

Business Ethics and Free Markets: A Social Contracts Perspective

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ABSTRACT

The purpose of this paper is to explore the relationship between business ethics and free market principles. We use the framework of Integrative Social Contracts Theory (ISCT) (Donaldson and Dunfee, 1999) as a lens to evaluate the effects of free markets on populations. ISCT proposes a set of overarching principles, called hypernorms, which emanate from an implied universal social contract. One of these hypernorms specifically appeals to “necessary economic efficiency” as a structural element in evaluating ethical choice. We view the specific inclusion of an efficiency hypernorm as a positive element in ISCT, because it allows for economic evidence of market successes to be weighed in concert with market failures. Moreover, the reverse is also true in that efficiency-enhancing choices need also to be consonant with fundamental hypernorms protecting the dignity and choice of individuals.

In order to make observation of the expected economic outcomes of policy choices, economic practices, and institutions that most closely reflect those of the conceptual “free market,” a measure of the degree to which the policies, practices, and institutions present in an economy rely on markets, individual responsibility, and free moving prices – the Economic Freedom of the World Index (Gwartney & Lawson, 2006) – will be employed. Economic and statistical analysis of the relationship between this widely referenced measure of institutional quality and other major macroeconomic indicators (such as per capita income, growth in output, employment, environmental quality, life expectancy, child mortality rates, etc.) will be used to analyze the impact of such institutions necessary

for economic efficiency on state populations. The issue of market failure will be addressed as an exception to the premise that “free markets” generally lead to efficient outcomes consistent with ISCT’s hypernorms.

INTRODUCTION

The purpose of this paper is to explore the relationship between liberal capitalism and business ethics. We use a five part analysis. First, we describe Integrative Social Contracts Theory (ISCT) (Donaldson and Dunfee 1999) as an ethical lens. We focus specifically on hypernorms, overall guides to action consistent with a hypothetical macro social contract. Second, we describe the essential economic characteristics of the profit maximizing firm in practical terms based on widely accepted financial valuation techniques (Koller et al 2005). Third, we present aggregate evidence of the connection among macro economic indicators of economic efficiency, freedom, and stable social institutions. Fourth, we describe a recent synthesis of stakeholder culture and ethics in light of the firm value maximization model. Fifth, we briefly summarize and discuss our conclusions and suggest that ethics researchers 1) incorporate reference to macroeconomic effects when analyzing individual cases of market failures and 2) utilize a reasonable selection of fundamental ethical principles that may be in tension when studying an individual ethical dilemma.

ETHICAL ANALYSIS USING INTEGRATIVE SOCIAL CONTRACTS THEORY

The situations involved in ethical issues are often not all clear cut. So you must ask yourself, given a certain situation, how do I determine if an action is ethical? In order to undertake ethical analysis, a person needs to consider 1) his or her own ethical framework, 2) the various ethical evaluation methods available, and 3) the diverse authorities to which different affected communities could appeal. ISCT is a particular methodology based on social contracts that helps in the analysis of the ethical dimensions of economic policies

and management actions¹. Social contract thinking has its historical precedence in Hobbes (1946), Locke (1986), and Rousseau (1968). Social contract thinking is explicitly recognized as a form of post conventional moral reasoning (Rest 1999).

Development of ISCT

One may see in social-contract thinking an emphasis on agreements, the rights and responsibilities of different groups, and potentially a way to adjudicate disputes and/or evaluate policy and actions based on those agreements. ISCT thinking is more easily and closely related to the world of business than are other approaches to ethical decision making because of its three principal strengths: 1) the relevance to real business situations due to the current adaptation of social contract thinking by Donaldson and Dunfee (1999), 2) a focus on various communities affected by decisions, and 3) realistic and specific guidelines to ethical reasoning that may be lacking in other ethical systems.

ISCT's development focused primarily on the problems inherent in a global economy, especially the ethical problems encountered by multinational companies when operating in developing countries. However, there is nothing in the system itself that limits its application only to the environmental, wage, and cultural issues of international business. The corporate governance and ethical issues present in all forms of economic systems provide an excellent opportunity to use ISCT.

Assumptions of ISCT

ISCT asserts the following three assumptions in establishing the groundwork for a common economic ethics. These assumptions set limits to the behavior of individuals and

¹ This summary of ISCT is adapted from Verreault, D., Yang, S., and Angel, J. "Sprint Corporation – Ethical Decisions and Tax Avoidance Strategies", *Issues in Accounting Education* (19.1.119-43)

groups in undertaking economic activity – including capital formation, production and distribution of goods and services, compensation, human capital systems, taxation, and distribution of profits.

- All humans are constrained by bounded rationality.
- The nature of ethical behavior in economic systems and communities helps determine the quality and efficiency of economic interactions. Higher-quality and more efficient economic interactions are preferable to lower-quality and less efficient economic interactions.
- Economic activity that is consistent with the culture, philosophical, or religious attitudes of economic actors is preferable to economic activity that is not.

The notion of bounded rationality is now common in the management literature. In terms of ethics, not all the relevant moral facts or processes can be recognized. People may not know exactly how to trade off two different approaches that seem to be inconsistent but based on legitimate, or at least deeply held, moral beliefs. In terms of the quality and efficiency of economic interactions, ISCT clearly recognizes that systems delivering higher orders of output in terms of quality and quantity and accomplishing the outputs more efficiently are preferred to those systems which do not perform efficiently. Thus, ISCT explicitly allows the integration of economic policy with other ethical dimensions of a decision. ISCT requires analysis of the appropriateness of a policy to a particular community. Here we must be aware of the potential to sink into moral relativism. The creators of ISCT refer to it as a pluralistic ethical system rather than as either relative or absolute. ISCT is located on the continuum between relativism (there is no right or wrong outside of context) and absolutism (only one way is right and context does not matter).

The Structure of ISCT

Donaldson and Dunfee (1999) in *Ties that Bind: A Social Contracts Approach to Business Ethics* provide a business-oriented treatment of social contracts. Their book is the most complete presentation of a stream of work that examines international business ethics and develops the arguments for a social contracts approach to business ethics. Examples of ethical analysis using ISCT include the setting of wage rates and living conditions of employees by multinational companies in developing countries; the appropriateness of participating in business systems that rest on graft or nepotism; and the obligations of multinational companies to the host country in the area of environmental protection (Dunfee and Warren 2001, Donaldson and Dunfee 1994, Donaldson 1989, Dunfee, Smith, and Craig 1999). See Dunfee (2006) for a summary of the development of ISCT and a discussion of its criticisms.

ISCT consists of five major components to maintain and balance cross-cultural demands of particularity and generality and interactions among communities. First, the system proposes that all communities and all agreements within and between communities should be guided by a set of fundamental moral precepts for all human beings called *hypernorms*. The existence, content, and nature of hypernorms, indeed the very necessity for hypernorms, is perhaps the most controversial part of ISCT (For criticisms and extensions of ISCT see Calton 2002, Philips 2006, and Soule 2002). We will provide a selection of hypernorms below for use in our analysis. Hypernorms are especially important in the context of this paper since we are focusing our economic arguments on macro economic and social factors.

Second, participants in individual communities form agreements consistent with a set of culturally generated norms. These are *authentic norms* and are determined by local contracts. These contracts recognize that rationality is bounded by the context and finite capacities of its community members. To be an authentic norm, the norm must be embraced by most of the community members who must act in accordance with that norm. Third, authentic norms become *legitimate norms* when they do not contradict hypernorms. For example, the authentic norm of slavery in the pre-Civil War community of southern white property owners in the U.S. could not now be considered a legitimate norm when judged against a hypernorm of dignity for each human being. Indeed, most would argue that slavery was an illegitimate norm judged against hypernorms asserted in the U.S. Constitution and a lack of authenticity for the community of slaves who were denied both *voice* and *exit* (both substantive hypernorms) notwithstanding the white property owning community's appeals to economic efficiency (a structural hypernorm).

Fourth, the system expects conflicts among legitimate norms of different communities. A set of "priority rules" are derived from hypothetical *macrosocial contracts* to determine how to identify and resolve conflicting legitimate norms. Those six rules of thumb for resolving conflicts:

1. Transactions solely within a single community, which do not have significant adverse effects on other humans or communities, should be governed by the host community's norms.
2. Existing community norms indicating a preference for conflict of norms should be utilized, so long as they do not have significant adverse effects on other individuals or communities.

3. The more extensive or more global the community that is the source of the norm, the greater the priority that should be given to the norm.
4. Norms essential to the maintenance of the economic environment in which the transaction occurs should have priority over norms potentially damaging to the environment.
5. Where multiple conflicting norms are involved, patterns of consistency among alternative norms provide a basis for prioritization.
6. Well-defined norms should ordinarily have priority over more general, less precise norms.

Fifth, ISCT is not an ethics calculator that allows you to provide inputs and to expect back a deterministic result. The system allows for and expects indeterminacy and conflict in some cases even after following the steps of the system. This places the decision maker in *moral free space* where a decision must be made in a considered way by appealing to virtue, consequence, duty, or some other post conventional moral reasoning system. However, moral free space only comes into play after the other steps in the system are completed and the ethical indeterminacy persists. Thus, ISCT circumscribes the bounds of moral free space through tests of an action or policy against hypernorms, authentic norms, legitimate norms, and priority rules.

Moral free space is the area bounded by hypernorms in which communities develop ethical norms representing a collective viewpoint concerning right behavior. Recognition of the existence of community moral free space is an important foundation of ISCT. Moral free space is necessary in ISCT because there are areas which simply are not prescribed and that require difficult judgments and tradeoffs among competing authentic

norms or between two relevant hypernorms. Areas outside the moral free space are illegitimate because they are inconsistent with hypernorms.

Hypernorms

Hypernorms represent limits on what communities may agree to do in their local community and are similar to universal principles that are designated to provide the normative basis to resolve transcommunal disputes. ISCT specifies some distinctive characteristics of hypernorms such as: *universal consensus, conformance with well-known global industry standards, consistency with the precepts of major religions, appeals to recognized sources of moral philosophy; support by relevant communities of professionals* (e.g., accountants or engineers), and *support by the laws of many different countries*. Thus, one cannot simply claim a principle and justify an action or policy.

Hypernorms should include notions of *exit* and *voice* for a community's authentic norms, *support for the essential background institutions* in society (e.g., legal system designed to assure freedom of people), *promise keeping*, and *respect for human dignity*. In a sense, hypernorms are used to identify philosophical criteria for moral behavior, such as "what ought to be." That is, a community *ought* to structure its agreements regarding business to promote efficiency in the production of goods and services. The hypernorm of *necessary economic efficiency* projects the performance of the system for capital formation, production, and distribution of goods and services directly into the ethical arena. *Integrity, honesty, informed consent*, and the *right to subsistence* are also commonly included as hypernorms.

Summary and Use of ISCT

Figures 1 and 2 present decision aids for analysis of a prospective or past decision, action, or policy. First, consider whether or not the action or policy is consistent with hypernorms. Remember, there is no definitive list of hypernorms, but we have supplied a sample list of candidates in the prior section. You may find at first cut that one or more hypernorms are violated. If a hypernorm is clearly violated, reject the action or policy. Second, consider whether or not the norm is an authentic one, based upon the local contract to which community members have agreed. Third, consider whether or not the norms you believe are authentic are also legitimate; that is, compatible with hypernorms. Carefully consider whether or not there is conflict or tension between the authentic norm represented by the action or policy. Other authentic norms, and the overriding limits to community action called hypernorms. Fourth, examine whether or not your legitimate norm is in conflict with other legitimate norms. Here we apply the priority rules to solve conflicts among legitimate norms. If application of priority rules fails to yield a clear answer, then the decision lies within the area of moral free space.

