

SOCIAL RESPONSIBILITY AND ECONOMIC EFFICIENCY

KENNETH J. ARROW

This paper makes some observations on the widespread notion that the individual has some responsibility to others in the conduct of his economic affairs. It is held that there are a number of circumstances under which the economic agent should forgo profit or other benefits to himself in order to achieve some social goal, especially to avoid a disservice to other individuals. For the purpose of keeping the discussion within bounds, I shall confine my attention to the obligations that might be imposed on business firms. Under what circumstances is it reasonable to expect a business firm to refrain from maximizing its profits because it will hurt others by doing so? What institutions can we expect to serve the function not merely of limiting profits but of limiting them in just those ways that will avoid harm to others? Is it reasonable to expect that ethical codes will arise or be created? My purpose in discussing these questions is not so much to achieve definitive answers as to analyze the kinds of consideration that enter into discussing them.

First of all, it may be well to review what possible ways there are by which the economic activity of one firm may affect other members of the economy. A substantial list comes to mind; a few illustrations will serve. A firm affects others by competing with them in the product markets and in the factor markets, in the buying of labor, buying of other goods for its use, and in the selling of its products. It pays wages to others. It buys goods from others. It sets prices to its customers, and so enters into an economic relation with them. The firm typically sets working conditions, including — of greatest importance — conditions that affect the health and possibility for accident within the plant. We are reminded in recent years that the firm, as well as the private individual, is a contributor to pollution. Pollution has a direct effect on the welfare of other members of the economy. Less mentioned, but of the

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same type, are the effects of economic activity on congestion. Bringing a new plant into an already crowded area is bound to create costs, disservices, and disabilities to others in the area if by nothing else than by crowding the streets and the sidewalks and imposing additional burdens on the public facilities of the area. Indeed, although congestion has not been discussed as much as has pollution, it may have greater economic impact and probably even greater health costs. Certainly the number of automobile deaths arising from accidents far exceeds the health hazards arising from automobile pollution. The firm affects others through determining the quality of its products, and again, among the many aspects of product quality we may especially single out the qualities of the product with respect to its pollution-creating ability, as in the case of automobiles, and with respect to its safety, the hazards it poses to its user. The question of social responsibility takes very different forms with regard to the different items on this varied list. It is not a uniform characteristic at all.

Let us first consider the case against social responsibility: the assumption that the firms should aim simply to maximize their profits. One strand of that argument is empirical rather than ethical or normative. It simply states that firms will maximize their profits. The impulse to gain, it is argued, is very strong and the incentives for selfish behavior are so great that any kind of control is likely to be utterly ineffectual. This argument has some force but is by no means conclusive. Any inclination for enforcing or urging social responsibility upon firms must of course reckon with a profit motive, with a desire to evade whatever response of controls are imposed. But it does not mean that we cannot expect any degree of responsibility at all.

One finds a rather different argument, frequently stated by some economists. It will probably strike the noneconomist as rather strange, at least at first hearing. The assertion is that firms ought to maximize profits; not merely do they like to do so but there is practically a social obligation to do so. Let me briefly sketch the argument:

Firms buy the goods and services they need for production. What they buy they pay for and therefore they are paying for whatever costs they impose upon others. What they receive in payment by selling their goods, they receive because the purchaser considers it

worthwhile. This is a world of voluntary contracts; nobody has to buy the goods. If he chooses to buy it, it must be that he is getting a benefit measured by the price he pays. Hence, it is argued, profit really represents the net contribution that the firm makes to the social good, and the profits should therefore be made as large as possible. When firms compete with each other, in selling their goods or in buying labor or other services, they may have to lower their selling prices in order to get more of the market for themselves or raise their wages; in either case the benefits which the firm is deriving are in some respects shared with the population at large. The forces of competition prevent the firms from engrossing too large a share of the social benefit. For example, if a firm tries to reduce the quality of its goods, it will sooner or later have to lower the price which it charges because the purchaser will no longer find it worthwhile to pay the high price. Hence, the consumers will gain from price reduction at the same time as they are losing through quality deterioration. On detailed analysis it appears the firm will find it privately profitable to reduce quality under these circumstances only if, in fact, quality reduction is a net social benefit, that is, if the saving in cost is worth more to the consumer than the quality reduction. Now, as far as it goes this argument is sound. The problem is that it may not go far enough.

