cause damage to the company, such as the bribed buyer who buys bad and expensive intermediate inputs from a supplier for the company. If the loyalty between employees and companies is neglected it will have negative consequences for both sides. This dependency of the company on moral behavior from the employee is not the only side of the equation. He does not even have to deliberately damage the company for his own benefit, it is sufficient if he decreases his work performance for the company imperceptibly. There is a big difference between commitment to one's job and meeting the minimum expectations.

Employees slowing down their pace of work does not help the company, especially in the era of increased competition in globalization. Perhaps the employees are also pursuing second jobs or hobbies during their working hours (consumption on the job). In the age of lean management, what company can afford to control all employees all the time?

Moral behavior is important for every company. Immoral behavior reduces economic efficiency. Morally, this means that the employees behave to the benefit of the company. The fact that employees are expected to behave loyally is a established understanding, which, has seemingly been forgotten in the light of unscrupulous manager enrichment in recent corporate crises.

A company is dependent on its employees to represent the interests of the company above their own interests, at least during their working hours. Employees must devote themselves fully to corporate productivity and also be loyal. Disloyal employees can damage the company permanently. Oftentimes the company's employees have knowledge about the company's competitive secrets and valuable company inventories. Employees are also generally expected to behave morally towards their colleagues. Only if the employees are open and fair among themselves is cooperation and thus common added value possible. If employees do not behave morally, superiors can no longer rely on their information or their performance. If employees manipulate their coworkers or hinder the success of other employees, as

in the Enron case, management can no longer make optimal use of their employees.

Conversely, a permanent workplace is not only the prerequisite for the employee's livelihood, but usually also for his family. Suppose the employee was loyal and his value-added contribution to the company was much greater than the salary he received over decades. Then, according to the implied loyalty contract, the employee would expect the company to be loyal as well. Kant saw a connection of gratitude for services as part of what separates humans from animals.¹²⁴

A company must therefore weigh the social burden redundancies can cause and should make every attempt to promote the employees within the company. If the company does not take the employees' interests to heart, it will deter potential employees. The company would risk the loyalty contract, thus the loyalty of all employees.

However, the burdens caused by structural changes resulting from globalization should be borne primarily by the public, thus the state. The general public benefits from the advantages of national and international market and competition mechanisms. The resulting welfare gains can be used to mitigate the negative effects of the market process. Social cushioning, in turn, increases the acceptance of market processes and the flexibility of workers who are not afraid of losing their jobs. In addition, the social security network keeps human capital from deteriorating and available for the work process. This is an advantage of the social market economy (see the chapter before).

The environment of a company considers it to be a part of the community. It lives not only in the community, but from the community, creating mutual dependency. The community is not only the income side either, since the employees are the most important input factor. The legal framework is also determined by the community. Even companies with the initial protection of politicians would not be able to maintain a position of defiance. BP could not stand up to the pressure from the public when the oil platform Brent Spar sank, because it is dependent on the community. This still holds in the age of globalization, though the community must be defined more broadly, or more internationally. According to the principle "do ut des" a minimum of social responsibility must be demanded from the company, which would explain the critical opinion of a large part of the population towards company abuse of the rules. The managers representing company decisions see themselves confronted with these expectations. The term 'social' here has nothing to do with socialist, but means a responsibility to the community. We cannot presume that companies have a conscience for social behavior; it must be demanded publicly by the community in the form of laws. If this does not occur, the company does not have a monetary incentive to behave as the community wishes and can in fact maximize its profit at the cost of the community (e.g. by disposing of production waste in a harmful manner, unfair competition or manipulating balance sheets). The behavior in accordance with the demands of the community may display cultural differences. We must be aware however that with technical progress (Internet,

¹²⁴ See Kant, Immanuel (1797), A108 and Kant, Immanuel (1793).

satellite television etc.) the economy is not the only thing being globalized, but that values, social movements and tendencies have shifted. The boycott of companies who had supported apartheid was carried out globally, for example. The increasing importance of public relations is also clear in the number of international firms that have begun publishing social and environmental reports.

