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ETHICAL BEHAVIOUR AND ALLOCATIVE EFFICIENCY

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Abstract. The issue of business ethics is generally addressed at the firm or micro level. It is believed that ethical behaviour contributes towards the success of a business enterprise. However, it is also imperative to study the role of ethical behaviour for efficient allocation of resources at the macro level. It is argued that the market system is generally more efficient than the traditional and command systems. The prerequisites of a market system include property rights, freedom of choice, and full information. Unethical behaviour including bribery, coercive acts, deceptive information, theft, and discrimination distorts the market system that leads to inefficient allocation of economic resources.

The mixed economy of Pakistan is based on a market system, government regulations, and limited property rights. The symptoms of unethical behaviour, including bribery, coercive action, theft and discrimination are found in both government institutions and the private enterprises which lead to suboptimal allocation of economic resources. It is suggested that collective efforts on the part of government and market participants to minimize unethical practices may result in efficient allocation of scarce resources and contribute towards the economic growth of the country.

I. INTRODUCTION

The issue of business ethics is generally addressed at the firm or micro level. There is a rapidly growing body of empirical literature that documents ethical reality in the business world. It is believed that ethical behaviour contributes towards the success of a business enterprise. From the perspective of the firm, ethics is closely associated with trust. Buyers benefit from ethical behaviour which creates the needed trust to support exchange relationship. Sellers also benefit from exchange relationship made possible by trust supported by ethical behaviour. For the long term success

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of the business it is badly needed to build trust among employees and management. Ethical behaviour encompasses trust which enhance productivity.

However, it is imperative to study the role of ethical behaviour for efficient allocation of resources at macro level. Resource allocation at macro level depends on the type of economic system being followed by a particular country/economy. An economic system is defined as a means of determining what, how, and for whom goods and services are produced in the presence of scarce economic resources.

The literature has defined three basic types of economic systems namely traditional, command, and market economies. *Firstly*, subsistence foods gathering, primitive agriculture, or nomadic herding characterizes traditional society. The questions of what, how, and for whom to produce are determined by customs and habits handed down from generation to generation. *Secondly*, a command society follows an economic system in which the questions of what, how, and for whom to produce are answered by a central authority. Most of the production in a command society takes place in government-owned or state-sponsored enterprises. Invention and innovation can be found in command societies, but their development and the use of their results are ordinarily controlled by the control authority. A large degree of discretionary power exists in a command society, which leads to a selective distribution of wealth. Those highly placed or those enjoying good relationship with the highly placed have first choice of products and services produced. Historically, traditional and command societies have been most common. Egyptian, Greek, Roman, and medieval societies (dictatorship, monarchies, and aristocracies) were composed of both traditional and command characteristics. *Thirdly*, the market society follows an economic system in which individuals acting in their self-interest determine what, how, and for whom goods and services are produced, with little or no government intervention.

It is argued that the market economic system is generally more efficient than the traditional and command systems. The present paper discusses the prerequisites of a market system in the next section. The most common types of ethical issues are presented in the third section and the fourth section discusses the effect of unethical behaviour on efficient allocation of economic resources. The resource allocation mechanism in Pakistan and unethical behaviour are the topics covered in section five. Finally, the last section suggests some collective measures on the part of government and market participants to minimize the unethical behaviour which may result in efficient allocation of scarce resources and contribute towards the economic growth of the country.

II. MARKET SYSTEM AND RESOURCE ALLOCATION

It is generally believed that market system is more efficient in allocation of scarce resources than the traditional and command systems. The prerequisites of a market system include property right, freedom of choice, and full information that are discussed below:

Property Rights

Ownership of private property is necessary for exchange to take place. Ownership of private property implies protection of property from exchange without one's consent. In a market economy the individual's right to own and dispose of property is regarded as basic. Property includes both physical property and intellectual or intangible property. An economic agent must agree to exchange a good or service in exchange for money or another good or service and if anybody will try to take away a good or service without the consent of the owner of the property it will be considered as theft. In the absence of the property right the economic agents will hesitate to produce and exchange goods and services since they fear that their goods and services may be stolen, and the market system will break down due to the refusal of the suppliers to provide products and service for which they may not be compensated. Therefore, for the market system to work, you must have the right to own private property, and your property rights must be respected. Without some guarantee that property rights will be protected, there would be little incentive to accumulate capital stock and therefore to grow economically.

Freedom of Choice

The freedom to pursue one's economic self interest is an intrinsic part of the market economy. The freedom of choice in exchange means that the consumers can decide what products and services to purchase if they have the money to pay for them.

