Issues in

BUSINESS AND SOCIETY

Capitalism and Public Purpose

Starling/Baskin

Issues in Business and Society: Capitalism and Public Purpose

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Preface

This book is an effort to bridge the gap between the academic study of *business and society* and its real-world application to problems of *public affairs* or *external relations*. It was written to serve graduates and undergraduates in a variety of programs as well as managers in business, industry, and government.

Dealing with the issues and problems covered in this book requires conceptual thinking ability rather than knowledge of quantitative methods or specific analytical techniques. Collectively, the cases bear evidence to the fact that the concept of "business and society" does not apply to any single topic such as public policy or social responsibility but rather to a system of organized complexity involving many environments (technological, economic, social, political-legal, and international). While the problems discussed are those faced by all types of organizations (large and small, public and private) they are not those normally treated in books of management, organization theory, or decision analysis. The issues dealt with here are of a broader and more subtle nature.

In this book, we grapple with the questions of how problems emerge within a society and later appear on the public policy agenda; how managers and their organizations effectively communicate with their external environment; and how they responsibly cope with government and participate in the political process. Underlying these questions is a philosophical one: What is the "right" action for society, for an organization, and for an individual?

At the heart of this effort are two convictions. The first is that managers, and the young men and women who would be managers, should be not only problem solvers but also problem finders. While the cases which follow do provide focus questions, they are also designed to allow for many possible problem definitions. The second conviction is that a manager should have the opportunity to think through the relationship between capitalism and public purpose and to ask how an economic system predicated on the self-interest of individuals can serve the common good.

The cases deal with real problems of real people and organizations. They present a spectrum of approaches to the subject: philosophical, psychological, economic, scientific, historical, etc. The materials have been thoroughly tested in the classroom and organized here to facilitate their adaption to a variety of courses.

We have received help from so many sources, and over so long a time, that adequate acknowledgments and thanks are impossible. We are deeply indebted to the officers and staff of the Alfred R. Newmann Library for their courtesy and helpfulness. We also thank our colleagues and students for their suggestions and advice. Dean Rosemary Pledger of the School of Business and Public Administration has encouraged our research in many ways. Finally, we thank the gracious and always helpful editorial staff of Kent Publishing Company, and acknowledge gratefully the assistance of Betty Brott in typing much of the text.

To the students at the University of Houston-Clear Lake, who have contributed to our education through the last decade, we would like to dedicate this book.

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Chapter 1

Business in the Modern World

A Framework for Analysis

We shall need keen insight to see our way. Now, as we are not remarkably clever, I will make a suggestion as to how we should proceed. Imagine a rather shortsighted person told to read an inscription in small letters from some way off. He would think it a godsend if someone pointed out that the same inscription was written up elsewhere on a bigger scale, so that he could first read the larger characters and then make out whether the smaller ones were the same.

— *Plato*
The Republic *II.368*

Primarily, this is a book about managers and their external environment. It rests on the premise that one cannot discuss intelligently business issues and, at the same time, ignore the societal context. Yet, until a few years ago, many business schools proceeded on the assumption that one could divorce business from society. To be sure, schools examined customers and employees, suppliers and lenders — but these groups hardly constitute the modern world in its totality.

Over the last decade, much progress has been made toward increasing students' understanding of the larger social context in which business enterprises must operate. Without such understanding, one runs the risk of missing opportunities, being constantly surprised by new problems, and always having to react to events. The cases in this book provide abundant testimony regarding the consequences of ignoring the social context of business operations.

Each case is well known, describing an actual situation. Because of their familiarity, it is hoped that these cases will generate a high level of reader interest. But inevitably some will question the relevancy of cases focusing almost exclusively on chief executives of large corporations. The answer to this criticism is simple: Lessons about business in general are most easily learned when they are written on a bigger scale. If Takeo Fujisawa, founder of Honda Motors (see Chapter 6) could read Sir Winston Churchill's *The Second World War* in Japanese translation, become impressed by the British leader's foresight and tough spirit, and then follow those principles in his corporate management, surely we should have no great difficulty in applying insights from these cases to small business.

