Beyond Risk Management, Toward Ethics: Institutional und Evolutionary Perspectives

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Introduction

The management of risk – on a societal level or related to organizational measures in businesses – is important and it is clearly related to moral concerns in life. The risky speculations in the financial sector in the past years have demonstrated this in the same manner as the nuclear catastrophe in Fukushima. Corruption cases, fraud issues, irresponsible mismanagement, risky products and other examples clearly show the importance of compliance measures in firms to manage risk on an organizational level. The main logic is “avoiding harm” to others – and who would deny that this is not ethically relevant. Of course it is.

In this paper, however, I argue that considering risk in business ethics is necessary but not sufficient for addressing these moral concerns since ethics in general is not merely about avoiding harm, but also about “a good life”, and because business ethics in particular is not merely about avoiding “bad practices”, such as corruption and fraud, but also about reflections on “good business practices”. Hence, risk management is neither identical with business ethics nor do the notion and concepts of risk management reflect the main challenges in the field of business ethics.

In the following sections I will first elaborate on some general normative perspectives in business ethics and then, based on these reflections, suggest two complementary institutional measures for firms. I will argue that compliance approaches need to be supplemented with by a so-called integrity approaches that not only bring the individual as (moral) actor back into play but also characterize more reflective institutional measures within the organization to foster corporate social responsibility.

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Extending the Perspective in Business Ethics

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In the past decades we can observe the negative consequences of a decoupling process between the private and public domains. The lack of national regulatory mechanisms has enabled fraud and unethical behavior within businesses. However, this rise in ethical problems seems to have raised interest in some aspects of social responsibility among businesses in modern societies. Since the late 1980s, an increasing number of publications on business ethics and an increasing number of business practices related to certain ethical issues have emerged.

We suggest interpreting these developments against the backdrop of the re-composition of society. Owing to the breakdown of the public and private dialectics, the tacit contract between firms and society – to maximize your profits, provide the population with work, the consumers with low prices for goods, while the politicians regulate our activities within the political framework – has lost some of its binding capacity. Firms are increasingly the focus of a critical society. Firms *are seen* as being responsible for their economic actions.

In the academic debate on business ethics we can identify two dominant streams of argumentation. The one can be located within the economic paradigm: ‘Neo-classical free-market libertarians believe that we need to rely more – not less – on markets and economic rationality. They argue in favor of self-interested economic actors and highly deregulated markets. Consequently, businesses ought to take ethical issues into account if – and only if – there is a pay-off. The other stream – we can call them the ‘radical critics’ – argue for the exact opposite: Their critique is aimed at what they believe are the foundations of market economies, such as managers’ and bankers’ ‘greed’. They want companies to engage in ethically sound behavior, and for the state to regulate economic actors strictly.

I argue that both perspectives have serious shortcomings, since they are limited to either, on the one hand, economic circumstances and the assumption that businesses are merely motivated by profits without considering the normative justification of such a motive (free-market scholars), or, on the other, to discussing firms’ “dos” and “don’ts” without taking into consideration societal realities.

We suggest extending the debate in business ethics by rephrasing it with the following questions: *What do businesses actually do to contribute to a “good society”?* *What do they want to, what can they, and finally, what should they, do in order to better contribute?*

The first question refers to concrete practices and empirical facts. “What do they want to do?” concerns the motivation of businesses to get involved in corporate social responsibility (which can be profit seeking or other motivations). “What can they do?” asks about the capabilities that are needed to be a “good corporate citizen” (on an individual as well as on an organizational level). And “what should they do?” reflects the role of businesses in society far beyond the other three elements.

If we apply this typology to the business ethics debate on risk management we can see that it somehow touches on the first three questions, but also that the

businesses' role of contributing to a good society is somehow less present und much less debated. Here "pure market systems" are either implicitly taken for granted or explicitly justified on a normative basis with a combination of Friedman's (1970) well-known phrase that the social responsibility of a business is to increase its profits and the necessity of political regulations.

Indeed, if it would be possible through national regulations to fully internalize negative external effects into the cost-benefit calculation of businesses, then there would be no need to talk about corporate social responsibility. Firms – the players – could then maximize their profits, while questions of social justice could be realized through political regulations, the rules of the game (Homann and Blome-Drees 1992; Homann 1993). Unfortunately, this simple idea does not work so well anymore in times of a "world society," where the economy and business interactions and transactions are globalized while the major regulatory measurement – law – is still mainly limited to a locally acting nation state. This is certainly a pity but a fact of modern societies that cannot be overlooked.

