The Irreplaceable Role of Ethics in Productive Exchange

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Why do people think that ethical business is a good idea? In this Note, in an argument that goes beyond those made to date,[1] I make the case that ethics in business is not only a good idea; but that ethics play an irreplaceable role in productive exchange. Without ethics business will always underperform.

Presently we can hear quite a chorus of *normative* voices who call on business to be "socially responsible" because they "should" be.[2] We also can hear a chorus of *instrumental* voices who suggest that "doing good" leads to "doing well."[3] I do not dispute either of these contentions. Rather, in this Note I wish add a missing *descriptive* voice, to suggest that business ethics provide a unique and foundational means for reducing inherent business uncertainties, and that in doing so they are irreplaceable in fostering productive exchange.

So let us lay an explicit foundation for linking ethics to productive exchange. This is a foundational argument because it flows from the irreducible structure of exchange: a seller, creates a work (product or service), for a buyer, as represented in Figure 1.[4]

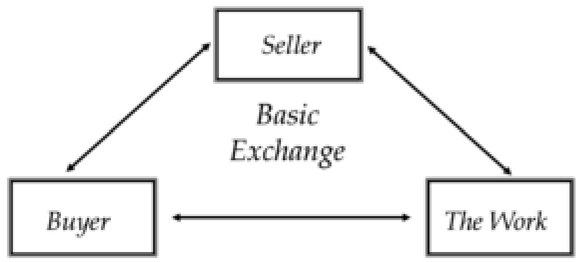

Figure 1 – The Fundamental Structure of Exchange`

It then follows that a business firm results when exchanges are grouped together. Bakers organize bakeries because they need to bake and sell *many* loaves of bread, not just one. Many customers buy bread at bakeries because they only need one or two loaves. We then have a simple and fundamental way to think about a business: as a means for grouping exchanges: the making and selling of many like-kind products/services as illustrated in Figure 2.

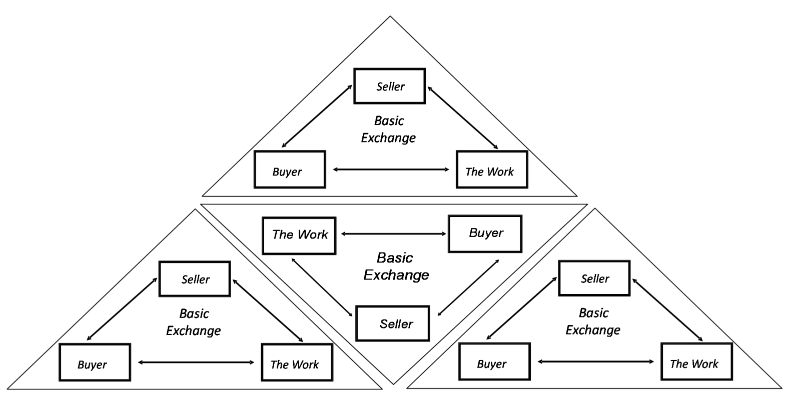

Figure 2 – The Business Firm as a Bundle of Exchanges

Helpfully, when we understand the business firm to be a group of exchanges bundled together, we can see that the principles required for creating each productive exchange will be equally essential to creating productive firms, because both firms and their component exchanges are founded upon a fundamental and irreducible structure. The key point made when we say “irreducible” when referring to the structure of exchange, is that the three elements depicted in Figure 1 are necessary for an economic exchange to happen: that is, exchanges occur *only if*these three elements are present.

Hence, as illustrated in Figure 3, no exchange can happen without a buyer, without the work, or without a seller. The entire structure always is required. Thus, all three elements matter.

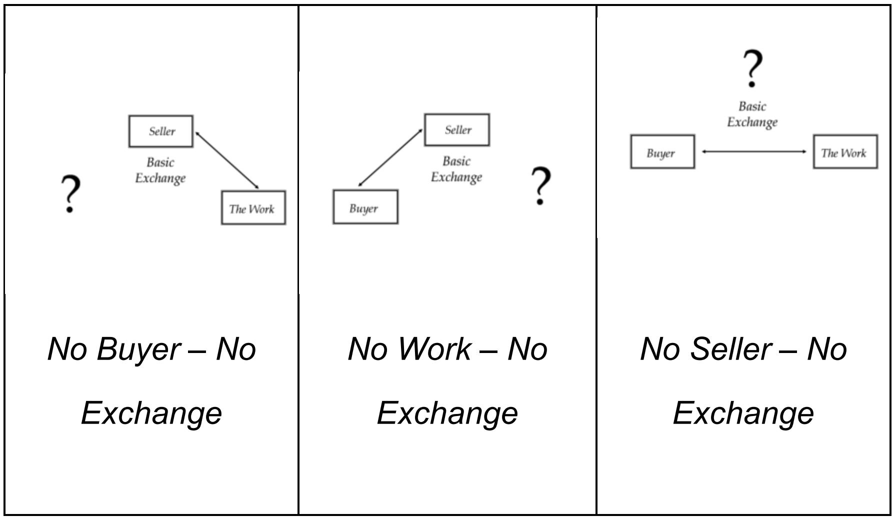

Figure 3: Proof – the Irreducible Structure of Exchange

The precondition of a standard irreducible structure for an exchange to occur is important, because—in an enduring irony—each element within an exchange also brings with it an exchange-defeating type of uncertainty. When these uncertainties are present, they produce **exchange entropy**: *exchange-defeating frictions that create obstacles that result in disorder* (the exchanges that might have occurred were prevented due to these uncertainties).[5] The three types of uncertainty, and their *primary* source are as follows (Table 1):