The producers also enjoy the freedom of choice if the business firms and entrepreneurs can freely produce goods and services at competitive market prices to take advantage of profitable opportunities. And finally the labourers may choose to work at any job for which they are qualified. The available set of goods and services in an economy using the market system are produced by the producers with the freedom of choice in production (*i.e.* pursuing the motive of profit maximization) and allocated to consumers based on their individual purchases. Each person buys the goods and services that he or she believes will best satisfy individual needs. In the aggregate, the goods and services are produced, the jobs or professions are selected, and goods and services are allocated in the most effective manner possible.

The inefficient use and allocation of resources occur when the producers are not free to produce a product or service which maximizes profits, labourers are not free to opt for a job for which they are qualified, and the consumers are not free to choose a product or service which best satisfies his or her needs.

Full Information

The market economic system relies heavily on the precondition of full information to buyers, sellers and wage earners. The buyers will be able to purchase a product or service which would maximize his/her satisfaction if he/she has the full information about the price, quality and availability of selected as well as the substitute products and services. The producer can combine the productive resources in the most efficient manner (least cost combination) if he has the full information about the availability, price, and characteristics of factors of production. The wage earners can also earn the maximum if they have the access to full information about the availability, reward and motive of the job for which they are qualified. In the absence of full information, consumers, producers and wage earners will not be able to exchange and produce goods and services that can lead to efficient allocation of economic resources.

A MODEL OF COMPETITIVE MARKETS AND ECONOMIC EFFICIENCY[1]

Under the ideal circumstances the market economic system, having the above characteristics and without the government intervention, can be explained with a model of purely competitive market. The competitive markets are believed to allocate the economic resources in an optimal way and create productive as well as allocative efficiency in resource allocation which is briefly described below:

Productive Efficiency

The productive efficiency of competitive market forces can be seen in its long run equilibrium when the firms earn zero economic profits. In effect, competition forces firms to produce their output at the minimum long-run

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[1]This section is based on Ekelund and Tollison (1985) and Ferguson *et al.* (1993).

average total cost and at a price just sufficient to cover that cost. This productive efficiency can be seen in the following diagram of long-run equilibrium in competitive firms:

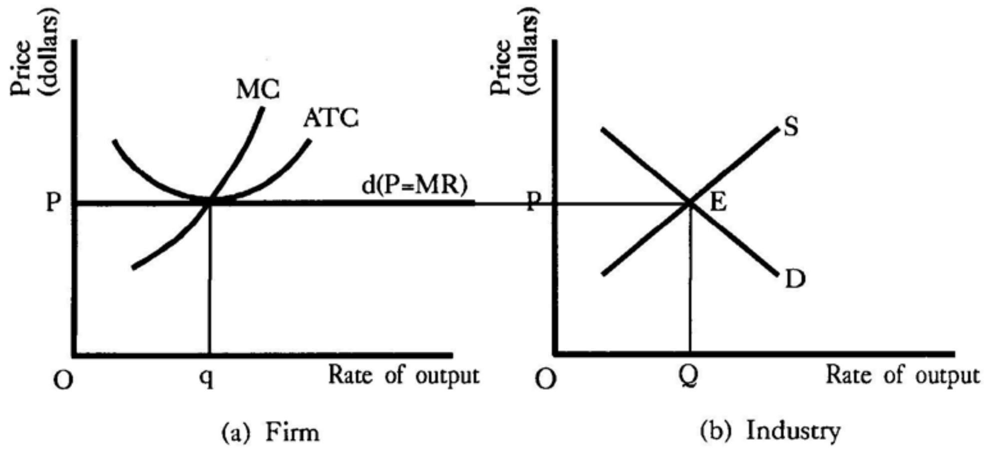

FIGURE 1

The Purely Competitive Industry in Long-Run Equilibrium[2]

The competitive firms produce at a point where $P = MR = LRATC = MC$. Inefficient, high cost firms will incur economic losses and will be forced to leave the market. The surviving firms will produce the industry output at the lowest possible cost of resources. Consumers also benefit from this situation because they are able to get the desired good at the lowest possible price.

Allocative Efficiency

The competitive market also creates allocative efficiency. Where the competition causes resources to flow to their most highly valued uses. The consumer demands are met as long as consumers are willing to pay for the production of additional output at a price that is higher than the cost of additional resources required to produce the output. This situation is expressed in the form $P = MC$, where price reflects the desire of consumers for additional units of the good. Marginal cost represents the opportunity cost of the resources necessary to produce an additional unit of the good.

