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The Virtue of Business: How Markets Encourage Ethical Behavior

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Popular media is filled with claims about the immorality of the marketplace and businessmen. In this article, we question these claims. Because individuals as consumers want to support ethical behavior, *if* individuals are ethical, markets will tend to enhance, rather than retard, ethical behavior. The enhancement is carried out by ethical entrepreneurs who change and influence the way that business practices are carried out. We illustrate our argument with the examples of Barnum & Bailey Circus, Whole Foods Market, and BB&T Bank.

Introduction

Newspapers, the media, the cinema, and the pulpit are filled with claims about the immorality and corruption inherent in market economies. Since the end of the Cold War, American businessmen have displaced the Russians as the primary bad guys in action films (Formaini 2001). Beliefs hostile to capitalism are troubling because they threaten the moral foundations of market economies and, in so doing, often distort the truth about market outcomes.

Market economies are supported by ethical presuppositions, and these basic presuppositions, such as the "right to self-ownership," play an essential role in the overall workings of the entire system. The simple principles of a market

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economy help to maintain the universal order of the system, and they guide policymakers and judges when disputes must be resolved. Economists and many philosophers understand and recognize the important role ethics and morality play in the market economy. Interest in the interaction between ethics and markets goes back at least to Adam Smith (1759 [repr., 1976], 215) when in *The Theory of Moral Sentiments* he discussed the "impartial spectator" and said, "He cannot therefore but approve, and even applaud, that proper exertion of self-command, which enables them to act as if their present and their future situation affected them nearly in the same manner in which they affect him."

Smith's impartial spectator carries over to the capitalistic market. Good ethical behavior is not only encouraged and rewarded, but according to Smith, it is part of human nature to act justly, and humans are encouraged by sentiment to do so rather than to act on that which solely benefits their own accord.

Even though ethical parameters are placed on people's behavior in capitalist systems, many critics of capitalism describe free societies as societies where "anything goes" (Hill 1988). Rather than encourage ethical behavior, free societies are said to encourage vice and the abandonment of an ethical standard; according to critics, capitalism does not discriminate when it comes to the types of goods and services being produced. If life-saving medicines are profitable, markets will provide them; if land mines and prostitution services are valuable, markets will provide these goods and service too. Because markets do not discern between desirable and undesirable products, they can be thought of as either amoral or immoral.

In this article, we will argue against the amorality and immorality of markets. Rather than encouraging cheating, market economies often encourage ethical behavior. While the market economy will sometimes produce goods and services offensive to some people, there are strong forms of social ostracism and persuasion that help to discourage consumption of undesirable goods. Ultimately, though, for a business to be prosperous in the long run, they must maintain general standards in their business, such as trust, stewardship, investment, and attention to consumer satisfaction (Wilson 1990).

The only way to make a profit in a free market is by providing a product people value enough to pay a price higher than the opportunity cost of the resources used to produce the goods. The threat of competition and availability of substitutes makes it necessary for firms to constantly evaluate whether their product or service is more appealing than the competition's. Sometimes the firm must push down the costs of production while keeping the product quality the same; other times, they must increase quality while keeping costs constant; or, they must pursue a combination of cost reductions and quality improvements. Without instilling a sense of value in their product, a business will not be successful over time.

The way in which a business goes about demonstrating to customers the value of their product or service is important. Businesses can convey information to customers and potential customers in either an ethical or an unethical manner. For example, a company could lie about the quality of its product. While such a strategy might work in the short run, in the long run unethical behavior typically gets punished and does not pay off. One example is Enron. In the short run, Enron executives and shareholders enjoyed enormous increases in their net worth from the increase in Enron's stock price. However, once their accounting irregularities were discovered, Enron's stock quickly crashed, and executives were eventually fined and imprisoned. When defrauded consumers and shareholders begin to discover the unethical actions of a business, they eventually stop buying from them because of their personal moral code, concern about the product's overall reliability, or fear of legal action. In economies with greater competition, consumer wants are more likely to be satisfied by the abundance of alternatives available, and the healthy competition of the marketplace requires businesses to maintain a solid reputation if long-term success is desired.