But what should we call the knowledge and skills required of managers to effectively interact with society? The preferred term is *external relations*, though *public affairs* would be equally descriptive. We believe further that external relations is as legitimate a management function as are planning, organizing, leading, and controlling.

What exactly are the skills and knowledge required for competency in external relations? This happens to be a question of some moment. Once posed, this question usually brings forth long, confusing lists of topics ranging from antitrust laws to zirconium shortages. The problem with this topical eclecticism is twofold. First, it fails to provide a conceptual framework for understanding the subject as a coherent whole and for integrating new issues as they emerge. Second, despite their length, such lists are often incomplete. Too often neglected are (1) the role of external communications (or public relations) in governmental relations; (2) the importance of *problem finding* in the problem solving process; and (3) the importance of negotiating skills in virtually all aspects of external relations. The cases in this book attempt to fill these gaps.

A FEW TERMINOLOGICAL DISTINCTIONS

This book uses several terms that merit explanation. At a bare minimum, to understand the interrelationship of business and society one must understand public policy, communications, and ethics. These three concepts run through every case with varying degrees of emphasis.

Public policies are broad statements of purpose that have the force of law. Generally speaking, public policies are major pieces of legislation passed by Congress (e.g., The Clean Air Act of 1970). But, in speaking about public policy, one must not forget that the rules and regulations, which bureaucrats in agencies write to implement this legislation, are also public policy. However, understanding public policy involves much more than knowing a particular legislative act (or agency regulation) chapter and verse — one must know the process by which a given issue arose in the first place.

In a corporate setting, those who scout the issues of the next two, three, or four years are known as *issues managers*. Their job is to scan publications, polls, and technical reports for hints of future issues that could prove significant to their companies. For example, Sears, Roebuck and Company, a leader in *issues management*, recognized growing concern about flammable children's pajamas and had flameproof garments on the shelves before they were mandated. Later, it pulled that nightwear when fears arose that flame-retardant Tris could cause cancer. In another area, Sears is looking ahead to possible future water shortages in the West by stressing the "water efficiency" of its appliances.

Knowing something about the process by which an issue is transformed into a legislative bill and, finally, a law is also helpful in understanding the concept of public policy. Equally important to business is the regulatory process through which governmental agencies implement laws. Corporate activities that attempt to shape legislation and influence administrative rules and regulations are termed *governmental relations*. Practicing effective governmental relations requires a knowledge of how power is distributed throughout the political system — and considerable skill in communicating.

In the last few years, there has been much talk about *political action committees* (PACs). The Federal Election Campaign Act of 1971 and its amendments provide the basis for the establishment and regulation of all current business PACs. Corporate involvement in PACs has generally consisted of making financial contributions to political campaigns. By doing this corporations hope to ensure their access to whoever is elected. Such support may also be directed toward particular candidates who take public policy positions advocated by a corporation.

Communications — both internal and external — includes negotiating skills, public relations, and listening. Essentially, *public relations* consists of evaluating public attitudes, promoting the goals of an organization as being those of the public, and implementing programs to earn public acceptance. To simply "do right" is not enough — for without effective communications responsible company actions can go unnoticed or, worse, become misunderstood.

In his 1938 classic on business management, *The Functions of the Executive,* Chester Barnard argued that communications lies at the heart of management success. Today the importance of communications cannot be overstated. It is required to motivate employees. It is required to conduct large-scale projects like the space shuttle, which bring government and literally thousands of businesses together. And it is required to negotiate with various groups in society — that is, if the company wishes to resolve problems outside of the courts.

Ethics, or the study of values, is the most troublesome area in the study of external relations. Which values are the correct ones in the day-to-day conduct of business? Why should business courses invade the province of religion, which also struggles with questions of right and wrong?