If $P > MC$, consumers will pay more for additional units of production than the cost to produce them. Under this situation, resources will be reallocated from other uses considered less valuable by consumers.

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[2]Source: Ekelund and Tollison (1985), p. 192.

If $P < MC$, consumers will pay less for additional units of production than the cost to procure them. Resources will be reallocated out of such production.

Acting in their self-interest, consumers and producers create a mutually beneficial outcome. Looking out for their own interest, producers seek to maximize profits, and yet in a competitive market the result is that consumers desires are met in the most efficient way possible.

Societal Welfare

Competitive market theory is based on the assumption that the pursuit of profits by firms is socially defensible because it produces the output mix that society values most highly. Consider for instance the market depicted in the following figure:

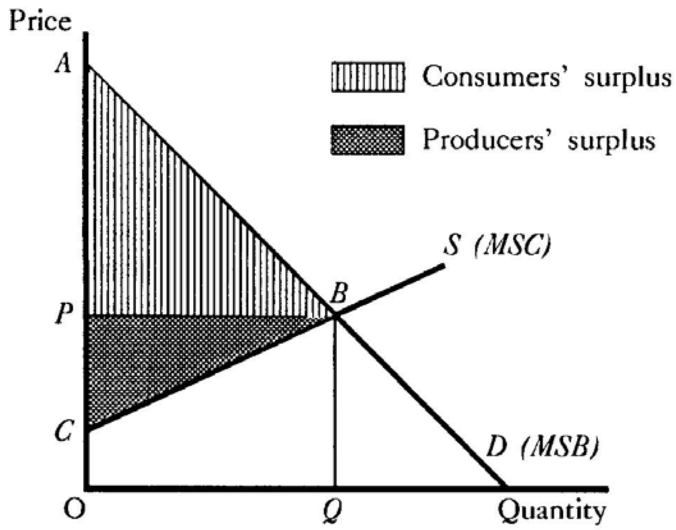

FIGURE 2

The Efficiency of the Market Equilibrium[3]

The demand curve, *D*, shows the price consumers are prepared to pay for a particular quantity. In this case price reflects consumer's valuation of the product and can therefore be regarded as measuring marginal social benefit (MSB) or the benefit obtained by society from the consumption of an extra unit. The market supply curve has its origins in the marginal costs curves of the individual producers. Consequently, it shows the cost to society of the resources used to produce an extra unit of the product, or marginal social

[3]Source: Ferguson *et al.* (1993), p. 376.

cost (MSC). MSC reflects the fact that in devoting resources to this particular product society cannot use them elsewhere to produce other products, which would themselves be of benefit.

Price and output are determined by market forces which reflect the self-interests of buyers or sellers. Market equilibrium is itself socially optimal because MSB equals MSC. It is also allocatively efficient and Parato optimal. The production of an additional unit of output would give rise to a misallocation of resources because the cost of such resources would exceed the benefit society would gain from their use. By similar reasoning, production of an output smaller than *Q* would lower society's welfare. The net benefit society obtains (total benefit less total cost) can be quantified by considering the shaded areas in Figure 2. The market charges consumers the uniform price, *P*. Their total expenditure on the product is shown by area *OPBQ*. How much they would actually be prepared to pay for quantity *Q* is shown by the area under the demand curve, *OABQ*.

The difference between these two amounts, the shaded area *PAB*, is termed consumers' surplus. From the point of view of suppliers the area *OPBQ* represents total revenue from sales. *OCBQ* shows the cost of the resources used. Thus, the shaded area *CPB* depicts producer's surplus, the amount available to cover fixed costs and normal profits for shareholders. Overall societal welfare is the sum of producer's surplus and consumer's surplus. In practice, however, the model of perfect competition is plagued by several productive and allocative inefficiencies. The ethical issues that cause distortions in the ideal functioning of such model are presented in the following section.

III. TYPES OF ETHICAL ISSUES

The most commonly faced and troubling ethical issues can be categorized in the following five major categories:

Bribery

Bribe is used to manipulate people by buying influence. Bribery has been defined by *Black's Law Dictionary* as "the offering, giving, receiving, or soliciting of something of value for the purpose of influencing the action of an official in the discharge of his or her public or legal duties". The item of value may be direct payments of money or property. It may also be in the form of a kickback after a deal has been completed. Velasquez (1992) refers to a commercial bribe as a "consideration given to an employee by a person outside the firm with the understanding that when the employee transacts business for his or her own firm, the employee will deal favourably with that person or with that person's firm."

