

An Evolutionary Logic Towards the Convergence of International Business Ethics

Tan, Boon Seng; Ko, Stephen

2014

Tan, B. S., & Ko, S. (2014). An evolutionary logic towards the convergence of international business ethics. *Society and Economy*, 36(4), 493-510.

<https://hdl.handle.net/10356/83711>

<https://doi.org/10.1556/SocEc.36.2014.4.3>

© 2014 Akadémiai Kiadó, Budapest. This is the author created version of a work that has been peer reviewed and accepted for publication by *Society and Economy*, Akadémiai Kiadó, Budapest. It incorporates referee's comments but changes resulting from the publishing process, such as copyediting, structural formatting, may not be reflected in this document. The published version is available at:
[<http://dx.doi.org/10.1556/SocEc.36.2014.4.3>].

Downloaded on 16 Sep 2024 10:00:54 SGT

An Evolutionary Logic towards the Convergence of International Business Ethics

TAN Boon Seng *

Institute of Singapore Chartered Accountants

Email: boonseng.tan@gmail.com

KO Chi-Chung, Stephen

Department of Management and Marketing

Hong Kong Polytechnic University

Email: stephen.ko@polyu.edu.hk

***corresponding author**

This is the preprint version of the paper. The final published version is available at <http://dx.doi.org/DOI:10.1556/SocEc.36.2014.4.3> .

An Evolutionary Logic towards the Convergence of International Business Ethics

Abstract

The fundamental problem in developing a theory of international business ethics, without imposing ethnocentric assumptions, lies in the inherent conflict between the need for universal ethics and the reality of diverse national cultures. The Integrative Social Contracts Theory holds an intermediate position between ethical *Universalist* and *Relativist* – recognizing universal hypernorms on the one hand and moral free space on the other. We argue that all businesses share a common objective of sustaining long-run economic value for their stakeholders. We develop this argument using an evolutionary logic into a hypernorm along three propositions: First, the firm influences, and is influenced by, members of the society (Social Context Proposition). Second, managers maximize profit subject to joint constraints of technical feasibility and ethical norms (Managerial Decision Proposition). Third, ethical norms evolve from interactions among the stakeholders without a central authority. Natural selection favors norms that maximize long run economic value for the society (Natural Selection Proposition). We show that the hypernorm can spawn widely agreed authentic ethical norms. However, moral bounded rationality when interpreting the hypernorm generates different authentic norms in the moral free space. The evolutionary logic is testable along the dimensions of variation, inheritance and selection of ethical norms.

Key Words: International Business Ethics; Integrative Social Contracts Theory; Stakeholder Theory; Norms; Natural Selection.

JEL: D64, D80, Z130

1. INTRODUCTION

The scope of business operation is increasingly international in the last five decades due to declining trade barriers, decreasing costs of travel and communication, and increasing ease of migration. Internationalization of business operation poses unique managerial challenges because of exposure to significantly different national cultures. The case of international business ethics is one of these emerging challenges. Corporate headquarter often, much to the resentment of subsidiary managers, imposes ethnocentric code of ethics on its subsidiaries. The fundamental problem in developing an international business ethics code lies in the inherent conflict between the quest for a universal normative ethics and the multicultural diversity of the subsidiaries. Given the multicultural diversity of subsidiaries, is convergence towards a universal business ethics norm possible? If a universal norm is possible, what would this norm be like?

De George (1994) argues that the adjective “international” means that the nature of business ethics is “universal” and not national-culture specific. Cultural differences in judging if an action is moral, or not, do not contradict the assumption of one normative ethics. For example, fairness is a key concept of international business ethics, but different national cultures can create divergent views in what fairness means in a given situation. On the other hand, the status between the corporate headquarters and its oversea subsidiaries is asymmetric. Corporate headquarter often unintentionally impose ethnocentric assumptions when formulating its ethical code.

This inherent conflict between universal ethics and diverse national cultures carries over to theorizing on international business ethics. Hendry (1999) critiques the international business ethic theory by Donaldson (1989) on the basis that ethnocentric assumptions are presumed as universal ethical norms. Hendry (1999) proposes to test for universality using the criterion of reciprocity –

exchanging the positions of the parties involved, and exchanging the positions of the analyst from different cultures, should not change the acceptability of the ethical code.

The paper builds on the Integrative Social Contracts Theory (ISCT) by Donaldson and Dunfee (1994; 1999) to explore a solution for the convergence of international business ethics. We propose a hypernorm in international business ethics where all businesses, independent of their national cultures, share a common objective of sustaining economic value for their stakeholders in the long run. We argue that the actions of a firm in a modern capitalist economy are executed via the firm's managerial decisions. Managerial decisions are guided by a profit maximizing objective under constraints that arise from technical feasibility and ethical norms. The firm exists in the context of a society and hence ethical norms are formed by interactions among the firm's stakeholders in the society. We call this the evolutionary logic for simplicity. We note that the evolutionary logic comes to the same broad conclusion as the hypernorm for "social efficiency" in Donaldson and Dunfee (1999) p.117-121, this paper contributes to the ISCT literature by giving clarity to the mechanics of the social efficiency hypernorm. We review the Integrative Social Contracts Theory in the next section before elaborating the evolutionary logic.

