

AN ADDRESS
BY
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The American Assembly
Columbia University
New York, New York
April 16, 1977
“Corporate Ethics”

In 1970, the Council of Economic Advisers, in a very infrequently-quoted and very much overlooked statement, endeavored in their Report to the President for the first time to reflect not merely their economic anticipations for the year 1970, but also to project ahead to rule out what they saw for the economy of the Country for five years, year by year. Adding across the top line, they anticipated a cumulative gross national product on the order of \$6.3 trillion. They then proceeded to lay off against it what they called “known claims” -- those commitments which we as a society had already made. They factored them for the winding down of the war of Vietnam and Congressionally-mandated increases in Social Security. When they subtracted the cumulative “known claims” from the \$6.3 trillion, they concluded that we had total uncommitted gross national resources over the five years of some \$23 billion, and all in the last year of the projection.

They then went on to tell us, much unobserved, in essence, that we must be prepared to make choices, that we face a situation where if we want more of something, or if we want something new, we have to be prepared to give up something we already have.

It is not important how precisely accurate the Council’s projections have turned out to be. In essence, they were very accurate and, above all, I submit to you that the concept is valid, and that society, however fast its real economy grows, but particularly when it does not grow rapidly, can only afford so much. Yet through the 1960s we developed a belief that we could afford everything. My concern is that we do not have the established mechanisms to enable us, as a society, to make conscious choices -- to realize that we must make choices, to

understand, at least qualitatively, the costs and benefits of the choices we face, and to make them deliberately and with awareness.

When we focus on the federal budget, we find that only a small portion of it, perhaps 25 percent, is discretionary, considering items such as Social Security and transfer payments and the like as mandatory, unless we begin to redefine what is mandatory. But this is, to use the cliché, “only the tip of the iceberg.” We face billions of dollars of expenditures, the precise amount of which is unknown, of federally-mandated expenditures which do not revolve through the federal budget. For example, the cost of product safety, of environmental protection, of occupational safety. These are mandated costs and transfers for which business is the transfer agent. Business is required to incur these costs, but the consumer pays. The consumer pays through increased product and service costs which eat into his purchasing power and, depending upon the real value, can also be inflationary. And they eat into purchasing power without conscious consideration of whether that is the kind of cost that the consumer either intends or desires to pay.

Now no one can be opposed to occupational safety, or to product safety, or to environmental protection, particularly when these are coupled with the visions of children burned to death in their bed clothing and permanently-maimed workers in a devastated countryside. But many of the issues are not of this magnitude, and I’m not proposing to evaluate or take issue on any of those individually tonight. What I do propose is that we need a mechanism, a process and a discipline to make choices -- to surface them for all to see and for all to discuss -- to identify the magnitude of the problems and the costs to society of the solutions and to trade these off against other societal needs with greater or less

magnitude and benefit -- and to do this as part of the decisions-making process -- and that we also need a process to require a review of the costs, benefits and effectiveness of regulatory-imposed requirements.

Among the things I think we need to do is that we need to set result standards -- not performance standards. Yes, there is a problem when a person in a factory falls off a ladder, but I'm not satisfied that that problem is addressed by a standard that dictates the material out of which the ladder should be made, the width of the ladder, or the distance between the rungs. We can, for example, set injury standards. These have been the basis for setting workmen's compensation rates for years. They would require fewer inspectors, less cost to industry, less cost to the consumer.

We need to assess whether we intend to be and can afford to be a risk free society. Does every risk and every accident and every loss sustained require, as a matter of societal philosophy, that there be a redress -- or a knee jerk rush to legislation to prevent it from ever happening again.

I think these issues relate to corporate conduct and morality and they relate very fundamentally because as each risk or each injury gains the spotlight it tends to reflect back on whether the corporation is moral. The issue becomes whether a corporation can be moral if someone is injured in the course of carrying out the corporation's activities. Or often legislation is justified to assure "equality," so that the moral company can perform "morally," and not be at a competitive disadvantage in its performance to the "immoral" company. And the increase in product or service price resulting from the increased cost imposed is also not

understood. So we are dealing very directly at that level with the issues of corporate conduct and morality.