Bribes create a conflict of interest between the person receiving the bribe and his or her organization. The bribe creates a private interest which is likely to be in conflict with the organization's interest. Bribery is most often used to gain sales, to enter new markets, or to change or avoid public policy.

Coercion

Coercion controls people by force or threat. It is defined by Velasquez (1992) as "compulsion; constraint; compelling by force or arms or threat …. It may be actual, direct, or positive, as where physical force is used to compel action against one's will, or implied, legal or constructive, as where one party is constrained by subjugation to another to do what his free will would refuse." The force is often the threat of the use of power upon the disadvantaged party. Coercion may involve the threat of blocking a promotion, the loss of a job, or blackmailing an individual in the industry. Coercion is used to compel an individual to act in a way that is against her or his will. Coercion may also be used against firms — for example, forcing a retailer to handle specific products in order to obtain other desired products.

Deception

Deception manipulates people and firms by misleading them. According to *Black's Law Dictionary*, deception is "the act of deceiving; intentional misleading by falsehood spoken or acted …. Knowingly and willingly making a false statement or representation, expressed or implied, pertaining to a present or past existing fact." This dishonest behaviour is one of the most common ethical transgressions. Deception includes distorting or falsifying research or accounting data, creating misleading advertising, and misrepresenting a product. It also is involved in fake expense reports, fudged performance appraisals, and misrepresented financial positions. Deception ranges from the small innocuous lie, which may cause little or no harm, to significant schemes to deceive, which may cause major economic or physical harm, including death.

Theft

Theft is the taking of something that does not belong to you. Joseph Nolass and Jacqueline Nolass-Haley (1990) define it as "the act of stealing. The taking of property without the owner's consent." This does not apply to property that is lost due to competitive forces when play is according to the economic rules of the culture. However, if property is lost through a change in the rules, the loss may be considered theft if it meets one of the following conditions:

1. It was not possible to take action that would comply with the new rules.
2. It was not possible to foresee the development of the new rules in time to comply with them prior to the loss.

Theft, too, covers a wide variety of ethical transgressions. The property may be physical or conceptual. Theft occurs in insider trading when one uses privileged information as one's own. It also occurs when products are counterfeited, or one engages in price gouging. Theft occurs when a firm's proprietary information is used to further another firm's ends. This information may be obtained via unauthorized use of company computers and programmes.

Price collusion results in theft because collusion keeps prices higher than normal and thus takes from buyers money that should not need to be paid to complete an exchange. Dishonesty in making and keeping contracts also results in theft.

Unfair Discrimination

Unfair discrimination is defined by *Black's Law Dictionary* as "unfair treatment or denial of normal privileges to persons because of their race, age, sex, nationality or religion …. A failure to treat all persons equally when no reasonable distinction can be found between those favoured and those not favoured." We refer to this as unfair discrimination in contrast to discrimination based upon their qualifications, and people are compensated on the basis of their relative contributions to the organization. Unfair discrimination occurs when one individual or class is favoured over another on the basis of irrelevant criteria. The key is the criteria utilized. Are the criteria relevant to the requirements of the job or function?

Velasquez (1992) cites three basic elements that must be present for unfair discrimination in employment to occur:

1. It is a decision against one or more employees (or prospective employees) that is not based on individual merit.
2. The decision derives solely or in part from racial or sexual prejudice, from false stereotypes, or from some other kind of morally unjustified attitude.

3. The decision (or set of decisions) has a harmful or negative impact upon the interest of the employees.

Unfair discrimination is present when an individual is denied a job, promotion, or other benefit based upon the individual's race, sex, or religion. These criteria have no relevance to such decisions.

IV. IMPACT OF UNETHICAL BEHAVIOUR ON RESOURCE ALLOCATION

The presence of unethical behaviour including bribery, coercion, deception, theft, and unfair discrimination distorts the market system which leads to inefficient allocation of economic resources, higher costs and a decrease in societal welfare. These effects are analyzed below:

Bribery

Bribery reduces freedom of choice by altering the conditions under which a decision is made. A bribe is used to make one choice more attractive to a decision-maker. The greater appeal is created by enhancing the personal gain associated with the choice by the addition of an unearned income payment. While the decision-maker gains by selecting the alternative with the bribe, the choice itself is usually less attractive and generally provides less total satisfaction. The bribe thus results in allocating more resources to a less desirable alternative.