2. INTEGRATIVE SOCIAL CONTRACTS THEORY (ISCT)

Donaldson and Dunfee (Donaldson and Dunfee 1994; 1995; 1999) lay the foundation of the Integrative Social Contracts Theory (ISCT) to advance the connection between the tradition of normative ethics in philosophy and the tradition of empirical ethics in management research. The authors argue that ethical obligations are integrated by macrosocial and microsocial contracts. Microsocial contracts are ethical norms the community has agreed and enforced. This norm is authentic if members can exit the community if they do not wish to comply with the ethical norms. Macrosocial contracts, also known as hypernorms, are guiding principles of what microsocial

contracts ought to be. Hypernorms arise from hypothetical consent that reasonable members of a community should accept as ethically binding. The authors argue that ethical reasoning is characterized by bounded rationality. Bounded rationality arises because we have finite capacity to assess facts, ethics theories have limitation to capture ethical truth, and the nature of economic systems is artificial. Bounded rationality implies that although universal hypernorms ought to be the basis to resolve ethical dilemma, authentic ethical norms are specific to culture, economic system and the social history of the community. The community's freedom to specify ethical norms in response to bounded rationality is the moral free space. The ISCT identifies four scenarios summarize in the following diagram from Donaldson and Dunfee (1999a)

INSERT FIGURE 1 HERE

First, some hypernorms are the community's ethical norms. Second, some ethical norms are not hypernorms but are compatible with hypernorms. Third, in the moral free space, it is unclear if the ethical norms are compatible with hypernorms due to bounded rationality. Lastly, norms clearly incompatible with hypernorms are illegitimate. Ethical *Universalists* recognize behavior as ethical, or not, base on a normative theory. Ethical *Relativists* recognize only the moral free space. The ISCT is an intermediate position recognizing that authentic ethical norms can be culture-specific because of bounded rationality, but ethical norms must not contradict hypernorms to be legitimate.

Dunfee (2006) reviews recurring themes for the critiques of the ISCT and notes the concept of hypernorm is a lightning rod for criticism. Donaldson and Dunfee (1999) distinguishes three types of hypernorms – procedural, structural and substantive hypernorms – arguing that the search for hypernorms arises from decision making and therefore hypernorms cannot be listed ex ante. Empirical

research using the ISCT framework to date – such as Hisrich *et al* (2003) and Spicer *et al* (2004) – focuses on identifying commonality of cross-cultural ethical norms across business communities to unveil hypernorms. However, this approach of discovering hypernorms may unveil common authentic norms instead of hypernorms. Furthermore, even if hypernorms are unveiled, van Oosterhout *et al* (2006) argue that hypernorms are unlikely to give rise to a unique set of authentic ethical norms. This indeterminacy arises because the condition for producing hypernorms – contracting parties are free to exit if they are not willing to accept the norm as ethically binding – is content-independent. This indeterminacy means that the ISCT cannot generate substantive, action-guiding ethical norms (van Oosterhout *et al*, 2006). Furthermore, ISCT is silent on the method to resolve conflicting hypernorms, and whether hypernorms are stable over time (Dunfee 2006).

3. THE EVOLUTIONARY LOGIC

We build on the ISCT, recognizing the role of bounded rationality in generating moral free space and the existence of hypernorms, but argue that there is one hypernorm – the evolutionary logic that all businesses, independent of their national cultures, share a common objective of sustaining economic value for their stakeholders in the long run. We illustrate that this hypernorm, which is consistent with consequentialist moral philosophy, can spawn commonly agreed authentic ethical norms. While the hypernorm is universal, national culture can interpret the hypernorm differently to generate different authentic ethical norms in the moral free space. We elaborate the evolutionary logic along three propositions. First, the firm operates in the context of a society. Therefore, the firm's action influences, and is influenced by, members of the society (Social Context Proposition). Second, managers maximize profit subject to the joint constraints of technical feasibility and ethical norms (Managerial Decision Proposition). Third, ethical norms evolve from conversations within the society. Therefore, norms that increase the society's long-run economic value tend to be adopted by society (Natural Selection Proposition).

3.1 Social Context Proposition

The firm is the decision making unit in business for a capitalist economy. The traditional view of the firm is the agency view: shareholders own the firm and delegate the firm's operation to managers, forming a principal-agent relationship (Jensen and Meckling, 1976; Ross, 1973). The shareholders' objective is to maximize the firm's value which consequently increases their wealth. Managers, as perfect agents, make decisions to maximize the firm's value subject to constraints arising from technical feasibility. An agency problem arises when managers maximize their private objective which is inconsistent with maximizing the firm's value. This agency problem is solved by using governance mechanisms and incentives to align the objective of the principal and agent. The agency view forms the basis of the legal framework for business firms in a capitalist economy.