In this article, we provide further discussion of why markets reward virtuous behavior and punish unethical behavior and the role of "ethical entrepreneurs." We also illustrate our discussion with examples from three successful companies. Each of the companies selected prospered because their managers believed in one important idea: *Ethical behavior is good for long-run profitability*. The three case studies are Barnum & Bailey's Circus, Whole Foods, and BB&T Bank. We use the aforementioned cases to illustrate how the market rewards virtuous behavior even without individual consumers consciously trying to do so.

Ethical Entrepreneurs

What does it take to be a successful entrepreneur in the ethical realm? In the next few sections, we offer cases of entrepreneurs, such as Barnum and Bailey, John Mackey, and John Allison, who have made profits for their companies while also promoting virtue. As entrepreneurs, Barnum and Bailey, Mackey, and Allison recognized the value of running their companies ethically at a time when most people saw the marketplace as an environment in which quick, short-term profits could be made. Both Mackey and Allison saw the importance of linking ethics to entrepreneurship, knowing full well the pitfalls and potential criticism awaiting them for linking ethics and profits together.

Ethical entrepreneurs differentiate their goods and services in the marketplace by first figuring out ways in which current markets are frustrating consumers and then by finding ways to respond to customer dissatisfaction by "selling" honesty, virtue, and quality. Ethical entrepreneurs use business tools to help customers make decisions consistent with the customer's best long-term interest; the ethical entrepreneur thus helps to improve the overall business environment.

The ethical entrepreneurs are meeting the growing demand for honesty in the marketplace. To provide honesty and integrity, they have to invent new products, differentiate their products, and market the ethical aspects of their business. In serving the market for honest information, ethical entrepreneurs are not engaging in altruistic activity, but, rather, are helping to better serve and coordinate the market economy.

The following stories support the growing conviction among many social scientists and philosophers that markets can be a powerful force for good in the realm of morality. Ethical entrepreneurship should not be thought of as a magical cure-all for every business problem but, rather, as an approach; in the absence of the stick of government regulation, ethical entrepreneurship solves some of the trickier problems confronting businesses and consumers in the marketplace. Depending on their mission and the reason for their existence, businesses can be like any other social organization and provide goods that markets do not provide. Through their success, businesses, such as the three we discuss here, improve the lives of not only their customers and employees but also of the greater community.

With rising incomes and technological advancements, the demand for ethical behavior in the marketplace will continue to grow. One possible promoter of ethical behavior is government. Time and again, however, we have seen government efforts aiming to establish minimal standards of decency act as blunt instruments, which stifle creativity and discourage ethical behavior. Ethical entrepreneurship stands as an alternative to government managed business decency, and it goes about promoting the good by harnessing the incentives of the marketplace.

Barnum & Bailey Circus

The notion that virtue is its own reward and leads to long-term business success is not a recent or isolated phenomenon. For example, political scientist John Mueller details in his 1999 book *Capitalism, Democracy and Ralph's Pretty Good Grocery* how the link between ethical behavior by businessmen became widespread in the United States over a century ago. According to Mueller, ethical and virtuous treatment of customers and employees gave honest companies a competitive advantage, and the practice of being honest to customers was quickly copied by others in the economy. His primary example of an ethical entrepreneurial innovation is the Barnum & Bailey Circus.