Under the proper assumptions profit maximization is indeed efficient in the sense that it can achieve as high a level of satisfaction as possible for any one consumer without reducing the levels of satisfaction of other consumers or using more resources than society is endowed with. But the limits of the argument must be stressed. I want to mention two well-known points in passing without making them the principal focus of discussion. First of all, the argument assumes that the forces of competition are sufficiently vigorous. But there is no social justification for profit maximization by monopolies. This is an important and well-known qualification. Second, the distribution of income that results from unrestrained profit maximization is very unequal. The competitive maximizing economy is indeed efficient — this shows up in high average incomes — but the high average is accompanied by widespread poverty on the one hand and vast riches, at least for a few, on the other. To many of us this is a very undesirable consequence.

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Profit maximization has yet another effect on society. It tends to point away from the expression of altruistic motives. Altruistic motives are motives whose gratification is just as legitimate as selfish motives, and the expression of those motives is something we probably wish to encourage. A profit-maximizing, self-centered form of economic behavior does not provide any room for the expression of such motives.

If the three problems above were set aside, many of the ways by which firms affect others should not be tampered with. Making profits by competition is, if anything, to be encouraged rather than discouraged. Wage and price bargains between the firm and uncoerced workers and customers represent mutually beneficial exchanges. There is, therefore, no reason within the framework of the discussion to interfere with them. But these examples far from exhaust the list of interactions with which we started. The social desirability of profit maximization does not extend to all the interactions on the list. There are two categories of effects where the arguments for profit maximization break down: The first is illustrated by pollution or congestion. Here it is no longer true (and this is the key to these issues) that the firm in fact does pay for the harm it imposes on others. When it takes a person's time and uses it at work, the firm is paying for this, and therefore the transaction can be regarded as a beneficial exchange from the point of view of both parties. We have no similar mechanism by which the pollution which a firm imposes upon its neighborhood is paid for. Therefore the firm will have a tendency to pollute more than is desirable. That is, the benefit to it or to its customers from the expanded activity is really not as great, or may not be as great, as the cost it is imposing upon the neighborhood. But since it does not pay that cost, there is no profit incentive to refrain.

The same argument applies to traffic congestion when no change is made for the addition of cars or trucks on the highway. It makes everybody less comfortable. It delays others and increases the probability of accidents; in short, it imposes a cost upon a large number of members of the society, a cost which is not paid for by the imposer of the cost, at least not in full. The person congesting is also congested, but the costs he is imposing on others are much greater than those he suffers himself. Therefore there will be

a tendency to over-utilize those goods for which no price is charged, particularly scarce highway space.

There are many other examples of this kind, but these two will serve to illustrate the point in question: some effort must be made to alter the profit-maximizing behavior of firms in those cases where it is imposing costs on others which are not easily compensated through an appropriate set of prices.

The second category of effects where profit maximization is not socially desirable is that in which there are quality effects about which the firm knows more than the buyer. In my examples I will cite primarily the case of quality in the product sold, but actually very much the same considerations apply to the quality of working conditions. The firm is frequently in a better position to know the consequences (the health hazards, for example) involved in working conditions than the worker is, and the considerations I am about to discuss in the case of sale of goods have a direct parallel in the analysis of working conditions in the relation of a firm to its workers. Let me illustrate by considering the sale of a used car. (Similar considerations apply to the sale of new cars.) A used car has potential defects and typically the seller knows more about the defects than the buyer. The buyer is not in a position to distinguish among used cars, and therefore he will be willing to pay the same amount for two used cars of differing quality because he cannot tell the difference between them. As a result, there is an inefficiency in the sale of used cars. If somehow or other the cars were distinguished as to their quality, there would be some buyers who would prefer a cheaper car with more defects because they intend to use it very little or they only want it for a short period, while others will want a better car at a higher price. In fact, however, the two kinds of car are sold indiscriminately to the two groups of buyers at the same price, so that we can argue that there is a distinct loss of consumer satisfaction imposed by the failure to convey information that is available to the seller. The buyers are not necessarily being cheated. They may be, but the problem of inefficiency would remain if they weren't. One can imagine a situation where, from past experience, buyers of used cars are aware that cars that look alike may turn out to be quite different. Without knowing whether a particular car is good or bad, they do know that there are good and bad cars, and of course