However, the agency view of the firm does not account for the social context of the firm's existence. The firm is the vehicle for trading in modern capitalism. We use the word trading in a general sense where a buyer and a seller exchange goods or services using money as a medium. For example, employment is a trade where firms buy labor services from workers. Due to trading, the firm is involved in a large variety of contracts with varying degrees of formality and specificity. The firm is created as a legal person to contract with the manager in an employment relationship. The firm is also the nexus of contracts with other entities – such as bond holders, employees, suppliers and customers – with the manager making decisions on behalf of the shareholders. The terms and conditions of many contracts can be written *ex ante*. In fact, these terms and conditions are sometime so well defined they are implied without explicit agreement of any party.¹ Other contracts, known as incomplete contracts, are enormously complex to write and enforce because of three factors: the

¹ For example, the act of payment is deemed the consumer's acceptance of the shop's offer to sell the goods at the displayed price and "standard" conditions. Conditions of "fitness for purpose" and "merchantable quality" are implicit standard clauses that are enforceable in a legal court.

uncertainty of the range of possible outcomes; the use of specific asset – specialized asset that has much lower value in the alternate use; and the high frequency of transaction. Implementing incomplete contracts involve huge transaction costs. Economic theorists argue that the firm brings these transactions within itself to economize transaction costs because solving disputes by fiat is less costly than litigation (Williamson, 1985; 1998). Therefore, the firm has relationships with a web of stakeholders that affect, and are affected by, the decisions that managers make on behalf of the firm (Freeman, 1984).

Freeman (1984) elaborates who the firm's stakeholders are. Generally, there are four groups of stakeholders: capital market stakeholders such as shareholders and bondholders; product market stakeholders such as consumers and suppliers; organizational stakeholders such as employees; and secondary stakeholders – who do not transact directly with the firm – such as union, government and community. The stakeholder view, which is a theory of business ethics, emphasizes the importance of considering stakeholders' interest when making managerial decisions (Phillips, Freeman, & Wicks, 2003).

3.2 Managerial Decision Proposition

We propose that managers maximize profit under the joint constraints of technical feasibility and ethical norms. Managerial decisions are influenced by an informal side of the firm – a side without a centralized authority that makes binding decisions on its members – which we call the community. A community arises from social interactions among members, and an implicit assumption that repeated interactions among members is reasonably expected to arise in future. A firm that establishes an overseas subsidiary, instead of simply exporting goods overseas, sends a clear signal of the intention to be a member of the community. Norms, including ethical norms, arise from the community stakeholders interacting at the organizational, societal and international levels.

The informal community coexists with formal institutions such as firms or sovereigns. The community formulates and enforces social norms, where business ethics norms are social norms about trading. Social norms are formulated by interactions among members of a community instead of optimization by a central authority. Consider a hypothetical community of bond traders consisting of bank managers who sell bonds, and firm managers who buy bonds. The buyers and sellers communicate through social networks like trade association, public media and personal networks. Buyers and sellers know about the disputes that they are not directly involved, how these disputes are resolved, and moral arguments in the resolution. Over time, the principle of resolving dispute which is accepted by the community becomes a social norm. In other words, the view that social norms arise by evolution and not by design have three implications. First, when formulating the norm, the community has no incentive arising from either side of the trade. For example, managers in the hypothetical bond market can change jobs and today's seller can become tomorrow's buyer. In a design view, each side has its own private incentive in a trading relation. The absence of private incentive provides a veil of ignorance, in the sense of Rawls (1971), which leads to distributive fairness when formulating business ethics norms. Second, the norm that arises from the disputed trade binds members of the community who are not involved in the trade. For example, most firm managers, and all external experts, are not directly involved in the dispute that leads to forming the norm in the hypothetical bond market. Third, there is a time lag for norms to be adopted by the community. Therefore, social norms are part historical legacy and part contemporary processes.

Norms are adopted and sustained if they are enforced. Norms are enforced by the community through sanction ranging from expressing disapproval to ostracizing the offending party. Internalized norms are followed even when violations are unobservable – these norms are sanction by shame or anticipation of shame. Bowles and Gintis (1998) outline four characteristics of a community and link these characteristics to enforcing norms. First, the low cost of information about a community's

members is due to frequent interactions. A good reputation for conforming to cooperative norms is therefore valuable and facilitates enforcing social norms. Second, a community has long lasting interactions among its members. Therefore, retaliation from not conforming to cooperative norms in the past is likely to occur in future. Third, a community's members are more likely to interact among themselves than with outsiders. Therefore, members of similar characteristics, such as cooperativeness, tend to form segments and increase the value of the norms within the segment. Fourth, limited opportunity for members to exit the community magnifies the three effects discussed – reputation, retaliation and segmentation – of enforcing norms. Elster (1989) argues that enforcing a social norm is costly to the enforcer for three reasons – enforcement requires effort, it risks future retaliation and it risks losing opportunity for cooperation. Axelrod (1986) coins the term meta-norm, which is the willingness to punish someone who does not enforce a norm. A rational member will enforce the norm when the meta-norm's cost of punishment exceeds the cost of enforcing the norm. Kandori (1992) develops a formal model of community enforcement of social norms where members change their partners over time. Assuming members are self-interested and can be observed to various degrees, Kandori shows that a community can sustain cooperation even when each member knows only his personal experience.

3.3 Natural Selection Proposition

In a path breaking article, Akerlof (1980) uses an economic model to show that norms, which Akerlof calls customs in his paper, are accepted and become binding within a group when the norms serve some useful purpose for the group. Norms that are disadvantageous to the individual still persist because an individual is sanctioned by loss of reputation for disobeying these norms. Business ethic norms are norms formulated and enforced in a social context using the firm as a trading vehicle. We postulate that business ethics norms that increase long run economic value are more imitated by natural selection than business ethics norms that do not. Therefore, business ethic norms serve the

purpose of maximizing long run economic value for the society. Nobel laureate Kenneth Arrow has perhaps argued most explicitly for the collective optimality of norms (Arrow, 1971: 22):

... I want to [call] attention to a less visible form of social action: norms of social behavior, including ethical and moral codes. I suggest as one possible interpretation that they are reactions of society to compensate for market failure...