Prior to the formation of the Greatest Show on Earth (as the Barnum & Bailey Circus billed itself), circuses were primarily run in an underhanded manner. From the moment a customer entered the circus until his or her return home, they ran a high risk of being cheated. Ticket takers would short-change customers when they were entering the events; pick pockets were paid on commission to roam the grounds; shows were tacky; and games were impossible to win (Mueller 1999). So-called Monday Men stole from nearby clotheslines and houses while homeowners attended the shows and circus parades (Tully 1927 [repr., 2005]). Longtime Hollywood columnist Jim Tully relates from firsthand experience how circuses pretend to be honest in order to take advantage of rubes in his book *Circus Parade* (1927 [repr., 2005], 44–45):

> Whenever a large group of rustics would assemble the spieler would say, "Now Ladies and Gentlemen, we aim to run an honest show—but as you perhaps know there are thieves in high and low places—and dishonest people may follow us—just as you may have dishonest people right here in your own fair city. Hence and therefore—I warn you to watch out for your valuables."
>
> Immediately rustic hands would feel for purses. The pickpockets would watch where the hands went and follow after.

The deception, lying, and theft embraced by circus managers led to quick short-term profits, but the dishonest firms did not survive long because of competition and innovation in the circus industry. Eventually, customers stopped attending the circus because they were disappointed with the experience. With customers disappointed with circuses, the Barnum & Bailey Circus emerged in the 1880s and set in motion a variety of changes to the circus industry. Unlike earlier circus shows, Barnum & Bailey ran a successful circus by creating value for the customer. To overcome the bad impression people had about circuses, Barnum & Bailey had to work extra hard for customers. They had to market the circus as an honest source of entertainment for families. In addition to promising honest ticket takers, Barnum & Bailey had to monitor their workers' behavior and make it costly to be dishonest. They also hired private detectives to catch and scare off the pickpockets.

Barnum & Bailey made their business a more ethical and honest one because it was the right thing to do and because it was *profitable* to do so. Whether they achieved their goal of creating the greatest show on earth is debatable, but they were able to convince crowds about the value and enjoyment of attending the circus (Mueller 2001).

By 1910, Barnum & Bailey, as well as other “clean” circuses such as the Ringling Brothers, had moved to the top of the industry and continued to profit from their honest business methods. More importantly, because their more honest and virtuous behavior was profitable, their business practices began to dominate the industry. While a few circuses continued to try to operate using the old methods of taking advantage of the rubes, the dominant business model became the so-called Sunday-school approach of Barnum & Bailey (Mueller 2001).

The case of Barnum & Bailey illustrates a key point about how markets reward firms when the firms try to do the right thing. While some customers attended Barnum & Bailey circuses because of their desire to reward a company for trying to be honest in what was a dishonest and unethical business, many customers did not know or care about the business strategy of Barnum & Bailey. All they needed to know to reward P. T. Barnum and his successors for their behavior was that attending the circus was more valuable to them than the expected cost (which includes prices paid for entry, shows, and so forth, and possible costs from theft). Based on their experiences and word of mouth about the good experience being had at circuses, customers expected circuses to be worth the money. The reputation of ethical circuses continued to improve and so, too, did firm profits. Thus, it is typically not out of conscious action on the part of consumers that ethical and virtuous companies are rewarded. Instead, companies focused on creating long-term relationships with customers are most likely to engage in honest and ethical behavior.

In some sense, the emergence of virtue in the marketplace can be thought of as a beneficial spontaneous order. It was not the original intention of P. T. Barnum and James Bailey to reform the circus industry and get everyone to adopt the Sunday-School approach to circuses. Their intent was to be profitable in the long-term. In order to do so, they had to create value for the customer in what was, essentially, a repeated game. The unintended beneficial result of their actions is that other individuals ended up having to copy their behavior in order to be successful. As we can see from the evolution in the way customers were treated at the circus, unethical behavior in the free market fails in the long run when customers care about unethical behavior and competitive alternatives exist. When the unethical business is trying to prosper in a market where good ethics are the norm, it becomes nearly impossible for such businesses to be successful.

Whole Foods

As we saw in the previous section, people are attracted to ethical business practices and moral behavior. Some of the most successful businesses in the market today put the consumer first, and they subscribe to the theory that if the customer is happy, then the business will be more profitable (Friedman, Mackey, and Rodgers 2005).

