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Designing Ethical Organizations: Avoiding the Long-Term Negative Effects of Rewards and Punishments

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ABSTRACT. Ethics researchers advise managers of organizations to link rewards and punishments to ethical and unethical behavior, respectively. We build on prior research maintaining that organizations operate at Kohlberg's stages of moral reasoning, and explain how the over-reliance on rewards and punishments encourages employees to operate at Kohlberg's lowest stages of moral reasoning. We advocate designing organizations as ethical communities and relying on different assumptions about employees in order to foster ethical reasoning at higher levels. Characteristics associated with ethical communities are identified and AES Corporation and Semco S/A serve as examples of corporations exhibiting the design characteristics and assumptions of ethical organizations.

KEY WORDS: community, ethical organizations, ethics, Kohlberg, moral reasoning, organization design, reinforcement theory

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> If one aim of business ethics is to create actors who take effective action, then a fundamental question of organizational psychology and practical business ethics commands our attention. How can ethical conduct be nurtured in organizations? (Margolis, 1998, p. 410).

The question of how to elicit ethical conduct in corporations has become a major concern as the media bombards us with reports of unethical and illegal behavior by employees and executives in the U.S. Recent news stories reveal accounting fraud at WorldCom (Ackman, 2003), securities and accounting fraud at Enron (Eichenwald, 2003a), McWane Inc.'s serious safety violations resulting in killing or maiming employees (Barstow and Bergman, 2003), and allegations that HealthSouth used illegal accounting schemes to defraud Medicare (Eichenwald, 2003b). We do not have to look very far to find numerous examples of corporate misconduct.

The prevalence of unethical conduct by Corporate America suggests that the prescriptions offered in the ethics and management literature, as well as the actions taken by corporations in recent years, have not resulted in the desired level of ethical behavior. Firms have been advised to draft codes of conduct (Newton, 1998), include stakeholders in decision making (Evan and Freeman, 1988) and create an ethical work climate (Cohen, 1993) or corporate culture (Mathews, 1988). The U.S. Sentencing Guidelines, enacted to prod firms into establishing effective compliance programs to prevent or address corporate wrongdoing, led to the development of codes of conduct, hotlines for reporting wrongdoing, ombudspersons, compliance training, compliance officers, and so on. Yet the pervasiveness of corporate unethical conduct appears to indicate that all of these efforts have not substantially increased ethical behavior by employees and managers.

We are not the first to raise concerns about the efficacy of efforts to promote ethical corporate behavior. For instance, the United States Justice Department has voiced concerns that the Sentencing Guidelines, and the ethics compliance systems they fostered, have elicited adherence to the letter but not the spirit of the law (Allenbaugh, 2001). The frequency of reported unethical and illegal conduct by employees detailed in the media raises serious questions about the degree to which the Guidelines have even resulted in adherence to the law.

We argue in this paper that corporations need to adopt an alternative model for eliciting ethical conduct by employees. Our approach rests on Kohlberg's model of moral reasoning, the development of a corporation as an ethical community and different assumptions than currently exist in most firms. We begin by discussing why employees within organizations behave unethically, using this to establish the impact that organizations have on employees' moral reasoning and behavior. Then we review Kohlberg's typology of stages of moral reasoning and argue that organizations operate at Kohlbergian stages, profoundly impacting employees' moral behavior.

We examine current approaches used to create ethical organizations, explaining how heavy reliance on rewards and punishments fosters low levels of moral reasoning, contributing to unethical behavior in the longer-term. Current approaches rest on faulty assumptions about ethical reasoning and moral development. Employees may initially behave ethically for the ''right'' reasons (i.e., using a higher level of moral reasoning) but over time they begin focusing on acquiring rewards or avoiding punishment. We maintain that an organization should be conceptualized as an ethical community developed around different characteristics and resting on alternative assumptions about employees. Top managers in an ethical community strive to behave ethically as role models for employees. AES, a large international firm and Semco S/A, a small international company demonstrate the feasibility and effectiveness of our ethical community model. We conclude with implications our arguments have for research, theory and practice.

Why employees behave unethically in a corporate setting

Many explanations for why employees behave unethically center on the corporation's culture or climate, organizational practices, reward systems, and the impact the firm has on employees' moral reasoning. We recognize there may be a few ''bad apples'' in the proverbial organizational barrel (Trevino and Youngblood, 1990) – individuals who would behave unethically in almost any situation – but we agree with management researchers who maintain that corporations elicit, inculcate, or even encourage unethical behavior by employees. Empirical data support this impact that firms have on employees' propensity to make unethical decisions and behave unethically. Managers interviewed maintained that few employees are inherently unethical: ''A clear majority believed that organizational pressures – not character flaws – had led people in their organizations to act unethically'' (Badaracco and Webb, 1995, p. 10). Thus, our overview of major factors attributed as causes for why employees behave unethically focuses on organization-level rather than individual-level explanations.

Unethical behavior may be inherent in business organizations because of their culture or climate (Cohen, 1993; Paine, 1994). The corporate illegality literature contains many examples of employees learning to engage in illegal activities as part of their job duties. An examination of price fixing in the heavy electrical equipment industry demonstrated that the firms involved had shared norms, beliefs and ways of doing things that included illegal or unethical practices; new employees learned unethical behavior as part of standard operating procedures (Geis, 1982). The organizational culture may intensely pressure employees for high performance or goal accomplishment, leading employees or managers to use any means possible, including illegal or unethical ones, to achieve management objectives (Baucus and Near, 1991; Clinard, 1983; Staw and Szwajkowski, 1975). Middle managers interviewed by Clinard (1983) frequently mentioned pressure from upper managers as a major factor resulting in unethical or illegal conduct.

