Journal of Markets & Morality 4, no. 1 (Spring 2001), 73-82

A Model to Assess the Ethics of Benefits Distribution

Alan Wong
Associate Professor of Finance
School of Business
Indiana University Southeast

Uric Dufrene
Associate Professor of Finance and Dean
School of Business
Indiana University Southeast

Many difficult ethical issues in business are associated with benefits distribution and they present a challenge to those who are confronted with such issues. This article presents a model that allows determination of the ethical implications of benefit-distribution practices or policies by using three simple tests. The tests ensure that distributive justice is considered when allocation decisions are made. The first test ensures that the most vulnerable recipient group is treated justly by other dominant groups. The second test prevents the interests of one group from being promoted at the expense of other groups. Through a mental exercise, the third test encourages unbiased consideration of the interests of all directly affected groups. To illustrate the model's applicability, it is used to determine the distributive fairness of two controversial practices. The model is relatively easy to use but there are limits to its effectiveness.

Introduction

When confronted with an ethical dilemma, it is expected that managers rely on their individual moral values to analyze the ethical implications and determine a course of action. However, a recent study found that individual values do not make a significant difference in managerial behavior in the workplace.[1] Personal values seem to dissipate in the workplace, especially in an environment where there are strong incentives to behave unethically. Even adopting a code of ethics was found to have little effect on behavior, except in cases where the company ethics policy was specific and clear.

Individual values are deeply held beliefs, and it is difficult to accept that individual moral values would simply disappear in the workplace. The problem may have to do with individuals failing to recognize that some business decisions have clear ethical implications. An inability to recognize this fact can lead to decisions being made purely on economic grounds. Even when one acknowledges an ethical dimension to a given situation, an individual might not know how to analyze the ethical dilemma in light of his or her personal values. A person's individual moral values might not have much to contribute, if the decision-maker does not have a clear idea of how to engage in ethical analysis. Employees may not be sure what is expected of them and how to internalize moral considerations in their decision-making process. Some may resort to law as an excuse, disclaiming any further ethical demands on them. This is not a reflection of a desire to be less responsible morally, but a lack of ability to engage in some type of moral reasoning within a business firm. One objective of this paper is to develop a practical model of ethical analysis that is relatively easy to use in the workplace.

A business corporation is more than an artificial person set up to perform an economic role. It is a nexus of contractual (explicit or implicit) relations between different groups of direct stakeholders. When different groups with divergent self-interests are brought together, conflicts of interests and clashes of expectations should be expected. Many of these stakeholder conflicts are usually associated with a firm's distribution system of benefits. Corporate decisions concerning distribution of benefits are usually made at the policy level where distributive procedures, practices, and guidelines are established. Another objective of this paper is to develop a model that can be used to analyze the ethical implications of policy decisions regarding benefits distribution. The model provides a structured and logical way for decision-makers to determine the fairness of a policy decision for groups affected by the distributive decision. Furthermore, it provides decision-makers with a process that permits them to use their own personal moral values in making decisions.

Model Development

Our model includes a few simple tests that help to guide the ethical analysis. For a distributive practice or procedure to be just, it should meet the requirements of all three tests structured in the model. The tests complement one another and ensure that some distributive justice is considered in making decisions over benefits distribution.

Test 1: The interest of the most vulnerable group is better served with the distributive practice than without it.

This test is developed on the basis of a principle expounded by John Rawls, a contemporary political philosopher. He argues that any given distribution of benefits should be equal. An unequal distribution would be justified only if the least advantaged group is better off with it than without it.[2] This test attempts to ensure that the most vulnerable group, which is usually the least influential, is given a fair distribution of benefits. If the vulnerable group is treated justly, it is likely that dominant groups would also be treated justly in the distribution of benefits. The most vulnerable group is chosen as the reference point for deciding whether a distribution is ethical.

The test requires that decision-makers first identify which group is considered the most vulnerable in a particular situation. The most vulnerable group in one situation is not necessarily the most vulnerable in every situation. Occasionally, it may be necessary to identify more than one group as the most vulnerable. Determining which group is most vulnerable has to do with the amount of influence an individual can exert over the outcome of a policy decision and the extent of financial uncertainty a group is subject to if it is not given its fair share of the benefits. In some situations, the choice of the most vulnerable group is clear-cut. In other less obvious situations, the personal values and beliefs of the decision-maker may slightly influence the determination of which group is the most vulnerable.

Test 2: The welfare of any, one group, including the most vulnerable, should not be increased at the expense of another.