Insert Figure 1

Insert Figure 2

THE ROLE OF THE FIRM IN A COMPETITIVE ECONOMY

Short term pressure to cut corners is common to all endeavors. Business is no exception. The counter weight to those pressures is both economic and ethical. Neither long term-value creation nor conformance with agreed societal norms discovered through ISCT are likely in an environment driven by short term accounting profit. But we assert that owners of firms risk their money to gain returns. Gaining those returns is the task of

management. Corporate governance systems, including much-abused executive pay schemes, strive to mitigate the agency problem introduced by the divergent goals of corporate owners and professional managers. There are strong empirical and theoretical reasons for believing that firms organized to make an economic profit, to earn a return above the opportunity cost of capital, in an economic environment characterized by free citizens and strong institutions create wealth and prosperity for its citizens. The independence of citizens and their involvement in the economic process coupled with great advances in information technology and information flows suggest a mutual reinforcement of the pursuit of economic value and the incidence of free cultures and strong, freedom supporting institutions.

Value Line, an investment advisory firm, produces a stock market graph of the U.S. markets from before the depression until 2005. The graph tracks the market value of the Dow Jones Industrial Average, the book value of the companies' shares (times three), and the earnings per share of the companies (times fifteen). The trend of all the lines is up and the correlation among the three lines is high. The results of earning profits and increasing the book value of the underlying companies is recognized in a relatively predictable way in increased market value of firms over a period of time that has seen the great depression, world wars, massive change in technologies, persistent and sometimes seemingly incurable periods of high inflation and high unemployment, the collapse of communism, terrorist attacks, and the emergence into a middle class of hundreds of millions of Chinese, Indian and other citizens amid burgeoning global integration. Those gains in wealth have benefited society. Nor is the story limited to the U.S. Dimson et al (2002) title their recent study of a century of global investment return as a "triumph of the optimists". The

argument of liberal economics linked with political freedom and respect for each individual is indeed one of optimism. Data support the optimistic economic scenario.

Total returns to shareholders vary around the world and tend to compensate shareholders for accepting investing risk. However, the highest returns accrue to those countries with some form of competitive advantage. In some cases, a country has raw materials, in others a work-oriented and reward oriented culture, in most an environment of protection for contract rights, private property, and individual freedom. Economies that have the highest Total Returns to Shareholders also experience the highest rates of job growth and the highest levels of Research and Development expenditures (Koller et al. p. 20).

Friedman (1982) said that the goal of a business is to make money consistent with the basic rules of society. In “The Goal”, Eli Goldratt (1992) in teaching the theory of constraints reveals that the goal of a business is to “make money” and that all operational processes and efforts within the business should be aimed at that goal. Rappaport (1986) developed the maximization of the present value of all future free cash flow as the fundamental metric for value creation; Stewart (1991) described the system of Economic Value Added (EVA) that prompts managers to seek out all projects with a positive net present economic value; and Koller et al. (2005) used prior models and insights from the worldwide valuation practice of McKinsey to promote a long-term value building management culture. Jensen (2001) describes the motivational factors of humans within the business and political setting, justifying the free market approach, consistent with Friedman, as minimizing the control of others over our lives when economic transactions remain in the business setting and are based on free exchange. Jensen (2001) also

describes the process of disinvestment and leveraged buyouts as a forced way to cure the problems of entrenched management and failed internal control systems. Porter (1996) describes the dynamics of competition and the role of hyper competitive geographical clusters in stimulating the pace of innovation. The 2006 Nobel prizes in Economics (Edmund Phelps) and Peace (Mohammad Yunus) went to people who recognized the power of entrepreneurship to transform society and enhance the dignity of the individual in modern society (The Wall Street Journal on 1/29/07).

There is a highly compelling theoretical and empirical argument at the level of the firm and industry that suggests the power of liberal capitalism to improve society. Such evidence acts as an underpinning to macro results and is consistent with those macro results. Our focus in this paper is at the macro level. As we turn to that evidence, we make two stipulations. We accept hypernorms (Table 2) as legitimate tests of the ethical quality of institutional, governmental and firm policy in both specific instances of conflicted ethical claims and in judging aggregate policy results at the national, regional, and world levels. Moreover, we also stipulate that the U.N. Global Compact Principles (Kell 2003) (Table 3) represent legitimate expressions of specific behavioral norms for business. We propose that both hypernorms and the Global Compact Principles serve as a specification and expansion of Friedman's "basic rules of society" for the 21st century global economic environment.

Insert Table 2

Insert Table 3

ECONOMIC FREEDOM AS A MEASUREMENT OF INSTITUTIONAL QUALITY

Introduction

In order to identify the degree to which free markets lead to both economic efficiency and outcomes consistent with business ethics as defined by the ISCT framework, we employ the metric of *economic freedom* developed by Gwartney and Lawson (2006) in their Economic Freedom of the World (EFW) index. This framework measures the degree to which nations employ institutions consistent with personal choice, voluntary exchange, the protection of persons and property, and the freedom to compete in markets. Generally speaking, economies with relatively high EFW index ratings may be described as more *free market* oriented than those with relatively low index ratings.

The EFW index has been in development for nearly 20 years, in publication for the last 10 years, and includes 123 countries for the 1970-2004 period. The index itself is composed of data from 38 distinct sources making up 21 component areas divided into five principle areas, which are the size of government, legal structures & protection of private property rights, access to sound money, freedom to trade internationally, and regulation & control of business. Apart from determining which of the components goes into which principle area, equal weighting is applied to each of the elements within each subcomponent, each subcomponent within each principle area, and each principle area within the broader index of economic freedom.

Economic freedom focuses on the capacity for the individual to determine the ultimate use of their private property and for free markets to determine the ultimate use of scarce resources in a society.² Consider the impact on economic efficiency that each of the five components of the EFW index is likely to have:

The size of government (expenditures, taxes, and state owned enterprises):

² It is important to note the concept of economic freedom is distinct from the idea of political freedom or civil liberties. There is no reason to believe that institutions necessary for that of economic freedom are at odds with those needed for the existence of either political freedoms or civil liberties.

As government grows, fewer resources are left for individuals to direct and more resources are put into the realm of collective decision-making. Even though most economists would argue that there is an efficient level of government in an economy, taxes – necessary to fund such government – distort relative prices and change the behavior of individuals from employing their first best use for scarce resources.

Legal structures and the security of private property rights:

In order for an individuals to efficiently utilize their private property (human, physical, or intellectual) they must be able to employ it in its highest valued use. With an institutional system of unbiased courts for the enforcement of contracts and the protection of private property, economic exchanges are free to occur across broad populations, vast distances, and through time. Without such a predictable and impartial set of legal institutions, the entrepreneurial potential for an economy is unlikely to be fully realized.

Access to sound money:

Sound money, a money supply for which the growth rate is predictable and so the capacity for money to “store value” through time is enhanced, is essential for individuals to be able to engage in exchanges through time. Governments that employ the creation of money to finance expansions of government erode the value of private financial instruments and erode the capacity of individuals to trade and create opportunities with them. The freedom of the individual to engage in exchange through time is further reduced if they are restricted from employing foreign currency bank accounts.

Freedom to trade internationally:

International trade can lead to greater economic efficiencies for a number of reasons. Specialization and trade according to the law of comparative advantage,

technology transfer, the capacity to achieve economies of scale, and the reduced capacity for firms / industries to act in less than competitive fashions each can lead to greater economic efficiencies from the scarce resources endowing an economy.

Regulation of credit, labor, and business:

The capacity for loanable funds markets to operate in competitive (and private) channels ensures that scarce loanable funds are employed in what the market (and not some public choice mechanism) determines is its highest valued use. The implicit freedom to hire is tied to the explicit freedom to dismiss which is often regulated in labor markets. The freedom to serve market interests quickly and flexibly ensures that scarce resources are capable of addressing the ever-changing needs of a vast and diverse population.

Each of these 5 principle areas of economic freedom are addressed using multiple measures, from varied data sources in the EFW index. In some cases, subjective data are employed (for instance in the recently fleshed out regulation area); in most cases, objective data are the mainstay of the index.

The top 10 “most free” and bottom 10 “least free” economies from 2004 are listed in Table 4. A complete list of the 123 countries in the EFW study (along with their EFW rating and relative ranking) is included in **Appendix 1**. Both level and change data for the EFW measure (used in both the broad analysis and growth regression analysis) are available from the authors upon request.

Insert Table 4

The Association of Economic Measures, Freedom, and Well-Being: Do Free Market Results Promote Conformance with Hypernorms?

With a measure of institutional quality reflecting the degree to which an economy represents the hypothetical *free-market* identified, analysis of *economic outcomes* may proceed. This section of the paper is composed of two parts:

- An analysis of the general relationship between the degree to which a country's institutions reflect concepts of economic freedom (as measured using the EFW index) and a broad range of macro indicators from a plethora of socially relevant issues, and,
- A more specific investigation into the particular impact of relatively more free institutions and the change in the liberality of such institutions on the growth of per capita income (in real PPP terms) through time.

Economic Freedom and Broad Macro Indicators – A General Analysis:

When examining the general outcomes of a free-market oriented system, there are many different dimensions of performance that can give us the information necessary to objectively assess the morality of the institutional structure making them possible. The general analysis in this paper will address the following:

- GDP per capita (realized productive capacity of resources per person)
- Unemployment (share of labor force – LF – actively searching for employment)
- GINI coefficient (a measure of the degree of income concentration / distribution)
- Income share of poorest 10% (how distorted is income at the lowest extreme)
- Literacy rate of those 15 years and older (% of LF with basic tools to participate)
- Children as share of LF (size of LF composed of individuals choosing to work, exclusively, rather than to continue their formal education)
- Life expectancy and Infant mortality (a measure of the quality of life – *generally*)
- Share of population with access to improved water supply (another measure of quality of life and the distribution of basic human needs)

- Environmental performance (a measure of the impact of a society on the environment and that environment's impact on members of the society)
- Corruption (a measure of the role of bribes to government officials and coercion by government officials as part of the economic decision making process)
- Political rights / Civil liberties (a measure of free & fair elections and the freedom of speech)

Economic Freedom and Broad Macro Indicators – Two Methodologies:

The methodology employed in this analysis is to examine correlation between relatively less free and more free economies and the particular macro indicator in question.

This is done in one of two ways:

- ***Where the countries are divided into 5 groups***, the “least free” group are those with 2004 EFW index ratings more than 1.5 standard deviations below the mean. These 10 states, which include Algeria, the Democratic Republic of Congo, Myanmar, and Zimbabwe, are clearly the “least free” from a relative / distributional perspective.³ The “less free” group is composed of those economies with EFW index ratings more than 0.75 but no more than 1.49 standard deviations below the mean. This group of 20 states includes China, Russia, Syria, and Columbia.⁴ The “average” economic freedom group is composed of those 63 countries with EFW ratings +/- 0.75 standard deviations about the mean. This set of countries includes Argentina, India, Mexico, and Turkey.⁵ The “more free” group are those with EFW index ratings more than

³ The *least-free* set (in the 5 group analysis): Algeria, Burundi, Central African Republic, the Democratic Rep. of Congo, the Rep. of Congo, Guinea Bissau, Myanmar, Rwanda, Venezuela, and Zimbabwe.

⁴ The *less-free* set (in the 5 group analysis): Benin, Cameroon, Chad, China, Columbia, Dominican Rep., Gabon, Malawi, Mali, Nepal, Nigeria, Pakistan, Papua New Guinea, Romania, Russia, Sierra Leone, Syria, Togo, and the Ukraine.

⁵ The *average-freedom* set (in the 5 group analysis): Albania, Argentina, the Bahamas, Bahrain, Bangladesh, Barbados, Belize, Bolivia, Botswana, Brazil, Bulgaria, Costa Rica, Cote d'Ivoire, Croatia, the Czech Rep., Ecuador, Egypt, Fiji,

0.75 but no more than 1.49 standard deviations above the mean. This set of 22 economies includes France, Japan, Chile, and Australia.⁶ The “most free” group are those with EFW index ratings more than 1.5 standard deviations above the mean. This set of 8 states includes Hong Kong, Ireland, the United Kingdom, and United States.⁷

- The analyses represented with quartile analysis (*where the countries are divided into 4 groups*) were originally presented in the 2006 EFW Annual Report and have been developed over a number of years – through many years of annual reports. A quartile analysis divides the group of countries into equal quarters and demonstrates the same sort of ideas as those represented in the 5-group distributional / relative format described above. These analysis were not replicated in 5-group form or updated with newer / alternate data as the data employed by Gwartney and Lawson (2006) were determined to be the most appropriate available for the topic represented.