Reward and punishment systems often help establish and strengthen corporate culture, including reinforcing unethical conduct by employees. The theory of differential association, often used in the corporate illegality and ethics literature, explains how this process occurs. According to differential association, an employee learns unethical conduct through operant conditioning or use of rewards and punishments by coworkers, managers and other organization members. Reinforcement can be so strong that an employee may even "unlearn" ethical behaviors when they are not reinforced as part of the corporate culture (Mathews, 1988).

We believe an organization's culture, reward and punishment systems, and related aspects of the organization's design or structure profoundly impact an employee's moral reasoning and thus the employee's ethical or unethical behavior. The organization's design or structure, as we explain later, includes aspects such as the size of organizational units and the organization's ability to effectively create a community (Fort, 1997). We argue, in conjunction with Fort, that employees often behave unethically in overly large organizations that prevent employees from feeling responsible for their decisions and actions. Too, these organizations tend to limit employees' ability to openly converse about ethical issues they face, making it more difficult for the employees to ethically reason at higher levels.

Researchers have argued that ethical behavior depends on a person's ability to ethically reason (Colby and Kohlberg, 1987). As Trevino's interactionist model (1986) illustrates, the employee's level of moral reasoning interacts with the culture and design of the organization. Trevino states, "…the individual's susceptibility to situational influences varies with cognitive moral development stage. Susceptibility is probably the greatest at the conventional level [Kohlberg's stages three or four] where the person's level of development leads to his or her looking to the group for a moral definition of the situation" (1986, p. 610). Thus, Trevino's model of unethical conduct links Kohlberg's stages of moral reasoning to the organization's culture, reinforcement systems and other characteristics, lending key support for the arguments in our paper.

We extend Trevino's arguments, maintaining that many organizations have adopted designs and developed cultures that operate at the lowest levels of moral reasoning, resulting in unethical decision-making and behavior by employees. Specifically, the heavy reliance on rewards and punishments and similar characteristics create organizations consistent with stages one and two of Kohlberg's model. We contend that organizations can be designed in ways that encourage employees to ethically reason at higher levels and to engage in ethical conduct.

Kohlberg's model of moral reasoning

Overview of Kohlberg's typology

Kohlberg's six stages and three levels of moral development (Colby and Kohlberg, 1987) represent one of the most widely cited typologies of ethical reasoning. Level one, the preconventional level, has two stages. Stage one represents heteronomous morality where individuals only do the right thing to avoid punishment. Stage two – individualism, instrumental purpose and exchange – occurs where individuals only do what is right to serve their own needs and interests. At level two, the conventional level, individuals reason at stages three or four. Stage three individuals do what is right according to group norms. Stage four individuals do what is right because rules or laws prescribe it and they view obedience to law as necessary to uphold social institutions. The final level, post-conventional or principled reasoning, consists of stages five and six. A stage five individual respects minority rights and beliefs. He or she recognizes that values and beliefs may be relative and he or she considers "moral and legal points of view but finds it difficult to integrate them." Stage six individuals have a universal set of principles and strong personal commitment to following them (Colby and Kohlberg, 1987, pp. 18–19).

Ideally, when an individual reached a higher stage the moral shift would be irreversible; however, specific social environments can result in stage reversal (Colby and Kohlberg, 1987, p. 350). The hypothesis that an individual's moral stage can reverse has been supported when looking at prison environments (Hickey and Scharf, 1980) and when taking into account the context, job function and type of work an individual pursues (Weber, 1990b; Weber and Wasieleski, 2001).

Research using Kohlberg's typology

Most research on Kohlberg's scale has focused on the level at which employees typically reason (e.g., Weber, 1991), training employees to reason at higher levels (Weber, 1990a), and how level of moral reasoning may change depending on locus of control (Trevino and Youngblood, 1990). Vidaver-Cohen (1998) understands that Kohlberg's level of moral development can give insight to business ethics researchers: "Kohlberg observed that motivation to maximize personal interests locks individuals into the lowest stage of moral reasoning, while motivation to maintain the social order enables a person to progress to higher levels of moral growth" (p. 387).

Trevino (1986) suggests that organizations may be able to use training or have employees engage in role-playing involving resolution of moral dilemmas to raise employees' moral reasoning. She argues for a two-pronged approach for eliciting ethical behavior in which executives and designers of organizations focus on improving the cognitive moral reasoning capabilities of employees and emphasizing the firm's impact on employees' behavior. Trevino (1986) supports the use of rewards to positively impact ethical behavior. Unfortunately, many organizations have gone too far in their reliance on reward systems and paid insufficient attention to how the firm can and does affect employees' ethical reasoning and behavior.

Applying Kohlberg's typology to organizations

We maintain that organizations, like individuals, operate at stages of moral development. Our argument builds on the work of several business ethics researchers. Reidenbach and Robin (1991) relied on case studies of organizations and the organizations' responses to various ethical situations as the basis for developing a model of corporate moral development. Their model applies Kohlberg's stages of moral reasoning to corporations, maintaining that firms operate at various stages of moral development.

