Can business learn to police itself?

Corporate Behavior:
Fewer Flaws Mean Fewer Laws

by AMITAI ETZIONI

THE SECRETARY OF an executive at Donallco, a California corporation, reported that when she scheduled her boss to fly on an airline (she cannot remember which one), he told her to change the reservation. When she asked him why, he exclaimed: “We make parts for those planes, and I am not flying on that plane.” Donallco specializes in the production of bogus aircraft parts. Such parts, according to a Federal Aviation Administration commissioned study, are “a serious safety problem.” (Not all of these are attributable to Donallco; it is not the only source of the parts.)

Incidents like this, coming on top of the savings and loan crisis and frequent scandals among defense contractors, in medical laboratories, and so on, have led to a movement demanding various kinds of reregulation or new regulation.

To combat deficiencies in the quality of tests performed in medical laboratories, Congress passed a law in 1988 that regulates the operation of over 300,000 labs. Licensing, periodic inspections, and proficiency testing are required and doctors will...
need to hire trained, licensed technicians instead of the nurses and secretaries who now perform many of the lab tests.

To tighten corporate auditing, regulations now before Congress would require auditors to report certain irregularities to the company, which, in turn, is responsible for notifying the Securities and Exchange Commission. Should the company fail to do this, the auditors will be required to submit its report to the regulators.

"Illegal behavior pays, and it is surprisingly common."

Over the next year, Congress must vote on reauthorizing portions of the Government Securities Act of 1986. The Government Accounting Office (GAO) submitted a report strongly urging Congress to give the Treasury power to introduce new regulation into this market. Several proposals have been advanced that would further regulate banking practices. These include tying deposit insurance to the riskiness of bank investments, greatly restricting the types of investments banks can make (e.g., limiting them to low-risk ventures), and doubling or tripling deposit insurance premiums.

The business community, the Republican Administration, most economists, and many others in the public at large are troubled by this turn toward more regulation. They basically hold that regulations are tantamount to government meddling; the less of it, the better.

BEYOND CAVEAT EMPTOR

What, if anything, is needed to replace regulation? The business community is surprisingly mum on that question. Occasionally, its representatives argue that no particular steps are needed because markets and, more generally, economic conduct, are self-correcting. If a supplier produces shoddy products that maim workers or endanger consumers, people will cease to buy these items and the suppliers will go out of business. Or, the insurance premiums suppliers will have to pay to guard against potential liability suits would be so high as to make unethical business unprofitable. Indeed, the anticipation of economic “penalties” is said to be so severe as to discourage manufacturers, sellers, and others from acting immorally. Its ethical nature is self-sustaining.

Unfortunately, this is not the case. There are many reasons unethical and even outright illegal behavior pays and is surprisingly common. Some conduct does not have clear, immediate victims but only slowly erodes the general confidence in the markets (insider trading). Years pass before the word spreads that certain products are unsafe, and, meanwhile, manufacturers rake in high profits. Three-wheel all-terrain vehicles (ATVs) caused over 1,150 deaths from 1982 until 1988, when consumer groups pressured manufacturers to cease production. Nursing homes that were caught after years of shortchanging their patients were often fined small amounts compared to what they gained; if they did acquire a poor reputation over the years, they then opened under different names in neighboring states. People who take medications that are deleterious have a hard time discerning what exactly caused their declining condition. For the market to work as expected, information would have to travel fast and free and be properly and quickly absorbed. But as the examples just cited illustrate, and as many other socioeconomic studies have shown, information often travels slowly, at much cost, is difficult to absorb, and is often incorrectly ingested. It follows that if reregulation is to be minimized, the integrity of the market will have to rely on some other forces than “buyer, beware.”

MASSIVE VIOLATIONS

Clearly, markets do not cleanse themselves — if they did, unethical and illegal conduct would not be so rampant. Reference is not to marginal technical violations of obscure laws but to systematic gross violations, such as labs that routinely charge for tests that they did not complete and then report to the physicians that all is well. Reference is not to isolated incidents of some devious firms but massive involvement, such as the following:

- The Resolution Trust Corporation, established to manage the S&L bailout, reports that criminal fraud was discovered in 60 percent of the savings institutions seized by the government in 1989.
- A Spring 1990 GAO report found that about 52 percent of the gasoline it sampled was labeled with a higher octane level than it actually contained.
- The Inspector General’s office in the Department of Defense reports that twenty of the 100 largest defense contractors have been convicted in criminal cases since 1983.
- A study by the Justice Department that looked at almost 600 of the largest publicly owned manufacturing, retail, and service corporations in the United States (those with annual sales of at least $300
million), showed that from 1975 to 1976 “over 60 percent had at least one enforcement action initiated against them [actions were all federal — administrative, civil, and criminal] . . . more than 40 percent of the manufacturing corporations engaged in repeated violations.”

