

## Room for Ethics in Business following the German Roots of Social Market Economy

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The current global financial and economic crisis has created an unprecedented recession and very high employment in addition to huge environmental and social problems. All these have stimulated discussions among economists regarding the need for a new paradigm allowing »fairness«, »ethics«, »social and ecologic responsibility« and »sustainability« to come to the fore in the economic system. Today, even liberal economists admit that the current situation is connected to the orthodox Neoclassical Economic Theory claiming that all economic agents act only for their very own interests and profits. This is reflected in »the shareholders' wealth maximisation« approach of the Anglo-American stock-market-based economic system. In this paper, we have attempted to construct a simple conceptual framework to integrate ethics or moral values with strategic management for business sustainability by focussing on the German Social Market Economy Model as a blueprint for a new economic paradigm.

Key words: Business ethics, sustainability, corporate social responsibility, social market economy, Freiburg school of economic thought, Mittelstand

### 1 INTRODUCTION

More than twenty years ago when one of us was doing his graduate research, his supervisor asked him a critical question after reading one paragraph of his draft thesis: »Do you think that there is anything called fairness in economics?« The supervisor was a professor of economics with a perspective mainly based on the neoclassical economics tradition and he was then claiming that there was no room for »fairness« in economics at all. But years later, for example, Fennel and McAdams were noting in the introduction chapter of their 896-pages edited book that »[t]he relationship between fairness and the economic concept of efficiency is usually cast as an adversarial one. Rational choice economics describes human behavior as motivated by simple self-interest, rather than by concerns about morality, justice, or fairness. Thus, it may seem strange to devote a volume to fairness within the field of law and economics. Yet we have found that the connections between concepts of fairness and the economic analysis of law are robust and diverse. We have compiled a volume of scholarship in which economics engages with fairness, challenging the idea that the two concepts are alien to each other. Indeed, the literature is so large that we could easily have produced a volume several times the size of this one.« [Fennel and McAdams (2013), p. 1]. In this regard, there is another interesting example: The former Federal Reserve chairman, Alan Greenspan, conceded to a congressional committee on 23th October 2008 that the global financial crisis has exposed a »mistake« in the

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free market ideology which guided his 18-year stewardship of US monetary policy. A long-time enthusiastic and vocal supporter of deregulation, Greenspan stated that he had been »partially wrong« in his hands-off approach towards the banking industry and that the credit crunch had left him in a state of shocked disbelief. »I have found a flaw,« said Greenspan, referring to his economic philosophy. »I made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms« [Clark and Treanor (2008). webpage]. Greenspan realized, that he lacked the corrective doubts in his economic philosophy, which often leads from an intellectual believe system to aggressive ideology and blind fundamentalism [Prantl (2013)].

It is not surprising that many of these critical perspectives have been highlighted after the ongoing global financial and economic crisis started in mid-2007. At present, every economist, perhaps even every layman knows well that following a significant economic growth in the post-Second World War period, the world has been struggling with an economic crisis since 2007. In the EU, the Mediterranean countries have still been suffering: Greece, Spain, Italy and even France have been affected severely. The German economy has been doing the best among other European countries.

Not just diminishing growth and unemployment, but also the world economy has currently some other and bigger problems. Perhaps technological revolution has brought unprecedented wealth to some countries, but its dual nature has been reflected in many social and environmental problems. For example, there are huge differences between countries' per capita income and consumption levels. In addition, overconsumption of natural resources caused unsustainable greenhouse gas emissions and therefore global warming.

Similarly, and in direct connection to this discussion, the »business ethics« and the »corporate social responsibility« movements have been gaining momentum globally with several initiatives. Currently, even the mainstream academic journals admit the relevance of ethical, moral or value-based challenges to the dominant discussion. In addition, there are brand-new journals particularly devoted to critical and interdisciplinary research and discussion to cover issues around ethical behavior in business and economics, and corporate social responsibility, environmental sustainability, globalization, international business etc. (See exemplary the »Journal of Markets and Ethics« which started publication in 2013).