This new societal configuration (Beschorner 2004) has led to a different understanding of businesses and their role not just as economic but also as political actors (Palazzo and Scherer 2006; Scherer et al. 2006). We cannot, whether empirically or normatively simply describe, explain or justify businesses in a given political framework (Beschorner and Vorbohle 2007). Rather we need to extend our analysis to a *more complex interplay of different actors (including political actors) that contribute to new forms of normative contexts* (purposefully three times plural).

What is important are the normative roles of businesses in these "enjeux" that are often collected under the heading of "corporate citizenship": The firm is an actor with liberal rights as well as republican duties or responsibilities (Matten and Crane 2005). Businesses are de facto contributors to governance structures; they are quasi-governmental actors. The question is: How can they contribute proactively to a "good society?" I regard this normative premise, this "ideal" of businesses as "good corporate citizen" as widely accepted in the international debate on business ethics.

However, a remaining question beyond this "ought to be" is obviously how to bring this into practice, or, more precisely, how to bring the "ought to be" and the "is" into fruitful interplay?

Institutional and Evolutionary Perspectives

In approaching an answer to this question, I will discuss two economic approaches to highlight different theoretical perspectives of business ethics. These are, on the one hand, what we call traditional economic perspectives, (neoclassical ideas, but especially approaches in New Institutional Economics) and, on the other hand, an alternative economic approach mainly oriented toward ideas associated with Evolutionary Economics. It will be demonstrated that neither one can serve as a

Fig. 1 Business ethics from a neoclassical perspective

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general theory of business ethics, but that both approaches highlight some of its important dimensions. The two main theses are:

1. Individual leadership is important for ethics of organizations. However, ethical leadership has to be embedded in suitable institutional frameworks. Institutions matter!
2. Pure compliance approaches (closely related to risk management) show serious shortcomings. They have to be supplemented (not substituted) by integrity approaches.

Theory of Business Ethics I: Traditional Economic Approaches

From a neoclassical perspective on business ethics, it is argued that constraints for businesses have been changed. In addition to the constraints set by the nation state, a more and more professionalized and better organized civil society limits the actions of businesses. Businesses at the end of the twentieth century and at the beginning of the twenty-first century cannot undertake business activities “at all costs” but increasingly have to legitimize their actions. Since the absence of legitimacy results in increased costs and/or reduced profits, businesses try to deal with these new requirements. This very simple idea is illustrated in the following figure (Fig. 1):

From a neoclassical perspective, businesses take ethical issues into account if – and only if – “they pay off”. The (*) symbolizes an ethical issue, such as child labor in developing countries, products or production processes that lead to negative ecological consequences, and so forth. While in situation A these aspects are not part of the rationality of the firm, in situation B they are included in the costing

process and utility calculations since the economic constraints have changed. This shift might have different reasons: a new law (such as an obligation to use new industrial filters to avoid CO₂ emissions), new market opportunities resulting from a value shift in society (such as “ethical” (niche) products), or the need to “avoid negative attention” (Nell-Breuning) by NGOs, the media, and finally consumers (such as in the case of child labor). To sum up, we can distinguish three important *external*, societal reasons for businesses to incorporate ethics into their economic rationality (Paine 2003): changes in the political framework, risk management as a form of “civil positioning”, and market positioning.

Apart from these external drivers of “sustainable change”, businesses see ethical, or better, moral issues as an important means for *improving the performance of their organizations*. While neoclassical economics has assumed firms to be black boxes, the *New Institutional Economics* investigates – among others – the coordination mechanism of social actions within organizations. It is well known that this field of research has led to a huge number of publications and the emergence of three interrelated approaches within the New Institutional Economics (see also the overview by Williamson 2000): property-rights-theory (Alchian and Demsetz 1972), agency-theory (Fama 1980), and, last but not least, transaction cost economics (Williamson 1975, 1985).