A similar model that applies Kohlberg's typology to corporations was developed by Logdson and Yuthas (1997). This model extends the corporate social performance literature, maintaining that a firm's moral reasoning impacts how the firm interacts with its stakeholders and the firm's level of social performance. The model draws attention to the relationship between a firm's level of moral reasoning and the degree of ethical behavior exhibited by the firm, building on the extant business ethics literature. Logsdon and Yuthas (1997) posit that organizations at stages one and two make decisions while focusing solely on what benefits the firm with little regard for or consideration of other stakeholders. Organizations operating at stage three make decisions according to industry norms and local community peers, while firms at stage four rely mainly on legal standards and requirements, and narrowly define the firm's relevant stakeholder group when making decisions (Logsdon and Yuthas, 1997). Organizations at the post-conventional level – those operating at stages five and six – focus on a broad range of stakeholders and make decisions that recognize the interconnectedness between the organization and its stakeholders (Logsdon and Yuthas, 1997). At stage five, organizations carry on dialogue with their stakeholders and strive to reach agreement on what constitutes the organization's role and responsibilities, while stage six organizations rely on universal ethical principles such as ethical virtues of honesty, trustworthiness, integrity and so forth to guide decisions. Thus, several existing models support our claim that organizations operate at stages of moral development.

A key distinction between our arguments and those of other researchers involves the question of whether organizations move between stages. Some researchers posit that organizations progress or regress from one stage to another in the model (Logsdon and Yuthas, 1997; Reidenbach and Robin, 1991) but we believe insufficient empirical data exist to support these claims.

Organizations do not appear to follow the same developmental path through the stages as individuals do (i.e., progressing from one stage to the next as they grow older, gain education or knowledge and so forth), but organizations can shift to a different level. Organizations could move to stages five and six by altering the fundamental characteristics of the firm to develop an ethical community. Alternatively, a firm could shift to a low stage of moral reasoning, for instance, if a new top management team fundamentally alters the organization so employees begin focusing exclusively on decisions that benefit or avoid punishment for the organization. We argue that many organizations have shifted to the lowest levels of moral reasoning by relying too heavily on rewards and punishments and attempting to link ethical behavior to reward systems.

The link between organizational rewards and Kohlberg's lowest levels

Virtually all of the management and business ethics literature suggests that the way to develop an ethical organization is to create a reward and punishment scheme or closely link organizational design mechanisms to rewards and punishments. For example, compensation systems, formal structures and control systems, and organizational norms are typically linked to rewards and punishments. These systems rely on reinforcement theory or the use of rewards to encourage desirable behavior and punishments to reduce or extinguish undesirable behavior.

Rewards and punishments come in many forms. Mathews notes that, "Rewards and punishments can be (a) tangible such as raises, promotions, various perks versus demotions, or firing; (b) social psychological such as invitations to participate in the work group's social activities, on the one hand, or ostracism from the group; or (c) psychological such as verbal praise, 'a hard worker,' or verbal censure, 'not a team player'" (1988, p. 36).

Little difference exists between rewards and punishments and their impact according to Kohn, although they elicit different stages of moral reasoning in Kohlberg's model. "Punishment and rewards are two sides of the same coin. Rewards have a punitive effect because they, like outright punishment, are manipulative. 'Do this and you'll get that' is not really very different from 'Do this or here's what will happen to you'"(Kohn, 1993, p. 58). As Kohn argues, both rewards and punishments lead individuals to feel controlled and punished over time.

The linking of rewards and punishments to ethical and unethical behavior, respectively, represents a step forward from ignoring ethics altogether, but it unintentionally creates a new problem by encouraging employees to ethically reason at Kohlberg's stages one and two. As Kohn notes, "In general, the more cognitive sophistication and open-ended thinking that was required, the worse people performed when working for a reward", and individuals anticipating rewards performed worse than people not expecting rewards (1993, p. 55).

How reinforcement theory impacts business ethics

There has been some discussion on how reinforcement theory impacts business ethics. According to Trevino, reinforcement theory "suggests that an organization can influence the ethical/unethical behavior of its members through specific rewards and punishments for ethical/unethical behavior" (1986, p. 613). Empirical research supports this, showing that unethical behavior increases in the short term when the firm rewards unethical behavior or punishes ethical behavior. Research by Hegarty and Sims (1978) and Trevino et al. (1985) support the appropriate use of rewards and punishments, noting, however, that rewards and punishments can inadvertently increase unethical behavior when they positively reinforce unethical conduct or punish ethical behavior. In another study that focused on ethical decision-making in negotiations, individuals more likely misrepresented their position and expected their opponent to misrepresent his position when operating in a high-incentive vs. a low-incentive situation (Tenbrusel, 1998). Thus, research suggests that reward systems may result in unethical conduct.

According to Kerr, problems with reward and punishment systems have been identified and commonly occur because organizations reward easily measured or quantified behaviors – improvements in financial performance or cost savings – rather than actual desired behaviors that cannot be readily observed or measured, such as ethical treatment of stakeholders (Kerr, 1995). Ethics researchers appear to respond to Kerr's concerns by placing greater emphasis on linking rewards to desired ethical behavior and punishments to undesirable unethical conduct.

Numerous researchers (e.g., Jones, 1995; Logsdon and Yuthas, 1997; Mathews, 1988) encourage the appropriate use of rewards and punishments, arguing that top executives can change unethical behavior of employees through the use of different reinforcement contingencies, i.e., by rewarding ethical behavior or withholding rewards previously linked to unethical behavior (extinction). Mathews maintains that, "For ethical behavior to become an integral part of everyday actions, the behavior must be reinforced and rewarded" (1988, p. 35). Similarly, Logsdon and Yuthas (1997) contend that employees make more effort to understand and follow top management's ethical values and guidelines if the organization rewards people who follow desired ethical practices and punishes or sanctions those who fail to behave ethically.