Within these various but interrelated discussions, one of the questions that should be raised is: »What makes the German economic system different from the rest at least in Europe?« Therefore, in this short paper, our objective is to understand how and why the German Mittelstand or SMEs sector based on the middle class seems to perform much better in economic, social and ecological terms in general compared with some other countries. In this respect, we will analyse why the values and the mind-sets can be an important »resource« of an individual business and a whole national economy. We will also attempt to construct a simple conceptual framework to integrate moral or ethical values to business sustainability. To that end, we will suggest that business strategy is directly related to ethical values of top management of any company. Within this framework, we then refer to the German SMEs sector (Mittelstand) and the German Social Market Economy model whose origins can be traced to the interwar Freiburg school of economic thought.

Therefore, in the following sections of the paper, first, the relationship between the state of the economy and the science of economics will be briefly sketched. This will be followed by a

discussion on business strategy for competitiveness and sustainability before the conceptual framework is set. The rest of the paper will focus on the German case.

## 2 THE STATE OF ECONOMY AND ECONOMICS

Before and after the great financial crisis of the 2000's, a number of accounting scandals came out in the United States and in other countries. For example, one of the then leading accounting firms Arthur Andersen had a significant role in the Enron Scandal by certifying fraudulent financial statements. Though more than half of the fees were charged for non-audit services, Enron paid Arthur Andersen \$154,8 million in total only in three years [Freier (2004)]. Not only those at Arthur Andersen but also at other major firms, professionals had been behaving in nonprofessional and also unethical ways by maintaining very close connections with the companies that they were supposed to be auditing. They had been violating regulations, certifying statements that fraudulent or at least misleading, and often obscuring the line between consulting and auditing [Freier 2004; Gardner 2006].

The sketched current state of the world economy is connected to the orthodox Neoclassical Economic Theory which claims that businesses are mainly for profit making and all economic agents including company owners and managers act (and have to act) as the homo economicus, the means-end rational model man focusing on his own wealth maximisation. This is very well reflected in »the shareholders' wealth maximisation« approach of the Anglo-American stock-market-based economic system with the focus on short-term stock price. Therefore, the neo-classical model traditionally provides its legitimacy to such actions that cause huge income discrepancies, other social and environmental problems. One of the leading neoclassical economists of the twentieth century, Milton Friedman, states that »the only responsibility of business is to its shareholders« and thus »the social responsibility of business is to increase its profits« [Friedman (1970)].

Economists, at least many of them claim that economics has always a special place among other social sciences. This perspective is grounded on the claim that economics is like positive sciences. It can measure the existing reality and then forecast the future economic activity by modelling *ceteris paribus*. These views are clearly understandable but often lack realistic conditions due to the narrow assumptions at least of a dramatically reduced and often static modelled world. However, when we look at the recent financial scandals, the role of economics becomes a question area itself. Paul Samuelson, another famous economist and a very widely used textbook's author, said once »I don't care who writes a nation's laws – or crafts its advanced treatises – if I can write its economics textbooks.« [Weinstein (2009)] This is true as economists can have influence on the accepted economic logic of a society. This logic can become central for its accepted ethics and can shape what is assumed correct and desirable in a broader economic and political life in a country [Earle et al. (2017)].

In other words, the current global crisis cannot be a coincidence but is rather the product of the central ideology shaped by an accepted economic logic or the science of economics that is taught in schools and universities. That is why since the beginning of the crises, there have been many discussions generally stating that there is an urgent need for a new economic paradigm [Josan and Voicu (2013); Chang (2014)].

To defend economics against such criticisms, some economists often distinguish between »positive« and »normative« economics. With this approach, positive economics involves measuring

economic realities and testing the validity of relationships between different elements. Hence, the field of positive economics is objective and verifiable. Normative economics, on the other hand, are based on value judgments and, depending on it, put forward »what is believed to be necessary«, »necessary to do« or »believed to be better«. Obviously, the validity of normative proposals cannot be tested.

However, measurement and forecasting require modeling, and modeling requires making a number of assumptions due to its very nature. There is no problem here. But, decision-making on economic issues definitely affects many peoples' life similar to decision-making on political issues. In fact, it is extremely difficult to distinguish the borders between decision-making in relation to political and economic issues; not only at country level but also at the business level. Therefore, modelling process can be influenced by the assumptions made. At this stage, those conflicts among different parties' interests should take the discussion to another area: persuasion and legitimacy.