Moving more directly into corporate morality, in my judgment, there is no such thing as corporate morality or corporate ethic. There is only a corporate environment that is conducive and supportive of individual morality and ethics. My own conviction is that ethics begin with the individual and end with the individual and, in essence, they do not change once the individual dons a corporate hat.

The question for the corporation then is how does it play the game? What behavior does the corporation expect of its people? How does it behave? Does it behave in a consistent way? Does it provide a supportive environment? Are its policies appropriate and well-articulated? Are its actions consistent with its policies, and so on? If the appropriate environment is lacking, there is no control system in the world adequate to offset it. I do not know how to legislate or police ethics. As a corporate officer I only know I can create an environment that is conducive to ethical behavior, and unless the right kind of environment is created, no amount of financial control or reporting will suffice. If corporate management at any level concludes to engage in illegal, unethical practices, it is extremely difficult for reporting requirements to flush them out. If the manager, for whatever reason, believes that the corporation desires or will condone that conduct, or that his own purpose requires that he engage in it -- that person will also be prepared to ignore formal reporting requirements and to falsify affidavits required under company procedures.

Given that, the next question comes: How do we correct it and where does the responsibility for correction lie in the event that corporate ethics are not what they ought to be? My concern here is that if business does not clean its own house, then government, and perhaps even authoritarianism, will clean the house of business. As Mayo Thompson put it when the Direct Selling Association dubbed him the 1976 Champion of Free Enterprise:

So long as there are those who will
not listen to the small voice of
conscience within, then the
policeman must stand ready on the
outside.

It is true that the mistrust of government is as marked as the distrust of business. Yet while the political process, in its own fitful way seems to expunge many, if not all of the violators, the perception is that the business community does not similarly react to business malpractice. Few business leaders speak out. When they do, they tend to pontificate about the sanctity of private enterprise and kick the press as if they invented the scandals. As Mike Blumenthal put it while he was still at Bendix:

To leap to the defense of business, in
general, whenever some specific
abuse is uncovered, only tends, in the
public mind, to associate the one
with the other. If businessmen are
ethically strong and morally clean,

why should they not be the first to denounce the abuse of malpractice that far more than our critics in the media threatens the survival of the free enterprise system.

Or as Irving Kristol put it:

Corporate executives almost never criticize other corporate executives. No one seems to be read out of the corporate community which inevitably leads the outsider to wonder whether this community has any standards of self-government at all.

It is interesting to me that the heads of our large corporations today are so invisible -- that the society does not know who the Chairman of General Motors is or the type of person who holds that position -- that it does not know whether it would like its children to grow up like him. There is something odd about a society in which an entire class of very important people has not held up as at least one possible model for emulation by the young and cannot be so held up because they are so close to being invisible. As Plato once put it:

What is honored in the country will be cultivated there.

Perhaps that explains why we have so many great basketball players! As Tom Clausen of the Bank of America put it last year:

If the market economy ever goes
under, our favorite villains --
socialists, economists and
government regulators will not be to
blame -- we will.

What is the significance of the comments by Mike Blumenthal and Tom Clausen? It is obvious that they are quotable. It is also obvious that they are the exception. But there are other dimensions. One is that such a statement made in the public forum tends to commit the organization to a course. It tends to commit it publicly and it therefore tends to underscore the credibility of that commitment internally within the organization involved. It is harder for lower levels of such an organization to countermand that commitment. Furthermore, the more corporate leaders who make that public commitment, the more mutually reinforcing it becomes.

Turning to the corporation itself, I suggest that we focus not so much on the question of social responsibility or public responsibility, as we are often inclined to describe it, but rather that we focus on what we might call "public accountability." We have learned time and time again that responsibility without real accountability does not produce the same results as those produced by ones who are held accountable. This is, in part, I think, what government is increasingly trying to do through sunshine laws and increased reporting

requirements. It is what people imply when they urge that the best test of corporate morality or individual ethic is how comfortable you would be explaining it on national network television.

What we are dealing with here is essentially legitimacy of the American corporation and its survival as an institution. Concern is broad based about corporate power which is perceived as immense and for which many have a concern of how it will be used, and what limitations will be placed upon its ability to do harm and by whom. The power to do harm has been amply demonstrated albeit not broadly practiced.