It is usually considered to be unfair to remove entitled benefits from one group and to give them to another. However, there are exceptions to this rule, notably the distribution of benefits to carry out either compensatory or retributive justice. A fair distribution of benefits should not be a zero-sum game, even when the welfare of the most vulnerable group is raised by it. A firm's distribution of benefits may be unequal but fair, based on the difference of contributions that respective groups made to the firm. However, an unequal distribution cannot be ethically justified if a portion of the entitled benefits for one group is distributed to another without the consent of the former group.

Test 3: Assuming that our loved ones could have belonged to any group, is there one group that we would not want them to belong to, given the distributive system in question?

If the response to this hypothetical question is positive, then the distributive practice should be deemed unfair. If the response is negative, then the practice should be deemed ethical. The underlying assumption in Test 3 is that decision-makers care about the welfare of their loved ones, which means they would not want them to belong to any group that is likely to receive less than fair treatment in the distribution of benefits. The test aims to ensure that the whole distributive package is analyzed in a way that is fair to all relevant groups. In performing this mental exercise, reviewers would also be less likely to allow their own current positions in life (e.g., management, employees, males, females, minority group members, and so forth) to cloud their judgment.[3] Decision-makers would be forced to consider all perspectives out of fear that their loved ones might end up in a group that is *unfairly treated in benefits distribution*. This would also ensure that agreement is possible among planners and reviewers in developing or revising a distribution system. While the personal values and beliefs of reviewers might slightly influence whether the whole distributive package is considered to be fair, the test would force reviewers to be less subjective.

In summary, our model provides a practical framework whereby a proposed action or current practice of benefit distribution can be quickly evaluated for its ethical implications. The action would be considered ethical if it meets the requirements of all three tests. The model is a far-from-perfect instrument of ethical analysis, but it does force decision-makers to think through the ethical dimension of a distributive practice. At a minimum, the model provides a link between personal moral values and distributive issues, thereby permitting decision-makers to perform some structured moral reasoning in the workplace. For limited illustrative purposes, this model is used to determine the distributive fairness of two business practices: maximizing stockholders' wealth and executive compensation with stock options. The two practices are associated with the distribution of a publicly held firm's earnings. The following ethical analysis should not be considered exhaustive because some key issues surrounding the two practices have not been discussed.

Illustration 1: Maximizing Shareholders' Wealth

In a publicly held company, stockholders are the owners of the corporation and management, serving as agents, should strive to make decisions that maximize stockholders' wealth. Many argue that such decisions would only favor one group of stakeholders with respect to the distribution of benefits. Such a distribution system is thought to be unfair and unjust.

Maximizing stockholder wealth is not tantamount to stockholders enriching themselves at the expense of other stakeholders.[4] It only implies that management should do all it can to increase the residual income to stockholders after all other immediate stakeholders have been compensated for their contribution to the firm.[5] Compensation to stockholders varies according to the level of earnings the firm obtains, whereas compensation to other stakeholders is fixed. Stockholders receive less with declining earnings and they may even lose money if earnings are negative. Moreover, if the company were to become insolvent and go into bankruptcy, other stakeholders' claims would have priority over the stockholders' claims.

Furthermore, other stakeholders benefit when management strives to increase residual income. Not all residual income is paid out to stockholders in the form of dividends. Earnings are also reinvested in the company, thus providing a cushion for other stakeholders if the firm was to encounter financial distress.

Stakeholder theorists have argued that the greater bargaining power that stockholders have (through management) over the firm's other stakeholders makes it unfair in setting the latter groups' fixed compensation and benefits. This argument may be true if the firm is a monopoly and there are no antitrust laws discouraging unhealthy competition. However, a free-market economy is a two-edged sword. At times, it may create conditions that increase stockholders' bargaining power in setting employee salaries and compensation to suppliers and lenders. On other occasions, it may produce conditions that favor a different set of stakeholders. A market economy provides a neutral framework and procedure that does not inherently favor any particular group.

Analysis

Test 1: The interest of the most vulnerable group is better served with the distributive practice than without it.

For the sake of simplicity, only three direct stakeholder groups are considered in this distributive issue. They are the publicly held firm's employees, lenders, and stockholders. Most people would probably select the employee group as the most vulnerable in terms of influence and the one having the fewest resources to cope with financial uncertainties. Since the average employee's large household expenditures are mostly fixed, most employees would prefer relatively stable compensation. Many employees and their dependents might not be able to handle their financial affairs successfully if compensation were significantly tied to uncertain firm earnings like that of the stockholders. In the presence of declining earnings, employees could receive much less than they can afford in terms of maintaining their current standard of living. Although such an alternative arrangement could decrease the firm's fixed financial costs, it puts the employee group in a more uncertain situation when sales decline. Generally, stockholders are in a position to handle more uncertainties than employees, due to their diversified sources of income. Thus, it can be argued that an employee's welfare is better off with the current practice than without it.