In terms of economic model, bribery increases the marginal cost of production for the producers which results in an increase in Marginal Social Cost (MSC) thereby shifting the MSC towards left resulting in an increase in price. This increase in price leads to a decrease in producer's surplus as well as consumers surplus and an overall decrease in societal welfare.

Coercion

Coercive acts — in the form of threats or force that prevents a seller from dealing with certain customers, buyers from purchasing from certain sellers, or buyers from buying certain products or services — decrease effective competition. This usually results in higher prices being paid and possible poorer products and/or services being provided than would occur if more competition had been present. The higher price decreases the demand for the goods or services below the level that would occur at competitive prices. Thus, fewer resources will be allocated to producing the goods or services than would be the case if competition had not been constrained by coercion.

In the context of economic model coercive acts shift the market demand curve towards left which results in a decrease in Marginal Social Benefits (MSB) which results in a decrease in producers surplus along with a decrease in consumer’s surplus and an overall decrease in societal welfare.

Deception

Deceptive information creates false impressions and leads buyers to select goods and services that provide less satisfaction than those which would have been purchased using accurate information. Deceptive information may also lead to deliveries at times other than promised, which can create costly disruptions in production runs, resulting in higher cost output. Buyers must pay more and thus buy less than would be purchased if deliveries had been on time. False delivery promises to consumers can also increase the cost of using products or services. Misinformation squanders money that could be used for other purchases. Delivering products and services that differ from those promised will also distort the system. Resources will be allocated to the delivered items and not to those wanted.

In terms of economic model deceptive information results in an increase in marginal cost for the individual producers and an increase in MSC for the market (a leftward shift in the MSC curve) which results in higher prices. This increase in price leads to a decrease in both producer’s and consumer’s surplus and a resulting decrease in societal welfare.

Theft

Theft significantly increases the cost of providing products and/or services. Losses due to theft of any type must be made up via larger profit margins which increase prices. The artificially increased prices due to theft will lower demand and thus result in a misallocation of resources.

The impact of theft can be translated using the economic model as an increase in MSC and resulting increase in market price which leads to a decrease in producer’s as well as consumer’s surplus. As a result overall societal welfare is decreased.

Unfair Discrimination

Finally, unfair discrimination often results in-the purchase of service from less capable people or the sale of goods and services to people who value them less than those discriminated against. Once again, we see a misallocation of resources. Unfair discrimination generally results in a lower level of satisfaction than fair discrimination.

In the context of economic model unfair discrimination decreases the Marginal Social Benefit, and therefore shifts the MSB curve towards left which results in a decrease in both consumer's surplus as well as producer's surplus and an overall decrease in societal welfare.

V. RESOURCE ALLOCATION AND UNETHICAL BEHAVIOUR IN PAKISTAN

In a mixed economy, such as of Pakistan, two primary mechanisms are relied upon to allocate the scarce economic resources to the production of goods and services for the use of individuals in the society. One is the market pricing system, by which privately owned and managed firms respond to prices determined by the demand and supply levels in individual markets, and undertake that level of economic activity which is in their own self-interest. The collection of all such firms operating under the institutions of the market mechanism is called the private sector.

Resource allocation decisions are also taken by the government, or the public sector, through its activities of levying taxes, undertaking expenditures for goods and services, making direct money transfers to households and firms, and establishing regulations for the operations of private sector. The public sector's decision-making actions encompass a significant share of the resources of the economy directly and influence the behaviour of the private sector indirectly.

It is generally argued that if both the private and public sector decision-makers follow the ethical behaviour it may result in efficient allocation of scarce economic resources. But the symptoms of unethical behaviour including bribery, coercion, theft and unfair discrimination are found in the public institutions and the private enterprises of Pakistan which leads to suboptimal allocation of scarce resources and hamper economic growth of the country.

The unethical behaviour of bribery is common in public enterprises where unofficial fixed percentage for obtaining the government contracts is considered as a regular feature of business. In the import/export business, the businessmen do not hesitate to pay certain amount for getting the import/export licences. In general, bribery has become a common feature in police, judicial, and in labour departments. Moreover, the kickbacks are also becoming a popular feature in the public enterprises. The most recent issue of IPPs can be quoted as an example. All of the above-mentioned unethical behaviours of public enterprises can be supported by a recent report by the World Bank mission quoted in a daily newspaper that the

Pakistani bureaucrats and judicial systems are the worst examples of unfair and unethical business practices.