This does not appear to happen, though. Badaracco and Webb (1995) showed that young managers describe their firms in fairly negative terms, place little emphasis on community and commitment and emphasize their willingness to leave their employers. "There was very little idealism about corporate visions, the values of top managers, or the role of companies in society... The bottom line for many interviewees was that very few companies embodied values consistent with those they hoped to live by" (Badaracco and Webb, 1995, p. 23). These managers may have discovered that their corporate environments did not support higher levels of moral reasoning and ethical behavior. Trevino recognizes that a gap may exist between a manager's and the organization's level of moral reasoning. She suggests "managers may feel pressured to rely upon justifications that are consistent with the reward structure of the business organization rather than the highest stage available to them, (1992, p. 450).

Organizations' over-reliance on rewards and punishments encourages employees to operate at the lower stages one or two, avoiding punishment or behaving ethically if they believe there will be reciprocity or rewards, respectively. Stages one and two are most frequently associated with the moral reasoning found in children and research suggests that most adults operate at either stage three – group norms – or stage four – rule of law (Colby and Kohlberg, 1987).

Heavy reliance on rewards and punishments encourages employees to behave ethically for the "wrong" reasons: to obtain rewards or avoid punishment. Employees will behave ethically while under direct supervision or when rules directly apply, but they may behave unethically when not monitored or when facing uncertain and ambiguous situations. Reward systems elicit temporary compliance but do not create lasting change in behavior or reasoning (Kohn, 1993). Too, rewards "can produce some damaging reactions... [E]mployees may be tempted to conceal any problems they might be having and present themselves as infinitely competent to the manager in control of their money" (Kohn, 1993, p. 58). Rewards and punishments create a powerful incentive for employees to ensure that behavior appears to meet criteria for rewards, to hide problems, lay blame on others, or engage in other unethical behaviors to avoid punishment.

Characteristics of organizations operating at Kohlberg's lowest levels

One of our central arguments involves the overly strong link organizations create between rewards and punishments and ethical (and unethical) behavior using a number of design characteristics. We explain how some of the major design mechanisms shift employees' focus from ethical behavior that fosters relationships with and upholds responsibilities to stakeholders, to acting in ways that generate rewards or avoid punishments.

Performance appraisal and compensation systems

Performance appraisal and compensation systems are based on rewards and punishments in that they usually assess behaviors that contribute to profitability or achievement of the organization's strategy and goals and reward or punish the employee accordingly. While Logsdon and Yuthas (1997) maintain that performance appraisals should incorporate ethical behaviors and be used to determine and allocate rewards for behaviors consistent with top management's ethical values and goals, in fact compensation systems usually fail to assess ethical dimensions of behavior. For instance, when managers were asked what behaviors were punished in their firms, most managers emphasized that "[p]oor performance was the surest way of earning discipline. In contrast, unethical behavior was rarely mentioned'' (Badaracco and Webb, 1995, p. 13).

Performance appraisal and compensation systems can negatively affect employee behavior. Systems linking compensation to performance rupture relationships and ''reduce the possibilities for cooperation'' (Kohn, 1993, p. 58). We believe these systems lower moral reasoning by focusing the employee's attention on behaviors resulting in rewards and avoiding punishments.

U.S. sentencing guidelines

The U.S. Federal Sentencing Guidelines (Sentencing Commission, 1991) also emphasize reinforcement theory. The Guidelines use a ''carrot and stick'' approach, offering reductions in penalties for firms that engage in unethical or criminal behavior but have a compliance program in place. Harsher penalties are imposed on firms without compliance programs or those that have not made a concerted effort to minimize unethical and illegal activities. The Sentencing Guidelines contain numerous prescriptions for how firms can establish an effective compliance program, most relying heavily on reward and punishment systems (e.g., having a compliance officer monitor adherence to organizational rules and penalize employees who deviate from them).

Compliance systems

Adoption of the U.S. Sentencing Guidelines increased compliance systems in firms wanting to avoid or minimize wrongdoing and the accompanying punishments meted out to firms caught engaging in wrongdoing. Compliance systems include codes of conduct, compliance or ethics officers, reporting hotlines, and other mechanisms; these systems typically punish employees who commit unethical or illegal acts and reward whistleblowers who report misconduct. Part of the standard response by a firm discovering wrongdoing involves increasing or tightening up rules and control systems to prevent recurrences. The use of reinforcement theory and design characteristics that rely on or are explicitly linked to rewards and punishments may result in or encourage unethical conduct. As Paine notes, ''[m]anagers who define ethics as legal compliance are implicitly endorsing a code of moral mediocrity for their organizations.'' (1994, p. 111).

Researchers arguing for a company code of ethics implicitly advocate operating at stage three, since company codes are group norms put to paper. Companies instituting ethics or compliance officers may at most operate at stage four since these individuals tend to be lawyers, trained to engage in rule-driven behavior (Paine, 1994). If, however, ethics officers operate on a punishment mode then the organization reverts to stage one on Kohlberg's model.

Design and size of business units

The design or structure and systems typically used in organizational departments, divisions or business units negatively impact moral reasoning. Trevino (1992) noted the importance of investigating how the design of work influences moral development or reasoning. ''The evidence thus far suggests that managerial work in business settings may not support moral reasoning at one's cognitive moral development capacity. Powerful organizational norms, reward systems, and structures may serve to constrain or even retard moral reasoning'' (Trevino, 1992, p. 456).

Many organizations can be characterized as low trust, despite rhetoric or efforts to create a culture of high trust. This stems largely from the use of rewards and punishments and other design characteristics. Organizations establish many rules and procedures, set up monitoring and control systems or ways to ''check up'' on employees to ensure that they do their jobs properly, promptly, do not violate organization rules or norms, or engage in wrongdoing such as embezzlement, sharing proprietary information, and so forth. As Kohn notes in his criticisms of the use of reward and punishment systems, ''Managers are creating a workplace in which people feel controlled, not an environment conducive to exploration, learning, and progress'' (1993, p. 58).