For example, in a recent Harvard Business Review article, Bower and Paine [2017] argue that the problem with »the shareholders' wealth maximisation model' is based on the widespread belief that maximising shareholder value is the most important responsibility of boards and managers. But that is a misunderstanding due to a matter of corporate law and a poor guide for ethical managerial behaviour. Then they point out the key role of »the agency theory« which gives legitimacy to, for instance, performance-based executive compensation schemes in relation to stock prices. Such schemes have played a very significant role in the accounting scandals mentioned earlier.

This is a long discussion area of course. But the tricky issue for us here is related to the concept of »legitimacy«. The recent corporate events at least in the last two decades have clearly indicated that when owners or top managers only focus on their own selfish interests to increase the share prices or company growth, other stakeholders such as small investors and employees can suffer extremely. How could they do such wrongdoings? If such acts are backed by thoughts or beliefs providing moral legitimacy in the given context, then it is easier to act in that way by using predefined justifications for the own value system. In fact, even the word »wrongdoing« implies a subjective standing related to ethical and legal considerations depending on the party involved.

Legitimacy is often related to persuasion and hence to rhetoric. If someone can persuade the others that his acts are legitimate, probably then he can carry on what he is doing. With this regard, Donald McCloskey [1994: back cover of book], another leading economist and historian, asks a fundamental question and answers: »Is economics a science?« [...] »Yes, economics measures and predicts, but – like other sciences – it uses literary methods too. Economists use stories like geologists do, and metaphors like physicists do. The result is that the sciences, economics among them, must be read as »rhetoric« in the ancient and honorable sense of writing with intent.«

We have not even mentioned yet, at least, the partial importance of theory building scientists personal experiences. Joseph Schumpeter, one of the pioneers in economics, has observed that the analyses and issues economists study are influenced by their own personal experiences. By also quoting from physiologist René Dubos stating that »[t]he raw materials out of which science is made are not only observations, experiments, and calculations of scientists, but also their urges, dreams, and follies«, Szenberg [1994, p. ix] notes that »[m]any in the profession [of economics] assume that people act in accordance with the profession's constructs, which are

abstracted from the psychological and political aspects of economic behaviour. They neglect the role of personal and social factors in the formation of economic discourse.«

In that regard, we argue that economics cannot escape from the values or interests or conflicts or ideologies of the people who have built it. That is why there are plenty of schools of thought within the borders of economics though the neoclassical tradition has been the major orthodox line widely taught at universities as if it would be the only school of thinking. As mentioned earlier according to the neoclassic economists for instance »the only responsibility of business is to its shareholders« and thus »the social responsibility of business is to increase its profits.« Under this economic logic, all the events that caused the global crisis could get the label »legitimate«. Because those business decisions makers were only looking after their shareholders' interests (or in fact through that rhetoric, they were looking after their own interests) whatever the potential costs at someone else's expense.

This argument then takes us to the issue of »values and value judgments« in relation to economics and business. Values are a ubiquitous issue. Bauer and Bolsinger [2017, p.17] state that »[i]n contemporary discourse, values become ambiguous, a term that includes various things: Laws, norms, commands, prohibitions, duties, virtues, ethos, customs, culture; social institutions as democracy, family and other concepts are often called values in everyday discourse. [...] The publicity of the concept of value rose due to the explicative character in the national economy and its reflection on the society and its order. [...] The history of political economy demonstrates a broad variety of interpretations regarding the meaning and function of value concepts«.

Therefore, values, value judgments, beliefs and understandings (i. e. moral, ethical or whatever) of all influential people such as theory builders, politicians, business people, whoever they are, will be very important for the society. Because such ideological perspectives and legitimacy concerns will shape »the mind-set« of decision makers. Within a business context, not only in regulatory authorities but also in companies. Interestingly but not surprisingly, the importance of an appropriate mind-set in economic activities can be easily seen in different countries economic systems. For instance, as mentioned earlier, the Anglo-American system is based on certain value judgments focusing on short-term share prices. However, let us say, the German economy has been operating in a quite different path since the end of the Second World War. Influenced by the First World War, the economic and financial crises of the 1920s and 1930s as well as the Second World War they developed a philosophical base which is called the Social Market Economy, or the Rhine Capitalism.