Economic Freedom and Broad Macro Indicators – To the Data:

Figure 3 shows that the realized productive capacity of an economy per person for relatively *more free* economies is nearly 20 times that of those in relatively *less free* economies.⁸ This astounding finding represents a comparison of economies not at the extremes (such as those in the *most free group* with EFW more than 1.5 standard

Ghana, Greece, Guatemala, Guyana, Haiti, Honduras, India, Indonesia, Iran, Israel, Italy, Jamaica, Jordan, Kenya, the Rep. of Korea, Latvia, Lithuania, Madagascar, Malaysia, Malta, Mauritius, Mexico, Morocco, Namibia, Nicaragua, Norway, Panama, Paraguay, Peru, Philippines, Poland, Senegal, Slovakia, Slovenia, South Africa, Spain, Sri Lanka, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uganda, Uruguay, and Zambia.

⁶ The *more-free* set (in the 5 group analysis): Australia, Austria, Belgium, Chile, Cyprus, Denmark, El Salvador, Estonia, Finland, France, Germany, Hungary, Iceland, Japan, Kuwait, Luxembourg, Netherlands, Oman, Portugal, Sweden, Taiwan, and the UAE. *Note: data for Taiwan was not available for many of the 5 group analysis.

⁷ The *most-free* set (in the 5 group analysis): Canada, Hong Kong, Ireland, New Zealand, Singapore, Switzerland, the U.K., and the U.S..

⁸ This result is found using data which control for cross-sectional differences in the price of goods (it is cross-sectionally real – PPP).

deviations about the mean) but rather only of those that were *relatively more free (and less free)* with EFW 0.75 - 1.49 standard deviations above (and below) the mean. An examination of the *most free* economies (with income per capita of \$27,646) shows their realized productive capacities as nearly 28 times of those *least free* (with income per capita of \$1,002).

In an economy where individuals are able to direct scarce resources to their highest valued use, where government is limited to its efficient ends, where free-moving prices are allowed to signal the relative value of alternate uses for scarce resources without the distortion of taxes, where the value of money is predictable, where private property rights and contracts between individual decision makers are enforced in an unbiased fashion, where individuals may trade with others across the street, the state, or in other countries, and where government does not create frictions between economic players in the market place for ideas, goods, and services it is not surprising that the productive capacity of the market (especially as measured by the economic metric GDP) would be enhanced. Even so, the *level of national income* is but one aspect of an economy's performance. The remaining 11 tables show a broader analysis which considers many of the other aspects of the economy which may be of importance to a society.

Consider the ability for individuals to find employment. Figure 4 shows that *more free* economies (5.9%) have measured unemployment rates 64% that of those *less free* (9.1%). At the *least free* extreme, economies have average unemployment rates of just over 17%. With more extensive and restrictive labor market regulations comes limits on how and when an employer may release an employee which results in implicit limits on how and when a potential employer may hire an employee.

As for the distribution of income, the GINI coefficient is one macroeconomic indicator of the degree to which income is evenly distributed across its earners. GINI coefficients (which are bounded by 0 and 1) closer to 1 represent very distorted distributions of income with a measure of 1 indicating that all income in an economy is received by a single individual and a measure of 0 representing equal distribution of income across the earners. Figure 5 shows that *more free* economies have more even income distributions than either the *less free* or *average economies*. Though the *least free* states are no more distorted (income distribution wise) than those *most free* the common misconception regarding the freedom to trade and the distribution of income (“the rich getting richer”) is not realized. This result is not unexpected as economic freedom is associated with unbiased opportunities and not selective institutions controlled by private bribes, government corruption, or collective decision making.

Figure 6 shows the income share of the “poorest” 10% of the population. In the *more free* economies, the “poorest 10%” receives (on average) a greater share – nearly 20% greater – than in the *less free* set of economies. This pattern is repeated for the *most free* versus *least free* set of countries. With unbiased opportunities come greater returns.

Literacy represents a key aspect of human capital needed for individuals to have the capacity to participate fully in society and the economy. Figure 7 shows that the *more free* countries possessed literacy rates nearly 30% greater than those *less free*.

Figure 8 shows the share of the population aged 10 to 14 who participate solely in the formal labor force. This EFW figure shows that with greater economic freedom, states realize lower and lower shares of their “children” in the labor force. Countries with index ratings in the top 25% have (on average) less than 1/3 of one percent of their children (10-

14) in the formal labor force (and outside of the classroom). Those with EFW ratings in the lowest 25%, rather, have (on average) 19.3% in such a realized outcome. As greater economic freedom leads to a greater realized productive capacity, it is not unsurprising that with greater income (and wealth) comes the capacity to invest in the human capital of the youngest members of society.

Insert Figures 6, 7, 8

Just as the share of the children (aged 10-14) in the labor force may be described as a *quality of life* macroeconomic measure, so too may life expectancy and infant mortality. Figure 9 shows both of these measures in a 5-group analysis. With greater relative economic freedom, states realize longer life expectancies and smaller chances for live births to be cut short before the end of infancy. *More free* economies in this analysis have infant mortalities 6.7% that of *less free* states (0.6% versus 8.9% of live births). Economic decision makers in *more free* countries also go on to live, on average, 20 years longer than in those *less free* (77.5 years versus 57).

Figure 10 demonstrates the share of the population with access to an improved water supply. The *more free* and *most free* states here, on average, have measured access rates of approximately 100%. The *less* and *least free* states, on the other hand, average approximately 70%. Just as with literacy, this fundamental need of the economic decision makers is more uniformly available to individuals within states possessing institutions with higher EFW index ratings than those with lower ratings.

Insert Figures 9, 10

It is a common misconception that free-markets are likely to lead to degraded environmental quality – as private ownership of “sensitive and valuable social interests”

may be traded away to the highest bidder. This conceptual failure does not consider the fundamental benefits of private property rights (and institutions which provide for protection of such private property). Private property gives the individual decision maker the explicit incentive to conserve / preserve, maintain, and provide privately owned resources to their highest valued use in society. Common property, on the other hand, is often abused, over consumed, and ultimately destroyed as no one individual (who may choose to consumer / preserve or maintain it) is able to realize the benefits of their actions. As such, the theory is supported by the empirical results. Figure 11 shows that environmental performance (measuring both the impact of economic decision makers on the environment and the impact of a degraded environment on economic decision makers) is correlated with institutions possessing higher and higher EFW ratings.

Corruption, as measured by Transparency International, is the degree to which coercion by government officials (and the use of bribes) is part of economic decision making. Figure 12 shows clearly that in economies possessing greater EFW index ratings, measured levels of corruption are less. This is a reasonable result as outcomes representative of the concept of corruption are actually explicitly included in the index. Still, by identifying this one particular aspect of macroeconomic performance in isolation, it becomes clear that this socially relevant outcome (for government to work in an unbiased fashion, without coercion wherever possible, and without selective application of policy) is found more commonly in states which possess lower measured economic freedom.

Insert Figures 11, 12

Often confused with the concept of economic freedom is that of political rights and / or civil liberties. Figure 13 shows measured political rights and civil liberties in states possessing EFW ratings in the top 25% were greater than those in the second quintile, which are greater than those in the third quintile, which are again greater than those in the least free quintile. Many of the same ideas regarding individual choice and the capacity to direct scarce resources where they are valued the most are represented in the concepts of political rights – even if the two dimensions of freedom are fundamentally different. Further, civil liberties do, in some ways, resemble the concepts addressed and defended by private property rights.

Insert Figure 13

A survey the broad spectrum of macroeconomic performance indicators shows that the importance of institutions representative of the concepts of economic freedom has a direct impact on not only the level of measured economic productivity (GDP) but on a broad spectrum of macroeconomic indicators which are likely to be important to that of society at large – including the distribution of income, a variety of measures for quality of life, and the degree to which the economic decision makers also enjoy political rights and civil liberties (among many others).

Economic Freedom, the Change in Economic Freedom, & Long-term Economic Growth:

The broad macroeconomic indicators analysis gives us a picture for the range of outcomes which can be associated with economies that adopt institutions reflecting the tenets of economic freedom and approximating the hypothetical free market. Though per capita GDP is only one measure of the performance of an economy, it is a clear indication of the realized productive capacity of a set of scarce resources (human, physical, and

intellectual). We have already examined the correlation between countries which possess institutions reflecting greater economic freedom (those closer to the *free market* benchmark) and per capita GDP and found that the *more free* and *most free* economies (as measured in 2004) had realized productive capacities 20 to 28 times greater than in the *less free* and *least free*. The next step is to see whether changes (as well as the general level of institutional quality) make any difference in establishing this metric for economic performance. We shall do this in the context of a mature, established, and rich long-run economic growth regression.

The question addressed in the following analysis is whether an economy's institutional quality, as measured by the degree to which an economy's institutions are consistent with the principles of economic freedom, has any measurable impact on the long-term economic growth of an economy. This analysis examines the question within the context of an established long-run economic growth model and includes within its specification all of the standard independent variables along with *both the level and change* in economic freedom for a cross-section of 101 economies over the 1980 to 2000 time period. With the composition and logic of the economic freedom of the world (EFW) indicator carefully outlined (above), the question of institutional quality and long run economic growth may proceed.

The relationship in question is examined over the relatively long-term (over 20 years). It takes time for decision makers and financial institutions to become convinced of the likelihood of policy persistence – facilitating the reorganization of resources needed for the full-impact of a liberal policy regime to be realized. It takes time for economies, once impeded by the strong arm of regulation, to operate in industries where their true

comparative advantage lay and where wealth may be created without inhibition. It takes time for all resources, whether human or physical, to be reallocated to where they are valued the most, making the largest measurable impact on the growth rate of the economy, the long-run growth rate, possible.

The choice of growth model in this study is an applied Barro (1991) methodology, common in the growth literature. The dependent variable is the average annual compounding growth of PPP GDP per capita for the period (1980-2000). There are two measures of human capital formation in the form of primary and secondary enrollment rates. There are three measures related to physical capital formation: private investment as a share of GDP, government investment as a share of GDP, and a measure for the start of period relative price of investment capital.⁹ Note that private and government investment as a share of GDP is employed in place of gross capital formation (the standard measure of investment) as the sub-components allow for a much more detailed examination of the differential impact of these two distinct forms of investment spending (see Gwartney, Holcombe, and Lawson 2002 and Skipton 2004). There is a convergence indicator in the form of the log of GDP per capita at the start of the period.¹⁰ Finally, a measure of sound monetary policy is included in the form of period inflation variability.¹¹

⁹ PPI80DEV measures the relative price of investment goods for a state in 1980 (the start of the period studied). Quite literally it is the deviation of the log of the price level of investment for a state relative to the sample mean as calculated by Barro and Lee (1994). In a handful of cases where observations were not available for 1980, observations for 1985 were used in their place.

¹⁰ The log of GDP per capita is regularly used as a convergence indicator in Barro style growth models. Income convergence would be shown, in a model like this, with a significant and negative sign on the beginning of the period per capita GDP measure (Ln GDP Per Cap 1980) – implying that high-income economies grew slower, during the span of the sample, than low-income economies thereby converging.

¹¹ Data for the standard elements of the Barro growth regressions came from a variety of sources. GDP and gross capital formation figures were collected from the World Bank, *World Development Index 2003 CD-ROM*; Penn World Table (v. 5.6a); International Monetary Fund, *International Financial Statistics Yearbook* (various editions); OECD, *Economic Outlook* (various issues); Central Intelligence Agency, *World Fact Book* (online – various years), and Central Intelligence Agency, *Handbook of International Economic Statistics* (1998). Enrollment, Assassinations, and Revolutions/Coups

The sample for the long-run economic growth analysis is made up of 101 economies. The difference between these 101 and the 123 in the full EFW index is comprised mostly of states that were not present in the data for the entire 21-year span. There are, though, a few states that were in existence for the entire period but for which data are not consistently available (for instance Myanmar over several periods and the Bahamas over the last 6 or 8 years).