The responsibility of companies towards society was already being debated more than a hundred years ago.¹²⁵ An example of a public interest is a clean environment. An NGO representing this interest is Greenpeace. These groups place moral demands on companies and try to exert influence on companies through public discussion in the media. The media here has a special social significance and responsibility as a catalyst for public interests.

Role-Play Game: Concealing Negative Product Properties

Choose the roles you want to play and discuss the roles of the various positions.

Cigarettes: 1. smokers (x2), non-smokers (x2) and tobacco companies (x2).

or

Energy drinks: 1. producer, 2. supermarket salesman, 3. sportsman with advertising contract, 4. consumer and 5. advertising agency.

Case Study: The Disaster of BP's Deepwater Horizon

Circumstances of the accident

Eleven people died in the explosion of the drilling vessel Deepwater Horizon on April 20 2010. The outflowing oil has led to a massive environmental disaster. Approximately 5000–100,000 barrels of oil into the Gulf of Mexico on a daily basis and the borehole could not be closed for months. According to a US court 3,19 million barrels (159 l each) of oil ran into the sea.

Public Relations

He wanted his life back. The BP disaster of the Deepwater Horizon was the largest oil spill in the world and the worst environmental disaster in US history. BP management tried from the beginning to downplay the disaster. For instance the chief executive of BP Hayward said that the spill won't cause big problems because the Gulf "is a very big ocean" and "the environmental impact of this disaster is likely to have been very, very modest." Hayward was speaking at an oil-spoiled beach in Louisiana on May 30th right into a TV-camera: "There's no one who wants this thing over more than I do, I'd like my life back." Hayward said on May 31st that there is "no evidence" that huge amounts of oil are suspended undersea.

Accusations

The BP rig was located in 1500 m deep water and had a drill reaching 5500 m deep into the ground. The MEPs from the Energy Committee have repeatedly criticized BP for breaching the usual safety standards. MEPs Henry Waxman and Bart Stupak came to the conclusion in 2010 that, "BP repeatedly chose risky procedures

¹²⁵ See Heald, Morrell (1957).

in order to reduce costs and save time and made minimal efforts to contain the added risk... Time after time, it appears that BP made decisions that increased the risk of a blowout to save the company time or expense. If this is what happened, BP's carelessness and complacency have inflicted a heavy toll on the Gulf, its inhabitants, and the workers on the rig."

BP was under pressure, as the work on the drill hole in the Macondo field was 6 weeks behind schedule. Each day's delay cost BP at least half a million dollars. BP responded with savings. For example, internal BP studies had recommended a double-walled lining of the drill hole with steel pipes. Nevertheless, BP decided to install a simple steel pipe at the end of the drill hole, saving the company seven to ten million dollars and 3 days' work.

The heavy drilling mud in the hole was meant to keep the oil in the deposit. According to the guidelines of the American Petroleum Institute, drilling mud has to be circumnavigated once to inspect it for enclosed gas bubbles and rock fragments. BP refused to do this.

The steel pipe of the liner must be surrounded by a concrete mantle in the larger well. This prevents gas escaping uncontrolled from the source. Spacers are used to hang the pipe centrally in the shaft. On April 16, BP decided to install only six of these "Centralizers", although a manager from Halliburton, recommended 21 centralizers and warned otherwise of a "serious gas flow problem." BP decided to save the time by flying in the remaining 15 spacers from the mainland. BP canceled the proposed test of the concrete layer. So BP was able to send the experts back who were already on board the Deepwater Horizon on April 20, and thus save a net 118,000 dollars for the up to 12 h-long test. Finally, at the top of the borehole, BP did not secure the wellhead with a lockdown sleeve before allowing pressure on the seal from below.

MEPs came to the conclusion that BP neglected four out of six barriers against rising gas, while two of the four were probably not functioning.

