Shareholder vs stakeholder vs market failure's model

Finance, Market

Business and ethics are often considered as opposite ends of a magnet, one in the means of seeking profit and other with the common assumption of refraining from profit maximization; so the question become is business ethics really an oxymoron? The usual perception of business ethics is very poor and pessimistic as many corporate executives say one thing yet do another. Although the maximization of self-interest and profit seeking is what drives the economy forward, but how should one's actions be justified, is it ok to do as you wish as long as the law permits?

Business managers along with other professionals have sets of ethical codes laid out and are to be followed. There is the bar set in place to monitor the practices of each individual lawyer; medical association for doctors as they perform medicine; and a ring to be worn to constantly remind the engineers of theirprofessionalismand the potential consequences of their work (Heath). Managers on the other hand do not have an association to oversee the decisions they make, whether they are permissible by law or meet the moral obligations.

However not having the standards on paper does not mean there aren't any to be followed. In order to make justification for the type of behaviours business managers have and to outline the appropriate actions they should take, many ethical theories have been developed since. There are three that best represent the key perspectives in this matter; Friedman's Shareholder theory, Freeman's Stakeholder theory and Heath's MarketFailureModel of business ethics (Heath).

Each of them is the pillars of which many other theories are based on but have very different and opposite views. The Shareholder theory suggests that manager has fiduciary duties to the shareholders only and must maximize profits as long as the law permits. The Stakeholder theory on the other hand suggests that managers have fiduciary duties to all stakeholders whom are positively or negatively affected by the decisions of the firm; shareholders are only of the stakeholders and their benefits cannot account for all.

The making of one group’s benefits can only be made in conjunction of making all other stakeholders better too; shareholders are no more special than the suppliers, customers, employees and communities. Both the Stakeholder and Shareholder’s theories are biased towards different ends, one suggesting profits to be maximized for one group while the other stating that profits should be common good for all. Furthermore, the Market Failure Model of business ethics comes in between the two, yet containing arguments of both but in revised versions.

I will argue in this paper that the Market Failure Model is the one that best describes the causes and effects of the businessenvironmentwe have today and the role ethics play within it. First, an extraction and analysis of the Market Failure Model will be conducted and be used to explain why it is the best fit for the current business environment and ethics. I will then explain the shortfalls of the Shareholder and Stakeholder theories and why they lack considerations on a broader scope. Market Failure Model Market failure is the situation when the competitive market fails to provide an efficient outcome.

In order for an efficient allocation of resources, there must be the absence of externalities, symmetrical information between buyers and sellers, insurance markets, and utility maximizing agents whom are rational when making decisions (Heath). However in the real world, the above conditions are rarely met and thus the idea of a perfect market becomes only ideal in theory but impractical in reality. In response to such failure in the market, two corrective phenomenons exist. The first being the creation of corporations which is organized in a system of hierarchy.

Managers have fiduciary duty to follow legal as well as moral constraints to achieve profit maximization for members in the hierarchy, in this case the shareholders. Moreover, in order to achieve the highest profits for anyone in the market, they will need to compete in prices as well as product innovation. Many historical scenarios has proven that competition leads to economic advancements where without it would result in economic stagnation. China and India had been communist states in the past where there were minimum price competition and product innovations, the government had full control and attempted to effectively allocate resources.

However such intervention only led to full economic stagnation andpovertyfor its people. By the late 80s, both the Chinese and India government returned control to the market itself where competition for profit resumed and thus the economies began to advance and has brought prosperity upon its people. This not only proved profit seeking, price competition in the market is rather healthy for the economy but also

concluded that government interventions in the market can create unneeded deadweight loss.

The second response to Market Failure involves preservation of the market transaction and is subject to legal and regulatory constraints (Heath). In a competing market, there are various strategies firms may take to maximize their profits. Strategies that involve only of lower prices, better quality and product innovation that would exist in perfect completion are referred to as preferred strategies whereas the ones involvingpollution, misleading advertising, sale of products with hidden defects are called non-preferred strategies (Heath).

From the Market Failure's perspective, the ethical firms will refrain from using non-preferred strategies even if they are allowable by the loophole of the law and regulations. These firms seek non-preferred strategies because they bring easy and quick forms of profits, but it is also short lasting. " Misleading advertising stands to false advertising as deception does to fraud" (Heath). When firms adopt misleadingadvertisementfor its products, it will bring short term profits before consumers realize they are being deceived.

However when consumers do acknowledge the unethical behaviours of the business, they will switch products and by the word of mouth spread unfavourable comments of the firm; thus in the long run, such business behaviour is not practical as bad reputation leads to loss of sales and eventual closedown of operations. Profit seeking often bears negative

conceptions due to the frequent exploitation of the market and flaws of the legal and regulatory systems.

These firms fail to consider the moral obligations they must also endure. The analogy between " orporate socialresponsibility" and " Good sportsmanship" effectively compares and applies such concept. Having good sportsmanship does not only include not breaking the rules of the game but also refraining from exploiting the loopholes and flaws of the regulations. Taking basketball for example, unavoidable physical contact will occur during the game; however one should avoid purposely injuring other players just to win.