The main growth regression (before the inclusion of the quality of institutions measure is introduced) is presented in Table 5 (EQ-1). This run of the model includes an income convergence indicator, primary and secondary enrollment rates, measure of monetary policy stability, measure of the relative price of capital investment, private investment as a share of GDP, and government investment as a share of GDP. The convergence measure is significant and possesses the expected negative sign.¹² The primary enrollment rate is not significant while the secondary enrollment rate is and possesses the expected positive sign. These two human capital measures deliver a proxy for the extent of human capital formation occurring at the beginning of the 21 year period of the sample.¹³ The coefficient on the inflation variability measure that captures the *soundness* of monetary policy (to be stable and predictable), is significant and possesses the expected negative sign. Where the annual rate of change in the general level of prices

figures are from William Easterly and Mirvat Sewadeh's online *Global Development Network Database* (#4 – Social Indicators and fixed factor time series). Enrollment figures were updated using the World Bank's *World Development Index 2003 CD-ROM*. Relative price of investment goods data were gathered from Barro, R. and J-W. Lee (1994).

¹² The *convergence* of income levels through faster growth rates exhibited by less developed economies (after controlling for the other macro aspects of the economy) is identified using a beginning of period GDP per capita measure. Using this technique, a negative and significant coefficient on the beginning of period GDP measure suggests economies with smaller beginning of period per capita incomes (all else equal) grew faster than their larger per capital income equivalents – suggesting convergence (Edwards 1992 and Levine and Renelt 1992).

¹³ Note that the primary enrollment measure is insignificant in both equations. The unexpected performance of this human capital measure may be due to multi-colinearity between the two human capital measures.

in the economy is volatile (as measured with larger standard deviations) there is a slower rate of economic growth – when the level of prices cannot be predicted it is hard for banks, firms, and consumers to plan forward very far. The “relative price of investment goods” measure (PPI80DEV) introduces the relative cost of capital investment into an economy. This measure is both significant and possesses the expected positive sign. In economies where the general price level for investment was higher, slower long-term economic growth followed. The coefficients on both private and government investment as a share of the economy are each significant and positive (as expected); the coefficient on private investment is significantly larger than that of government investment reflecting the likely efficiency advantage that residual claimancy has on the decision making process. The adjusted r-squared for this specification of the model (EQ-1) is 0.548.

Insert Table 5

Equation 2 (EQ-2) in Table 5 is the same growth regression but with the both the level of and change in economic freedom (EFW) during the sample period. All of the other independent variables remain, basically, as they were before (with only slight changes in coefficients). The level of economic freedom metric (EFW 1980-2000) enters the equation significant at the 99th percentile and with a positive coefficient (as expected). The change in economic freedom variable also enters the equation with the expected positive sign and significant at the 95th percentile. These two outcomes suggest that both the relative level of institutional quality and the change during the period are associated (even after controlling for differences in human and physical capital, the relative price of investment goods and the soundness of monetary policy) with higher growth rates of real – PPP per capita GDP. This is a fairly dense model which includes within it much of what

the literature would consider important for explaining differences in long-run economic growth. Even so, institutional quality is able to introduce and explain remaining differences between the states from the data. This is despite the fact that institutional quality certainly impact things such as private investment (see Gwartney, Holcombe, and Lawson 2006), trade flows – and so growth (see Skipton 2006), and the accumulation of human capital and is so underestimated by this model in its estimated impact. With the addition of the institutional quality data the adjusted r-squared for the growth model (EQ-2) climbs modestly to 0.587.

Conclusions from the Broad and Growth Analysis:

Do institutions reflecting free-market ideals (as measured by the metric of economic freedom) lead to outcomes that conform with both efficiency and social well-being? The answer from both a survey of general macroeconomic indicators and a carefully specified, mainstream Barro-style economic growth equation with two measures for human capital formation, two measures related to physical capital formation, a measure of the relative price of physical capital formation, a measure for sound monetary policy, and a convergence indicator is a resounding yes. Further, not only does the level of institutional quality appear to lead to greater long-term economic growth, but the change in its level appears to have a measurable impact on growth as well.

A Word of Caution Regarding Market Failure:

We do not want to abstract too far away from the clear association shown in the broad analysis and statistical relationship identified in the growth equation, but, it is worth noting that free-market design does not come without the need to watch carefully for

instances (such as would be described in the economics literature as) *market failure* where some sort of intervention would be needed in order to correct the "rules of the game" that account for the observed inefficient market outcomes. Even so, caution must be followed when making decisions to modify outcomes resulting from the interaction of hundreds of millions of individuals (with their varied, particular preferences and immediate ability to observe the true opportunity costs of our scarce resource base). Suffice to say, much literature exists regarding the existence and particular nature of market failure -- ranging *from* poorly defined property rights leading to pollution externalities *to* non-rivalry / non-excludability issues resulting in the under provision of so-called *public goods* such as those basic medical services which prevent communicable diseases and / or fundamental research investment called "basic research" upon which much commercial research is based but for which there is a underwhelming incentive to pursue privately. As such, it is worth mentioning that market failure exists in markets of any institutional structure (including free markets) and, as such, must be addressed with caution, but the particulars of how and when market failure may exist is outside the scope of this analysis.

STAKEHOLDER CULTURE AND MANAGEMENT CULTURE TYPE

The analysis of macro results strongly suggests that systems based on free economic transactions tend to be associated with a variety of other beneficial effects. Moreover, the macro evidence is buttressed by very strong economic and applied finance models at the firm level. But some "firms" do unethical things. What are the essential characteristics of unethical firms? Jones (2007) first disposes of the anthropomorphic fallacy. Top management makes the decisions, not firms. Moreover, we assert that the actions and policy decisions of the vast majority of actions of firm managements meet the

requirements of ISCT's hypernorms and the Global Compact. Aggregate results strongly argue that case.

Several culture types are suggested to be the driving force behind management's decision making (Jones 1995, Jones et al. 2007): Egoist, Instrumentalist, and Moralistic. Each of these cultures is proposed to perceive claims from stakeholder groups differently based on their ethical views. Table 6 presents the proposed relationships.

Insert Table 6

The defining ethical characteristic of the *corporate egoist culture* is suggested to be short-term shareholder wealth maximization (Mitchell, 1997 p. 151). (We suggest that short-term personal wealth accumulation for the executives is the proximate cause.) We reject the corporate egoist culture on two principal grounds. First, a top management culture that behaves this way misunderstands the underlying value creating requirements for long-run value building. In other words, the steps that such a firm might do such as; reduction of R&D; minimizing maintenance of key systems; cheating on EPA requirements, knowingly contracting with violators of basic labor standards; under investing in human capital; cheating on taxes and a host of other actions are likely to exact value destroying consequences in the longer run. Such a culture is inconsistent with the value building model described by Rappaport, Stewart, and Koller cited above. The capital markets penalty for not building long-term value is the withdrawal of capital in the form of declining stock prices or a potential takeover. The egoist culture, if not changed, will likely prevent the firm from participating in job creation or innovation and will weaken rather than enhance the macroeconomic correlations of freedom, social progress, and economic achievement. Second, the ethics of egoism is itself inconsistent with post-

conventional moral thinking and does not qualify as an acceptable ethical system as it lacks elements of a post convention schema. “The defining characteristic of post-conventional thinking is that rights and duties are based on sharable ideals for organizing cooperation in society, and are open to debate and logical consistency, experience of the community, and coherence with accepted practice.” (Rest et. al. 1999, p. 41). The elements of systems that fulfill those characteristics are 1) primacy of moral criteria, 2) appealing to an ideal, 3) sharable ideals and 4) full reciprocity. Egoist managers simply do not exercise an acceptable ethical pattern. We reject that approach as inconsistent with the evidence we have cited.

To the egoist, authentic contracts consistent with hypernorms are not binding and will be broken if immediate benefit to the management group is apparent. Such a situation results often from the lack of power of a stakeholder even in the presence of legitimacy. (See the last three rows in Table 6).

An egoist culture might justify dumping PCBs into the Hudson River (GE), devising fraudulent tax schemes to evade taxes for clients (KPMG), and disclaiming any responsibility for working conditions at contracted offshore factories (Nike). In these three cases, the perceived *power* of other communities was small, even if the claims were *legitimate* and/or *urgent*. The EPA might not know or be effective in enforcement of regulations in the GE case. In the KPMG case, the Internal Revenue Service was likely overextended, and, even if challenged by the IRS, penalties were likely to reclaim only a portion of fees. In the Nike case, geographic distance, legally distinct corporate entities, and the weakness of overseas employee groups made the egoist calculus relatively easy when weighed against increased short term gross margins. The actions of GE violated the

hypernorm of *respect for essential governmental institutions* and the *trust* of New York communities as well as its own professed code of conduct. KPMG broke the hypernorm of *trust* with the IRS, taxpayer communities, and the AICPA and violated at least two professional codes of conduct. Nike's policy might be viewed as a violation of the hypernorm requiring *respect for human dignity*. Nike is now on the board that led to the development of the U.N. global compact cited earlier. GE is focusing massive investment in renewable resources and environmental remediation technology. KPMG renounced the partners participating in the tax schemes and has made public and legally binding promises to avoid such actions in the future.

Instrumentalist and *moralist* culture types reflect consideration of ethical considerations but for different reasons. The instrumentalist management culture will track the ethical implications of a decision or policy and calibrate its effect on the economic benefits to the firm. The moralist will seek out to do the ethically correct action independently of the economic effect. It is beyond the scope of this paper to parse the possible differences in actual policies, although we believe that there are some important ones. We would expect both management cultures to actively incorporate ISCT in the evaluation of policy either as an instrumental means for increasing value through positive effects such as a more productive work force or through avoidance of sanctions. The moralist culture will grant high salience to groups with no power who are both legitimate and urgent. The instrumentalist culture will grant moderate salience to such groups. (See row three on Table 6.) An instrumentalist culture with an understanding of the financial principles of long-term value creation is likely to integrate policies and decisions that

conform with ISCT and the Global Compact Initiative and promote value creation for the enterprise.

The two most productive changes that would affect and increase the salience to firm management of all groups with legitimate claims are 1) increasing the power of communities and institutions in order to increase the salience of those communities' legitimate claims and 2) decreasing the incidence of egoist management cultures. The best way to accomplish the first goal is to pursue the spread of freedom and the development of legitimate institutions and community norms consistent with a post conventional moral system such as ISCT. The best way to accomplish the second goal is for Boards of Directors, large institutional owners of organizations, governments and NGOs to work against the development of egoist top management cultures in their firms, and to identify actions that indicate breaches with ISCT hypernorms or Global Compact Principles.

Eliminating an egoist culture has two dimensions. The first dimension involves corporate alignment with long term value creation. Specifically, adoption of value building metrics based on long term economic value; linking compensation to long term value buildup; halting the unjustifiable explosion in executive pay; and empowering directors with the knowledge and means to use value-based models. The second dimension involves raising the visibility of the ethical dimensions of corporate activity to a highly visible place. Use of a "Balanced Scorecard" with appropriate measures or a "Triple Bottom Line" helps to reduce myopic action.

Dow Chemical cites its triple bottom line as an expression of sustainable development. "The manifold interests of all Dow stakeholders converge under the Triple Bottom Line of Sustainable Development. The Triple Bottom Line is the ultimate balance

sheet, calling attention to the three fundamental areas – economics, environment, and society – where companies impact the quality of life. The Triple Bottom Line provides a clear means to assess Dow’s progress against our goals for improvement. And, it provides a framework that directs all Dow activities to ensure that we continue on the course prescribed by our Mission statement.” (Dow 2007). The use of the stakeholder salience model and the typology of corporate management types presents legitimate opportunities to address instances of ethical shortcomings of management consistent with ISCT’s hypernorms and the Global Compact principles, while still recognizing the overwhelming evidence of macro economic benefits that a system of liberal capitalism provides.