There were other failures. A BP manager decided shortly before the accident to exchange the drilling mud for seawater in the production pipe between the seabed and the surface. There was a loud controversy between the BP representative and a person from the company Transocean, which operated the Deepwater Horizon. Because of its lesser mass, water can exert less pressure on the source than sludge so that the gas is more able to ascend. A warning device and a device to stop the gas supply were missing in the engine room of the drilling vessel. In the end there was a gas explosion.

Consequences

BP estimated in July 2016 that the costs from the explosion of the oil platform Deepwater Horizon totalled nearly 62 billion US dollars in penalties, damages, cleaning expenses and court costs. After including tax deductions it came to 44 billion dollars. However, BP's annual profit in 2014 was already as high as before the disaster at 25 billion dollars.

Hayward had to step down from his position as CEO. He received \$1.5 million in compensation and a pension of \$17 million from BP. In 2011 Hayward returned

to the oil business. Together with investors and the Turkish billionaire Mehmet Sepil, he founded the company Genel Energy to explore oil in the Kurdish north of Iraq. Mehmet Sepil was punished in 2010 in the UK for insider trading.

Hayward still has a good reputation in the oil industry. “People know he was the scapegoat, he was the sacrificial lamb,” said Fadel Gheit, an oil and gas analyst at Oppenheimer & Co. In 2013 Tony Hayward was awarded the honorary degree of Doctor of Technology by Robert Gordon University, Aberdeen. While standing loyal at the side of Hayward during the scandal, his wife Maureen Fulton was granted a ‘quickie’ divorce in 2012, saying Hayward exhibited ‘unreasonable behaviour.’

Tasks

1. Apply the ethical evaluation criteria known to you.
2. What is the blame for the BP disaster and how would you have judged it?
3. How do you explain the behavior of BP?
4. Has the behavior of the management paid off?

Solution of Task 1

1. Conviction ethics: The security requirements were deliberately not adhered to by BP, which is why one cannot assume a moral attitude, that is, no good will. In addition, the BP management did not show enough compassion and regret after the oil disaster, as judged by the public.
2. Kant’s rules of ethical reasoning: (A) Categorical imperative: Law: Everyone violates the security requirements: No! Would I myself be willing to be affected by such risky behaviour? No!
(B) Publicity rule: The rights of the public and BP workers have been violated: No! (C) Practical Imperative: No, BP only used the environment as a means to maximize profit.
3. Duty ethics (deontological ethics): No, the security requirements were clear.
4. Ethics of responsibility (teleological ethics): The security requirements served the purpose of preventing such a misfortune. BP has seen the consequences of negligence.
5. Moral Economics: There appeared to be insufficient state controls revealing and punishing the negligent behavior of the oil companies in drilling, so everyone is forced to behave in a risky manner.

<http://thehill.com/blogs/congress-blog/energy-a-environment/103255-letter-to-tony-hayward-chief-executive-officer-of-bp-rep-henry-waxman-and-rep-bart-stupak>; http://www.alternet.org/rss/breaking_news/209848/waxman_letter_to_hayward%3A_bp_%27carelessness_and_complacency_have_inflicted_a_heavy_toll%27; <https://www.welt.de/wissenschaft/article139533067/Die-lange-Katastrophe-der-Deepwater-Horizon.html>, <http://www.handelsblatt.com/unternehmen/industrie/deepwater-horizon-umweltskandal-kostet-bp-62-milliarden-dollar/13880076.html>, <http://www.sueddeutsche.de/panorama/golf-von-mexiko-oel-katastrophe-sparen-und-sterben-1.959866>; <http://www.spiegel.de/wirtschaft/unternehmen/deepwater-horizon-ex-chef-von-bp-tony-hayward-ist-zurueck-a-1002134.html>; <https://www.thetimes.co.uk/>

article/embattled-bp-chief-i-want-my-life-back-jmmvng9p0s; <http://ireport.cnn.com/docs/DOC-461890>; <http://content.usatoday.com/communities/greenhouse/post/2010/05/scientists-warn-of-oil-plumes-under-gulf-surface/1#.WSQQv2e7qig>; http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10748826; <http://www.rgu.ac.uk/news/robert-gordon-university-honours-oil-executive/>; <http://www.dailymail.co.uk/news/article-2241697/Divorce-shamed-BP-chief-Tony-Hayward-loyal-wife-stood-wake-Deepwater-Horizon-disaster.html#ixzz4htphzxOp>