Test 2: The welfare of any, one group, including the most vulnerable, should not be increased at the expense of another.

Due to the uncertainty of return and the additional risks shouldered by stockholders, they should be compensated through deliberate managerial attempts to increase residual income to the fullest possible extent. The return to the stockholder group will be inadequate if management has no fiduciary obligation to the stockholder. The increase of residual income is rarely done at the expense of other stakeholders, due to the fixed nature of their compensation structure and to the legal protection of their market-based contracts with the firm. When these contracts are signed with the firm, they usually contain restrictive covenants that protect them from any future managerial attempts to change the benefit allocation system. If not done at the expense of the other stakeholder groups, it is difficult to grasp why it is unjust to allow stockholders to reap extra economic rewards if the firm performs well, due to the higher risks they shoulder. Any increased residual income would also improve the situation of other stakeholders in terms of more stability and greater financial integrity for their contracts with the firm. The fiduciary duty of management to maximize stockholders' wealth should generally work to every group's advantage, and not to the detriment of any specific group.

Test 3: Assuming that our loved ones could have belonged to any group, is there one group that we would not want them to belong to, given the distributive system in question?

Most people would not have any problem with their loved ones belonging to any of the three stakeholder groups discussed above. Under the stockholder wealth maximization system, benefits allocation is generally structured so that each group is compensated adequately for the risk taken and the contribution it makes. The nature and size of compensation may be different but, no one, group is unfairly treated in benefits distribution. Stockholders who bear the residual risk are compensated well if the firm does well. The firm's employees and lenders are generally compensated a fixed, contractual amount as previously agreed upon. Furthermore, the stockholder wealth maximization system also reflects the effect of market demand and supply forces, which do not inherently favor any particular group.

Result

Using the ethical model, the “maximization of stockholders’ wealth” distributive system should be considered ethically justified because it meets the requirements of all three tests. At least, it should be considered procedurally just, even though the results of such distribution may not seem equitable to other stakeholders when the firm is doing exceptionally well.

Illustration 2: Executive Compensation with Stock Options

Numerous corporate executives have received large compensation packages recently, which has led some critics to claim that the sheer size of these packages is unfair to other groups. We will use our model to analyze whether large executive compensation packages based on stock options are ethically justified.

Corporate executives might be compensated, based on straight cash compensation plans, such as salary and bonus. While this practice is an important part of any compensation program, it is oriented toward the short run. If a firm is managed myopically, the consequences could be disastrous for all stakeholders and the long-term health of the economy. Recognizing this shortcoming, many firms add a long-term compensation component. These plans are usually in the form of stock options. The plans permit an executive to receive future stock or cash if the performance of the firm is exemplary, as indicated by such long-term measures as the firm’s stock price or market value. Thus, stock options can make executives instant millionaires, many times the multiple of the average salary of a rank-and-file employee. A major share of any company’s executive pay structure comes from stock options rather than straight cash compensation plans.[6]

Analysis

Test 1: The interest of the most vulnerable group is better served with the distributive practice than without it.

There are three stakeholder groups directly involved in this issue: the firm’s stockholders, management, and non-managerial employees (thereinafter employees). The employees would generally be considered the most vulnerable group for the same reasons discussed above. Are the employees better off when stockholders compensate top management handsomely based on stock option plans? The stock option plans have an indirect beneficial effect on the employee group. The plans motivate executives to make strategic decisions that increase the stock price and market value of the firm. With a higher stock price, the firm can efficiently raise capital. The resultant lower cost of capital permits the firm to accept more capital projects and expand profitably, increasing the demand for more employees. If the firm chooses not to expand, the lower cost of capital enables the firm to compete more effectively and increase profits. Either way, a higher stock price increases the probability that the firm can offer more attractive compensation plans to its employees. At the least, a more profitable firm is able to maintain the funding of any existing employee compensation plans. Although the stock option plan does not directly affect the employees' compensation, it should generally benefit employees more in the long run than without it.

Test 2: The welfare of any, one group, including the most vulnerable, should not be increased at the expense of another.

Huge compensation packages received by executives in the form of stock option benefits might seem exorbitant, but may not, however, be funded at the expense of other stakeholder groups. When the stock price of a firm increases to a level that is above the stock option exercise price, the executive may find it attractive to exercise the stock options. This allows the executive to purchase stock at a discount. The participant can then either hold the stock or sell it immediately for cash gains. The cash gains originate from selling stock to new investors. The additional shares sold may dilute *current* stockholders' earnings per share or ownership interest, but it is more than offset by the increase in stock price, due to the firm's better performance. If an executive manages a firm more effectively as the result of the stock option incentives, all stakeholders benefit. However, if the firm does not perform well, no options are exercised and an executive's compensation may decline significantly. Yet, in such a case, nothing has been taken away from any group, including the current stockholder group. The stock option compensation plan is not funded at the expense of any group. It is funded by increasing the financial well-being of the company, which, in turn, benefits all relevant stakeholder groups.