their willingness to pay for the cars is influenced accordingly. The main loser from a monetary viewpoint may not be the customer, but rather the seller of the good car. The buyer will pay a price which is only appropriate to a lottery that gives him a good car or a bad car with varying probabilities, and therefore the seller of the good car gets less than the value of the car. The seller of the bad car is, of course, the beneficiary. Clearly then, if one could arrange to transmit the truth from the sellers to the buyers, the efficiency of the market would be greatly improved. The used-car illustration is an example of a very general phenomenon.

Consider now any newly produced complex product, such as a new automobile. The seller is bound to know considerably more about its properties than all but a very few of its buyers. In order to develop the car, the producer has had to perform tests of one kind or another. He knows the outcome of the tests. Failure to reveal this knowledge works against the efficiency of satisfying consumers' tastes. The argument of course applies to any aspect of the quality of a product, durability or the ability to perform under trying circumstances or differing climatic conditions. Perhaps we are most concerned about the safety features of the automobile. The risks involved in the use of automobiles are not trivial, and the kind of withholding of safety information which has been revealed to exist in a number of cases certainly cannot be defended as a socially useful implication of profit maximization. The classical efficiency arguments for profit maximization do not apply here, and it is wrong to obfuscate the issue by invoking them.

Perhaps even more dramatic, though on a smaller scale, are the repeated examples of misleading information about the risks and use of prescription drugs and other chemicals. These again manifest the same point. Profit maximization can lead to consequences which are clearly socially injurious. This is the case if the buyers are on the average deceived — if, for example, they have higher expectations than are in fact warranted. They are also injured when on the average they are not deceived but merely uncertain, although here the argument is more subtle. One consequence may be the excessively limited use of some new drugs, for example. If the users of the drugs become fully aware of the risks involved but are not able to assess the risk with respect to any particular drug, the result may be an indiscriminate rejection of new treatments

which is rational from the point of view of the user; this, in the long run, may be just as serious an error as the opposite.

Defenders of unrestricted profit maximization usually assume that the consumer is well informed or at least that he becomes so by his own experience, in repeated purchases, or by information about what has happened to other people like him. This argument is empirically shaky: even the ability of individuals to analyze the effects of their own past purchases may be limited, particularly with respect to complicated mechanisms. But there are two further defects. The risks, including death, may be so great that even one misleading experience is had enough, and the opportunity to learn from repeated trials is not of much use. Also, in a world where the products are continually changing, the possibility of learning from experience is greatly reduced. Automobile companies are continually introducing new models which at least purport to differ from what they were in the past, though doubtless the change is more external than internal. New drugs are being introduced all the time; the fact that one has had bad experiences with one drug may provide very little information about the next one.

Thus there are two types of situation in which the simple rule of maximizing profits is socially inefficient: the case in which costs are not paid for, as in pollution, and the case in which the seller has considerably more knowledge about his product than the buyer, particularly with regard to safety. In these situations it is clearly desirable to have some idea of social responsibility, that is, to experience an obligation, whether ethical, moral, or legal. Now we cannot expect such an obligation to be created out of thin-air. To be meaningful, any obligation of this kind, any feeling or rule of behavior has to be embodied in some definite social institution. I use that term broadly: a legal code is a social institution in a sense. Exhortation to do good must be made specific in some external form, a steady reminder and perhaps enforcer of desirable values. Part of the need is simply for factual information — as a guide to individual behavior. A firm may need to be told what is right and what is wrong when in fact it is polluting, or which safety requirements are reasonable and which are too extreme or too costly to be worth consideration. Institutionalization of the social responsibility of firms also serves another very important function. It provides some assurance to any one firm that the firms

with which it is in competition will also accept the same responsibility. If a firm has some code imposed from the outside, there is some expectation that other firms will obey it too and therefore there is some assurance that it need not fear any excessive cost to its good behavior.