Whereas early concepts for an institutional foundation of a theory of the firm particularly emphasized aspects of hierarchical control and economic incentives (hard facts) to deal with the problem of social interaction within organizations, in recent years *soft facts*, such as trust, integrity, credibility and fairness, have become increasingly important in economic literature. We want to outline three important reasons for this development:

1. *Coordination*: Social coordination through soft facts can reduce transaction costs since expensive control and incentive mechanisms can become redundant.
2. *Motivation*: Transaction cost economics have been criticized as “bad practices” (not only for ethical, but also for economic reasons) because control mechanisms tend to become a self-fulfilling prophecy of one basic behavioral assumption of transaction cost economics, which is opportunism. An increase in opportunism (such as fraud), however, leads also to the necessity for better and more expensive control systems (Ghoshal and Moran 1996; Moran and Ghoshal 1996). As a consequence it is argued that the “atmosphere of transactions” and hence values have to be taken into account.
3. *Cooperation*: While economic analyses usually stress the dimension of competition in a global economy, the German business ethicist Josef Wieland (1996, 1997, 1999, 2001) argues that there is another side of the coin. In conjunction with increased trade and competition, one can also observe an increase in cooperation among businesses owing to factors such as mergers and acquisitions as well as business networks and more complex supply chains. The ability to cooperate has become an important economic resource in times of globalization, which can lead to positive economic consequences for businesses.

It is important to note that this last argument of “governance ethics” (Wieland 1999, 2001) has a slightly different theoretical status in comparison with the rather mainstream arguments of transaction cost economics. It is argued that values in business organizations are *sui generis (ontologically)*: Trust and fairness are *not the result of utility maximization*; communicating such values has to be seen as an original type of action and as an original type of interaction constituting social relations. According to Max Weber’s theory of action, this can be regarded as value rationality (*Wertrationalität*), which is not a subtype of utility maximization (*Zweckrationalität*) but an original type (Beschorner et al. 2012; Beschorner 2002). In this respect, businesses are seen as multi-lingual actors. They not merely speak and understand economic terms (profits) but also communicate in juridical, political and moral terms as well as through other “language games”. Communication in terms of values is the basic and constitutive element of cooperation within the organization (intra-organizational) and between organizations (inter-organizational). Intra- and/or inter-organizational cooperation may have an economic advantage for businesses (Wieland 1999, 2001) since it helps stabilize social relations. This argument by Wieland represents an important improvement in economic analyses.

In relation to business practices, implementing an institutional mechanism called the *compliance approach* has been suggested. The main characteristic of this approach is a system of explicit and unambiguous rules, such as codes of conducts, to deal with certain moral issues. There are rules to prevent corruption, which deal with the handling of gifts for example. And there are rules to prevent fraud, irresponsible or abusive management, and mismanagement, as described above.

Theory of Business Ethics II: An Alternative Approach

The suggested measures associated with compliance approaches are important and relevant for certain issues in business ethics. However, I argue that these standard procedures undermine ethical actions in the long run since a strict compliance to defined rules lead to a *lack of reflexivity* within the organization. On the one hand, this seems to be bad for business practices from an economic standpoint since it tends to produce bureaucracy in the worst sense. On the other hand, a compliance approach misinterprets the term “ethics” as “moral”. Ethics includes the requirement of (*ethical*) *reflection* about moral problems and not just compliance with moral rules.

Unlike compliance concepts, *integrity approaches* (Beschorner 2005; Paine 1994; Steinmann and Olbricht 1998; Thielemann 2005) emphasize institutional arrangements focused on a more dynamic and reflexive character of organizations. Thus, integrity management should not be misunderstood as a pure form of individual ethics but as a more fruitful *linkage between individual actions and institutional arrangements* that fosters ethical behavior. Such a change in perspective leads to a different understanding of business ethics since intra- and inter-organisational (institutional) arrangements differ from compliance approaches. They emphasize

the need for an open organization (open dialogue with external as well as internal stakeholders) rather than the closedness of the organizational processes (through certain compliance rules) (Badura 2002; Ulrich 1997).

Moreover, I argue that there is a need for a *more dynamic* theory of the firm in general and business ethics in particular, than is suggested by New Institutional Economics. Here, we consider Evolutionary Economics as an interesting candidate for providing us with new insights into firms. While New Institutional Economics emphasizes the role of businesses as reactive adaptors *within* the market system, an evolutionary perspective stresses the proactive function of businesses as a guiding metaphor. Hence, Evolutionary Economics is also interested in the *transformation* of market economies through businesses. As a matter of fact it is crucial that *a theory of firms deals with the most important 'cultural engine' in modernity*. Businesses have to be seen as more than just responders to somewhat external signals (Beschorner 2007; Pfriem 2009). Businesses influence de facto the institutional contexts through their (economic) actions and, thus, should be seen as important actors that either limit new forms of societal and economic organization or contribute to it in a positive manner. Current circumstances, especially ecological problems and situations in developing countries, necessitate a systematic shift toward a different society. To work out the relevance of businesses for sustainable change – the limitations but also the opportunities – is the real challenge for businesses ethics. Evolutionary Economics helps us achieve such an understanding.