Another organizational characteristic, subunit or organization size also impacts moral reasoning and ethical behavior. Researchers drawing on evolutionary biology argue that human beings need to work in fairly small groups or organizational units (see e.g., Fort, 1997, 1999). The complexity involved in interactions and decision making in a large organization unit add to the problem of morally reasoning and making ethical decisions. For instance, an employee given one small piece of the overall job may be unable to acquire all essential pieces of information. Different demands from or conflicting goals of various managers and coworkers and the sheer number of individuals that may need to be consulted to ensure ethical behavior can lead an employee to retreat rather than morally reason and act ethically in a large organization unit.

Organizations address the problems of larger, complex subunits by instituting procedures governing information, creating controls, specifying appropriate and inappropriate behavior, and so forth. Access to information, especially financial information, is typically limited to individuals on a "need to know" basis: employees who do not appear to need the information to perform their job or tasks cannot gain access. Even in today's knowledge-based organizations, a key concern involves maintaining control over the organization's proprietary or firm-specific knowledge since it helps create the firm's competitive advantage.

Codes of ethics

Firms have tried to address some problems associated with the design and size of the organization by providing employees with codes of ethics or by instituting other procedures.

> Some corporations have composed codes of ethics in an attempt to bring about adherence to legal and ethical precepts. Others require executives to sign compliance affidavits that state that they have not engaged in illegal behavior against or on behalf of the corporation during the preceding year. Some companies have formed 'watchdog' committees by which the activities of the individuals within the corporation are monitored by an internal oversight group. Some high-level corporate executives are encouraging employees to 'blow the whistle' internally… (Mathews, 1988, p. 14).

Many codes of ethics or signed affidavits encourage stage four moral reasoning by emphasizing adherence to rules, procedures and laws. Systems involving internal oversight "watch-dogs" shift moral reasoning down to level one as employees attempt to avoid punishment. Moral reasoning could be at level two if employees can receive rewards for whistle-blowing or getting a clean report from the oversight committee.

Individual leaders

Characteristics of an organization's leader and group processes may increase unethical activities by reducing individuals' attention to ethical considerations. A study by Dukerich et al. (1990) supported this, indicating that a group's moral reasoning decreased when the group leader operated at a low level of moral reasoning. Similarly, the ethical leadership literature maintains that a leader substantially impacts group or organization ethics. Bass's transactional leadership theory suggests transactional leaders offer rewards to employees in exchange for desired behaviors, including ethical behaviors. Transformational leaders emphasize compatibility between the employee's and the organization's goals, with rewards contingent on achieving mutually compatible goals (Bass, 1990).

Responding to critics who demand controls

Critics of our argument will charge that rules, procedures, control systems and similar characteristics are essential to ensure product or service quality, maintain firm performance, protect the organization's vital assets and knowledge, and reduce opportunities for employees to engage in wrongdoing. These represent legitimate issues and concerns, but the approaches used unintentionally convey the message that employees cannot be fully trusted to know how to behave ethically and responsibly. Firms are typically designed for the few individuals who might behave unethically and take advantage of the organization rather than for the majority of employees who can be trusted to conduct themselves responsibly and ethically.

An organization wishing to move away from reliance on reinforcement theory must conceive of and design the organization as an ethical community, as we explain in the following section, and this includes adopting a different set of assumptions about organizations and a different set of assumptions about employees. Additionally, our concept of an organization as a community suggests that managers have a responsibility to help develop employees so they can operate more autonomously and be trusted to behave ethically.

The corporation as an ethical community

The legal concept of a corporation has focused on property and contract rights as opposed to the concept that a corporation represents a community (Nesteruk, 2002). A shift in focus on the latter concept changes our conceptualization about how we view ourselves as individuals in organizations and how we view the organization itself. Solomon maintains that, "[w]e are all individuals, to be sure, but we find our identities and our meanings only within communities, and for most of us that means – at work in a company or an institution" (1992, p. 326). A corporate community can change and enhance the employee as well as providing meaning and identity. According to Nesteruk, "the characterization of the corporation as a community provides a set of meanings that fosters the growth of individuals in and through their relationships. At the core of this culture is a different understanding of the self" (2002, p. 450). Thus, we come to know and have the potential to develop ourselves when we operate in a corporate community.

When we view a corporation as a community – or more specifically, as an ethical community – we begin to focus on how the organization shapes and develops the character of employees working within it. A key responsibility of managers becomes that of helping employees develop into ethical persons who exhibit moral virtues, emphasizing who employees are and not just what they do (Nesteruk, 2002). This suggests that a corporation as a community can foster higher levels of moral reasoning and ethical behavior among employees.

Communities, or mediating institutions as Fort (1997) refers to them, socialize employees and make them aware of their responsibilities to others. A community involves relationships with others and responsibilities members have toward one another, rather than allowing employees to conceive of themselves as independent individuals focused on their own self-interest.

The concept of community as depicted here fits with Aristotle's work on virtue ethics (Nesteruk, 1996; Solomon, 1992). Aristotle maintained that "one has to think of oneself as a member of the larger community, the *Polis*, and strive to excel, to bring out what was best in ourselves and our shared enterprise. What is best in us – our virtues – are in turn defined by that larger community, and there is therefore no ultimate split of antagonism between individual self-interest and the greater public good" (Solomon, 1992, p. 322). Virtues represent universal character traits such as integrity, honesty, treating people with respect, trust and so on that contribute to development of an ethical community. The community to which Aristotle referred was society as a whole, but business ethics researchers maintain that his ideas apply equally well to the corporation as a community (e.g., Fort, 1997; Nesteruk, 1996; Solomon, 1992). A corporation's goal becomes helping employees exhibit ethical virtues in their day-to-day interactions and decisions so they develop into more ethical individuals and create an ethical corporate community.