### 3 BUSINESS STRATEGY FOR COMPETITIVENESS AND SUSTAINABILITY

The area of strategic management in business is based on a very simple question: »Why do some firms perform better than the others in the market?« Though the question is very simple, answering this question requires a lot of hard work. We can begin with two other simple questions: »What is a business firm?« and »What is the purpose of a business firm?« As we will focus on the first question in the Conceptual Framework section below, here we particularly concentrate on the second question: »What is the purpose of a business firm?«

There may be various answers to this question. For instance, possible answers could be »making money« or, »increasing the share price as much as possible to make the shareholders richer and the wealthier than ever before«. All these answers may be accepted correct till a certain extent. As earlier emphasized, the orthodox Neoclassical Economic Theory claims that busi-

nesses are only for profit making and all economic agents including firm owners and managers must act rationally. In this context, rationality means focusing only on his own wealth maximisation, and therefore the only responsibility of the business is to its shareholders. Such an understanding leaves less room for social or ecological responsibility. But there is no single unique form of capitalism in the world and in fact, there are varieties based on different value-sets in different parts of the world. That is why nobody can claim that there is only one single truth in these types of discussions. We agree that for profit-making businesses a firm's unconditional side condition objective is profit making. For large corporations (even for smaller ones) enhancing the shareholders' value could be a major concern, and profitability of business forms the basis for the shareholders' pecuniary value. In addition, though in reality there are only a handful of companies that can survive longer than a decade or a couple of decades, theoretically a company's lifetime is endless and there are no contradictions between targets of lifespan and shareholder's wealth maximisation regarding the operations of a firm.

On the other hand, there are some studies that prove the opposite views. For instance, in their famous book »Built to Last«, Collins and Porras [1994] search for the major reasons behind their success of the most successful companies such as 3M, American Express, Boeing, Procter and Gamble and Wal-Mart. They call such companies »visionary companies«. In this respect, they suggest, that one of the myths of such huge success is that they exist first and foremost to maximize profits. They say that contrary to widely accepted myth »maximizing shareholder wealth« or »profit maximization« has not been the prevalent driving force or primary objective of such visionary companies. They rather pursue a group of objectives. Making money is definitely one of those but not necessarily the primary one. However, they are equally guided by a core ideology that is based on some core values and objectives far beyond just making money. Paradoxically, such companies often make more money than purely profit-driven companies, because they seek to do the »right« thing with all their power.

Similarly, De Geus [1997] focusses on this issue by categorizing companies under two major types in accordance with their primary reason for being in business namely »the economic company« and »the river company«. He states that economic company exists only for profit making but nothing else. By contrast, the river company exists for the community or around the community. It does not mean that the river company does not care about profits or return on investment. It does. However, such a company is itself a community and longevity is also a major reason for existence. Therefore, »to produce both profitability and longevity, care must be taken with the various processes for building a community: defining membership, establishing common values, recruiting people, developing their capabilities, assessing their potential, living up to a human contract, managing relationships with outsiders and contractors, and establishing policies for exiting the company gracefully« [De Geus (1997). p. 126].

Mackey and Sisodia [2014] say that there is another way of thinking about capitalism and business that is really needed now under the current state of the world economy. They call this »conscious capitalism« in which conscious businesses are motivated by higher purposes that integrate the interests of all their major stakeholders. Their consciousness enables them to see the interdependencies that exist among all the stakeholders, and in turn, this allows them to discover and harvest synergies from situations that otherwise cannot be utilized due to trade-offs.