DISCUSSION AND SYNTHESIS

In this paper, we argued for the adoption of ISCT and the Global Compact as legitimate means of analysis and as standards for businesses in both local and global communities. We coupled that argument with an extensive look at macro indicators associating liberal economics with gains on a variety of social indicators. We also looked at a model that helps to understand a class of management decisions that are both inconsistent with one or more hypernorms and inconsistent with building long-term corporate value.

Fundamental economic theory of free market economics; the applied-finance theory of the firm that focuses on high returns on invested capital, growth and capital mobility; and the selection of evidence cited that such focus at the firm level leads to strength in industries, in jobs and in innovation makes a powerful case that societal and institutional support for fundamental drivers of value creation need to be nurtured rather than curtailed.

The ethical climate in top management groups must be understood within the context of a system where basic assumptions about human behavior, the human desire for freedom, sound economic and finance theory, positive evidence from aggregate firm value creation, and positive correlations among overall indicators of freedom, social indicators, and free markets combine to make a highly convincing case for pursuing free and fair trade, embracing liberal free market economics, strengthening key institutions in all societies and respecting the individual.

We believe ISCT with its focus on communities, pluralism, and conflict resolution presents a powerful lens to help analyze the conflict among various authentic norms and tension between hypernorms in a global environment. The inclusion of economic efficiency in the creation of goods and services as a structural hypernorm within ISCT explicitly brings the productive side of economic action to the table of ethical debate. We suggested that both the hypernorms of ISCT and the Global Compact Principles are legitimate benchmarks for managers, and we cited a model that explains the potential for egoist management cultures to flout these principles. Nothing here absolves or excuses managers who commit micro malfeasance in the pursuit of a macro good. Rather, we argue that there exists a consistency between long-term value creation, ethical management, and social benefits. Much of what we have said about economic results and firm values is accepted within the broad economics and finance communities. The social and economic laboratory of the twentieth century provides ample evidence that liberal capitalism provides the best opportunity for increasing economic welfare for communities and for providing a freer environment consistent with respect for the individual.

We hope that researchers within the business ethics community might reflect either agreement within the general parameters we have outlined, or cite theory and empirical results of weight that support a competing or alternate world view. In such a way, progress in the quality and effectiveness of ethical analysis might be enhanced. (See, for example Allinson 2004, Bohle 2006, Marens 2006, Miles 2006, Raisel 2003, Scherer 2006 for examples where such foundation building might be incomplete or absent). Certainly, we expect there to be tension between various authentic norms and difficult tradeoffs among hypernorms. We expect there to be market failures, failures of management, and failures of governmental institutions. We will encounter instances of egoist management teams and graft ridden governments. All of these are the stuff of ethical analysis. To promote a cumulative literature, shouldn't the context of such analyses be generally reflective of our experience in the world?

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FIGURES AND TABLES

FIGURE 1
Application of ISCT to an Action or Policy

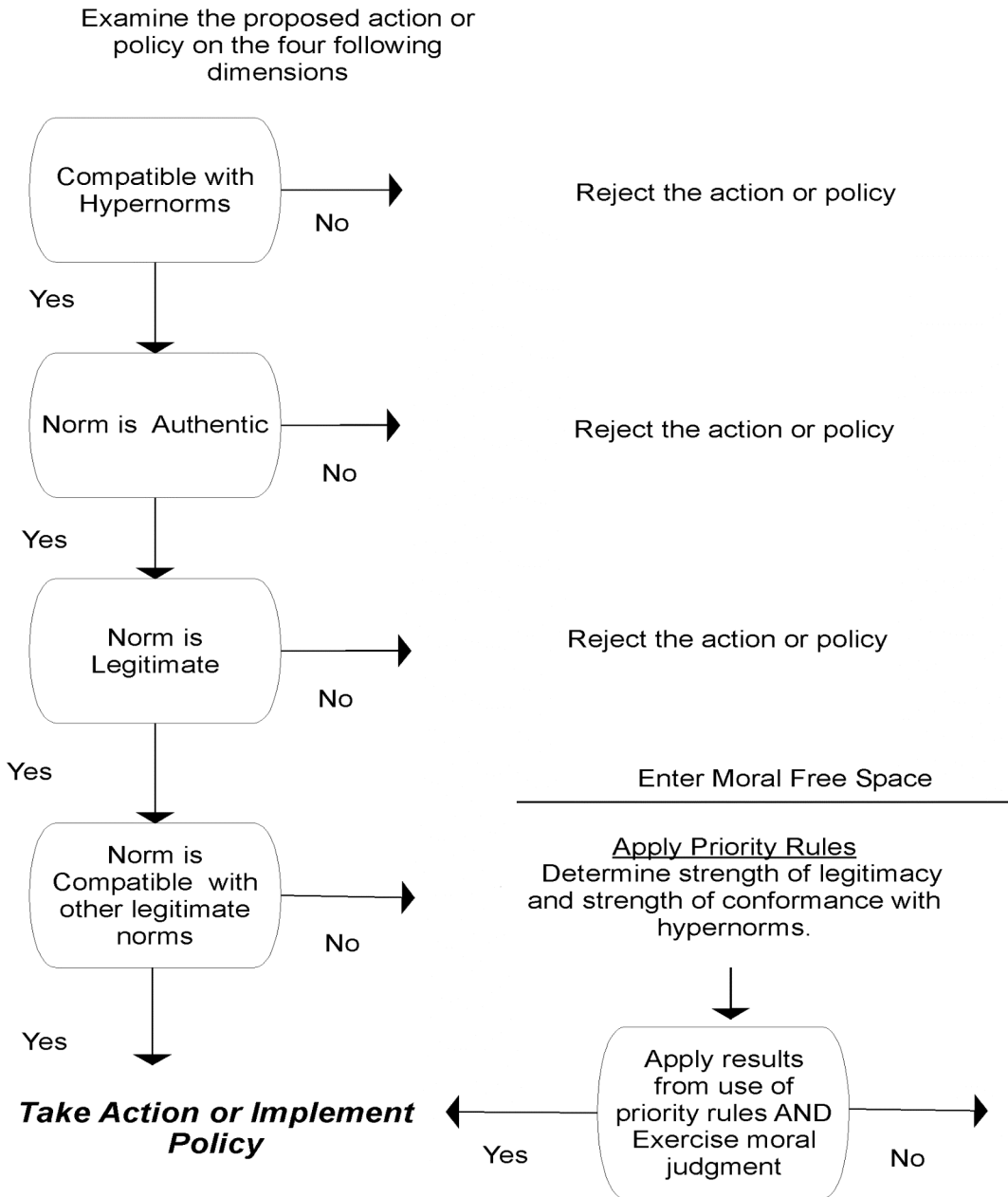


FIGURE 2
ISCT Model: Components and Definitions

Area outside Moral Free Space

- *Incompatible with Hypernorms*
- *Illegitimate Norms*

Moral free space: norms seem compatible with, but possibly in tension with, hypernorms or conflict with legitimate norms from a different or same community. Apply priority rules and moral reasoning.

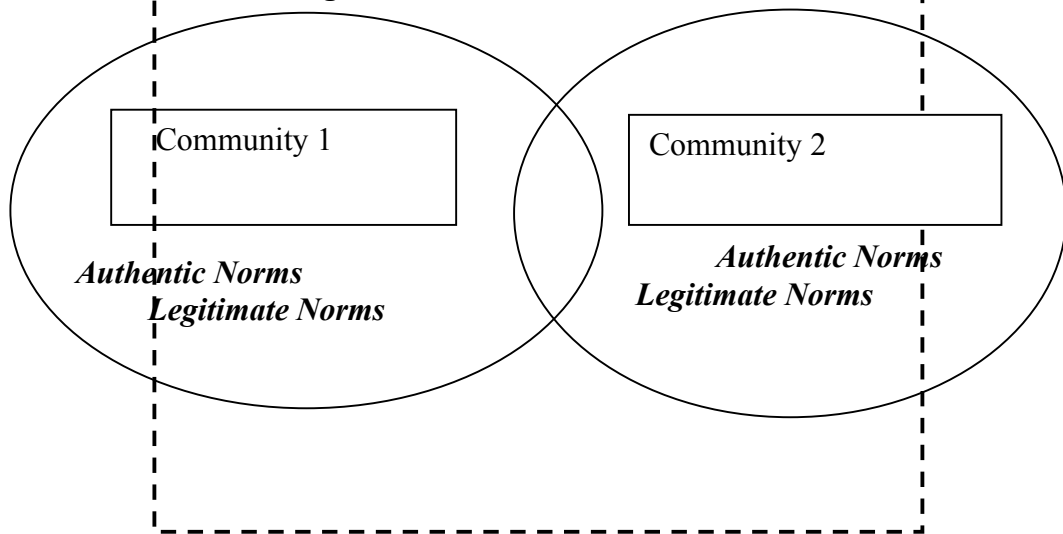


Fig. 3 GDP Per Capita

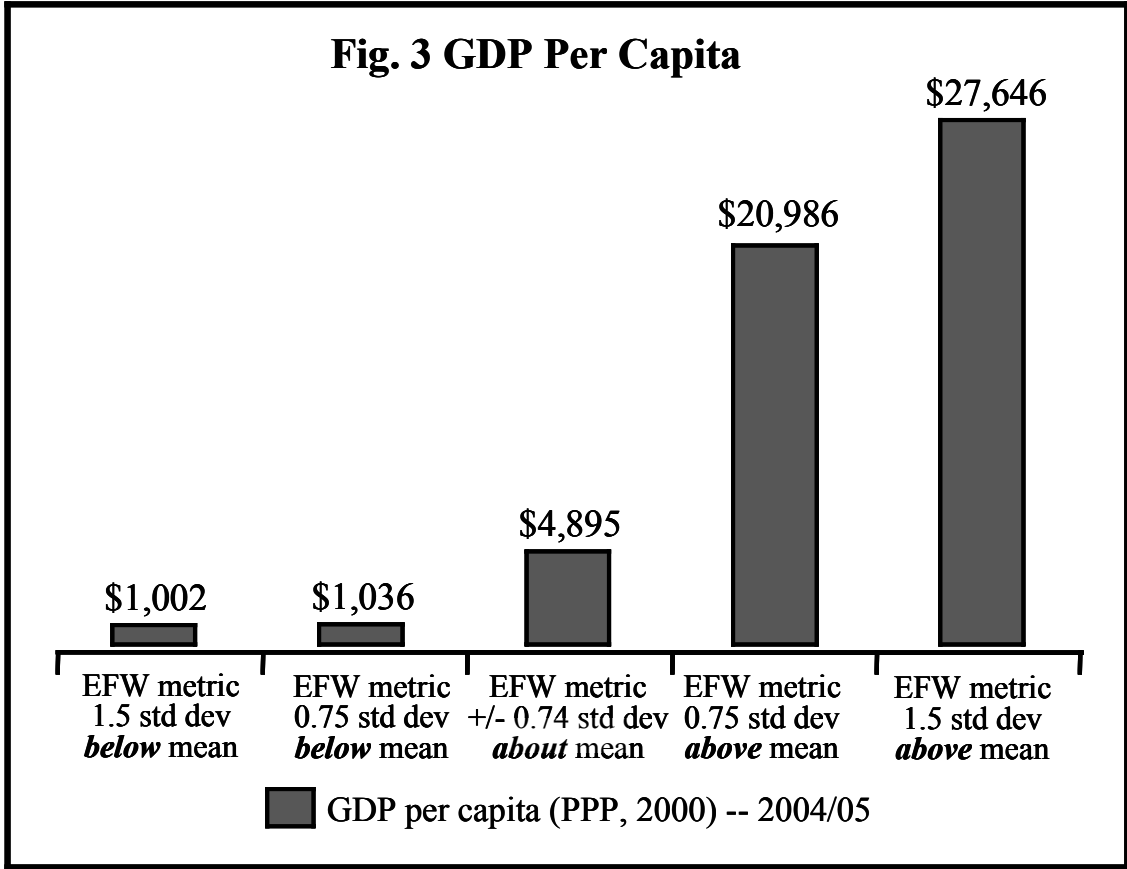


Fig. 4 Unemployment (% of labor force)