Several important characteristics of corporate communities appear in the literature. One essential aspect involves encouragement of "good conversations" about ethical issues (Waters, 1988). Waters argues that these conversations represent part of "integrity management" by leaders in a corporation. Leaders need to initiate these conversations with employees and demonstrate their willingness and interest in discussing ethical issues that employees encounter at work.

Another necessary characteristic of corporate communities entails allowing employees to make or participate in decisions that affect them and how they do their work. Fort (1997) suggests this could include having some sort of employee representation on the corporation's board of directors, but it should definitely involve letting employees determine issues that affect their lives at work such as how their work gets done.

The size of the organization to which the employee belongs relates closely to these first two characteristics of good conversation and participation in key decisions. Fort (1997) draws on evolutionary psychology to suggest that smaller groups such as we had in hunting societies hundreds of years ago may be essential for individuals to feel responsible for others and for the effect of their decisions. He cites Dunbar's work on the brain to indicate that humans may not be able to establish real social relationships with others when operating in groups or organizations larger than 150 people (see Fort, 1997, p. 194). Larger organizations preclude participation in conversations across the organization and make employee involvement in decisions extremely difficult. Thus, establishing a community within an organization seems to require that managers pay attention to developing and maintaining fairly autonomous units that are fairly small in size.

A corporate community does not necessitate abandonment of goals of profitability or having top management set strategic direction for the organization. In fact, establishment of a community and allowing employees to participate in decisions that directly affect them may lead to better alignment of employees' and the organization's goals (Fort, 1997). A community encourages employees to adopt a holistic approach (Solomon, 1992) viewing their lives at work as meaningful, critical for employees' identity or sense of self, and consistent with their lives outside of work (i.e., not requiring the employees to adopt a different set of ethical standards at work versus at home). These characteristics of a corporation as a community contrast greatly with current approaches used or advocated to create ethical organizations.

Alternative assumptions about employees

Traditional organization designs reflect a set of assumptions about employees that may not result in ethical behavior. As discussed earlier, reinforcement theory links behavior with outcomes and assumes employees do not engage in cognitive processes or ethical reasoning. Heavy reliance on rewards and punishments implicitly assumes employees cannot be expected to "do the right thing" simply because they are or want to be ethical persons or because they enjoy the intrinsic satisfaction of knowing they behaved ethically. Bureaucratic designs with layers of management, control systems, rules and procedures, limited access to information and compliance systems unintentionally signal that employees cannot be expected to morally reason or behave ethically on their own and cannot be trusted. Firms reinforce this message with their standard reaction to wrongdoing of tightening up controls, increasing supervision, adding rules and so on. Few researchers or managers question the impact organization design mechanisms and responses to wrongdoing have on moral reasoning.

Alternative assumptions

We propose an alternative model for creating ethical organizations that operate at stages five and six of Kohlberg's moral reasoning, reflecting very different assumptions. (Organizations could operate at stages three and four also, but our interest involves creating organizations that encourage and engage in ethical reasoning at stages five or six.) Our model assumes an organization based on virtues (Solomon, 1992) or moral principles results in a high-trust culture (Covey, 1997). In this type of environment, employees can be fully empowered and trusted to make ethical decisions and behave ethically. The firm needs minimal control systems, monitoring mechanisms and little reliance on rewards and punishments to guide behavior.

Researchers such as Trevino (1992, citing Trevino, 1986, 1990 and Turiel and Smetana, 1984) argue that organizations wanting ethical behavior need to develop managerial systems and organization designs that permit and encourage employees to take personal responsibility for decisions and actions. Further, Trevino et al. (1999) found that a value-based cultural approach to creating an ethical organization was most effective at preventing ethical lapses. We agree, although we believe the systems and designs currently used – that rely mainly on rewards and punishments – do not encourage high levels of moral reasoning or personal responsibility.

An example of our alternative assumptions can be found in AES Corporation, a large private electrical utility established by Dennis Bakke and Roger Sant in 1981. AES emphasizes six key assumptions, reflected in treatment of employees and the firm's design. The firm assumes employees are: "thinking, creative, and capable of making hard decisions; willing and able to assume accountability and responsibility; unique and deserving of special treatment; fallible, even intentionally at times; positively disposed to work in groups; and eager to make a contribution'' (AES(A), 1996, p. 7). Bakke and Sant believe bureaucracy and hierarchy are incompatible with their firm's values and assumptions. Bakke suggests that children in our society have more control over their own lives than working adults so the AES approach respects the fact that the single most important feature of work is the ability to make your own decisions (Bakke, 1999). This fits with designing an organization as a community that develops employees' capabilities and allows employees to make key decisions about how they perform their work (Fort, 1997).

Semco S/A, a multinational firm in Brazil, provides another example of a firm matching its values with its structure. Like AES, Semco's employees have a high degree of control over their working environment. According to Ricardo Semler, Semco's CEO, ''[a]t Semco, we have no set work hours, no assigned offices or desks, no dress codes. We have no employee manuals, no human resource rules and regulations… People go to work when they want and go home when they want… In other words we treat our employees like adults'' (Semler, 2000, p. 57). Semco has taken worker participation to a whole new level: employees have the freedom and responsibility to make decisions about their own work environment, including who they hire, who stays in the work group and how much everyone is paid (Semler, 1993).