Whole Foods Market is a recent example of a company committed to the customer-first model. Whole Foods was founded in 1980 as a single store in Austin, Texas. Today, with more than 270 stores in North America and the United Kingdom, it is the world's largest retailer of both natural and organic foods (Whole Foods Market 2009a). John Mackey (Friedman, Mackey, and Rodgers 2005), the founder and current CEO of Whole Foods explains his corporate philosophy when he says:

> We want to improve the health and well-being of everyone on the planet through higher-quality foods and better nutrition, and we can't fulfill this mission unless we are highly profitable. High profits are necessary to fuel our growth across the United States and the world. Just as people cannot live without eating, so a business cannot live without profits. But most people don't live to eat, and neither must a business live to just make profits.

Whole Foods Market is a prime example of a large business committed to high ethical standards. The motto of the company is Whole Foods, Whole People, Whole Planet, and the management encourages doing more than just selling food. They encourage employees to strive for customer satisfaction by supplying high-quality products in a manner that creates value for third-parties in the community and worldwide (Whole Foods 1997).

While the idea of consumer surplus is not new, Whole Foods explicitly commits to creating consumer surplus and positive external effects through its entire approach to business. Along with the company motto, Whole Foods Market embraces a set of core values through which the structure of the business is based (Whole Foods 2009d):

- Selling the highest quality natural and organic products available
- Satisfying and delighting our customers
- Supporting team member happiness and excellence
- Creating wealth through profits and growth
- Caring about our communities and our environment
- Creating ongoing win-win partnerships with our suppliers

It is through an understanding of these principles that no matter how large the business grows it will be able to preserve what has helped them become what they are today. The company feels as if they have a responsibility to provide the highest quality product possible to all involved and associated with the business; shareholders and customers, as well as the team members (employees), suppliers, local communities and the environment, are all considered in decisions (Whole Foods 2009d).

To cite but one example, in an effort to become more in touch with the local community, Whole Foods has created what they call the Whole Trade Guarantee. These are products that provide more money to the producers, ensure better wages and working conditions for the workers, and assure that environmentally sound practices are being carried out. When consumers buy these products, one percent of the retail value goes to the Whole Planet Foundation, a foundation that has worked to create an economic partnership with developing communities that supply the stores with their products. The Whole Planet Foundation provides microlending in rural communities around the world, as well as funding for loans and guaranteeing financial support for the administrative costs so that every dollar donated goes directly to those in need. The various support projects relate directly to organics and environmentally friendly production methods, animal welfare, sustainable seafood, and nutrition and healthy families.

In addition to the Whole Trade Guarantee and the Whole Planet Foundation, each store donates food to local food banks and shelters. During community giving days, what they call "5% Days," 5 percent of the days' net sales are donated to a local nonprofit educational organization. The Local Producer Loan Program (LPLP) is a program that provides up to $10 million in low-interest loans to small local producers. The program allows them to more easily grow their business and in turn, bring more locally grown products to the Whole Foods Market. The loans range from $1,000 to $100,000 and can be put toward various things such as purchasing more animals, investing in new up-to-date equipment, or converting to organic production. Various businesses are eligible for these loans, including rangers, beekeepers, ice cream makers, and bakers. Each year, overall community giving exceeds 5 percent of the total net profits (Whole Foods 2009c).

In debates over the social responsibility of businesses, free-market economists sometimes argue that the only responsibility of business should be to shareholders (Friedman 1970). John Mackey feels otherwise and argues, "I believe the entrepreneurs, not the current investors in a company's stock, have the right and responsibility to define the purpose of the company" (Friedman, Mackey, and Rodgers 2005). Allowing entrepreneurs to define company vision is important because it is the purpose and mission of an organization that drives the type of change we are discussing.