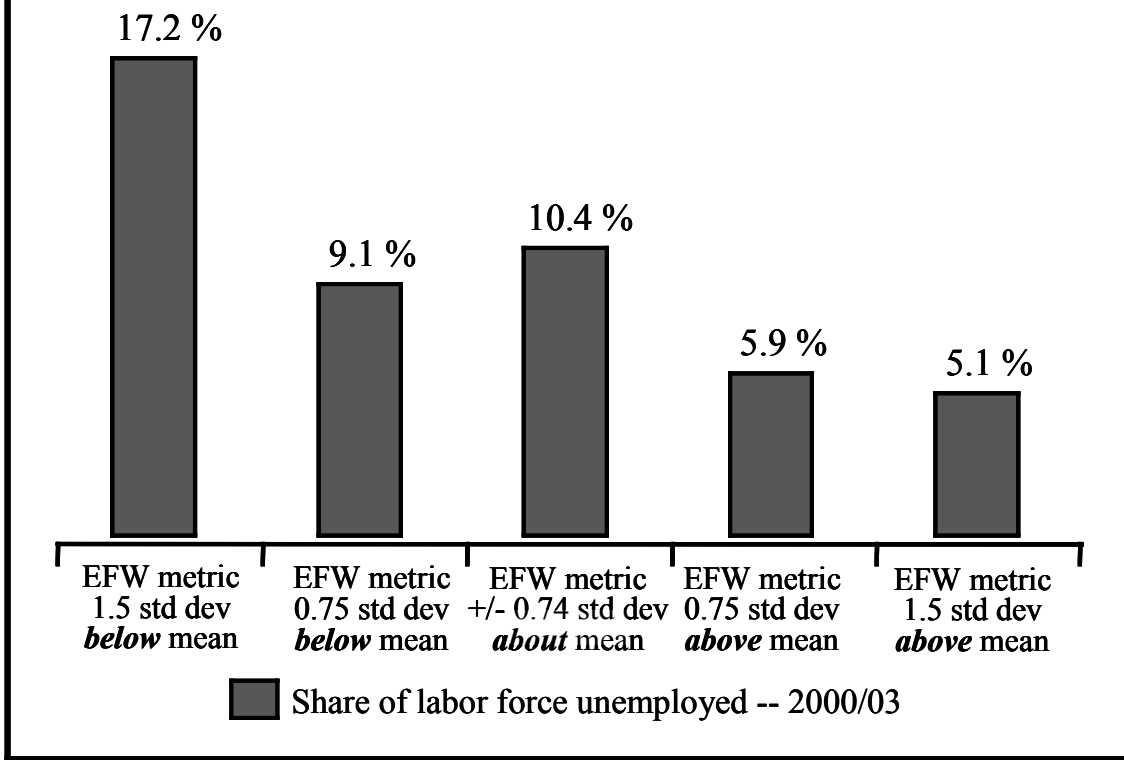
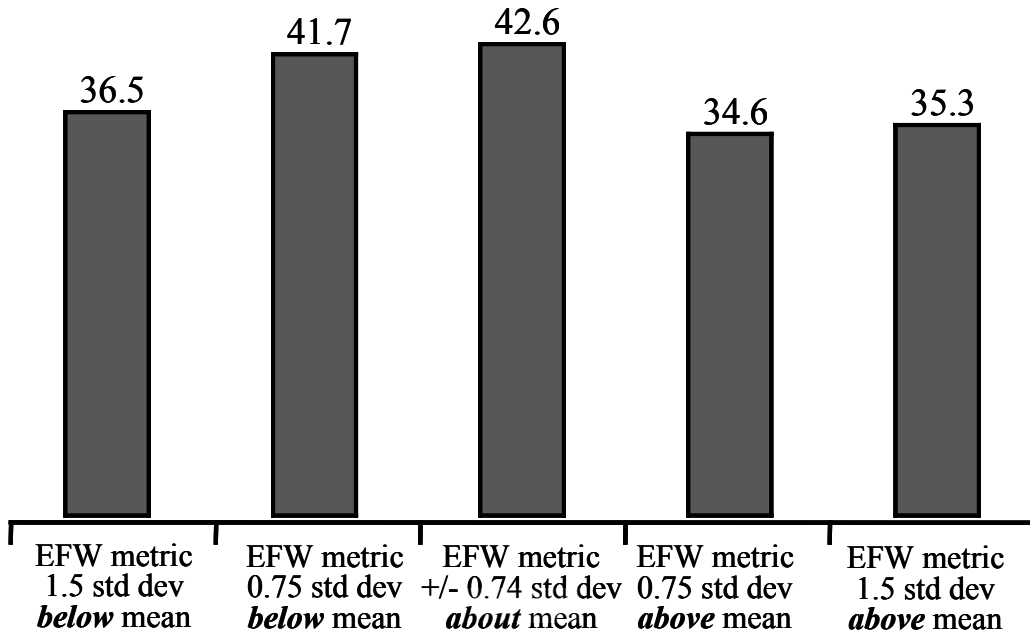
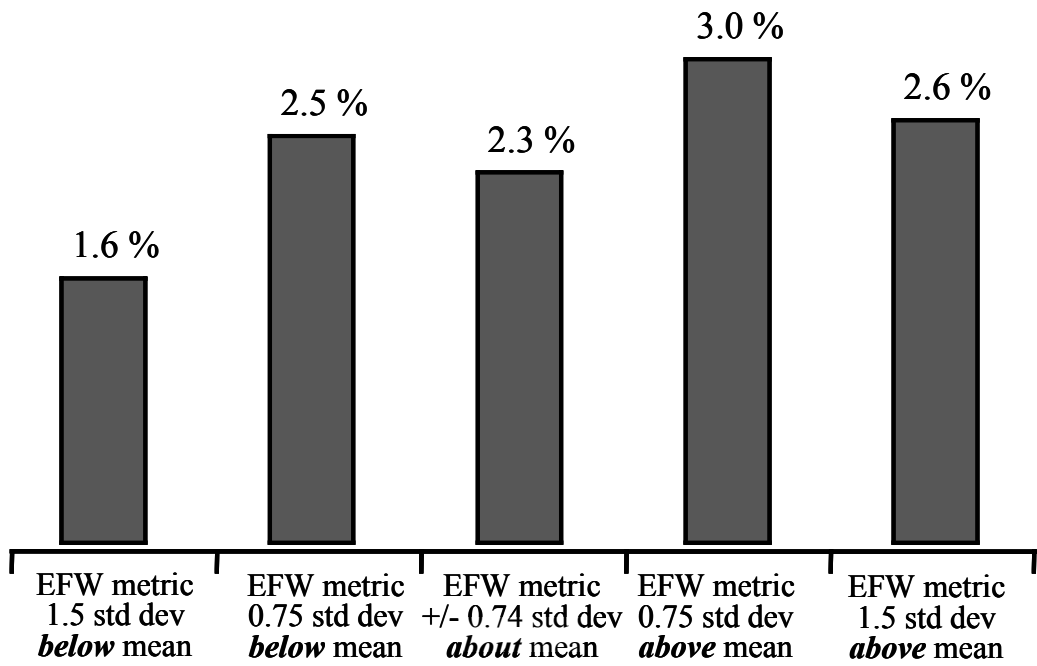


Fig. 5 Income Distribution (*GINI*, 2000/03)



■ GINI coefficient -- 2000/03
(0-1; higher values indicate greater income disparity; a value of 1 would indicate all income in country received by one person)

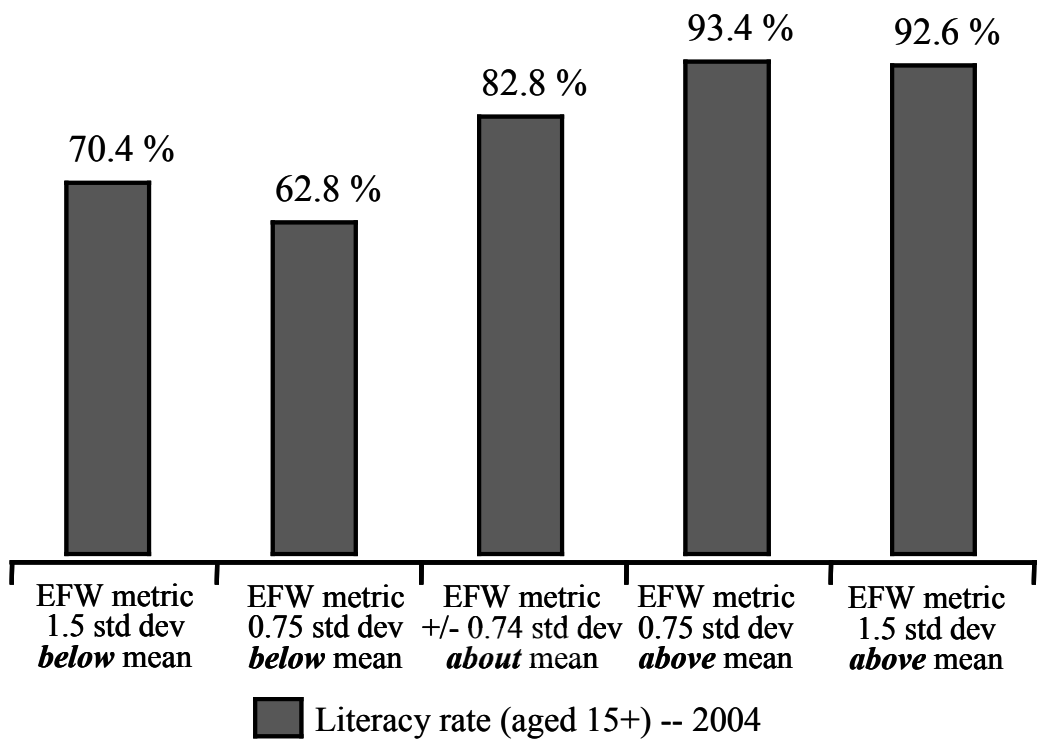
Fig. 6 Income Share of Poorest 10% -- 2000/03



■ Share of Income received by poorest 10% -- 2000/03

Note: Data limitations in the 1.5 std dev below mean countries limit the observations.

Fig. 7 Literacy Rate (age 15+)



Note: Data limitations in the 1.5 std dev above mean countries limit the observations.