Test 3: Assuming that our loved ones could have belonged to any group, is there one group that we would not want them to belong to, given the distributive system in question?

In this situation, undoubtedly most would prefer their loved ones to belong to the executive group because of its more alluring compensation package with stock options. It is perceived that executives are compensated at a higher rate, proportionally speaking, to what they contribute or to the risks they take. Sometimes the increased value of executive stock options is due more to the stock market than to the performance of the firm. Although the interest of employees (also the most vulnerable group) is better served with this distributive system than without it, the unfairness stems from the employee group not being provided with the same incentive opportunity as executives. In this context, the employee group is treated unjustly, and so it makes sense that we would not want our loved ones to belong to the employee group.

Result

Based on our model, one requirement of the three tests fails, which means that executive compensation by stock options in its present form should be considered unfair and ethically unjustified. However, our analysis should only be treated as a simple illustration of the general applicability of the model and should not be taken as an exhaustive ethical analysis of the topic. If all the relevant issues surrounding the executive stock option question were considered, the conclusion could be different.

Limitations of the Model

The model is simple to understand and relatively easy to apply. However, there are limits to its effective use. First, our model is useful if the ethical issue in question affects people who are members of a firm's immediate stakeholders—employees, management, stockholders (or owners), creditors, and consumers. Since these persons are more directly affected by decisions made in a corporation, the effect of decisions on these groups can be more reliably predicted. It becomes increasingly difficult to predict the effect of an action on remotely associated groups outside the firm's immediate stakeholders because the relevant information is not readily available.

Second, our model requires a mental exercise on the part of decision-makers and assumes they are risk-averse. For the sake of their loved ones, it is rational for them to protect the welfare of the most vulnerable group out of fear that their loved ones might end up in that group. However, this assumption does not always hold true for those who may be risk-takers. They prefer risk and might not hesitate to wager that their loved ones or children would not end up in the most vulnerable group. Thus, they might view an ethical situation quite differently than people who are risk-averse.

Third, our model is not effective for handling situations where non-distributive justice and rights are involved, such as the obligations of gratitude, non-maleficence, and fidelity.[7] Furthermore, the model is not capable of handling virtue ethics, which probes a person's behavior to uncover underlying motives and desires. The model is also not equipped to analyze issues of utilitarianism.

Finally, the tests in the model were devised to determine the fairness of a benefit-distributive system or practice, based only on the ethical merits of the practice and not by comparing it with alternative distributive practices.

Conclusion

Different stakeholder groups have their own unique interests, which may occasionally conflict with others pursuing their own self-interests. In such situations, influential groups often dominate vulnerable ones in an attempt to advance their own interests. The model in this article provides a framework that enables different groups with conflicting interests to agree on principles that will promote procedural justice. Although the relevant stakeholder groups in a distributive situation might receive unequal benefits, the distribution should be considered fair if the distributive procedure is just. The three tests in the model analyze whether a distributive procedure is just. This does not imply that the three tests provide a complete analytical tool for determining distributive justice, but they do provide a logical starting point and a way to ask questions and reflect upon the ethical implications of a distributive procedure. The model is a useful means for linking personal and business ethics.

Notes

1. Arthur P. Brief, Janet M. Dukerich, Paul R. Brown, and Joan F. Brett, "What's Wrong with the Treadway Commission Report? Experimental Analyses of the Effects of Personal Values and Codes of Conduct on Fraudulent Financial Reporting," *Journal of Business Ethics* 15 (1996): 83–198.
2. T. L. Beauchamp and E. B. Norman, *Ethical Theory and Business,* 4th ed. (Newark, N.J.: Prentice-Hall, 1993), 604–12.
3. J. R. Boatright, *Ethics and the Conduct of Business* (Newark, N.J.: Prentice-Hall, 1993),106.
4. Uric Dufrene and Alan Wong, "Finance and the Education Debate," *Journal of Education for Business* 70 (1995): 179–81.
5. Alan Wong and Uric Dufrene, "Stakeholders Versus Stockholders and Financial Ethics: Ethics to Whom?," *Managerial Finance* 22, 4 (1996): 1–10.
6. Donald E. Kieso and Jerry J. Weygandt, *Intermediate Accounting,* 8th ed. (New York: John Wiley & Sons, 1995), 821.
7. Alan Wong and Eugene Beckman, "An Applied Ethical Analysis System in Business," *Journal of Business Ethics* 11 (1992): 173–78.