We shall deal with the last question first. The amount and quality of wisdom in the Bible does not always apply to or solve perplexing problems of worldly conduct simply because the immediate issues of daily life are not the authors' chief concern. Romans 12:2 states:

> Adapt yourselves no longer to the pattern of this present world, but let your minds be remade and your whole nature thus transformed.

Specific rules of conduct for the modern world of commerce are not explicitly stated in religious texts. There is a gap between ancient wisdom and the perplexing reality with which managers must deal.

Under ordinary circumstances, managers cannot be expected to transcend their particular, localized, and self-regarding opinions about right and wrong. They are most likely to suppose that whatever seems good to them as businessmen must obviously be good for society. This thought is not without scholarly basis. It has as its antecedent Adam Smith's doctrine of the "invisible hand," which explains how the voluntary actions of millions of individuals can be coordinated through a price system without central direction. In *Wealth of Nations* (1776), he showed how in a capitalist economy the impulse of self-interest would bring about the public welfare:

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to

> render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.

This is a highly sophisticated and subtle insight, but it should not be interpreted as a justification for egotism or selfishness. Rather, it shows the mutuality of the relationship between the individual and the social community of which he or she is a member. On the one hand, individuals have a claim to freedom in order that they may realize their own inner powers and capabilities. On the other hand, society recognizes that these claims are warranted, that the individual's freedom really does contribute to the general good. From this point of view, a moral community is therefore one in which individuals responsibly limit their claims to freedom in the light of general social interests and in which the society itself supports their claims because the general well-being can be realized only through individual initiative and freedom. Thus the general social good is the basis for the individual's rights and duties. But this social good is neither distinct from nor opposed to the happiness of the individual — how could it be when part of the individual's happiness derives from sharing in this social good?

Consider a hypothetical case in which this mutuality of relationships between the individual and social community is absent. A city without zoning could sprawl uncontrollably; if only lightly taxed, it could easily become a citadel for egotism and selfishness. Corporate employees would live in private enclaves of walled-off condominiums and have their own private police, fire departments, and garbage collectors. Question: How "happy" are these managers in this hyper-individualistic environment?

It is unlikely that Smith would approve of our imaginary city. In developing his concept of self-regulating market mechanisms in *Wealth of Nations*, Smith carefully indicated a valid function of government* (besides defense and law enforcement):

> Erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

The concept of general social good, which we have been discussing, deserves a definition: the shared interest of members of a community. More for-

* In addition, he spelled out certain conditions under which the market fails to operate properly. Since a knowledge of these conditions can be helpful in analyzing the cases that follow, they call for relatively extended consideration (see Appendix to this chapter). One of the weaknesses of Smith's treatise is that it fails to address the **external effects of** *government* action undertaken to correct the market. While market "defects," such as absence of competition, are regarded as immediate justification for government intervention, political mechanisms, such as regulation, are not treated — though they may certainly have "defects" that adversely affect the market.

mally, the general social good, or public purpose (as we shall call it here) may be thought of as what men and women would choose if they saw clearly, thought rationally (i.e., balanced what one desired with what could be done), and acted disinterestedly and benevolently. Is this an impossible standard to which to aspire? In his *Theory of Moral Sentiments* (1759), Smith put forth the view that man was a creature driven by passion but also self-regulated by his ability to reason and — no less important — his capacity for sympathy. This duality serves to make the market system go and provides men with the rational and moral faculties to create and adopt policies by which the day-to-day struggle can be made civil and even turned to the common good.

In the cases that follow, the reader is encouraged to ask the usual questions: What is the problem here? What are the options? In light of the preceding discussion, one might also address the question of how decisions can be brought more in line with public purpose.

Appendix Economic Regulation: History, Rationale, and Problems

For many decades, the Federal Government has regulated the prices and the conditions for entry in certain sectors of the U.S. economy. This type of regulation, often called "economic regulation," was broadly applied to the transportation, communications, and financial sectors of the economy. Whatever historical purposes were served by economic regulation, there is an increasing consensus that much of this Federal regulation no longer serves the interests of the contemporary economy. Indeed, over the last several years a substantial part of this economic regulation has been relaxed or eliminated.