Let me then turn to some alternative kinds of institutions that can be considered as embodying the possible social responsibilities of firms. First, we have legal regulation; as in the case of pollution where laws are passed about the kind of burning that may take place, and about setting maximum standards for emissions. A second category is that of taxes. Economists, with good reason, like to preach taxation as opposed to regulation. The movement to tax polluting emissions is getting under way and there is a fairly widely backed proposal in Congress to tax sulfur dioxide emissions from industrial smokestacks. That is an example of the second kind of institutionalization of social responsibility. The responsibility is made very clear: the violator pays for violations.

A third very old remedy or institution is that of legal liability — the liability of the civil law. One can be sued for damages. Such cases apparently go back to the Middle Ages. Regulation also extends back very far. There was an ordinance in London about the year 1300 prohibiting the burning of coal, because of the smoke nuisance.

The fourth class of institutions is represented by ethical codes. Restraint is achieved not by appealing to each individual's conscience but rather by having some generally understood definition of appropriate behavior. Let me discuss the advantages and disadvantages of these four institutions.

In regard to the first two, regulation and taxes, I shall be rather brief because these are the more familiar. We can have regulations governing pollution. We can also regulate product safety. We may even have standards to insure quality in dimensions other than safety. The chief drawback of direct regulation is associated with the fact that it is hard to make regulations flexible enough to meet a wide variety of situations and yet simple enough to be enforceable. In addition, there is a slowness in response to new situations. For example, if a new chemical, such as a pesticide, comes on the market and after a period of time is recognized as a danger, it requires a long and complicated process to get this awareness

translated into legal action. One problem is that legislative time is a very scarce factor; a proposal to examine the problems involved in some pesticide may at any given time be competing with totally different considerations for the attention of the legislative or regulatory body. In short, there is considerable rigidity in most regulatory structures. For certain purposes it is clear that regulation is best but it is equally clear that it is not useful as a universal device. In the case of taxes on the effects, rather than on the causes, there is a little more built-in flexibility. To combat pollution, taxation is probably the most appropriate device; a tax is imposed on the emission by the plant, whether in water or in air. Now this means the plant is free to find its own way of minimizing the tax burden. It is not told it must do one thing, such as raising smokestacks to a certain height. It is free to try to find the cheapest way of meeting the pollution problem. It may well decide that the profitability situation is such that it will continue to pollute and sell the product presumably at a somewhat higher price. This decision is not necessarily bad; it implies that the product is in fact much desired and it provides an automatic test of the market to see whether it is worth polluting or not, because in effect the consumer is ultimately paying for the pollution he induces. However, it is difficult to see how this method, useful though it is in the case of pollution, would have any relevance to safety, to see how one could frame a tax which would make very much sense. Taxation appears to be a rather blunt instrument for controlling product safety.

Legal liability can be and has been applied; i.e., courts have allowed damages in cases arising out of pollution or out of injury or death due to unsafe products. The nature of the law in this area is still evolving; under our system this means that it is being developed by a sequence of court decisions. Just exactly what the company or its officers have to know before they can be regarded as liable for damages due to unsafe products is not yet clear. No doubt it would certainly be held even today that if officers of a company were aware that a product had a significant probability of a dangerous defect and they sold it anyway without saying so, and if the defect occurred, legal liability would be clear. But it is frequently hard to establish such knowledge. No doubt if society wants to use the route of legal liability as a way of imposing social

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responsibility, then it can change the principles on which the decision is based. For example, one might throw the burden of proof on the company, so that in the case of any new product they have to run tests to show positively that it is safe. Their failure to make such tests would be an indication of their liability. One could imagine changes of this kind which would bring the law more into line with what is desirable. But there are some intrinsic defects in the liability route which, in my opinion, make it unsuitable in its present form as a serious method of achieving social control or of imposing responsibility on profit-making firms. First, litigation is costly. In many cases there are social wrongs or social inefficiencies which are quite significant in the aggregate and are perceived by a large number of people, each of whom bears a small part of the cost. This is characteristic of pollution and may be the case with certain kinds of quality standards. It really does not pay any particular person to sue, and if a few people do sue it does not really do the company much harm.