We agree with Bakke and Semler that a different set of assumptions about employees and their capabilities and different organization design mechanisms create ethical organizations–those organizations in which employees are expected and have the freedom to engage in high levels of moral reasoning and ethical behavior.

Two case examples of the characteristics of an ethical community

We argue strongly against the use of rewards and punishments as the core of the organization's design since these encourage lower levels of moral reasoning and unethical behavior – or ethical behavior for the wrong reasons. Rewards and punishments may elicit ethical conduct in the short-term, for instance, when management directly observes, initially institutes desired rewards, or initially administers punishments for noncompliance or unethical conduct; however, they will not result in ethical behavior in the longer term, for the ''right'' reasons, and they will elicit unintended consequences. We outline major characteristics of an organization that operates as an ethical community, showing how these shift the focus of managers and employees from what rewards or benefits the organization or avoids punishment to an emphasis on fostering ethical relationships with the organization's internal and external stakeholders.

Smaller groups or organizational units

An ethical organization design requires relatively small, communal groups or ''mediating institutions'' (Fort, 1997) rather than the large subunits and fairly bureaucratic designs we frequently observe. Individuals do not have the cognitive capabilities to operate effectively in very large subunits or organizations, according to Fort. They also can relate to and identify more closely with the values of the firm and their group when they belong to a smaller group.

AES Corporation, one of our examples, illustrates these design characteristics. AES has over 10,000 direct employees, operates in 19 countries and runs 111 plants including some that were formerly unionized. The company is organized into small ''families'' of 10–20 individuals, each with total responsibility for key decisions, including hiring, purchasing, making safety inspections, and budgeting. Employees frequently move from one team or family to another. This approach, referred to as a honeycomb, results in a very flat organization structure with three or fewer levels between all employees and Bakke, the current CEO. Total sharing of information supports everyone's ability to make decisions and results in all AES employees being designated as insiders for stock trading purposes (AES(A), 1996; AES(B), 1995; Burr, 1998).

Semco, a $160 million South American Company with approximately 1300 employees, was primarily a manufacturing company in the 1990s. By 1999, 75% of its business was in the service industry and it is now heading into e-business (Semler, 2000). Semco tries to keep its company organized into smaller groups so Semco plants have less than 150 employees. Teams at these plants range from 5 to 20 employees. According to Semler, ''[u]sually, … people will perform at their potential only when they know almost everyone around them… That is our experience, anyway.'' (1993, p. 125). New entry-level employees spend the first 6 months at the company moving from place to place. During this time they meet new people, try out jobs and learn about the company. When they find a place that ''fits'', they stay. The program, called ''Lost in Space'', resulted in less than 1% turnover in the last 6 years (Semler, 2000).

Semco's very flat organizational structure – referred to as a ''circular organization'' – has only three levels, Associate, Partners and Counselors. The Counselors, comprised of Semler and five other people, coordinate the general company strategy while Partners lead the business units and Associates constitute everyone else. A group of Coordinators (6–12) for each business unit guides the teams of Associates but can float through the system, return to being Associates and may make less money than Associates. According to Semler, in this system Associates still make all the decisions they feel competent to make (1993, p. 192).

Core ethical values guide employee conduct

Another key aspect of AES and Semco involves their emphasis on key values. The four key AES values include acting with integrity or ''wholeness'', fair treatment of all stakeholders including employees, creating a fun working environment, and behaving in a socially responsible manner. Top management at AES specifies that the firm's purpose involves much more than profit, they strive ''to steward resources to meet a need in society'' (AES(A), 1996, p. 6). To achieve the firm's values and purpose, AES does not impose a reward and punishment scheme. Teams have responsibility for setting up their own pay structure and employees are not punished when they make mistakes. The organization displays high trust in employees and a high tolerance for mistakes. During a public lecture, Bakke was hard pressed to remember any times when an employee had been fired from the company (Bakke, 1999).

Semco's key value – ''give people the freedom to do what they want, and over the long haul their successes will far outnumber their failures'' (Semler, 2000) – is exemplified in six ''lessons'': Forget about the bottom line; Never stop being a start-up; Don't be a nanny; Treat employees like adults; Let talent find its place; Make decisions quickly and openly. Employees choose the way they are paid and have several options. While Semco does not guarantee job security, in fact each employee is ''rehired'' every 6 months, and they have very low turnover. Semco rarely fires employees for anything other than cause, and if Semco employees have to be terminated due to financial problems, the company helps them start their own businesses. This often results in the ex-employee becoming a Semco supplier or partner. Almost all promotions at Semco are made from within the company and all members of teams evaluate everyone with the ''grades'' posted for everyone to see. Finally, Semco will not pay bribes even if it creates an unreasonable amount of bureaucratic red tape (Semler, 2000).

Ethical leadership and reinforcing virtues of an ethical community

We agree with Covey (1997) that leaders should not tie rewards to their own and the firm's performance and instead they should view leadership as a moral or ethical endeavor. Leaders exemplify virtues that contribute to formation of an ethical community (Solomon, 1992). Empirical research supports the importance of ethical leadership, showing that leaders operating at a high level of moral reasoning – ethical leaders – foster group moral reasoning at the same or a higher level (Dukerich et al., 1990, cited in Trevino, 1992).