“The business community should draw its associations and enforce its codes.”

These reports feed into the reregulation movement. (That many other economies are less scrupulous, not only in the Third World but also Japan, is besides the point; Americans seem to demand a higher level of integrity from our corporations.) To put it differently: Business requires public acceptance. If it loses legitimacy, if the public no longer considers business conduct to be basically proper and morally sound, the public will force new government controls from the White House, Congress, or the courts. While some reregulation may be necessary, it would be better all around if business could raise its level of integrity without being made to do so.

The business community, to encourage moral behavior, should draw its associations and enforce moral codes somewhat like lawyers and physicians do, encourage business leaders to elevate integrity on their agenda, and prevail upon business schools to expand the moral education of executives. These three major reforms are discussed next, one at a time by necessity. However, their efficacy relies heavily on their being advanced more or less simultaneously so that they may reinforce one another.

DISINTERESTED PARTIES

When I served as the staff director of a commission investigating nursing homes in the state of New York, many demanded more government regulation of that industry. The commission was appointed after months of reports of gross abuses in largely proprietary (for-profit) nursing homes. Owners were said to have diverted funds allocated for patients’ food and medicine to buy themselves rare paintings and luxury cars. The homes were understaffed and the elderly were drugged to be more manageable. As the commission prepared public hearings, I invited the heads of ten major corporations for a private discussion. I told their representatives that the commission wished to learn what could be done by the business community itself to curb abuses. After all, I pointed out, other professions, such as law and medicine, have their own associations, codes of ethics, and enforcement mechanisms. Could the managers of business also act like a professional association and help weed out the leading abusers in the nursing homes?

It was like giving a party to which nobody came. The business community, at least those with whom I spoke at the time and since, were not interested. My experience illustrates a much wider phenomenon. Lawyers and physicians define what is proper and improper conduct, and have some mechanisms — however weak and inadequate — for encouraging members to behave. And, at least occasionally, they do disbar the most extreme abusers, giving some bite to their associational voice. (Only the National Association of Manufacturers [NAM] has a broad statement on good practices but they have no enforcement mechanism. The Business Roundtable issued in 1988 a statement on business ethics; however, it called for actions by corporations — not the Business Roundtable.) Accountants also have a code of conduct. But most business associations have no such codes and none have an enforcing mechanism. Nobody ever gets kicked out, however much they gouge the public — or one another.

True, business people are different. One needs no specific license to practice and hence, even if business executives were to treat themselves as a profession, they would not have the same power as medical societies or bar associations. However, it does not follow that business associations have no power and that there are no ways to shore up the ethics part of their endeavors. There is nothing to prevent the Business Roundtable, the Chamber of Commerce, the National Association of Manufacturers, the Conference Board, and other such

The Ethics of Self-Preservation

The ethics movement couldn’t be more timely. Given the looming threat of layoffs and enormous pressure to turn a profit these days, managers are sometimes understandably tempted to engage in a bit of dodgy behavior. “People are so desperate to keep their jobs that they act inappropriately,” says Michael Josephson, who heads the Joseph & Edna Josephson Institute of Ethics in Marina Del Rey, California.

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bodies, from conversing with their members, establishing what they consider proper moral conduct, and forming their own moral codes. The deliberations themselves are sure to have some salutary effects and so would the codes.

These could be given more weight if the CEOs of particularly errant corporations were taken for a “walk in the woods.” And in extreme cases, being kicked out of, say, the Business Roundtable is sure to get a corporation’s (and the market’s) attention. Unlike a disbarred lawyer, however, it would not prevent the corporation from continuing in business. But the social and economic penalties are likely to be substantial.

While not all corporations belong to these associations, most are members of one body or another. Those that are not would come under pressure to join, to become active on the side of ethics. Corporations that do not join, somewhat like accountants who are not members of the American Institute of Certified Public Accountants, would come under extra scrutiny because not belonging to some association that has and sustains a code of ethics could become a mark for clients to beware.

If the business associations were inclined to move even further in the direction of professionalization, they could make a list available to federal, state, and local government agencies of censured and disbarred corporations. These agencies in turn would be unlikely to award contracts to such corporations. If these same lists were to be made available to not-for-profit organizations such as schools, hospitals, and colleges, the bite of the associational code would be further enhanced. Finally, corporations may find it difficult to justify to their shareholders doing business with corporations that are defined as unethical by their own associations. All said and done, even if only a few corporations are censured or disbarred each year, this will go a long way to shore up integrity.

**LEADERSHIP REQUIRED**

Note that this approach assumes the association’s codes are based on extensive dialogues among the members and not arbitrarily introduced. The acts of censure and disbarment are but the rough cutting edge of this approach. It is essential, as in all moral systems, to gain the voluntary compliance of most members because they perceive the code to be morally compelling and necessary if business is to maintain its legitimacy. Now, with no clear — or even unclear — characterization of improper or intolerable behavior, business communities offer little guidance in matters that are moral.