Type of Uncertainty		**Source**
Informational uncertainty	·	Seller
Relational uncertainty	·	Buyer
Resource uncertainty	·	the Work

Table 1: Types and Sources of Uncertainty[6]

In ethical terms, each type of uncertainty increases where business ethics are low/weak; and each type of uncertainty decreases where business ethics are high/strong. This result occurs because business ethics help buyers and sellers to know what to expect from each other. When, for example, a buyer and a seller know each other well and have a long history of dealing fairly and beneficially in their relationships (business ethics are high/strong), there are fewer exchange-defeating frictions from, for example, mistakes, distrust, and non-payment. Exchange entropy is minimized thereby. Exchanges are then made easier, and more of them are likely to occur. Thus, to strengthen productive exchange within society, it follows that business ethics are essential.

But how, exactly, do business ethics reduce informational, relational, and resource uncertainty, and thereby reduce exchange entropy and increase productive exchange? To answer this question we need both: (1) a working definition of business ethics; and (2) support for the assertion that business ethics increase the likelihood of productive exchange by reducing the effects of the three types of uncertainty inherent in all potential exchanges.

Business Ethics: A Working Definition

According to noted ethicist, Manuel Velasquez (and colleagues), ethics can be defined as: "well-founded standards of right and wrong that prescribe what humans ought to do, usually in terms of rights, obligations, benefits to society, fairness, or specific virtues."[7] And when we apply this definition to the processes of exchange that we have been discussing, we then have a working definition of business ethics that is suitable to our purpose: *well-founded standards of right and wrong that prescribe what parties to economic exchange (sellers and buyers) ought to do, usually in terms of rights, obligations, benefits to society, fairness, or specific virtues.* For our purposes in this Note, we therefore need to examine the uncertainties that adhere to sellers (informational), buyers (relational), and works/products-services (resource) to see how following well-founded standards of right and wrong can reduce exchange entropy from these uncertainties, and increase productive exchange.

The late Harvard Professor of Philosophy, Robert Nozick, defined productive exchange as activities that: "make purchasers better off than if the seller had nothing at all to do with them."[8] While "better off" is subjective to the buyer, the result is unambiguous in that it comports with the fundamental structure—a seller provides a work (product/service) to a buyer—while also being beneficial. It is in meeting the beneficial standard that business ethics is essential to productive exchange. Where uncertainty about either information, the relationship, or the resources intrudes upon the exchange, it is reasonable to expect that the potential buyer will expect a reduced benefit. It has been demonstrated empirically that this erosion of expected benefit by uncertainty is the reason that many exchanges that might have happened, do not.[6] Thus, without business ethics (well-founded standards of exchange behavior), informational, relational, and resource uncertainty hamper exchange productivity.

Business Ethics Create Productive Exchange by Reducing Uncertainty

Ethics and Informational Uncertainty**.** Information, in its formal technical sense, is the resolution of uncertainty; and in its larger roles, also is used semantically (as data), and in the pragmatic sense (as knowledge).[9] Gain in entropy (the waste of otherwise useful energy) means loss in information.[9] Thus, where ethics can produce gains in information by resolving various uncertainties in exchange (e.g. through increasing accountability and decreasing corruption and free riding) it can be argued that informational uncertainty is reduced, and with it exchange entropy.[10], [11], [12]

Ethics and Relational Uncertainty**.** Relational uncertainty refers to the possibility of moral hazard and distrust in an exchange. The resolution of relational uncertainty is accomplished through trust, which often builds in a relationship over time through regular observation: i.e., that parties to economic exchange are seen to do what they ought to do in respecting rights, faithfully fulfilling obligations, acting in fairness, and benefitting society. Relational uncertainty is reduced through a very wide variety of ethical actions: from (for example) exercising responsible leadership, stakeholder engagement, and building social capital[13], to increased trust-building through accountability[12].

Ethics and Resource Uncertainty. The idea of "doing well by doing good" is as old, at least, as its sometime attribution to Benjamin Franklin. Resource uncertainty arises due to constraints in the availability and value of resources, which means that likely there will be fewer opportunities created (in the form of exchanges) where resources are uncertain.[6] There are several arguments that connect ethical behavior to resolving resource uncertainty, among them being those that suggest, for example, that corporate philanthropy is in fact the purchase of insurance for reputational resources[14], and that resources are more accessible when organizations are seen through the lens of business citizenship.[3]

Concluding Thoughts

Exchange is inherently social. Exchange requires human interaction (buyer and seller) about a work (some product or service). Business ethics provide a unique means whereby the (informational, relational, and resource) uncertainties that adhere to exchange are reduced, and productive exchange results. Business ethics therefore play an irreplaceable role in productive exchange, because—using the idea of an irreducible structure of exchange that takes us beyond normative and instrumental justifications—we now can describe more clearly how ethics play an essential part in business; and how, without ethics, business will always underperform.

ENDNOTES

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