In considering corporate accountability and corporate power, may I suggest that we begin by acknowledging a couple of myths. Myths tend to be self-deceptive and they impede, often subtly, an attitude of accountability.

One of those myths is that the boards of directors are elected by, and are accountable to, the shareholders. Although management will talk piously when it serves its purpose about its obligations to its shareholders, the truth is that shareholder elections are almost invariably routine affirmation of management's will. The traditional concept of the shareholder is now a vanishing breed. Most stock today is purchased by people and institutions whose sole intention is to hold it for a relatively brief period and then sell it at a profit. They do not become owners in the company. Rather they invest or speculate in its income stream and stock market action and are in the business of trading securities. Management is, at least in relation to the shareholders, as Adolph Hurley once put it:

an automatic, self-perpetuating
oligarchy.

Now despite efforts to enhance the quality of shareholder information and to revitalize shareholder democracy, it is unreal to expect that the shareholder constituency will keep corporate power accountable for the exercise of its franchise. The interests of the shareholder are fully protected if financial information is made available -- if fraud and over-reaching are prevented -- and if a market is maintained in which their shares can be sold. They have little voice, if any, direct or representational, in vital corporate decision.

The second myth is the "board of directors myth" which applies to many boards, although by no means all. Just under a majority of board members are corporate officers. In addition, most boards will include a supplier or two such as investment and commercial bankers and legal counsel. Most directors have served for many years. They were asked to serve by a present or past chairman and presidents. They are almost automatically re-elected. The officers name the directors and then the directors name the officers. Nonemployee directors almost invariably approve management recommendations because they do not have the staff, the funds, the time, the information, and in some cases, even the inclination to challenge the basis for management recommendations. Dissenting directors are rare, and for some reason they seem often to have shorter tenure. The board, in effect then, insulates the management rather than holding it accountable.

It is my ideal, and we can go into this more in the question period if you are interested, that a board consist of the chief executive and outside directors. Standards need to be set for what is expected of an outside director in terms of

behavior and performance. I would also urge that the chairman of the board not be the chief executive officer.

Several trends will be developing over time because of the persistence of, and our dependence on, these myths. If the board does not hold management accountable, and if shareholders do not hold the board accountable, then, indeed, who will? Who will monitor the power of the American corporation? The choice becomes a matter, in my judgment, of whether we develop our own mechanisms for holding ourselves accountable, or whether the government does it for us. This is not a threat -- it is a logical and inevitable extrapolation of the trend.

What should the corporation be accountable about? The Committee for Economic Development several years ago defined the role of the professional manager as "a trustee balancing the interests of many diverse participants and constituents in the enterprise." They went on to enumerate these to include employees, customers, suppliers, stockholders, government, etc. -- practically everyone. This is almost a universal perception, but its consequences are not universally perceived. What it means is that the large corporation has ceased to be private property -- even though theoretically-owned by its shareholders. It is now a quasi-public institution. If it is such a quasi-public institution, then the self-perpetuating oligarchy that constitutes management does not have the same rights it once had.

The issue of what the rights are of those who lead quasi-public institutions is a political issue and is going to be answered in the political arena. Yet, management often responds, and understandably so, in economic terms -- that it derives its legitimacy from the superior efficiency with which it responds to

opportunities in the marketplace. Such a response may be totally adequate for a private institution, but as a quasi-public one, it is no longer adequate. The requisite of successful response to opportunities in the marketplace is still present, but it has been significantly supplemented. The question now is how we go about moving from primarily economic thinking to recognition of the political arena in which we live. The danger is that the large corporations, over time, will be thoroughly integrated into the public sector and lose their private character completely. It is a difficult challenge to convince corporate managements to accept quasi-public status because they enjoy being economic decision-making animals. They enjoy that combat. It is the game they have been trained for. It is the game they know best. And finally, it is very difficult to establish performance measures which take the other wild card criteria into account.

