Module 2 Session 3

Theories of Business Ethics

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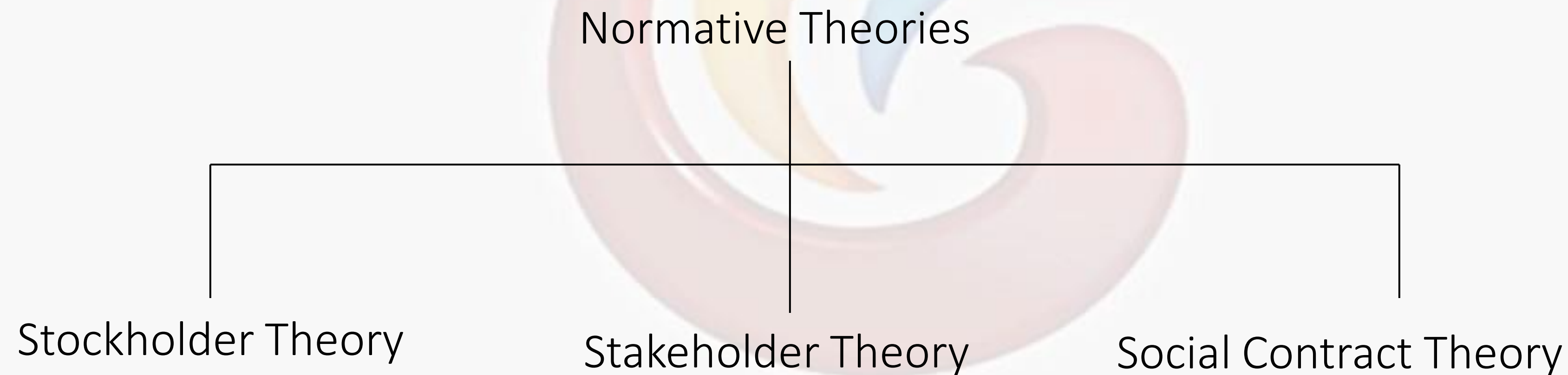
Topics to be covered

- ✓Normative theories of ethics
- Stakeholder theory
- Stakeholder theory- Its criticisms
- Stockholder theory
- Stockholder theory - Its criticisms
- Social contract theory
- Social contract theory Its criticisms

Normative Theories of Business Ethics: Classification



Normative Theories of Business Ethics

Stockholder Theory/ Agency Theory

- It expresses business relationship between stock owners and their managers running the day-to-day business of the company. As per the theory, managers should pursue profit only by all legal, non-deceptive means.
- Also known as shareholder theory, according to which businesses are merely arrangements in which one group of people i.e. the shareholders advance capital to another group i.e. the managers to realize certain ends which are beneficial to them.
- The managers are empowered to manage the capital advanced by the shareholders and are duty bound by their agency relationship to carry on the business exclusively for the purpose outlined by their principals.
- The theory has been summarized by Milton Friedman who asserted that there is one and only one social responsibility of business- to use its resources and engage in the activities designed to increase its profit so long it stays within the rules of the rules of the game, i.e. to stay engaged in open and free competition without deception or fraud.

Criticism of Stockholder theory

- It has been described as part of corporate law which has lost its importance in modern times. It is regarded as impractical and foolish by many ethicists which cannot be relied upon to secure the common good.
- In today's world government plays an important role in collecting taxes from the corporates which is used henceforth for the public good. Therefore there is no true free market in the economy prevailing these days.
- It is based on false analogy. If government of democratic societies have a moral justification to spend the taxpayers money for promoting the common welfare of people without taking their consent, it might mean, that businesses are also justified in carrying out social welfare activities without the consent of the shareholders. This is based on a wrong and far-fetched assumption.

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Stakeholder Theory

- This theory argues that a corporate's success in the marketplace can best be assured by catering to the interests of all its stakeholders (shareholders, customers, employees, suppliers, management and the local community). This objective is achieved when corporations adopt policies that ensure an optimal balance among all stakeholders.
- It stresses that regardless of the fact whether the management achieves improved financial performance or not, managers should promote the interests of all stakeholders.
- It considers a firm to be an instrument for coordinating stakeholders interests and considers managers as having a fiduciary responsibility not only to the shareholders but all of them.

Stakeholder Theory

- Principles that guide corporations are:
  - **First principle is Principle of corporate legacy-** according to this the corporation should be managed for the benefit of its stakeholders: its customers, suppliers, owners, employees and the local community. The rights of these groups must be ensured and further the groups must participate in decisions that substantially affect their welfare.
  - **Second Principle is the stakeholder fiduciary** principle that asserts that management bears a fiduciary relationship to the stockholders and to the corporation as an abstract entity. It must act in the interests of the corporation to ensure the survival of the firm, safeguarding the long-term stakes of each group.

Stakeholder Theory - Criticisms

- It is not applicable in practice by corporations.
- There is comparatively less empirical evidence to suggest a linkage between stakeholders concept and corporate performance.
- The major problem with this theory stems from the difficulty of defining the concept, like who really constitutes the genuine stakeholders. There is an expansive list of stakeholders.
- It is also argued further that intent of the theory is better achieved by relying on the hand of management to deliver social benefit where it is required rather than suggesting a wide range of stakeholders.
- Stakeholder model also stands accused of opening up a path to corruption and chaos; since it offers opportunity to divert wealth away from shareholders.
- It can also be criticized on the ground that it extends the rights of the stakeholders far too much.

Social Contract Theory

- This is based on the principles of "social contract", wherein it is assumed that there is an implicit agreement between the society and any created entity such as a business unit, in which the business recognizes the existence of a condition that it will serve the interest of the society in certain specified ways.
- This theory is drawn from the model of political-social theories propounded by Thomas Hobbes, John Locke, and Jean Jacques Rousseau.
- The theory is based on an assumed contract between businesses and members of the society who grant them the right to exist in return for certain specified benefits that would accrue to them. These benefits are a result of the functioning of these businesses, both for their own sake and for that of the larger society.
- When members of the society give the firms legal recognition, the right to exist, engage them in any economic activity and earn profit by using the society's resources such as land, raw materials, and skilled labour, it obviously implies that the firms owe an obligation to the society. This would imply that business organizations are expected to create wealth by producing goods and services, generate incomes by providing employment opportunities, and enhance social welfare.

Social Contract Theory

- As consumers members of the society benefit from the establishment of the business firms in three ways:
  - Business firms provide increased economic efficiency, by enhancing the advantages of specialization, improving decision making resources and increasing the capacity to acquire and utilize expensive technology and resources;
  - They offer stable levels of production and channels of distribution;
  - They provide increased liability resources, which could be used to compensate consumers adversely affected by their products and services.

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Social Contract Theory

- Business Firms are likely to produce the social welfare element of social contract and enjoin the business firm should act in such a manner so as to
  - Benefit consumers to enable them reach maximisation of their wants;
  - Benefit employees to enable them secure high incomes and other benefits that accrue by means of employment;
  - Ensure that pollution is avoided, natural resources are not fast depleted and workers' interest are protected.

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Social Contract Theory – Criticisms

- Critics argue that social contract is no contract at all. Legally speaking a contract is an agreement between two or more persons which is legally enforceable provided certain conditions are observed.
- A contract implied meeting of minds, which does not exist in so called social contract. It is neither an explicit nor an implicit contract.

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