Our proposed model for designing ethical organizations stipulates that if unethical behavior does occur, top managers should investigate the situation to determine why employees do not fully understand the organization's virtues and how to implement the virtues more appropriately: remedial action would re-emphasize the virtues and strengthen trust within the organization. AES demonstrated this approach in 1992 when their Shady Point plant in Oklahoma was found to be involved in fraud for falsifying water samples. Employees tried to cover up water contamination at the company's wastewater treatment center; the violations were relatively minor and there was no indication that the river had been polluted. The stockholder, lawyer and investment banker reaction was swift and vigorous, with all parties calling for a total reorganization of AES, establishment of more levels of control, adoption of a legal compliance program, and for the company to drop its values statement unless AES could show that the statement led to profitability (AES(A), 1996). The plant itself was different from other AES plants in that employees had decided on a more formal organizational structure, were more likely to cite pay as their motivating value, were less likely to rotate among families or teams, and had lower levels of education and technical experience; additionally, the plant manager believed that the workforce differences required adoption of a somewhat different set of assumptions about employees and a different organization design. Ultimately, Bakke convinced Sant and the executive committee that the problems at Shady Point were the result of the organization structure and not the employees, as Bakke explained in 1994:

> We know that honeycomb really didn't have a good test at Shady Point. It was never given a chance to take hold. But once the people were thoroughly introduced to the ideas, they began to outpace other plants in their commitment. They did go through a six-month period of heightened controls, of course. They added more reporting layers and specialists to manage human resources and environmental compliance. But after awhile they wanted to become part of AES again. When they did, they went full steam ahead. They've done a tremendous job of eliminating hierarchy and completely blurred the distinctions between maintenance and operations. They have gotten rid of the added supervisors and taken on more responsibility as individuals and teams (AES(B), 1995, p. 2).

This shows that Bakke does not make excuses for the problems at Shady Point and does not blame the employees. His (and the organization's) high level of trust in employees is shown by relying on employees to set up their own method for resolving the problem. Bakke reflected back on the experience, saying that "What we regarded as a catastrophe of values our external constituencies read as a catastrophe of economics" (AES(B), 1995, p. 2). At this point, AES values and ethical design have won out and have not compromised financial performance.

Good conversations about ethics and employee participation in decision making

The importance of responding to unethical behavior by having corporate leaders accept responsibility and understand why unethical conduct occurs cannot be overemphasized. Kohn argues that "rewards ignore reasons" and that: "In order to solve problems in the workplace, managers must understand what caused them… But relying on incentives to boost productivity does nothing to address possible underlying problems and bring about meaningful change" (1993, p. 60). Although Kohn focuses on productivity or performance problems, we believe his argument extends to unethical behavior. Managers must determine how and why unethical behavior occurred and address the root causes before they can expect to create real change.

Identifying causes of ethical lapses and development of effective solutions requires participation and dialogue between managers and employees. This reflects one characteristic of ethical communities discussed earlier in the paper, namely the importance of top management and managers at all levels of the organization fostering and participating in meaningful conversations about ethical issues. Our example of AES demonstrates that this requires managers be willing to admit when they make a mistake. They need to exhibit the virtue of intellectual humility or remembering and admitting times when they have been wrong (Paul, 1993). Managers have great difficulty doing this when they operate in organizations in which their admission of a mistake may result in a punishment or forfeiture of a reward.

Employee participation in decision making contributes to an ethical community by allowing employees to have greater say in and control over their own work. Semco not only allows employees to make decisions about their work area, such as how to arrange machinery or what color to paint walls but they provide employees with entrepreneurial opportunities (Semler, 1993). Employees can propose a business plan, purchase excess machinery or other resources from Semco, and even obtain a loan with which to start up operations in the same or in a related industry, for instance, becoming a Semco supplier or customer. This helps Semco avoid layoffs and the overhead associated with maintaining unnecessary equipment and gives employees the freedom of choosing to work for Semco or open their own firm. Thus, Semco not only gives employees choice over how they perform their work but whether or not they work for Semco.

Organizations can achieve these characteristics, become ethical organizations, encourage high levels of moral reasoning and remain very profitable as AES and Semco illustrate. It requires an organization design reflecting high levels of moral development, i.e., trust, fairness, responsibility and integrity. Unlike organizations with values statements reinforced by rewards and punishments, the values of ethical organizations are reinforced by recognizing the uniqueness of each individual employee, respecting the human nature of employees and making business decisions based on whether the firm's values are being met. This requires an ongoing commitment to the values and continually encouraging and practicing the organization's values.

Conclusion

We raise serious questions about how organizations use reward and punishment systems and organization designs based on them, arguing that these approaches foster low levels of moral reasoning and unethical behavior. Our alternative organization design, based on different assumptions about employees, encourages the organization and its employees to operate at stages five and six of Kohlberg's scale. AES Corporation and Semco S/A demonstrate the application and feasibility of our ideas, showing our ideas can result in both ethical conduct and profitability.

Our paper has important implications for theory and research in management and ethics. Researchers need to empirically test our arguments regarding the impact of rewards and punishments on moral reasoning and ethical behavior. If reinforcement theory leads to low levels of moral reasoning and unethical conduct as we argue, researchers must rethink many theories and models for managing employees, designing organizations, and for eliciting ethical behavior.

Managers and entrepreneurs should give serious consideration to our arguments. Much advice offered to managers, especially for fostering ethical conduct, involves instituting reward and punishment systems or mechanisms linked to reinforcement systems. Entrepreneurs are told to add layers of management, rules and procedures, create divisions or large subunits organized around products, services or geographic areas with little attention paid to unintended consequences of these designs and the assumptions they implicitly convey to employees. Our alternative approach suggests managers and entrepreneurs should create and maintain strong values and treat employees as highly responsible and ethical individuals. Top managers must continually model ethical conduct and converse openly with employees about ethical issues in order to establish an ethical community. Employees should be expected to make mistakes at times with the understanding that management will treat them fairly and leaders will accept responsibility for not having fully emphasized and communicated the corporate values.

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