In the mixed economy of Pakistan it is not hard to find out the examples of coercive action at both public as well as private enterprise level. "Qabza Groups" are a common feature which results in illegal occupancy of public (*e.g.*, Railways land) and private properties thereby distorting the property right. Fear of snatching the moveable property is also increasing. According to a recent report by BBC, the motor vehicle snatching incidents in the city of Karachi are 750 motor cars per month which is leading towards a higher insurance premium on motor vehicles. Uncertainty about the government policy also constitutes coercive actions. The nationalization of private banks in 1974 can be quoted as an example. Most recently, after nuclear explosions, announcement of freezing the foreign currency accounts of resident Pakistanis can be quoted as another example of coercive action.

The unethical behaviour of theft is common in public utilities including WAPDA. Tax evasion is a common phenomenon in the business circles where certain amount is paid to the income tax officers to overlook the underreported taxable income. The unfair business practices of cheating in the quality as well as quantity of the product is another feature which distorts the market system.

Unfair discrimination, having an adverse effect on the efficient allocation of economic resources through the market system, is present in Pakistani economy at all levels. The literature supports the existence of discrimination against female and rural population in education, training, and employment at both public as well as private enterprises level (*see* for example Bodla, 1998). The quota system for admissions and employment on provincial level also represents a case of discrimination that distorts the market system. It is not hard to find the examples of discriminatory behaviour in the private sector. One can safely quote the example of discrimination against the small suppliers as far as the access to credit facility is concerned, the less influential, small sized businessmen are also discriminated against the ruling class and the other pressure groups.

Deception, meaning manipulating people and firms by misleading them, is not hard to find in Pakistani business culture. Majority of the private firms misrepresent the financial information to create a false impression about them and to minimize the tax liability. At times firms also try to manipulate the share price in the stock market by artificially controlling the demand or supply of the shares in the market place. There is a lack of existence and implementation of intellectual property rights, *e.g.* trademarks etc. which results in the production of "number two" (*i.e.* low grade) products.

All of the above unethical practices prevailing in Pakistan lead to the distortion of market system which leads towards inefficient allocation of scarce economic resources. There is an urgent need to develop a policy framework to minimize these unethical practices which may lead to efficient allocation of economic resources and long-term growth of the economy. The following concluding section of the paper presents some policy recommendations that are expected to minimize the unethical practices and lead the economy towards economic growth.

VI. CONCLUSIONS AND POLICY RECOMMENDATIONS

The mixed economy of Pakistan lacks the property rights, freedom of choice and full information, which are the prerequisites of a market system. Moreover, the unethical practices of bribery, coercion, theft, unfair discrimination, and deception are also present at both the private as well as the public enterprise levels which lead to suboptimal allocation of economic resources. The following policy recommendations are suggested to improve the situation:

1. There is an urgent need on the part of the government to protect the property rights and freedom of choice, which calls for an immediate stop to hostile practices against private enterprises as well as steps like freezing the foreign currency accounts. The legal system should also provide the mechanism to protect the private property rights and freedom of choice.

2. Develop the market system to provide the full information to the market participants including consumers, producers, suppliers, and wage earners. To this end, there is an immediate need to increase the literacy rate and develop the communication channels.

3. Minimize the direct role of public sector in business and trade activities, rather the government's role should be to provide legal and physical protection and disburse justice to the economic agents operating in private sector of the economy.

4. Develop a mechanism to check bribery and theft which needs overhauling of the entire system. To this end a top to bottom approach is suggested. Privatization of WAPDA and Railways is a right step towards minimizing the problem of theft.

5. There is a pressing need that the government should improve the tax collection system instead of levying the new direct or indirect taxes. Documentation of the economy will help achieve this objective.

6. The government should abolish the quota system for education, training, and employment. There is also a need to stop the discriminatory practices based on sex, province, and ethnic background at both the public as well as private enterprise level.

7. The culture of fixed percentages and kickbacks should be changed to fair business practices. To achieve this government should initiate the accountability process on all levels of the society including the bureaucrats as well as the politicians. Transparency of the legal system is the prerequisite for the success of the accountability process.

8. The government can also control the deception by protecting the intellectual property rights and trademarks. The policy should be devised to deal with the misrepresentation of the financial information.

9. Last but not the least, there is an immediate need to minimize the unethical behaviour by preaching and exercising the Islamic, social and economic values.

Most of the above-mentioned policy recommendations are focused on the policy makers, based on the belief, that it is the leader's job to show the right path to the people. Now is the time for the policy makers to develop the appropriate policy framework for establishing a market system, and minimizing the prevailing unethical practices which will result in efficient allocation of economic resources and contribute towards the economic growth of the country.

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