... Non-market action might take the form of a mutual agreement. But the arrangement of these agreements and especially their continued extension to new individuals entering the social fabric can be costly. As an alternative, society may proceed by internalization of these norms to the achievement of the desired agreement on an unconscious level.

There is a whole set of customs and norms which might be similarly interpreted as agreements to improve the efficiency of the economic system (in the broad sense of satisfaction of individual values) by providing commodities to which the price system is inapplicable.

Natural selection of social norms favors business ethics norms that increase long run economic value. Nelson (2006) argues that although the mechanics of biological evolution differs substantially from evolution of human culture — including business ethics — the general Darwinian principles of variation, inheritance and selection remains valid for an evolutionary social science. The moral free space arising from moral bounded rationality in ISCT provides the variations of authentic ethical norms; these norms survive beyond the individuals through the managerial decision context and the social context of ethical norms; norms that increase long run economic value jointly for all stakeholders are selected preferentially. We propose that these principles jointly form a hypernorm that spawn authentic ethical norms in the following sections. We use the stakeholder framework to examine some well known business ethics norms involving stakeholders in the capital and product

markets, organizational stakeholders, and secondary stakeholders who do not interact directly with the firm.

3.3.1 Asymmetry of Information: Business Ethic involving Capital and Product Stakeholders

There are many behaviors that are commonly agreed to be unethical. Examples of such behaviors involving capital and product stakeholders include creative accounting, fraud, misleading advertising, passing off defective products as good ones, abuse of intellectual property and others. These unethical behaviors destroy economic value due to asymmetry of information.

Assume that there are two types of cars: a good one is worth \$2000, and a *Lemon* is worth \$1000. Suppose that there is equal chance of randomly picking up a good or bad car from the market, and asymmetry of information exists, that is only the seller knows if his car is a *Lemon*. The market for *Lemons* will displace the market for good car² -- only *Lemons* will enter the market at the price of \$1000 (Akerlof, 1970). If there is an accurate test for the quality of cars, then the markets for good cars and *Lemons* can both exist. In this case, the test would be worth the difference in price of the good car and the *Lemon*.³ The value created by the test is usually divided among the parties: the tester gets a fee, the seller gets more profit, and the buyer has more consumer surplus with good quality cars. The *Lemon* principle explains why the cost of dishonesty exceeds the loss to the aggrieved party; far greater economic value is destroyed in the displacement of the “high quality” market.

² The buyer is willing to pay only \$1500 so that the expected gain from trade is zero, i.e. equal chance of winning and losing \$500. However, only the seller of *Lemon* will enter the market at this price and alter the chance of getting a good car.

³ If you know you have a good car (worth \$2000) and the market will only transact at the price of *Lemon* (\$1000), you will at most pay the tester up to the difference (i.e. \$1000) to prove you have a good car.

The *Lemon* principle also explains why *guanxi*, or prior social relationships, and communal business institutions are very important when commercial regulations are not well enforced. While these are solutions to overcome asymmetric information between buyer and seller, or investor and firm, the scale and scope of business becomes much smaller. In developed capital markets, users of financial information rely on auditing as the unbiased test for the quality of the firm's asset. Financial accounting provides the lower⁴ limit of a firm's value that banks, bondholders and investors use for investing decisions. The cost of raising funds without reliable auditing will be very high for firms. At the outbreak of the Enron scandal, share prices of all firms in the same market, even those firms unrelated to Enron, plunged because the quality of financial information became suspect and triggered off the *Lemon* effect. The Sarbanes-Oxley Act, enacted in 2002 as a reaction to tighten accounting control in the aftermath of a number of major corporate and accounting scandals, has compliance costs amounting to millions for most large firms. However, using the *Lemon* principle, this cost is a small price to pay for the smooth functioning of capital market. In developed capital market, business ethics is not a business option, it is an economic imperative.

3.3.2 Fairness and Equilibriums: Organizational Stakeholders

Asymmetric information is less severe within firm than in the market. Therefore, other mechanism may drive the evolution of ethic norms involving organizational stakeholder. We propose that ethic norms evolve so that complying with the norm results in a more efficient equilibrium than not complying. For example, it is generally agreed that fair treatment of employees is an ethical norm, but it is less clear if fair treatment creates more economic value in the long run than unfair treatment. We

⁴ The conservative principle in financial accounting ensures that expense is recognized much quicker than revenue despite the matching principle. For example, sales and R&D expenses are instantly recognized while its "potential" revenue is recorded only when the goods are delivered. This way of accounting suits the financiers as users of information. The manager who needs to know the economic value needs to rely on other means such as cost accounting techniques and Balance Score Card.

use a well known case study of Nucor Steel in 1986 (Ghemawat, 1994; Ghemawat and Stander, 1990) to illustrate how fair treatment of employee allows a firm to attain a more profitable equilibrium than its competitors.