Another problem is that the notion of liability in law is really too simple a concept. Legal liability tends to be an all-or-none proposition. Consider a product such as plastic bags. They are perfectly all right for storing clothes or food but there is a risk that small children will misuse them, with serious consequences. One would hardly want to say that there is any legal liability ascribable to the plastic-bag makers, for even the safest product can be misused. On the other hand, one might argue that a product that can be misused ought to be somewhat discouraged and perhaps some small degree of responsibility should be imposed, particularly if no adequate warning is issued. The law does not permit any such distinctions. Thus, in an automobile case, one party or the other must be found wrong, even though in fact a crash may clearly be due to the fact that both drivers were behaving erratically, and it would be reasonable to have some splitting of responsibility. At present, with some minor exceptions, the law does not permit this, and I suppose it would confuse legal proceedings irreparably to start introducing partial causation. Economists are accustomed to the idea that almost nothing happens without the cooperation of a number of factors, and we have large bodies of doctrine devoted to imputing in some appropriate way the consequences of an action to all of its causes. It is for these reasons that this kind

of crude liability doctrine seems to be unsuitable in many cases. A number of other problems with litigation could be mentioned. Consider very high-risk situations that involve a very low probability of death or other serious adverse consequences, as in the case of drugs, or possible radiation from nuclear power plants. The insurance companies are willing to insure because the probability is low, but once insurance is introduced the incentive to refrain from incurring the risk is dulled. If you are insured against a loss you have less of an incentive to prevent it. In the field of automobile liability, it has become clear that the whole system of liability has to a very great extent broken down. The result is a widespread movement toward no-fault insurance, which in effect means people are compensated for their losses but no attempt is made to charge damages to the persons responsible. Responsibility is left undecided.

Finally, litigation does not seem suitable for continuing problems. Pollution will be reduced but not eliminated; indeed it is essentially impossible to eliminate it. There remain continuous steady damages to individuals. These should still be charged to firms in order to prevent them from polluting more. But enforcement by continuous court action is a very expensive way of handling a repetitious situation. It is silly to keep on going to court to establish the same set of facts over and over again. For these reasons taxes which have the same incentive effects are superior.

Let me turn to the fourth possibility, ethical codes. This may seem to be a strange possibility for an economist to raise. But when there is a wide difference in knowledge between the two sides of the market, recognized ethical codes can be, as has already been suggested, a great contribution to economic efficiency. Actually we do have examples of this in our everyday lives, but in very limited areas. The case of medical ethics is the most striking. By its very nature there is a very large difference in knowledge between the buyer and the seller. One is, in fact, buying precisely the service of someone with much more knowledge than you have. To make this relationship a viable one, ethical codes have grown up over the centuries, both to avoid the possibility of exploitation by the physician and to assure the buyer of medical services that he is not being exploited. I am not suggesting that these are universally obeyed, but there is a strong presumption that the doctor is going

to perform to a large extent with your welfare in mind. Unnecessary medical expenses or other abuses are perceived as violations of ethics. There is a powerful ethical background against which we make this judgment. Behavior that we would regard as highly reprehensible in a physician is judged less harshly when found among businessmen. The medical profession is typical of professions in general. All professions involve a situation in which knowledge is unequal on two sides of the market by the very definition of the profession, and therefore there have grown up ethical principles that afford some protection to the client. Notice there is a mutual benefit in this. The fact is that if you had sufficient distrust of a doctor's services, you wouldn't buy them. Therefore the physician wants an ethical code to act as assurance to the buyer, and he certainly wants his competitors to obey this same code, partly because any violation may put him at a disadvantage but more especially because the violation will reflect on him, since the buyer of the medical services may not be able to distinguish one doctor from another. A close look reveals that a great deal of economic life depends for its viability on a certain limited degree of ethical commitment. Purely selfish behavior of individuals is really incompatible with any kind of settled economic life. There is almost invariably some element of trust and confidence. Much business is done on the basis of verbal assurance. It would be too elaborate to try to get written commitments on every possible point. Every contract depends for its observance on a mass of unspecified conditions which suggest that the performance will be carried out in good faith without insistence on sticking literally to its wording. To put the matter in its simplest form, in almost every economic transaction, in any exchange of goods for money, somebody gives up his valuable asset before he gets the other's; either the goods are given before the money or the money is given before the goods. Moreover there is a general confidence that there won't be any violation of the implicit agreement. Another example in daily life of this kind of ethics is the observance of queue discipline. People line up; there are people who try to break in ahead of you, but there is an ethic which holds that this is bad. It is clearly an ethic which is in everybody's interest to preserve; one waits at the end of the line this time, and one is protected against somebody's coming in ahead of him.