Therefore, now we can ask: Which approach is the correct one for a higher competitiveness but more importantly for sustainability in the longer term? We can suggest that each approach has its own assumption. For instance, the first one is based on the assumption of »business as

war«, or the other one is based on the assumption of »business as value creation« [Hansen and Smith (2006), p. 201]. When you look at the business literature you can find plenty of books and articles which are favoring one or the other. As both of them are based on different assumptions, probably it is better to say that there can only be an ethical based answer to the initial question. However, such a discussion clearly highlights: The moral mind-set of a management executive is critically important for his or her decisions when strategy formation process occurs. Similar to other social science in business and economics, all theories are assumptions-based. Depending on the period, such theories and assumptions may also be widely regarded correct or not. Though, the orthodox assumption of money making as final goal was widely regarded as the sole business motivation by the latest financial crisis; after the crisis many authors have started to argue that currently, the problem is either the lack of ethics in the business world or the wrong ethics that is based on the dominant assumption about how the game is played [Hansen and Smith (2006)]. As a result, public and private organizations currently have attributed more attention to the improvement of ethical business behaviour all over the world. The business community's ethical and social responsibilities have thus become a public concern. Even many business schools have introduced business ethics courses to their curriculum.

#### 4 A RESOURCE-BASED APPROACH: VALUES AS A RESOURCE

The Resource-Based Theory (RBT) of the firm, which is in the center of our conceptual framework, simply defines a firm as a bundle of resources. Hence we classify all available resources for a firm under three basic categories as:

Firstly, physical/visible/tangible assets such as land, capital, equipment etc. Secondly, non-physical/invisible/intangible assets such as brands, patents, license etc. (i.e. intellectual property). All such assets, tangible or intangible, are all under legal protection in connection with ownership rights.

However, there are also some assets that cannot be put under the first two groups; and cannot be protected legally. But they are still extremely important for the firm's operations. These are called »capabilities« in general and refer to tacit knowledge, work routines, organizational culture, and trust among the people in the firm etc. We think that this third group of resources also include the mind-set of all the people involved but particularly of the top management. And, the mind-set cannot be separated from the value judgments of the people. Interestingly, though these assets cannot be under legal protection, this would not be a problem of the firm as these are the ones that can rarely be transferred or imitated.

Competitiveness of a firm will depend on that firm's resource base. Depending on the industry in which the firm operates, the importance hierarchy of these three resource groups may differ. For instance, operating in the iron and steel or petrochemical industries would require heavy capital involvement (the first group of assets) while pharmaceutical or computer software industries may require a large stock of intellectual property (the second group of assets).

This takes the issue to organizational culture. Organizational culture can be a source of competitiveness or vice versa. Organizational culture is directly related to the top management's values. If the top management cares about the ethical behavior, social responsibility, environmental concerns etc., the culture of the organization will be strongly influenced by this standing. Even it might be easier for small and medium-sized enterprises and family firms whe-

re the smaller size fosters personal interactions for value transfers; there are also examples of multi-nationals who act in that way.

## 5 THE FREIBURG SCHOOL AND THE GERMAN MITTELSTAND

When focussing on the German small and medium-sized enterprises, we can realize that a great majority of them are owned by families and those families have had their own traditions. Traditions which are value based. Influenced by the disaster of two lost world wars and the economic and financial crisis in the late 1920s and 1930s the fathers of the German constitution after World War II created an economic system which was not a plain copy of the Anglo-American stock market system.

Based on the Ordoliberal Ideas of the Freiburg School which was founded by Walter Eucken and Franz Böhm in the 1930s they integrated a social component into the liberal market economy and created the Social Market Economy which drove the post-war »German Wirtschaftswunder«. It was the ordoliberal credo of »freedom« and »responsibility« together that created an entrepreneurial spirit and influenced especially the family-owned small and medium-sized enterprises.

A decisive role in this system, however, was played by the state, that was responsible for creating an open, value-based, legal business environment without boundaries and corruption and with a reliable administration for every market player regardless of his economic power. In such a trustworthy business environment, entrepreneurs felt treated fairly and were able to grow and expand their businesses in a free and open market. On the other hand, they had less reason to play unfairly, cheat or avoid and evade taxes because they had a transparent, reliable partner in the state.