Nucor Steel's financial performance in 1986 was outstanding despite the poor profitability of the U.S. steel industry (Ghemawat, 1994; Ghemawat and Stander, 1990). The two critical ingredients in Nucor's strategy were building new steel mills cheaply and operating these mills efficiently. In 1986, labor union of the U.S. steel industry resisted the adoption of labor saving technology⁵ and job re-design to enhance plant efficiency. In contrast, Nucor's workforce was not even unionized and had a lower turnover rate than the industry average. Nucor could quickly bring in labor saving technologies and use a stable construction team. At the same time, Nucor's average wage was far below the industry's average, but the wage plus group bonus was the highest in the industry. The high bonus incentive linked a worker's income to his group's productivity. Nucor was able to earn economic profit in a very competitive environment using a low cost strategy driven by operation efficiency and labor saving technologies. Why were the competitors unable to imitate Nucor's success strategy?

Implementing Nucor's strategy requires mutual trust between management and workers. This foundation is build from fair business practices. For example, in a bad year, Nucor worker's income decreases by 15-20%, its manager's income decreases by 30-40%, but the senior officer's income decreases by 60-70%. Nucor reduces workday per week instead of retrenching workers, and the target to receive bonus is adjusted for the less workdays. An opportunistic manager in bad time puts the burden for cost reduction unfairly on workers and protects the income for decision makers, while the benefits accrual to the decision makers in good time. Workers respond to managerial opportunism by

⁵ For example, integrated steel mills are stuck with open heath technology which is less productive than the newer continuous casting method.

forming labor union, which is suspicious that the management's intention of introducing labor saving technology is to cut jobs, to bargain favorably in the workers' interest. Without mutual trust, labor union resists the introduction of efficiency enhancing bonus scheme because bonus can be easily withheld unlike wage. The bargaining between union and management is a transaction cost to allocate economic value among parties but does not create value. This case shows that business ethics and profit need not be inconsistent. It can become a rare and non-imitable resource to embody the firm's sustainable competitive advantage. Managerial opportunism destroys value for shareholder, manager and worker.

When firm strategy embodies the development of human capital that is firm specific (Becker, 1975), a reputation for high standards of business ethics is a pre-requisite. Firm specific human capital (FSHC) refers to the accumulation of skills which value is higher to the firm than the outside market. FSHC can arise from skills complementary to capital, such as skills in operating specialized equipment unique to the firm, or labor, such as tacit knowledge R&D team, that has lower value outside the firm. Investment in FSHC is risky and gives rise to the hold-ups problem, which happens one party is in a good position to bargain a bigger share of the profit after the other party makes an investment. The solution to the hold-ups problem is joint investment in human capital and deferred compensation in life-time employment with compulsory retirement age (Becker, 1975). The firm's reputation for good business ethics is a prerequisite for the solution because the firm can dismiss the worker before paying out the deferred compensation.

3.3.3 Rent Seeking: Business Ethic involving Secondary Stakeholders

When using the case method, there is a trade-off between insight from the case and the limited generalization of the result beyond the case. We strengthen our proposal that ethical norms evolve so that its compliance results in a more efficient equilibrium from an economic model of rent seeking.

Unethical behavior can destroy economic value and delay growth at the economy level through rent seeking behavior. Rent seeking refers to activities by which an individual, or firm, gains wealth through means other than trade and production. Examples of rent seeking include bribery and corruption,⁶ corporate stealing and infringement of intellectual property, all of which are considered unethical, if not illegal, in most societies. Murphy, Andrei and Vishny (1993) describe a model to explain why rent seeking is costly to economic growth. In the model, farmers in an economy can choose any one of the three activities: produce a high yield crop that can be expropriated (output α), produce a low yield crop that cannot be expropriated (output γ), or steal from the neighbor (steal β). For simplicity, assume that the payoff from stealing is β up to a certain number of bandits n , and then declines afterwards. This is because as more farmers become bandits, there is less to gain for each bandit. Some farmers will switch to low yield crop when there are bandits. The payoffs for each group are as follows:

 INSERT FIGURE 2A to 2C HERE

In Figure 1A shown above, stealing is costly because of effective law making and strict enforcement, and the first bandit does not even obtain γ as payoff. No farmer will become a bandit, and it is better to produce a high yield crop (which pays α) than a low yield crop (which pays β). In Figure 1C, the cost of stealing is lowered drastically; the rent seeker's payoff curve rises where β is above α . The producer and rent seeker payoff curves intersect where the payoff is γ . Nobody will produce a high yielding crop because it will be stolen. Figure 1B shows the intermediate case where β is between α and γ . The producer's and rent seeker's curves intersect at two points, and the

⁶ These two activities are really two sides of the same coin.

equilibrium comprises a mixture of bandits and farmers producing high yielding crops.⁷ This model shows that rent seeking destroys economic value: the payoff is at α without bandits, and at γ when the bandits are totally uncontrolled. The primary effect, which does not change the economic value, is a transfer of wealth from farmers to bandits. The secondary effect, which destroys economic value, is the farmer's switch to producing a low yield crop that cannot be appropriated. The secondary effect is huge as producers outnumber the rent seekers in most economies.

The cost for rent seeking can be increased sanction by law enforcement or social sanctions. For transactions that can be fully specified *ex ante*, legal enforcement is feasible but may be costlier than social sanctions. For transactions that cannot be fully specified *ex ante* and occur frequently between fixed parties, the firm internalizes the transaction and uses social sanctions and fiat to resolve conflicts.