Although certain teams do adopt such tactics like those firms using non-preferred strategies to makemoney, but most top ranked teams along with the most reputable firms still win by applying only of the preferred strategies. Attack on Shareholder's Theory Milton Friedman' Shareholder theory argues that there is a fiduciary relationship between the managers and shareholders; managers by all means possible and permissible by law, must maximize profits (Friedman). However recent corporate scandals proof otherwise.

The case of Enron for example, where corporate CEO and president along with other top executives engaged in a sequence of deception behaviours to achieve the maximum profit, not for shareholders but for themselves. Even on the verge of bankruptcy, these top managers froze the shares held by common shareholders so they could sell out all their shares while everyone else will suffer the drop in price. This proved the willingness to break the law

never mind moral obligations, in order to maximize the self-interests of the managers themselves.

It is mistaken to trust the strength of the fiduciary relationship between managers and shareholders where the shareholders are without protection. One may argue that shareholders can simply fire the irresponsible manager, but as Enron proves, these managers can easily cheat shareholders without being found out until it is too late. Another shortfall of the Shareholder theory is the inconsideration for others who are also affected by the firm's decisions. Lockean argues that shareholders are entitled to the profits as employee deserves their wages, but it is unconvincing because it only defines the legal obligations but not the moral (Heath). We have no legal obligation to give but do not mean we have no moral obligation to give to charity"(Heath) This quote from Heath suggests that even though it is not by law that we must be moral and has concerns for other, but it doesn't mean there aren't any moral and ethical codes to be followed. Attack on Stakeholder Theory The Stakeholder theory compared to the Shareholder theory argues that managers have fiduciary duties to everyone who are affected by decisions of the firm, including suppliers, customers, employees and many others (Freeman).

It is true that consideration for these stakeholders are important when making business decisions however it doesn't mean managers have fiduciary duties to all. Managers in corporations are trusted directly of property rights of shareholders with no alternatives and minimum protection against uncertainties. Suppliers, customers, employees and other stakeholder on the

other hand have the ability to choose whether they are to be affected by the corporation.

If suppliers refuse to agree to conditions and prices offered by firm, they may wish to supply to other firms instead; when customers refuse to pay for certain products or cannot agree to values (values referred to the corporate operations and its effects in the society) offered by the firm, they may choose not to purchase it’s products; and lastly employees may choose to resign from his position when conflict of interest and ethical concerns occur or may blow the whistle and expose the wrong doings of the firm to the public.

Each group of stakeholders have their own alternatives in dealing with managers decisions and do not have property rights already invested and paid to managers for the outcomes of their performance thus they cannot be considered as having fiduciary relationships with managers. The major flaw of the stakeholder theory is that it assumes the stakeholders are not capable of making their own rational decisions and has left the responsibility of their wellbeing in the hands of others.

The second shortfall of the Stakeholder’s theory is its short-term and narrow scope view of the matter and failed to consider the long-term strategies of the firm and wellbeing of the people. Walmart has been growing exponentially in recent years, but has also been experiencing much negative publicity like poor wages and benefits for its employees. When worker aren’t paid enough, the most common solution they seek is from the managers raising their wages.

However most of these workers fail to realize they are only being paid according to their skill sets, rather than holding the managers and corporation responsible they should instead reflect on themselves and obtain highereducationor more specialized skills to be worthy of their pay. If workers demand two or three dollars increase of their wage, they also need to consider the overall effects on the firm and not just themselves; it is not about a little more on one person's pay cheque but the effect of thousands of workers and the incremental costs that a firm will bear.

The market is competitive in nature, when firms fail to make profits, it will cease in existence in the long run. When the firm becomes bankrupt, all employees will lose their jobs and whom should be held responsible for that? Conclusion In conclusion, all three theories share different views of business ethics and the role of managers should take in it. Shareholder theory argues managers have fiduciary duty to shareholders only and should seek to maximize profits as long as it's legally permissible; Stakeholder theory states managers have fiduciary duty to all stakeholders and must make ecisions so when certain stakeholders are made better off, the others involved must also be better than their original state. Both of these theories tries to outline what behaviours managers should take on a biased perspective yet fails to fit actual economic and market characteristics. Heath's market failure model on the other hand suggests that managers do have fiduciary duties to shareholder only but should make decisions meeting their moral obligations as well, meaning adopting strategies that best benefit the firm and the society in the long run.

Certain firms may donate to charity because they feel morally responsible or perhaps to cut taxes or simply for publicity; however in the overall wellbeing of the society, intentions matter but results matter even more. Firms that adopt non-preferred strategies will eventually break laws or be publicly criticized, will suffer losses in sale and be eliminated by firms applying preferred strategies because the market works to correct itself of its failures.

Bibliography Heath, J. (n. d.). Business ethics without stakeholders.

In F. Allhoff & A. Vaidya (Eds.), Business in Ethical Focus: An Anthology (pp. 110-126). Peterborough: Broadview. Friedman, M. F. (n. d.). The social responsibility of business is to increase its profits. In A. Allhoff & A. Vaidya (Eds.), Business in Ethical Focus: An Anthology(pp. 65-69). Peterborough: Broadview. Freeman, E. F. (n. d.). A stakeholder theory of the modern corporation. In A. Allhoff & A. Vaidya (Eds.), Business in Ethical Focus: An Anthology (pp. 69-78). Peterborough: Broadview.