This was the beginning of the German Mittelstand which consists mainly of family-owned small and medium-sized enterprises. Those companies are characterized by showing a greater responsibility in their decisions than big multinational corporations usually do. Not only against financial decisions because they are dealing with their own private equity, but also against the environment, their employees and the society in total. Obviously, their aim is making profits, but money doesn't seem to be their one and only target. The value approach in their business approach let them treat their employees in a responsible way by i.e. paying fair and appropriate wages.

This economic behavior, which is sometimes labelled as »stupid« by short-sighted officers of big corporations, has two major advantages. Firstly, the employees feel fairly treated and are satisfied with their working conditions. Secondly, they are usually able to save some of their monthly salary for future expenses. They might think about buying real estate, a house or a flat, or starting a family. By doing this, the regular employee is able to claim more responsibility for his personal environment and has the chance to develop himself as a member of a middle-class society. This is how an open society ideally supports development of new products for the domestic market, because there is plenty of purchasing power in the hands of masses. If we look at the business world of today, we see a large number of perfect multinational corporations driven mainly by money orientation covered as »shareholder value«. We also realize a growing gap between super-rich and poor who will probably never have the chance to develop themselves as self-responsible members of a middle-class society.



The small and middle-sized enterprises in Germany described as »Mittelstand« always played a vital role in developing a middle-class society in the post-war Germany. Without their responsible behaviour against the state and the society, the »Wirtschaftswunder« of the 1950s would not have developed in the positive way it did. The fact that those companies kept their value based traditions and acted responsibly against their environment in the last decades stabilized the German economy and society in a way that Germany was not affected as hard as other European countries by the influences of the economic and financial crises of the last years. The German Mittelstand acted according to the »live and let live«. Besides making profits the target was always the development of a middle-class society which is an important basis for every democracy. Abolishing the middle-class society that we can observe nowadays in quite a lot of highly developed countries has deep impacts on democracies and societies in total.

## 6 CONCLUSION

The ongoing global financial and economic crisis has caused an unprecedented recession in many countries. Together with diminishing growth and employment, the world economy has also been facing huge environmental and social problems. All these have stimulated discussions among economists regarding the science of economics and the need for a new economic paradigm. Many now argue that the economy is not governed by natural economic laws and in fact, it is based on a man-made institutional structure. Therefore, it should be possible to modify the global system to build a new version of conscious capitalism [[www.conscious-capitalism.org](http://www.conscious-capitalism.org) 2017] to generate sustainable development in line with the increasingly complex realities and the global goals [[www.un.org/sustainabledevelopment](http://www.un.org/sustainabledevelopment) 2016] of the world. Currently, even many liberal economists argue that the current state of the world economy is directly connected to the orthodox Neoclassical Economic Theory which claims that businesses are only for profit making and all economic agents act only for their very own interests. This is very well reflected in »the shareholders' wealth maximisation« approach of the Anglo-American stock-market-based economic system. As a result, they argue that the neoclassical model provides the legitimacy to those actions caused environmental and social problems such as global warming and vast income discrepancies.

However, contrary to the neoclassical economic vision, new discussions have gained a momentum in the public scene regarding »fairness«, »ethics«, »social and ecologic responsibility« and »sustainability« in the economic system. In this paper, we attempt to construct a simple conceptual framework to integrate ethics or moral values with strategic management for business sustainability by focusing on the German Social Market Economy Model as a blueprint for a new economic paradigm. This is important and interesting since the German economy performed best among other European countries in the current economic crisis, and hence this case could be helpful in reflecting the practical examples of sustainable and ethical approaches to business.

SMEs are particularly very important in Germany where they play a big role in forming a middle-class society (so-called the Mittelstand). The Mittelstand is the backbone of the dynamism of the German social market economy. German SMEs contribute substantially to the country's GNP and total employment. For instance, over 99% of all German companies were SMEs in 2014. The number of SMEs in the country was 3,55 million and they were employing more than 24 million people, by also generating more than 60% of the GNP. German SME's are often family-run businesses with a long tradition. It is the mutual respect of employers and

employees and a value-based management that make those types of companies so successful. These companies are entrepreneurial in their nature and not always growth-oriented individually. Many small business owners do not aim to grow the company size at all. The Mittelstand case is a clear reflection of the philosophy of social market economy.

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