4. BEHAVIORAL DEVIATION FROM BUSINESS ETHIC NORMS

While the evolutionary logic proposes a guiding hypernorm of authentic ethical norms (what “ought” to be), we observe that actual behavior (what “is”) often deviates from these ethical norms. In other words, ethical norms are normative – the norms are formed without one being in a position of trade as buyer or seller which cause a vested interest due to the position – but actual behavior consider one's position in the trade and may deviate from the agreed norms. Using the Prisoner Dilemma from game theory, we argue that value creation for business ethics norms is consistent with a more efficient equilibrium over alternative equilibriums under a long run perspective, and identify the self interest that make actual behavior deviates from normative norms. Individuals acting on short run interest behave differently from what business ethics norms prescribe.

⁷ The other intersection is not in equilibrium because low yielding crop cannot be stolen, so there is no bandit.

Suppose there is an economy that comprises players A and B. The players can choose one of two actions: “Smear” or “No Smear”. If players choose “Smear”, they spread rumors of unsubstantiated claims of poor quality of the other’s product, which is unethical. If they choose “No Smear”, they do nothing. Suppose the payoff can be represented by the matrix as follows in Table 1, how will they choose rationally?

INSERT TABLE 1 HERE

The choice depends on whether this is a one-shot or repeated game. In the one shot game, both players will engage in a smear campaign and each earns a payoff of 7. This is because if one chooses “No Smear”, the opponent will choose “Smear” to get a better payoff, and the player will be worse off. This outcome has the lowest total payoff of all the possible scenarios. However, the private incentive in the game ensures that both players will choose “Smear” in a one shot game, known as the Nash equilibrium, which is sub-optimal. The best payoff, which is the Pareto efficient outcome, is for both players to choose “No Smear”, but this will not happen in a one-shot game as explained earlier. In a repeated game, there is a cost for staying at the Nash equilibrium, specifically the cost is $17-7=10$, for every player in all but the last round. Smearing the opponent in the current round has a marginal gain, specifically the gain is $20-17=3$, but will cause retaliation in subsequent rounds. Therefore, long run self-interest and ethical behavior becomes aligned in a repeated game, but short run self-interest does not. As society is expected to be stable, business ethics norms should be formed adopting the long-run framework. There is a private incentive for a player to deviate from ethical norm in an end-game situation. This is because the marginal gain is not counter-balanced by the marginal cost for staying at the Nash equilibrium at the next round. The game also shows that imposing restrictions to rule out

unethical choices is costly in foregoing the marginal gain of smearing the opponent, but the shift to a more efficient equilibrium more than compensates for this cost in repeated games.

A person perceived with a high standard of ethics makes a good business partner in reducing commitment problems (Jones, 1995). An ethical person is a good agent that requires less monitoring by the principal, a good seller that requires little cost from *adverse selection* (Akerlof, 1970), a good buyer that poses no hold up problem, and a good team member that will not free ride on others. We argue that a person's behavior is observed by others in a society only some of the time. Given the value of being perceived as ethical, a rational person will conceal unethical behavior and make ethical ones visible to provide a valuable signal. However, knowing that a rational person will conceal unethical behavior, observed unethical behavior is given more weight than ethical ones. Indirect observation by others, especially observers with a good reputation, is also important in evaluating a person's ethical standing. Frank (1988) shows that a person who merely appears ethical for self-interest will be caught with sufficient frequency that maintaining a reputation for honesty is difficult. The immediate reward for opportunism, temporally distant benefit of being ethical, irrational discounting, and unknown probability of receiving temporally distant reward, can easily make a rational person mistakenly opt for quick payoffs. Therefore, being ethical is a signal of being a good business partner. However, given that any behavior is partially observed, and reputation is often proxy for direct observation, consistently being ethical is more important than visibly being ethical to provide any useful signal. Contemporary research – such as Kish-Gephart et al (2010), Boomer et al (1987) and Trevino (1986) – has provided richer models on the deviation between normative ethics (what “ought”) and actual behavior (what “is”) than what we have described.

5. CONCLUSION

We started by wondering if the inherent conflict between the quest for a universal normative ethics and the multicultural diversity of the subsidiaries can ever be resolved, and if so, in what way is that possible. The ISCT's intermediate position (between ethical *Relativist* and ethical *Universalist*) is an attractive start point that provides an opportunity to propose a hypernorm along three propositions.

We define business ethic norms as informal behavioral rules guiding trading relations. These norms arise, in the absence of a formal central authority, through interactions among stakeholders (social context proposition). We argue that managerial decision considers ethical constraints (managerial decision proposition), contrary to the agency view of the firm, and consistent with the stakeholder view. Business ethics as social norms is a mechanism to incorporate stakeholders' interest in managerial decision. Furthermore, business ethics norms which are formed through interactions among a community will meet Hendry (1999) reciprocity criterion. We propose that business ethics norms are subjected to natural selection so that society adopts norms consistent with maximizing long run economic value (natural selection proposition). If this logic is correct, then there is a hypernorm, independent of national culture, which is the foundation of international business ethic norms. This principle is consistent with long run social efficiency and accommodates the interests of diverse stakeholders. While the convergence of business ethics norms in multinational firms seems far fetched at this time, Sadowski and Thomas (2012) report that professional accounting bodies – specifically American Institute of Certified Public Accountants (AICPA) in the US and International Federation of Accountants (IFAC) outside the US – are already working towards the harmonization of ethics standards for the accounting profession.