Is there a conflict between morality and profit? There are empirical studies that show that socially responsible companies are equally successful or more successful than others.¹²⁶ However, the costs of ethical measures tend to be short-term, while the gains are only in the long term. For example, short-term costs arise from no longer using child labor in Asia, and only in the long term is the profit derived from a better image. In the short term, the renouncement of safety measures for deep-sea drilling (BP) is unlikely to lead to losses from oil leaks and environmental damage, but to high profits. In addition, the benefits that ethical business policies entail are often qualitative (intangible assets, soft facts) that are not measurable (such as employee loyalty and satisfaction, image and trust).

According to an Emnid survey, a stronger consideration of family aspects led to an increase in satisfaction and motivation among 85% of employees.¹²⁷ According to a Prognos study, family-friendly measures show a return of at least 25%.¹²⁸ Some of the costs of immoral trade are illustrated by examples. For example, Paine estimates Roebuck & Company's loss due to immoral selling practices at \$60 million.¹²⁹ Gallup, the consulting firm, was able to show that the productivity of companies can be improved by increasing their emotional employee loyalty.¹³⁰

The German University of Economics and Management surveyed 1000 interviewees and found that motivation barriers account for an average loss of 29.9% in labor productivity. This is a great potential for increasing the productivity of companies in Germany.¹³¹

In another study, with 1000 employees surveyed, asked which is the most important of three factors for their productivity; 59% of those questioned answered employee satisfaction, followed by payment (including company profits), and 42%

¹²⁶ See Donaldson, Thomas/Preston, Lee E. (1995), S.71; Margolis, Joshua Daniel/Walsh, James Patrick (2001) and Bassen, Alexander/Meyer, Katrin/Schlange, Joachim (2007).

¹²⁷ See Becker, S. (2003), p. 33.

¹²⁸ See Prognos AG (2003).

¹²⁹ It was determined in the lawsuit against the auto service company Sears, Roebuck & Company that the extreme incentives to increase profits led to an increase in cases of customer fraud. There were minimum work hours for mechanics and minimum sales requirements for certain auto parts as well as large rewards for high profits, all of which put employees under too much pressure. See Paine, Lynn Sharp (1994), pp. 107.

¹³⁰ See <http://www.gallup.com/de-de/175571/gallup-gmbh.aspx> and <http://www.schmezer-consulting.de/news-detail/items/erfolgsfaktor-mitarbeiter-fuehrungskraefteentwicklung-gallup-studie-2014.html>

¹³¹ See Büser, Tobias/Stein, Holger/von Königsmarck, Imke (2012), p. 3.

named the company's working climate and a good relationship with colleagues.¹³² Studies show that hostility in the workplace promotes mental illness. Fear and depression due to lack of recognition reduce performance and productivity. Respect and recognition are the basic prerequisites for identification and motivation. Collegiality in the office prevents depressive moods and boosts performance.¹³³

Summary

Ethics pays off in the long term for companies. There is a short-term goal conflict between profit and ethics but not a long-term one. Central to the functioning of a market economy on the basis of self interests is private property. Otherwise, the incentive and sanction mechanisms of the competition functions described above do not work.

Comprehension Questions

1. Do companies have a social responsibility?
2. To what extent does market take morality into account? Explain this using the allocation model and the competition functions.
3. Is there a target conflict between profit and morality?
4. To what extent does morality complement the market?

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¹³² See Institute of Leadership & Management (2014), p. 2.

¹³³ See Volk, Hartmut (2006).

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