If one examines changes in the moral orientation of other groups that in turn affected the public mind regarding what it considered legitimate, such as the neoconservative, environmental, or suffrage movements, at the forefront were inspirational leaders. These are leaders who champion new directions and build the moral support for changes in perspectives and values. The very first leaders are often intellectuals, writers, or editors as different from each other as Irving Kristol is from Rachel Carson and Ralph Nader. Once their voices are heard and their messages are out, however, their new definitions of the problems and proposed solutions are picked up by community leaders, leaders of one segment or another of the population (e.g., women), and course-setting politicians (John F. Kennedy).

While there has been in recent years a significant increase in attention to the need to shore up integrity by academic and other intellectual circles (by no means limited to the left or other traditional critics of business), the next stage has not taken place. With rare exceptions, influential voices within the business community have not made strengthening the moral fiber of business a significant theme of their concerns. Business leaders speak up against deficits, government intervention, the crisis in schools, and many other subjects, but only infrequently about following a higher pathway of conduct within their own profession. On the contrary, they often dismiss reports about extensive illegal and unethical conduct with statements such as: “Many, if not most, organizations are composed of morally and ethically honorable people who genuinely try to comply with the law” (testimony of John Borgwardt, Boise Cascade Corp., before the U.S. Sentencing Commission in 1990). They claim
that if transgressions do occur it is frequently because of some “rogue employee’s misstep” (Robert J. Giuffra, *The American Enterprise*, May/June 1990), or because “compliance with our laws is not always a simple and precise task” (James Carty, National Association of Manufacturers, testimony before House Subcommittee on Criminal Justice), and thus, unintentional violations may occur in even the most conscientious corporations.

Before a major movement of self-reform can take place, these leaders need to find their moral voice and address their own communities. A few mavericks who did speak up provide an indication of what needs saying. For example:

- “We as business leaders must convince the American people that we are committed to highly ethical behavior, on both a personal and corporate level. This does not call for a new public relations strategy. Instead, we need to demonstrate our commitment to instituting practical programs to preserve the integrity of our employees and our firms... The only way to achieve a corporate climate in which ethics becomes a part of everyday decision making is to start at the top (Edward L. Hennessy, Jr., chairman and CEO, Allied-Signal).”

- From another business leader: “I've heard business people say that we should operate honestly and ethically even though doing so makes it harder to do business. I have news for them — they're wrong. Operating honestly and ethically makes it easier to do business. I will go even further than that: ethical conduct — and the feeling of trust that results — is the basis of successful business; in fact, it is the basis of our free American socioeconomic system. We must compete in the arena of values — not efficiency, productivity, or performance. The public already assumes that. We should show ourselves as decent human beings — not anonymous companies but people who are honest, ethical, and concerned with the public good (Robert V. Krikorian, chairman, Rexnord).”

"Business school students often have insufficient moral education."

- The 1988 Business Roundtable’s report on business ethics and the role of management states: “In the experience of these companies with regard to corporate ethics, no point emerges more clearly than the crucial role of top management. To achieve results, the chief executive officer and those around the CEO need to be openly and strongly committed to ethical conduct, and give constant leadership in tending and renewing the values of the organization. Companies find it necessary to communicate that commitment in a wide variety of ways — in directives, policy statements, speeches, company publications, and especially in actions.”

"Reregulation is the symptom, not the underlying cause.”

Most business leaders, though, have yet to be heard from on this issue.

Finally, individual members of the business community must be reached. Ideally, moral education starts at home and is reinforced by one’s peers, neighbors, and church. However, given the sorry state of American families, many of them are not sufficiently intact to provide effective education, especially moral education. Single parents or married couples come home after an exhausting day at work to do household chores, often having little time or energy to deal with psychologically taxing matters such as questioning their children’s conduct, helping them choose proper peers, and so on. Pop psychology literature provides parents with further assurances that they need not intervene. As a result, schools are increasingly teaching moral education, as difficult and controversial as this is.

Business schools must pick up the slack as well, as those who come through their doors often have insufficient moral education or believe that business people must leave their values behind. Several business schools have always had ethics courses. In recent years their numbers have increased. Other business schools have expanded and strengthened their ethics education. Still, most students graduate from most business schools with very little moral preparation. This is a major area in which shoring up needs to occur.

Ultimately, the purpose of business associations, codes, leadership, and education is not simply to retard reregulation. Reregulation is the symptom, not the underlying cause. What is needed is to maintain the legitimization of business, by enhancing its ethical conduct, and either rehabilitating or isolating those members who undermine the social acceptance of all business, to the detriment of both business and society.