The evolutionary logic accommodates testable predictions along the dimensions of variation, inheritance and selection. Here is a non exhaustive list of testable predictions from examining historical and cross country differences in business ethics norms:

H1: *Globalization correlates with converging of business ethics norms over time.* The variations in ethical norms arise from moral bounded rationality due to the artificial nature of economic systems. Globalization increases the interaction between societies with diverse economic systems and authentic norms. Incompatible norms need to be resolved and become convergent over time.

H2: *Trade intensity between countries correlates with converging business ethics norms.* This is a cross sectional equivalent of the first hypothesis. Factors that increase interaction between societies with diverse economic systems, such as trade intensity, tend to produce convergent authentic norms.

H3: *Fair business ethics norms correlate with perceived membership in a society.* Business norms tend to favor local firms over foreign firms especially for economies that have a longer history of being closed. Extreme unfairness tends to occur when there is discrimination that excludes a party from social membership.

H4: *Business ethics norms change towards better understanding of how the current norms affect economic value for the stakeholders in the long run.* For example, the rise of the ethics of the environment correlates with better understanding of the sustainability of environmental exploitation in the context of rapid technological advancement in the last few decades and considering future generations as stakeholders.

The key managerial implication of the evolutionary logic is that a hypernorm exists among different authentic ethics norms among the subsidiaries. The ethical legitimacy of these authentic ethics norms is evaluated using the three propositions in the evolutionary logic. Differences in authentic norms are expected to converge over time. The key limitation of the evolutionary logic is the identification of only one hypernorm which is consistent with consequentialist philosophy. Further research is needed to accommodate multiple hypernorms and to validate the propositions empirically.

REFERENCES

- Akerlof, G. (1970) The Market for *Lemons*: Qualitative Uncertainty and the Market Mechanism. *Quarterly Journal of Economics*, 84(3): 488-500.
- Akerlof, G. (1980) A Theory of Social Custom, of which Unemployment may be one Consequence. *Quarterly Journal of Economics*, 94: 749-775.
- Arrow, K. (1971) Political and Economic Evaluation of Social Effects and Externalities. In Intriligator, M. (ed.), *Frontiers of Quantitative Economics*. Amsterdam: North-Holland: 3-25.
- Axelrod, R. (1986) An Evolutionary Approach to Norms. *American Political Science Review*, 80(4), Dec., 1986: 1095-1111
- Becker G. (1975) *Human Capital*. Chicago: University of Chicago Press.
- Boomer, M., Gratto, J., Gravender, J., Tuttle, M. (1987). A Behavioral Model of Ethical and Unethical Decision-Making. *Journal of Business Ethics*, 6(4):265-280
- Bowles, S. and Gintis, H. (1998) The Moral Economy of Community: Structured Populations and the Evolution of Prosocial Norms. *Evolution & Human Behavior*, 19(1), January 1998:3–25.
- De George, R.T. (1994) International Business Ethics. *Business Ethics Quarterly*, 4(1):1-9
- Donaldson, T. (1989) *The Ethics of International Business*. Oxford: Oxford University Press.
- Donaldson, T. & Dunfee, T. W. (1994) Toward a Unified Conception of Business Ethics: Integrative Social Contracts Theory. *Academy of Management Review*, 19(2): 252-284.
- Donaldson, T. & Dunfee, T. W. (1999) *Ties That Bind: A Social Contract Approach to Business Ethics*. Cambridge: Harvard Business School Press.
- Donaldson, T. & Dunfee, T. W. (1999a). When Ethics Travel: The Promise and Peril of Global Business Ethics. *California Management Review*, 41(4):45-63.
- Dunfee, T.W. (2006). A Critical Perspective of Integrative Social Contracts Theory: Recurring Criticisms and Next Generation Research Topics. *Journal of Business Ethics*, 68 (3):303 - 328.
- Elster, J. (1989) Social Norms and Economic Theory. *Journal of Economic Perspectives*, 3(4), Autumn: 99-117

- Frank, R. (1988) *Passion Within Reason: The Strategic Role of Emotions*, New York, Norton.
- Freeman, R. (1984) *Strategic Management: A Stakeholder Approach*, Pitman, Boston.
- Ghemawat, P. (1994) Competitive Advantage and Internal Organization: Nucor Revisited. *Journal of Economics & Management Strategy*, 3(4): 685-717.
- Ghemawat, P. and Stander III, H. (1990) Nucor at a Crossroads. *Harvard Business School Case* 793-039 .
- Hendry, J. (1999) Universalizability and Reciprocity in International Business Ethics. *Business Ethics Quarterly*, 9(3):405-420.
- Hisrich, R.D., Bucar, B. & Oztark, S. (2003). A Cross Cultural Comparison of Business Ethics: Cases of Russia, Slovenia, Turkey, and United States. *Cross Cultural Management Journal*, 10(1) (January, 2003): 3-28
- Jensen, M. and Meckling, W. (1976) Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure. *Journal of Financial Economics*, 3(4): 305-360.
- Jones, T. (1995) Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics. *Academy of Management Review*, 20(2): 404-437.
- Kandori, M. (1992) Social Norms and Community Enforcement. *Review of Economic Studies*, 59(1), Jan., 1992: 63-80
- Kish-Gephart, J.J., Harrison, D.A. & Treviño, L.K. (2010). Bad Apples, Bad Cases, and Bad Barrels: Meta-analytic Evidence about Sources of Unethical Decisions at Work. *Journal of Applied Psychology*, 95(1): 1-31
- Murphy K., Andrei, S. and Vishny R. (1993) Why Is Rent-Seeking So Costly to Growth? *American Economic Review*, 83(2): 409-414.
- Nelson, R. (2006). Evolutionary Social Science and universal Darwinism. *Journal of Evolutionary Economics*, 16(5), 491-510.
- Oosterhout, J. van, Heugens, P.P.M.A.R. and Kaptein, S.P. (2006). The Internal Morality of Contracting: Advancing the Contractualist Endeavor in Business Ethics. *Academy of Management Review*, 31(3), 521-539.
- Phillips, R., Freeman, F., and Wicks, A. (2003) What Stakeholder Theory Is Not. *Business Ethics Quarterly*, 13(4), Oct., 2003: 479-502