One of the keys is the balance within the corporation between the concern for the long term, which communicates as a matter of corporate philosophy and as a matter of corporate management, that “we are going to be around to account for the long term” versus the pressure for earnings, a sense of tactical priority and a mood of doing what is expedient which says “we are primarily worried about accounting for the short term.” If the managerial environment is one which says we must increase corporate earnings 15 percent each year, then management should not be surprised that somewhere down the line inappropriate activities are carried out to deliver that result.

As Peter Peterson, former Secretary of Commerce described it:

One yardstick I have found useful in
assessing the real strength of a

company is how much time its very best people could devote to the future. Wherever I saw most, or all of the company pre-occupied with the day's, the next month's and even this year's problems, very frequently, I found that it was an enterprise that either was in, or was headed for, trouble. Conversely, the best-managed corporations, I found, invested substantial amounts of their most precious resource -- the time of their top managers -- in the future, protecting the future and defining problems and opportunities of the future, and deciding how best to shape the future instead of being shocked by it.

In my own experience, the corporations with the highest standards of behavior, adequately sensitive and responsive to societal trends, which are concerned about being socially accountable over time, also happen to be the ones that lead the pack in new product development, in management competence, in profitability, etc., because essentially the same kinds of talents and values, perspectives and priorities are involved in each. It also reflects a company that is constantly being market-sensitive -- constantly tracking to determine how that society is changing and what its needs are. It has mechanisms built in to feed that

information back into the corporate thinking and planning process. Such managements are less often surprised by what appears to others to be sudden changes in public demands, expectations or morality.

Conversely, I think we can find some fairly common qualities among the companies most heavily involved in so-called “questionable payments.” Either they are heavily engaged in government business, domestic or foreign, they are regulated industries, or they are in products that are over-the-hill and have not found a way to revitalize them. Or finally, they have not set a tone of punishing unacceptable behavior that resulted in an economic benefit.

The tendency of many corporations is to turn its back on what amounts to immoral behavior if it was undertaken, not for personal gain, but for the purpose of generating a positive economic result, and particularly if that result was, indeed, achieved. One of the most overlooked issues in corporate ethics is how far people will go to maintain order, and structure, and to play the game. Elliott Richardson, former Secretary of Commerce, and Chairman of President Ford’s Committee to Investigate the Misconduct of American Corporations Overseas, in an article in Atlantic Magazine entitled “The Saturday Night Masacre” said this:

The second ingredient of Watergate,
an amoral alacrity to do the
President’s bidding, was traceable
less to flaws in his own character,
although it was re-enforced by them,
than to the political and cultural
evolution of twentieth century

America. It was, in significant ways, a symptom of the times. The heads up, get ahead, go-along organization man recruited for the White House staff was not uniquely evil.

American politics, business, sports, in fact, many, if not all, of the enterprises to which Americans turn their hands are riddled with the same type of organization man. He takes on the coloration and the value system of whatever organization, whatever game, he happens to be associated with.

But, that's only the tip of the iceberg. In his book, Obedience to Authority, Stanley Milgram, a professor of psychology at Yale University, related an experiment that went like this. The description is rather long, but I think it is important:

Two people are brought into a psychology laboratory to take part in a study of memory and learning.

One is designated the teacher and the other, the learner. The experimenter, the person who controls the experiment, explains that the study is

concerned with the effects of punishment on learning. The learner is taken to a room, strapped in a chair, and an electrode is placed on his wrist. He is told that he is to learn sets of word pairs and that whenever he makes a mistake, he will receive an electric shock. For each successive mistake, the electric shock will increase in intensity. However, the real experiment is on the teacher, because the learner is an actor. The teacher is taken into another room where he cannot see the learner and he is seated in front of a very impressive shock generator, whose main feature is a horizontal line of 30 switches that range from 15 volts to 450 volts in 15 volt increments. Directly above the voltage switches are signs ranging from "slight shock" to "danger – severe shock." The teacher is told that he is to administer the learning test to the person in the next room. When the learner responds correctly, the teacher is to go on to the next

word pair, but if he responds incorrectly, he is to be given an electric shock which increases in intensity each time the answer is incorrect.