An evolutionary theory of the firm leads us – at least from the point of view of mainstream economists – to a radical change in perspective, where the principle of utility maximization is questioned and replaced by *routines* as the basic analytical unit. I will demonstrate that this perspective enables us to put the spotlight on crucial but neglected issues in economic theory: the origin of capabilities within corporations and innovations. Thus, businesses will be unchained from an underlying incentive-response model in traditional economics, and economic theories will be opened to recent discussions in economic sociology. The theoretical perspective from Evolutionary Economics can contribute to a better understanding of the above-mentioned integrity approach to business ethics.

The basic idea in Evolutionary Economics was developed by Nelson and Winter (1982). They argue that traditional economic theories have little understanding of innovations and economic change. While the existence of innovations in traditional economics comes out of a “book of blueprints”, economic change is mainly explained through somewhat external shocks. The term “evolutionary” in Evolutionary Economics seems directly linked to Darwin’s ideas in evolutionary biology and lets us assume a naive transfer of biological metaphors and mechanisms to economic theory. This, however, is not the case for most scholars in Evolutionary Economics. “Evolution” is seen as a term that focuses on aspects of development and change. Blind selection in Darwin’s evolutionary biology is merely a subtype of a general process of change and development (Hodgson 1993). Indeed, a Darwinian approach is rejected by most evolutionary economists. In contrast, they argue that their “theory is unabashedly Lamarckian”(Nelson and Winter 1982, 11) and so Evolutionary Economics is based on an interpretative theory of action; hence, on a more adequate conception for social sciences.

The basic category of this theory of action is *routines or habits*. As in transaction cost economics, it is argued that actors act through bounded rationality. However, unlike transaction cost economics, bounded rationality is not explained as a lack of information (due to opportunism). Bounded rationality from an evolutionary perspective is the result of the actor's cognitive limitation. Hence, Evolutionary Economics emphasizes *thick* versus *thin* bounded rationality (Foss 2001; Lindenberg 1998). The terms *routines* or *habits* characterize cognitive schemata or cognitive frames that are the basis for decision-making processes and thus – in comparison to traditional economic approaches – “the explanatory arrow [runs] in the opposite direction: instead of habits being explained in terms of rational choice, rationale choice ... [is] explained in terms of habits” (Hodgson 1998, 178). In this regard, five aspects of an evolutionary theory of the firm are relevant here.

First, a business is seen as a bundle of routines. Business performance strongly depends on the ability of businesses to organize these routines in a fruitful way. Hence, unlike markets, firms have the ability to accumulate knowledge and to innovate. While markets are built on exchange, businesses are built on (the organization of) knowledge.

Second, Coase's (1937) question about the existence of the firm can therefore be answered by Evolutionary Economics in a manner different from, albeit complementary to, that of New Institutional Economics. Firms exist owing to the fact that markets cannot produce innovations. Firms are neither regarded as a somewhat strange anomaly within a fantastic coordination mechanism called the market (Neoclassical), nor are they merely seen as a facilitator to reduce the cost of social contracts (New Institutional Economics). As an alternative, the organization of firms is described as an *original* modus of coordinating social actions with an original outcome: capabilities, knowledge and innovations.

Third, since knowledge within firms is not completely available in explicit form but mainly part of implicit routine-orientated actions, it cannot be bought on markets or copied from competitors.

Fourth, institutional arrangements within organizations do not merely have to take into account the effective coordination, motivation, and cooperation of social actions (New Institutional Economics, see above) but have to simultaneously foster circumstances under which certain capabilities can emerge. This perspective permits us to develop a richer understanding of the relevance of certain organizational capabilities. While transaction cost economics merely emphasizes the effects of one certain resource for transactions, an evolutionary perspective also raises the question of the *origin* of this important organizational resource. Moreover, the resource- or competence-based approach in Evolutionary Economics regards cooperation abilities as just one important organizational resource. *Creative, learning, and innovative capabilities* are at least as important as cooperation.