Fig. 8 Children in Labor Force (*ages 10-14*)

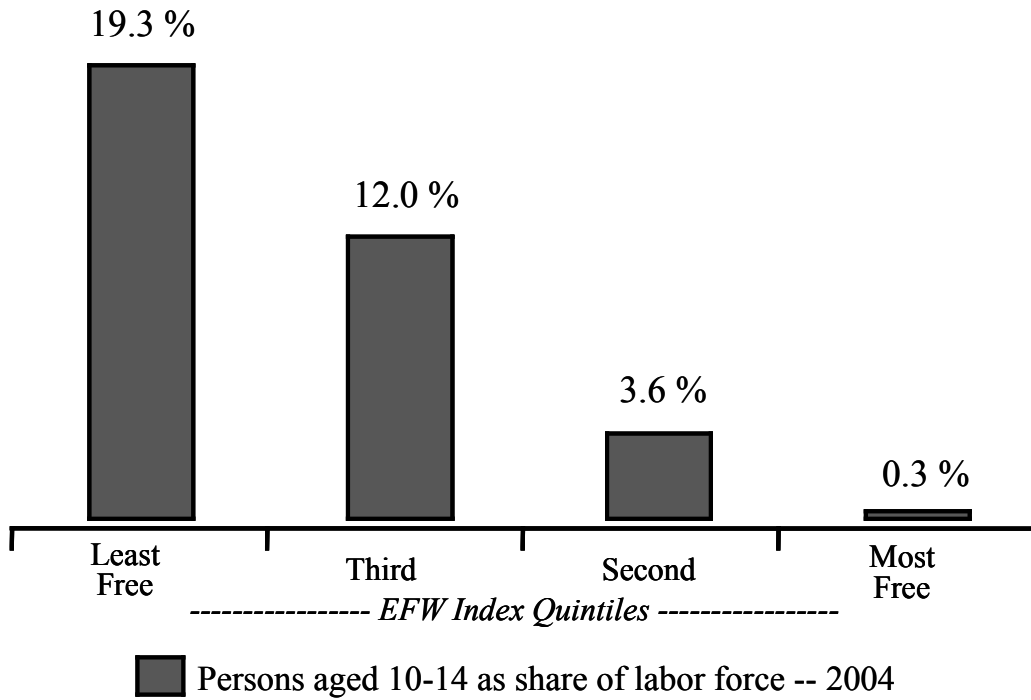


Chart source: 2006 Economic Freedom of the World Annual Report

Fig. 9 Life Expectancy and Infant Mortality

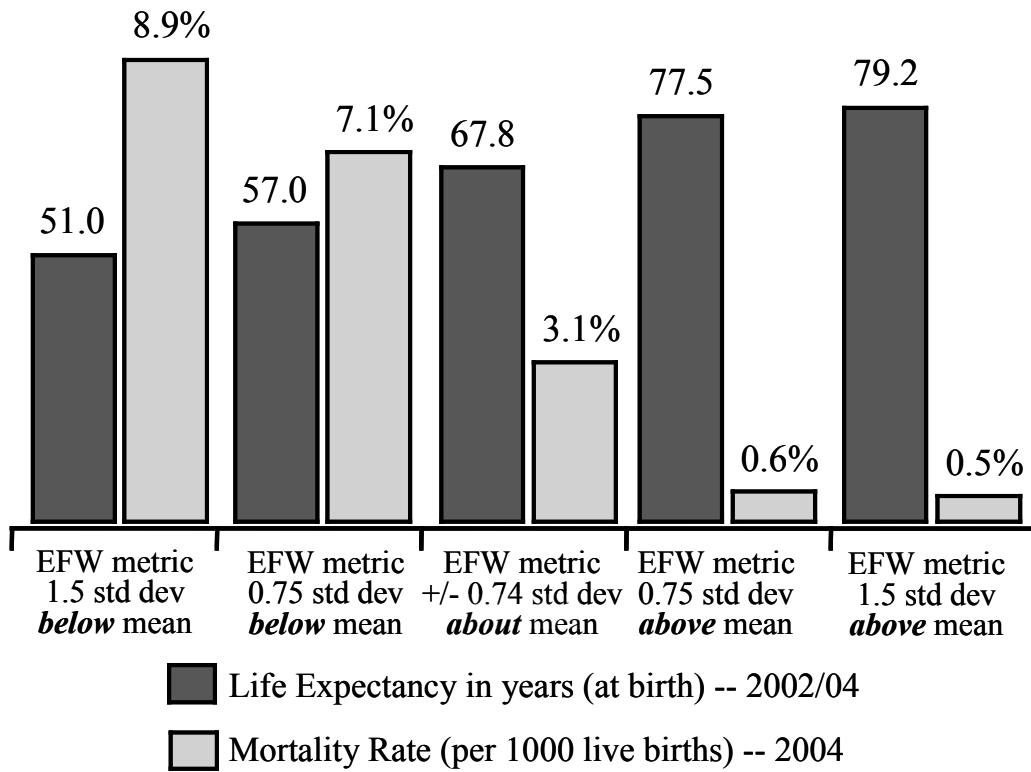


Fig. 10 Access to Improved Water Supply

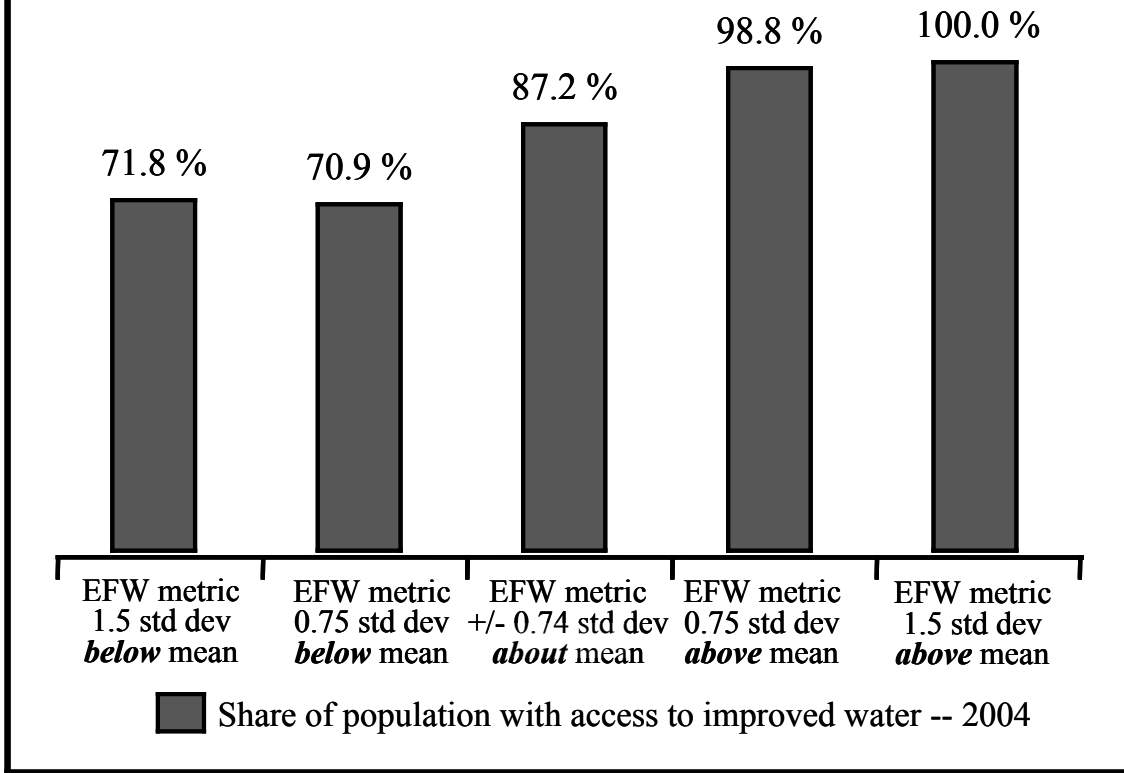
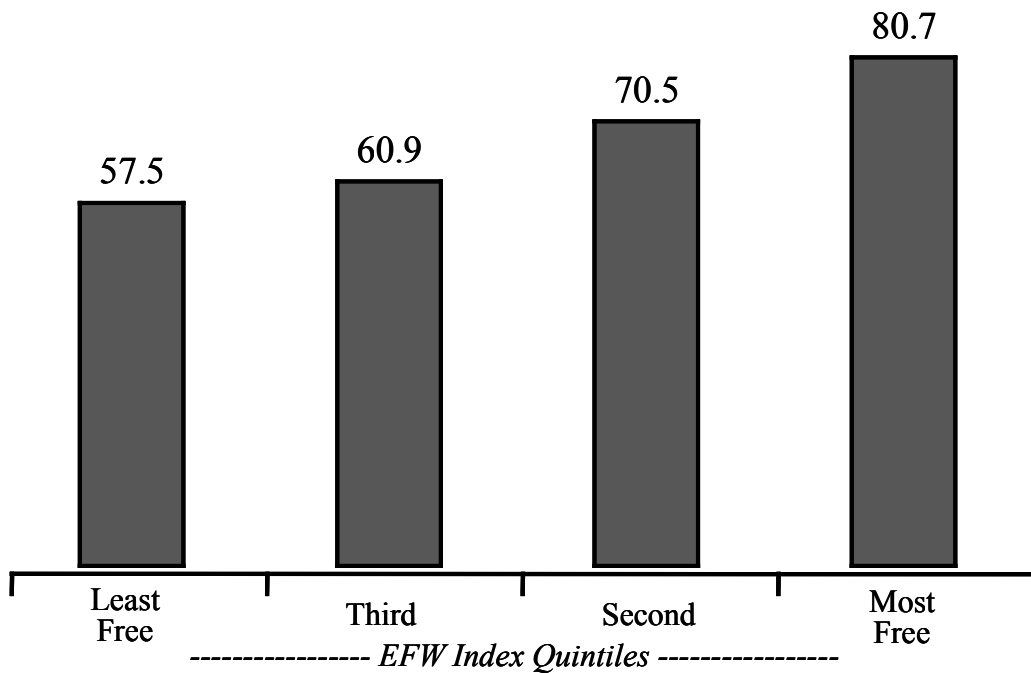
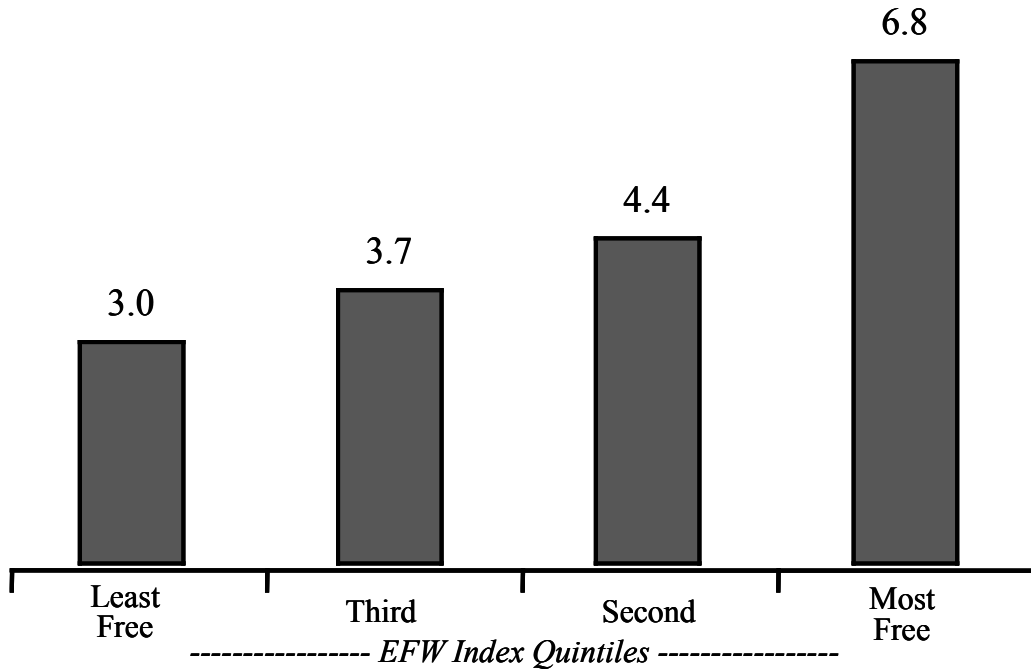


Fig. 11 The Environment



■ Environmental Performance -- 2004
*Center for Environmental Law & Policy (Yale Univ.) and Center for International Earth Science Information Network (Columbia Univ.)
(higher index values indicate greater environmental performance)*
Chart source: 2006 Economic Freedom of the World Annual Report