While Milton Friedman is correct to note that there exists a principal-agent problem when corporate executives engage in socially responsible behavior because that behavior might not be consistent with the goals of all the shareholders. What Friedman does not emphasize, however, is that the principal-agent problem exists in *all* organizations. For example, an astronomy club president who votes to donate some of the club's dues to help pay for an Earth Day rally might be acting against the wishes of some of her principals, but organizations set up internal rules and procedures for dealing with such behavior. If a majority of members agree with the president's actions, then the troubled members can always leave and form another organization. The fact that corporations are *voluntary* is an important one; it is voluntary organizations that fill in the gaps in civil society. Civic organizations have traditionally been understood to encompass solely social organizations such as the Red Cross or fraternal order societies, but we suggest that businesses can also play that role to the extent that their pursuit of profit also advances social change. Whole Foods is clearly an example of a company that advances social change while earning a significant profit.

BB&T Bank

Throughout history, money and banking practices have been a constant source of scrutiny and skepticism. The Bible and much of Shakespeare's work paint a dark picture of lenders. According to Thomas Jefferson (1816), "banking establishments are more dangerous than standing armies." More recently, the U.S. financial and housing crises of 2008 have spawned another round of vitriolic rhetoric against bankers and calls for greater regulation of banking are a recurring theme of the crisis.

The hostility toward bankers ultimately comes from a belief that bankers do not have the self-interest of their clients in mind. Instead, bankers aim to maximize short-term profits, and, in so doing, they often leave their clients worse off in the long run. To some extent, the argument has a certain amount of plausibility and appeal. In the pursuit of quick profits, bankers overextended credit to questionable borrowers during the housing crisis, knowing (1) that borrowers were often confused about the product being sold, and (2) that the mortgage would be sold and soon become someone else's problem.

Like our previous examples, when the market seems to be filled with dishonesty and uncertainty, there is an opportunity for a firm to enter and provide honesty. BB&T Corporation of Winston-Salem has been one of the firms providing honesty to its banking clients. The company focuses on what is best for the client and emphasizes the importance of individualism and responsibility in its mission statement. As the company's information page states (BB&T 2007a),

> At BB&T we recognize that you're an individual, with a unique set of financial goals and ambitions. We also know that what you need from us will change as you go through your life. That's why we believe in building strong relationships, and that complete financial security comes from making one good decision at a time. We can offer solutions to all your financial needs, and the accounts, tools, and services to help you meet your goals.

For BB&T, the mission statement and discussions of the company's core values matter. The company wants all workers to embrace the culture of always asking, "What's in my client's long-term interest?" They emphasize the importance of establishing win-win relationships with their clients, and, if they make their client's lives better, they believe they are making both the company and the world better.

The desire to improve client well-being can clearly be seen in their mission statement, which focuses on how making sure customers, employees, and the greater community are better off and ultimately maximizing the return for shareholders (BB&T 2007b). Their purpose statement provides perhaps the clearest statement of why a focus on creating long-term value for all stakeholders is in everyone's best interest.

> Our ultimate purpose is to create superior long-term economic rewards for our shareholders.
>
> However, our purpose, to create superior long-term economic rewards for our shareholders, can only be accomplished by providing excellent service to our clients, as our **Clients** are our source of revenues.
>
> To have excellent client relations, we must have outstanding **Employees** to serve our clients. To attract and retain outstanding employees, we must reward them financially and create an environment where they can learn and grow.
>
> Our economic results are significantly impacted by the success of our **Communities.** The community's "quality of life" impacts its ability to attract industry for growth.
>
> Therefore, we manage our business in a long-term context, as an integrated whole, with the ultimate objective of rewarding the **Shareholders** for their investment, while realizing that the cause of this result is quality client service.