Rawls, T. (1971) *A Theory of Justice*. Cambridge, Mass., Harvard University Press.

Ross, S. (1973) The Economic Theory of Agency. *American Economic Review*, 63 (May): 134-139.

Sadowski, S.T. and Thomas, J.R. (2012). Toward a Convergence of Global Ethics Standards: A Model from the Professional Field of Accountancy. *International Journal of Business and Social Science*, May 3(9): 14-20.

Spicer, A., Dunfee, TW., Bailey, WJ. (2004). Does National Context Matter in Ethical Decision Making? An Empirical Test of Integrative Social Contracts Theory. *Academy of Management Journal*, 47(4): 610-620.

Trevino, L.K. (1986). Ethical Decision Making in Organizations: A Person-Situation Interactionist Model. *Academy of Management Review*, 11(3): 601-617

Williamson, O. (1985) *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. Free Press.

Williamson, O. (1998) Transaction Cost Economics and Organization Theory. *Technology, Organization, and Competitiveness* , 1, March: 17-67.

		Player A	
		No Smear	Smear
Player B	No Smear	A=17, B=17	A=20, B=3
	Smear	A=3, B=20	A=7, B=7

Table 1: Payoff Table for Prisoner Dilemma Game

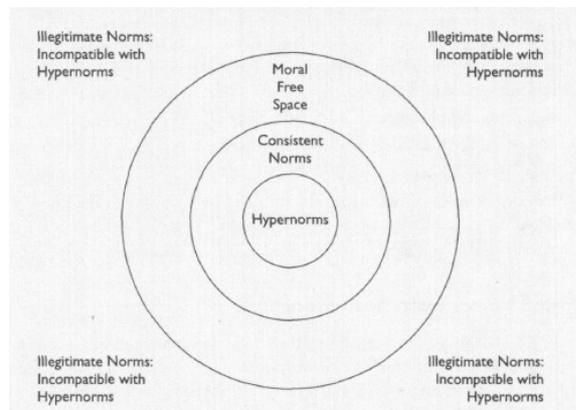


Figure 1: Hypernorms, Consistent Norms, Moral Free Space and Illegitimate Norms

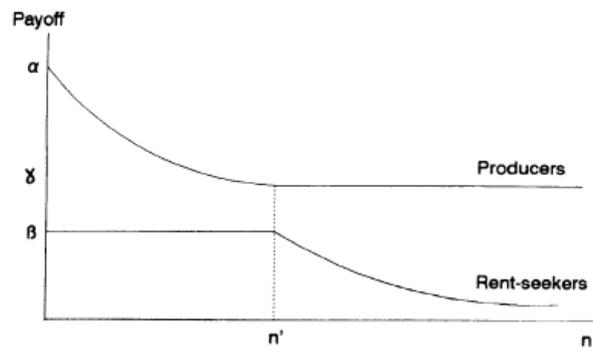


Figure 2A: Payoffs for Producers and Rent Seekers when Stealing is Costly

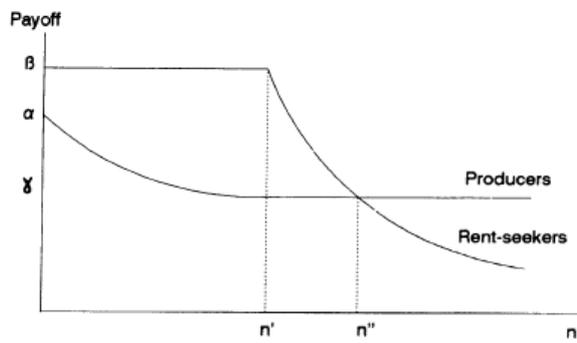


Figure 2B: Payoffs for Producers and Rent Seekers when Stealing is moderately Costly

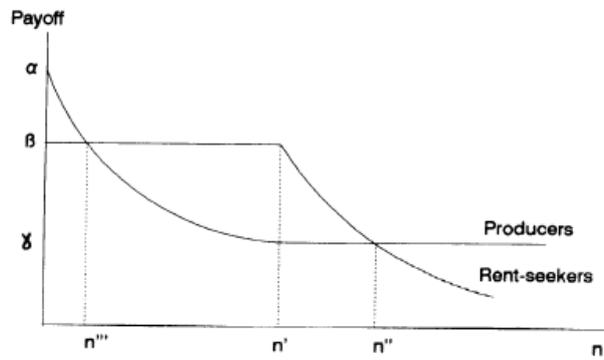


Figure 2C: Payoffs for Producers and Rent Seekers when Stealing is not Costly