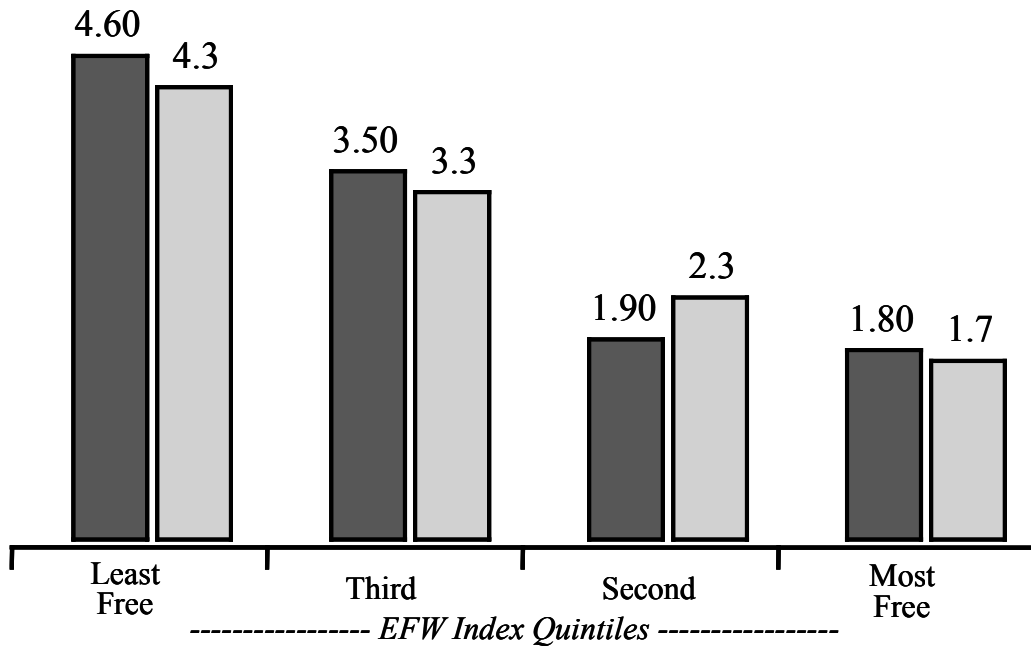
Fig. 12 Corruption



■ Corruption -- 2004
Transparency International, 2005 Corruptions Perceptions Index (1-10; lower index values indicate greater corruption)

Chart source: 2006 Economic Freedom of the World Annual Report

Fig. 13 Political Rights / Civil Liberties



■ Political Rights -- 2004 □ Civil Liberties -- 2004

Freedom House, Freedom in the World Country Ratings (2005)

(Range 1-7; lower index values indicate greater political freedoms / civil liberties)

Chart source: 2006 Economic Freedom of the World Annual Report

Table 1
Summary of Key ISCT Terms

1. A *community* is a self-defined and self-circumscribed group of people who interact in the context of shared tasks, values, and goals, e.g., Shell Oil, The OECD, the tax department of KPMG.
2. *Authentic norms* bind individuals in communities to agree on the structure and direction of their community; the concept of authentic norms is designed primarily to maintain cultural sensitivity and to allow for diverse systems within an overall system that is compatible with hypernorms. In Figure 2, some authentic norms of communities 1 and 2 lie outside the dotted lines and therefore are not legitimate. An example of an illegitimate norm might be for a company based in a developed country to outsource to a contractor who uses child labor.
3. *Moral free space* is the area bound by and compatible with hypernorms in which communities can act with integrity to their traditions, customs, and mores. The decision maker acts in moral free space when an act or policy seems to be in tension with a hypernorm and/or two or more legitimate norms conflict. For example, the KPMG tax planners may often be in conflict with the IRS where KPMG's motives to minimize taxes legally conflict with the IRS's desire to maximize tax receipt income compatible with the tax law.
4. Hypernorms and priority rules are designed to provide the normative basis to resolve transcommunal disputes. *Hypernorms* are universal principles and set "the boundaries of the moral free space of communities"; *priority rules* describe the procedures to settle disputes between conflicting authentic norms. For example, the hypernorms of *necessary economic efficiency* and *trust* may be violated if the IRS never attempted to challenge abusive tax shelters, or if a country appropriates private property without due process and appropriate compensation.
5. Application of priority rules may still be indeterminate. In those instances, the decision maker must make his or her own moral judgment. We should note that application of priority rules themselves might require a good deal of judgment. For that reason, we place application of the priority rules as part of moral free space in Figures 1 and 2.

Table 2
Hypernorms by Category

Procedural Hypernorms

- Voice
- Exit

Structural Hypernorms

- Necessary Economic Efficiency
- Private Property
- Respect for Essential Social Institutions

Substantive Hypernorms

- Promise Keeping
- Trust
- Respect for Human Dignity
- Right to Subsistence

Table 3
UN Compact Principles

Human Rights

1. Business should support and respect the protection of internationally proclaimed human rights; and
2. make sure they are not complicit in humans rights abuses

Labor

3. Business should uphold freedom of association and the effective recognition of the right to collective bargaining;
4. the elimination of all forms of forced and compulsory labor;
5. the effective abolition of child labor; and
6. eliminate discrimination in respect to employment and occupation.

Environment

7. Business should support a precautionary approach to environmental challenges;
8. undertake initiatives to promote greater environmental responsibility; and
9. encourage the development and diffusion of environmentally friendly technologies.

Source: The Global Compact Network (Kell and Levin 2003)

Table 4: Economic Freedom of the World Index, 2004			
10 Most Free Economies	2004 EFW	10 Least Free Economies	2004 EFW
Hong Kong	8.71	Rwanda	4.82
Singapore	8.55	Central African Rep.	4.79
Switzerland	8.23	Burundi	4.70
New Zealand	8.22	Algeria	4.63
United States	8.17	Guinea-Bissau	4.59
United Kingdom	8.10	Venezuela	4.44
Ireland	8.10	Congo, Dem. R.	4.14
Canada	8.04	Congo, Rep. Of	4.14
Iceland	7.91	Myanmar	3.32
Luxembourg	7.86	Zimbabwe	2.77
Source: Gwartney and Lawson (2006).			

Table 5: Institutional Quality and Long-Run Economic Growth			
Dependent Variable: Average Annual Compounding Growth of PPP GDP Per Capita 1980-2000 <i>(t-statistic is in parenthesis)</i>			
Independent Variable		Eq-1	Eq-2
Constant		- 0.003 (0.21)	- 0.028 (1.81)***
LN GDP Per Cap 1980		- 0.004 (2.07)**	- 0.006 (2.93)***
Enroll P ^a		- 1.1E-04 (1.37)	- 8.2E-05 (1.06)
Enroll S ^b		2.8E-04 (2.93)***	2.1E-04 (2.23)**
Std Dev Infla Rate ^c		- 8.2E-06 (3.96)***	- 6.7E-06 (3.27)***
PPI80DEV ^d		- 0.01 (3.30)***	- 0.01 (3.33)***
Priv Invest % GDP ^f		0.002 (5.64)***	0.002 (4.26)***
Govt Invest % GDP ^g		0.001 (1.85)*	0.001 (2.78)***
EFW ^h			0.007 (3.01)***
Change in EFW 80-00 ⁱ			0.004 (2.21)**
Adjusted R-squared		.55	.59
Sample size		101	101
*** significant at the 1% level ** significant at the 5% level * significant at the 10% level			
a. Enroll P 80: Primary school enrollment rate in 1980			
b. Enroll S 80: Secondary school enrollment rate in 1980			
c. Standard deviation of change in GDP deflator (inflation) from 1980 to 1999			
d. PPI80DEV: Relative price of investment goods in 1980			
e. Gross Cap Form: Gross capital formation as a share of GDP 1980-1999			
f. Priv Invest % of GDP: Private investment as a share of GDP (period average, 1980-2000)			
g. Govt Invest % of GDP: Government investment as a share of GDP (period average, 1980-2000)			
h. EFW: <i>Economic Freedom of the World Index</i> , period average 1980-2000			
i. Change in EFW, Change in the <i>Economic Freedom of the World Index</i> from 1980-82 to 1999-2001			

Table 6
Comparison of Stakeholder Salience Models

Stakeholder Attributes					Salience Strength by Stakeholder Culture Type		
Power	Legitimacy	Urgency	Mitchell et al. (1997) Stakeholder Type	Mitchell et al. (1997) Stakeholder Salience	Corporate Egoist	Instrumentalist	Moralist
Yes	Yes	Yes	Definitive	High	High	High	High
Yes	Yes	No	Dominant	Moderate	Moderate	Moderate	Moderate
No	Yes	Yes	Dependent	Moderate	<i>None</i>	<i>Moderate</i>	<i>High</i>
Yes	No	Yes	Dangerous	Moderate	High	High	Moderate
Yes	No	No	Dormant	Low	Moderate	Moderate	Low
No	Yes	No	Discretionary	Low	<i>None</i>	<i>Low</i>	<i>Moderate</i>
No	No	Yes	Demanding	Low	<i>None</i>	<i>None</i>	<i>None</i>
No	No	No	Non Stakeholder	None	<i>None</i>	<i>None</i>	<i>None</i>

Source: Adapted from Jones et al. 2007

Appendix 1: The Economic Freedom of the World Index (EFW)												
Rank	Economy	EFW	Rank	Economy	EFW	Rank	Economy	EFW	Rank	Economy	EFW	
82	Albania	5.97	47	Czech	6.93	69	Kenya	6.31	95	Romania	5.67	
117	Algeria	4.63	17	Denmark	7.63	27	Kuwait	7.29	100	Russia	5.60	
74	Argentina	6.19	105	Dominican	5.43	38	Latvia	7.08	114	Rwanda	4.82	
11	Australia	7.83	90	Ecuador	5.75	44	Lithuania	6.96	88	Senegal	5.76	
16	Austria	7.69	78	Egypt	6.11	10	Luxembourg	7.86	99	Sierra	5.63	
51	Bahamas	6.76	30	El	7.25	87	Madagascar	5.77	2	Singapore	8.55	
42	Bahrain	7.03	13	Estonia	7.72	109	Malawi	5.35	46	Slovak Rep	6.94	
92	Bangladesh	5.72	86	Fiji	5.78	57	Malaysia	6.66	75	Slovenia	6.19	
77	Barbados	6.15	15	Finland	7.71	101	Mali	5.56	55	South	6.70	
28	Belgium	7.29	25	France	7.29	36	Malta	7.15	39	South	7.07	
67	Belize	6.34	108	Gabon	5.38	40	Mauritius	7.05	33	Spain	7.18	
103	Benin	5.51	18	Germany	7.63	59	Mexico	6.62	81	Sri Lanka	6.00	
61	Bolivia	6.53	70	Ghana	6.30	93	Morocco	5.71	24	Sweden	7.30	
37	Botswana	7.09	50	Greece	6.82	122	Myanmar	3.32	3	Switzerland	8.23	
84	Brazil	5.88	58	Guatemala	6.64	63	Namibia	6.41	106	Syria	5.42	
71	Bulgaria	6.25	118	Guinea-	4.59	112	Nepal	5.16	26	Taiwan	7.29	
116	Burundi	4.70	85	Guyana	5.81	12	Netherlands	7.72	65	Tanzania	6.35	
102	Cameroon	5.55	89	Haiti	5.75	4	New	8.22	60	Thailand	6.60	
8	Canada	8.04	62	Honduras	6.47	72	Nicaragua	6.23	113	Togo	5.00	
115	Central	4.79	1	Hong	8.71	110	Niger	5.27	53	Trinidad &	6.74	
111	Chad	5.20	23	Hungary	7.35	97	Nigeria	5.64	68	Tunisia	6.32	
21	Chile	7.44	9	Iceland	7.91	32	Norway	7.22	83	Turkey	5.96	
96	China	5.66	56	India	6.68	29	Oman	7.28	64	Uganda	6.36	
104	Colombia	5.46	80	Indonesia	6.03	94	Pakistan	5.69	107	Ukraine	5.42	
120	Congo,	4.14	79	Iran	6.10	34	Panama	7.17	14	Unit. Arab	7.71	
121	Congo,	4.14	7	Ireland	8.10	98	Pap. N.	5.63	6	United	8.10	
31	Costa Rica	7.22	35	Israel	7.15	73	Paraguay	6.21	5	United	8.17	
91	Cote	5.72	45	Italy	6.95	48	Peru	6.82	41	Uruguay	7.04	
76	Croatia	6.16	43	Jamaica	7.01	66	Philippines	6.34	119	Venezuela	4.44	
22	Cyprus	7.39	19	Japan	7.48	54	Poland	6.74	52	Zambia	6.76	
			49	Jordan	6.82	20	Portugal	7.45	123	Zimbabwe	2.77	

Source: Gwartney and Lawson (2006).