A second form of regulation, "social regulation," is addressed to situations where unregulated activity may pose significant threats to public health, safety, or the environment. Although there is an increasing consensus that economic regulation should be substantially reduced, no such consensus exists concerning social regulation. Also, unlike economic regulation, the magnitude of social regulation has grown rapidly since the mid-1960s with the passage of extensive environmental and safety legislation.

Economic regulation has diminished in recent years due to a variety of deregulation measures. Substantial evidence is now available concerning the performance of industries that have experienced full or partial deregulation.

Source: *Annual Report of the Council of Economic Advisers, 1983* (Washington, D.C.: G.P.O., 1983), pp. 96–102.

This appendix summarizes the history of Federal economic regulation, its rationale, its impacts, and the effects of recent laws designed to ease economic regulation. The appendix also identifies some opportunities for further deregulation. Special attention is given to the economic regulation of energy, transportation, communications, and financial markets.

A BRIEF HISTORY

The first broad body of Federal economic regulation was established in 1887, when the Congress created the Interstate Commerce Commission (ICC) to resolve the increasing controversies between the railroads and shippers. Most of the regulation of other sectors, except for energy, was established by the end of the 1930s and reflected efforts to deal with problems similar to those that led to the creation of the ICC. The agencies created in the 1930s tended to operate in much the same way as the ICC, and the outcome was much the same.

Economic regulation often evolved from a dispute among several groups. For example, the Federal Communications Commission (FCC) was created to resolve disputes among users of the broadcast spectrum. The Civil Aeronautics Board (CAB) was created to resolve a dispute among several Federal agencies concerning the administration of airmail contracts.

Congress delegated direct resolution of these disputes to an independent agency with very general authority. The typical "public convenience and necessity" standard cited in the enabling legislation provides no direct guidance about how the regulatory agencies should resolve disputes. The independent commissions are essentially quasi-judicial institutions that have developed their own bodies of administrative law.

The initial regulations of the independent agencies often served the interests of the regulated industry. For example, some scholars contend that the ICC, by initially reinforcing the railroad cartels, caused higher average prices and reduced the variance of prices. For a long time, both the CAB and the FCC restricted entry to the number of firms operating at the time these commissions were created.

The initial regulation led to more regulation that served to protect the interests of the initially regulated firms. For example, ICC regulation was extended to trucks, buses, freight-forwarders, and barges, thus restraining the developing competition to the railroads. FCC regulation was extended to cable television, protecting broadcasters using the frequency spectrum.

Over the long run, many economic regulations have not served the interests of either producers or consumers. The development of excess capacity, relatively high wages, restraints on technological improvements and operating practices, and competition outside the regulated environment led to the lower-than-average rates of return in many of the regulated industries. Consumers have often been adversely affected by higher prices and restrictions on service.

One other pattern of economic regulation was introduced in the 1930s. A belief that the depression was caused by excessive competition provided a rationale for many laws and regulations that directly restricted entry, output, and competition. The broadest such law, the National Industrial Recovery Act, was declared unconstitutional; other similar legislation, such as the Agricultural Adjustment Act of 1938, is still in force. One might argue that the several regulatory commissions and laws approved in the 1930s achieved their intended effect of raising prices. A later generation questioned whether this effect was desirable.

The Traditional Rationale

The two traditional justifications for economic regulation have been to preserve the potential economic efficiencies associated with natural monopoly in some industries and to eliminate the inefficiencies thought to be associated with excessive competition in others.

Natural Monopoly A *natural monopoly* exists when the entire relevant demand for a good or service can be satisfied at the least total cost by a single firm. At the local level it is probably wasteful to have duplicate distribution systems to provide telephone, electric, gas, and water services. Among industries regulated at the Federal level, major gas pipelines and high-voltage electric lines are often considered natural monopolies. Long-distance telephone transmission may also be a natural monopoly in areas of low density. Railroads are a potential natural monopoly only for that declining share of rail traffic for which the shipper does not have an effective choice of carrier or mode of transport.