The following figure summarizes the above arguments from Evolutionary Economics, compares them with Transaction Cost Economics, and outlines the relationship with ethical issues (integrity versus compliance approach) (Table 1):

Table 1 Transaction cost economics, evolutionary economics, and ethics

	Transaction cost economics	Evolutionary economics	
Theory of action (bounded rationality)	Weak bounded rationality (lack of information)	Strong bounded rationality (lack of cognitive abilities)	t1.1
Existence of firms	Reduce transaction costs	Enables innovation	t1.2
Organizations as	Nexus of contracts	Bundle of routines → knowledge, capabilities (explicit and implicit)	t1.3
Institutional arrangements	Stabilizing social relations	Enabling change	t1.4
Relevance of soft facts	Cooperation in and between organizations	Development of organizational capabilities, especially creative, learning, and innovative capabilities	t1.5
Relation to ethical issues	Avoidance of opportunism, fraud, etc. (defensive)	Enabling sustainable change through business practices (proactive)	t1.6
Institutional arrangements related to ethical issues	Compliance approach	Integrity approach	t1.7

Table 2 Ethical measures in corporations (examples)

Compliance approach to avoid ... through ...	Risk management systems	t2.1
	Codes of conducts	t2.2
	Corrective organizational measures	t2.3
	Avoidance of opportunism, fraud, etc.	t2.4
	Specific anti-fraud training for management	t2.5
Integrity approach to enable sustainable change through ...	Social standards to Bind on certain values (e.g. SA 8000)	t2.6
	Fair dialogs with stakeholders	t2.7
	Ethical corporate philosophy (mission and vision for a just society)	t2.8
	Organizational measures to build ethical capabilities	t2.9
	Ethical learning processes	t2.10
	Development of personal integrity	t2.11
	Social standards to foster reflexivity and dialogs (e.g. AA 1000)	t2.12

Business Ethics: Toward a Socio-Economic Perspective

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What are the consequences of the general firm-theoretical perspective we have outlined with respect to New Institutional Economics and Evolutionary Economics for business practices? And how are the compliance and integrity approaches related to each other? Table 2 outlines examples of ethical measures applied by corporations from compliance and integrity perspectives:

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I consider risk management and compliance approaches mainly as direct strategies for preventing fraud (as noted above), economic crime, and irresponsible or

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abusive management and mismanagement. As such they are helpful in avoiding “bad practices” in businesses. However, as stated earlier a strict compliance approach has some serious shortcomings:

1. Compliance approaches tend to moral positivism since the orientation on certain rules is underlined. This leads to a decrease in reflexivity about actions.
2. Compliance approaches are defensive in the sense that the main focus is on the avoidance of “bad practices” rather than the development of “good practices”.

In contrast, *integrity approaches* emphasize ethical learning processes that should lead to sustainable change in and through businesses. For example, (fair) dialogues with external and internal stakeholders as facilitators to increase (ethical) reflexivity are stressed. Businesses are seen as proactive actors, as cultural engines that do more than merely react to external stimuli. Consequently, visions of “a just society” and so forth are included in this perspective. In summary, the radical idea of integrity approaches is the permanent reflection of businesses practices in the light of ethical principles. As such, integrity within organizations is seen as a core competency for businesses for economic reasons: If businesses extend their perception, they can react and adapt more flexibly to economic and societal change.

I regard compliance and integrity approaches as complementary. Neither one alone would contribute sufficient results. This is true for economic as well as ethical “success”. From an economic perspective, a compliance approach tends to build bureaucracy in the worst sense (Weber’s “iron cage”). The alternative, however, of a high degree of reflexivity and permanent learning processes would also fail in a pure form. Social relations and organizations need a certain degree of stability through institutions. As the “management guru” Henry Mintzberg once correctly pointed out, we cannot permanently learn: sometimes we have to work, too.

With respect to the ethical dimension, the arguments are similar: While compliance approaches tend to moral positivism, integrity approaches overemphasize ethical reflections. Eventually, the later would even undermine ethical behavior. Whistle-blowing, as an example of a certain type of open communication with external stakeholders, can obviously destabilize trust and credibility within organizations. In summary, we understand compliance and integrity approaches as two ideal types and quite contrary ideals that mark extreme positions in the field of business ethics.

However, given the dominance of compliance approaches in academic business ethics as well as in business practices, I want to make it clear that these models cannot serve as a general theory of business ethics since important issues are neglected. Further research and concrete practical measures within firms should investigate and work out a proactive role for businesses as drivers for sustainable change rather than assuming them to be located in a given frame.

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