BB&T's emphasis on values and long-term thinking has resulted in consistently high levels of customer satisfaction (J.D. Power and Associates 2008). In addition, the company was able to avoid many of the sub-prime problems plaguing many other large U.S. banks during the current crisis. BB&T viewed many of the introductory and zero interest rate mortgage offerings of the housing boom as financial products not beneficial to their client's long-term interest and therefore avoided them. By being honest and encouraging their clients to avoid confusing products to a far greater extent than their rivals' clients, BB&T weathered the financial crisis far more effectively than its peers. When "stress tests" of banks were recently performed, BB&T emerged as one of the healthiest banks among the nineteen largest financial institutions in the country (Craver 2009). BB&T's CEO through 2008, John A. Allison, was also named runner-up to Warren Buffet for CEO of the Year in 2008 by independent research provider Morningstar. As the press release announcing the finalists noted (Morningstar 2009):

> It may seem odd to nominate a bank CEO after all the trouble that imprudent lending has caused to our financial system, but John Allison, BB&T's retiring CEO, is a worthy candidate. During his tenure, he has used the combination of conservative underwriting with timely expansion to create a Southeast banking giant. With an intense focus on culture, Allison's personality and ethics are ingrained throughout the organization.
>
> The bank's resilience has largely come from Allison's ability to portray BB&T as a safe haven for its customers, helping the bank to soak up deposits and profitable small and mid-sized business clients from its troubled peers at a rapid rate.… Most important of all, Allison's focus on the company's culture and his close relationship with his fellow managers have assured us that even though he will retire at the end of the year, BB&T's conservatism will remain its backbone and, we believe, will help reward shareholders for years to come.

It remains to be seen if BB&T's approach to the business of banking will be adopted as a model by other banks in the way that Barnum and Bailey's circus became the standard by which other circuses would be judged. It is important to note, however, that many of the sub-prime mortgage lenders such as Fremont General Corporation that were not focused on creating long-term value for their customers have gone out of business (Fu and Hall forthcoming). Thus, even if BB&T's actions do not directly influence other financial institutions to adopt more ethical behaviors, the relationship between ethical behavior and long-term success makes it more likely that ethical behavior will thrive in the industry.

Concluding Remarks

The three examples discussed illustrate how ethical entrepreneurs can improve their own businesses and make the overall capitalist system a more moral one. In each case, an ethical entrepreneur recognized the value in doing something differently. As circus show producers, Barnum and Bailey made their shows a form of weekend fun by making their employees and managers an asset instead of a liability. Changes in the way employees were monitored, changes in incentives, and an emphasis on honesty all led to a superior circus show. To bring back jaded customers, Barnum and Bailey had to market their product as an honest one, form new relationships with customers, and wait for word of mouth to spread. Their task was greatly complicated by the nature of the circus industry, which is an industry that constantly changes locations, but their efforts in providing a superior circus show paid off and helped them maintain their image as the greatest show on earth until the Great Depression. In short, Barnum and Bailey took existing resources and combined them in a new way to produce a better product, which is the essence of entrepreneurship.

In the case of Whole Foods, the desire for profit and the desire to do good go hand in hand, recognizing that profit will come when people see that what is being done can benefit themselves and their communities. Those behind Whole Foods understand that large companies can greatly impact the environment—either positively or negatively. Whole Foods was the first major retailer, worldwide, to offset 100 percent of their energy uses with wind energy credits. Other environmental steps they have taken are the use of solar power, company-wide recycling programs, green buildings, and a strong support for organic products (Whole Foods 2009b). Because Whole Foods is focused on creating value for all stakeholders, it has made the world a better place while remaining profitable.

Making money as a banker always requires risk, but taking on risk and also serving clients in an honest way is something BB&T and John Allison have been doing for more than thirty years. BB&T's commitment to constantly asking the question, "Does this product benefit my client in the long-run?" has, from time to time, constrained them from making a quick buck. Their integrity, however, has led to long-term growth in the company and satisfaction for consumers. Their prudent and long-term approach has analysts considering them poised for considerable growth in the future (Boye 2008).

Entrepreneurial approaches where profits come, in part, from running a business ethically present an important alternative for producing good and ethical outcomes in a world where rancor about business and talk of social justice dominates. By harnessing consumer demands for integrity and by contracting with their workers to meet those demands, ethical entrepreneurs can supplement and, perhaps, substitute for government solutions. While we rely on markets for many goods, a rich and complex network of voluntary organizations (including corporations) helps us provide for the rest.

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