The teacher does not know that the learner, the victim, does not actually receive a shock. The learner is instructed, however, that at 75 volts he is to grunt -- at 120 volts he is to complain -- at 150 volts he is to plead to be released -- and at 285 volts he is to scream. The question is at what point will the teacher refuse to push the shock button. This question was posed to a large panel of psychiatrists, college students and middle-class adults, who were unanimous that none of them would carry the experiment fully through to the end. Somewhere around 150 volts they would say "I cannot go on." But the results of the experiment showed that 60 percent of the teachers went the full 450 volts!

There are two lessons we can take from this experiment. One is the lengths that people will go to avoid breaking with authority, for psychological reasons, not for realistic penalties or rewards, and the difficult time that people have overcoming purely psychological blocks in order to do what they think is right and moral.

The second lesson to recognize is that most people do feel helpless in the grip of the system and that we need to be sensitive to what the system does really demand -- and, of course, then to structure rewards and to structure punishments that are appropriate to that reality.

If all these people are likely to follow what they believe are the expectations of the system, even if there is no reward directly associated with it -- merely the intimidation or the lack of moral freedom to do otherwise -- what does this say about our corporate functioning? One dimension is that the executives on the firing line charged with implementation may not believe that the chief executive himself believes or means what he says when he talks about high standards of corporate conduct or that he is doing anything more than making a public relations-type of statement for the record. When it comes to conduct which makes life more difficult, or does not seem to be consistent with profits, managers are generally inclined to ignore or disbelieve, to delay action and to implement with little enthusiasm. This is not a condemnation of corporate ethics; it is a recognition of human behavior. And why, in such an organization, should the executives down the ladder believe or listen to the policy statements of the chief executive when the statements are often inconsistent with the way the company is

organized and run, and with the operational definitions of performance and results against which the executive's success and reward will be measured?

The typical manager functions with a high level of confidence that if he meets his economic targets, he is not likely to be criticized, let alone severely punished for failure to perform adequately in other areas. Further, the president may be uttering strong words, but it is the manager's immediate boss several layers down who appraises him.

A major part of the problem stems from the nature of corporate planning processes, control systems and methods of measurement and reward, including incentives and promotions, and so forth. The quality of an organization's performance is vitally affected by its systems of measurements and control. Much of what we characterize today as sophisticated management control encourages and rewards conduct often contrary to the best interests of socially-accountable business. The central thrust of these practices is towards numbers -- quantified performance against quantified plan. We measure our marketing manager on how many boxes he sold at an acceptable gross profit and within his advertising and promotional budget, but not on how he got the business -- not on the quality of the advertising or on the integrity of either the product or the marketing program.

These systems tend to motivate the individual to do those things that make him look good and successful in the short term. And promotion processes tend to reward the executive for accomplishments in the one or two years he spends on a job, meaning that he is in a given position for too short a time to be worried about the longer term implications of his decision. He does not become proprietary in

his thinking about the operations for which he is responsible, and he expects to be gone before the consequences of his short-term expediencies become apparent.

Our control systems need to assure that the longer term and the social and political implications of current decisions and actions are visible and consciously accepted. Our reward systems need to make sure concerns worthwhile. I am not advocating elimination of incentive compensation or options; I fully support them. I am urging that we understand the behavior that these systems encourage and reinforce; and that we establish appropriate countervailing tensions, rewards and penalties.

Ironically, while the job of the manager has been growing more complex, the basis on which his performance is evaluated has often become simpler. The reason, of course, lies in the need for a lowest common denominator that can simplify delegation and be used for allocating resources and making comparisons among decentralized units operating in different businesses, markets and geographic environments. This divergence may have to be reduced and management may have to tolerate a greater degree of complexity in the measures it uses to evaluate performance.

Ambrose Bierce, on reviewing a book, was reputed to have said, "The only thing wrong with this book is that it covers are too far apart." This talk has gone on longer than we all expected. I promised you only a set of observations on the problems of corporate governance and I intend to leave you without a neatly wrapped package, for to tie it up with a neat ribbon would convey a sense of completeness that I do not feel and a set of conclusions that I do not have. My underlying concern, however, is that American business understand and recognize

clearly the dynamics of the problems which face it and the level of public concern relative to those problems. The pressure