In the context of product safety, efficiency would be greatly enhanced by accepted ethical rules. Sometimes it may be enough to have an ethical compulsion to reveal all the information available and let the buyer choose. This is not necessarily always the best. It can be argued that under some circumstances setting minimum safety standards and simply not putting out products that do not meet them would be desirable and should be felt by the businessman to be an obligation.

Now I've said that ethical codes are desirable. It doesn't follow from that that they will come about. An ethical code is useful only if it is widely accepted. Its implications for specific behavior must be moderately clear, and above all it must be clearly perceived that the acceptance of these ethical obligations by everybody does involve mutual gain. Ethical codes that lack the latter property are unlikely to be viable. How do such codes develop? They may develop as a consensus out of lengthy public discussion of obligations, discussion which will take place in legislatures, lecture halls, business journals, and other public forums. The codes are communicated by the very process of coming to an agreement. A more formal alternative would be to have some highly prestigious group discuss ethical codes for safety standards. In either case to become and to remain a part of the economic environment, the codes have to be accepted by the significant operating institutions and transmitted from one generation of executives to the next through standard operating procedures, through education in business schools, and through indoctrination of one kind or another. If we seriously expect such codes to develop and to be maintained, we might ask how the agreements develop and above all, how the codes remain stable. After all, an ethical code, however much it may be in the interest of all, is, as we remarked earlier, not in the interest of any one firm. The code may be of value to the running of the system as a whole, it may be of value to all firms if all firms maintain it, and yet it will be to the advantage of any one firm to cheat — in fact the more so, the more other firms are sticking to it. But there are some reasons for thinking that ethical codes can develop and be stable. These codes will not develop completely without institutional support. That is to say, there will be need for focal organizations, such as government agencies, trade associations, and consumer defense groups, or all combined to

make the codes explicit, to iterate their doctrine and to make their presence felt. Given that help, I think the emergence of ethical codes on matters such as safety at least, is possible. One positive factor here is something that is a negative factor in other contexts, namely that our economic organization is to such a large extent composed of large firms. The corporation is no longer a single individual; it is a social organization with internal social ties and internal pressures for acceptability and esteem. The individual members of the corporation are not only parts of the corporation but also members of a larger society whose esteem is desired. Power in a large corporation is necessarily diffused; not many individuals in such organizations feel so thoroughly identified with the corporation that other kinds of social pressures become irrelevant. Furthermore, in a large, complex firm where many people have to participate in any decision, there are likely to be some who are motivated to call attention to violations of the code. This kind of check has been conspicuous in government in recent years. The Pentagon Papers are an outstanding illustration of the fact that within the organization there are those who recognize moral guilt and take occasion to blow the whistle. I expect the same sort of behavior to occur in any large organization when there are well-defined ethical rules whose violation can be observed.

One can still ask if the codes are likely to be stable. Since it may well be possible and profitable for a minority to cheat, will it not be true that the whole system may break down? In fact, however, some of the pressures work in the other direction. It is clearly in the interest of those who are obeying the codes to enforce them, to call attention to violations, to use the ethical and social pressures of the society at large against their less scrupulous rivals. At the same time the value of maintaining the system may well be apparent to all, and no doubt ways will be found to use the assurance of quality generated by the system as a positive asset in attracting consumers and workers.

One must not expect miraculous transformations in human behavior. Ethical codes, if they are to be viable, should be limited in their scope. They are not a universal substitute for the weapons mentioned earlier, the institutions, taxes, regulations, and legal remedies. Further, we should expect the codes to apply only in situations where the firm has superior knowledge of the situation.

I would not want the firm to act in accordance with some ethical principles in regard to matters of which it has little knowledge. For example, with quality standards which consumers can observe, it may not be desirable that the firm decide for itself, at least on ethical grounds, because it is depriving the consumer of the freedom of choice between high-quality, high-cost and low-quality, low-cost products. It is in areas where someone is typically misinformed or imperfectly informed that ethical codes can contribute to economic efficiency.