Such industries present a dilemma. Competition may result in unnecessarily high production costs through duplication of facilities, but an unregulated monopoly may not act in the public interest. Without regulation, a monopoly would probably set prices too high and produce too little, with consumers willing to pay more for additional output than the cost of supplying that output. A typical solution to this dilemma is maximum price regulation. The primary objective of price regulation is to set the monopoly's price as close as possible to incremental cost while still assuring the monopoly a market rate of return on its investment.

The growth of demand or the introduction of substitutes for a product can often transform a natural monopoly into what — in the absence of regulation — could become an effectively competitive industry. Oil pipelines, for example, are often assumed to be natural monopolies. However, these pipelines now face competition from other pipelines and other modes of transportation. Regrettably, price regulation often continues long after it is efficient, restricting the emergence of a competitive market. The history of the railroads provides a compelling illustration. In many parts of the country rail lines were few and far between in the 19th century. But as the market for transportation services grew, and as technology developed, automobiles, buses, and airplanes provided increasing competition for passenger traffic, and trucks, barges, and pipelines provided increasing competition for freight. The natural monopoly justification for regulation was probably not applicable in most rail markets by the middle of the 20th century.

Even in markets where elements of natural monopoly still exist, government intervention will not necessarily produce a more efficient use of resources. Increasingly, analysts are coming to recognize that, just as there are market imperfections, there are also government imperfections that must be considered in making public policy choices. The relevant tradeoffs are not between imperfect markets and flawless government regulation, but rather between markets with imperfections and regulation which is imprecise and sometimes counterproductive.

Excessive Competition The second traditional justification for economic regulation is that unfettered markets result in *excessive competition.* This justification was used for regulating railroads in the late 19th century and other industries in the 1930s. A common element in early discussions of excessive competition was that without regulation, unrestrained rivalry among firms would result in losses for some or all of them and that adequate production of an otherwise viable product would prove unsustainable. This argument, which was often rather vague, failed to note that business losses are not a sufficient basis for government intervention. Losses and business failures are a normal part of the operation of competitive markets; they act to eliminate inefficient firms and to shift production to meet changes in consumer demands.

While the concept of excessive competition was not generally well defined, it has now come to refer to at least four possible sources of market imperfection: natural monopoly, cyclical demand with imperfect capital markets, predatory pricing, and suboptimal product quality.

As explained earlier, where natural monopoly conditions exist, competition among several firms can lead to higher costs because of wasteful duplication.

A second interpretation of excessive competition is based on the argument that certain industries, particularly those with cyclical demand and heavy fixed investment, are prone to excessive price fluctuations. According to this argument, firms are forced to close down during recessions and then unnecessarily incur large start-up costs during recovery because of alleged imperfections in capital markets. These wasteful shutdown and start-up costs are avoidable, it is argued, if government regulation sets minimum prices or allows firms to do so.

A third definition of excessive competition focuses on the concept of predatory pricing. Unregulated competition in some markets is alleged to result in monopolization by a firm that engages in predatory pricing — setting prices below cost in order to drive out competitors. To succeed, a predator must outlast its rivals and barriers must exist to prevent the entry of new competitors once the predator raises prices. Regulation to prevent firms from charging excessively low prices is intended to prevent such predatory practices and hence the higher monopolistic prices that would prevail once the predator has eliminated its competitors. No consensus exists among economists that such predatory tactics are effective. Indeed, many economists believe that apparently "predatory" behavior, if ever successful, is a manifestation of cost advantages or an enhanced ability to bear risk.

A fourth interpretation concerns the alleged tendency of certain competitive markets to produce goods or services of inadequate quality, safety, or reliability if consumers are imperfectly informed about those characteristics. For example,