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Introduction

The Continuing Demand for a Moral Foundation

> There are obviously many economists who still believe that self-interest is the dominant human motive. There's no doubt that it's a very important human motive … but I think most people who aren't in that narrow tradition realize that other motives are important, too. We try to get ahead of our rivals, but we also care about other people and wish them well. We don't take advantage of every conceivable opportunity to gain at the expense of others. Students exposed to the narrow self-interest model often don't like it; they often feel alienated by it.
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> *An Interview with Robert H. Frank*

A Harvard Business School professor has recently written about "the economist's straightjacket" or "the unquestioning and universal acceptance by economists of self-interest – of shareholders, managers, and employees – as the conceptual foundation for business design and management" (Simons 2019, 2). The inability to think beyond narrow self-interest can be attributed to the rising influence of a group of prominent economists associated with the University of Chicago after the 1970s. Nobel Prize winners in economics have questioned the commitment to narrow self-interest within their field, including Amartya Sen (awarded in 1998) and Vernon Smith (awarded in 2002). Yet, the powerful influence of the "Chicago School" ensures that the straightjacket of self-interest remains in place in economics as well as the sister disciplines of finance and accounting. Through its continuing influence on business education in general, the economist's straightjacket also impacts business practice, public policy, and public opinion regarding capitalism itself. In this introductory chapter, I address the continuing demand for a moral foundation

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for capitalism from the perspective of business leaders, business educators, and policymakers.[1]

1.1 THE DEMAND FROM BUSINESS LEADERS

On August 19, 2019, the Business Roundtable announced the release of a new Statement on the Purpose of a Corporation. Signed by 181 CEOs of America's leading corporations, the Statement represented a significant departure from previous statements issued by the Business Roundtable for over twenty years (since 1997). While expressing continued support for free-market capitalism, the new Statement challenged business leaders to ensure "that the benefits of capitalism flow to every American." In particular, it extended corporate responsibility beyond the interests of shareholders to other stakeholders of the firm including employees, customers, suppliers, creditors, and the communities where the corporation resides and does business. According to a lead author, "It was time to reflect more accurately how our CEOs operate their companies and to challenge each other to do more" (Business Roundtable 2019).

After releasing its new Statement on the Purpose of a Corporation, the Business Roundtable welcomed public comments on its website. As expected, critics on the left expressed deep skepticism regarding the ability of corporations to reform themselves after decades of corporate scandals and related market crashes including the dotcom crash of 2000 and the mortgage market crash of 2007–08. Surprisingly, however, critics on the right expressed equally deep skepticism because they viewed the new statement as a veiled descent into socialism. As I read through the comments, it became clear to me that the discussion was dominated by the powerful influence of the Chicago School. Milton Friedman and George Stigler cited the eighteenth-century Scottish philosopher Adam Smith as the poster child for their economic theory based on narrow self-interest. As Friedman made clear in a 1970 article in *The New York Times*, their theory left the corporation with no direct social responsibility other than to increase profits for its shareholders.[2]

[1] As the epigraph to this chapter states (Schmotter 1998), students exposed to the assumption of narrow self-interest in economics often don't like it. It typically takes years of training and indoctrination for students to set aside their own moral beliefs and accept this behavioral assumption as an inevitable aspect of capitalism.

[2] In his strongly worded article, Friedman (1970) stated that business leaders who believed the firm should take seriously "its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary reformers … (were) preaching pure and unadulterated socialism."

The new Statement on the Purpose of a Corporation by the Business Roundtable reflected the continuing search for moral legitimacy among business leaders in capitalist society. In his book, *From Higher Aims to Hired Hands: The Social Transformation of American Business Schools and the Unfulfilled Promise of Management as a Profession*, Rakesh Khurana (2007, 14) characterized legitimacy as the currency of capitalist institutions: "For organizations in general, legitimacy is an important aspect of the social fitness that enables them to secure advantages in economic and political markets and improve their chances of survival." Written immediately before the great market crash that threatened capitalism in 2007–08, Khurana (2007, 366) emphasized the need for corporate managers to look beyond the narrow self-interest of shareholders:

> In a world increasingly characterized by collaborative systems rather than rigid hierarchies, where public attention to the consequences of corporate activity now focuses on issues such as global labor standards and environmental degradation, and where a vacuum in global political leadership has left the world rudderless in a period of enormous economic and social upheaval, the purpose of management and corporate leadership necessarily goes beyond "maximizing shareholder value." It is not hyperbole to suggest that business is at a unique inflection point calling for a fundamental reconsideration of the meaning of corporate leadership.

Prior to the powerful influence of the Chicago School, the Business Roundtable emphasized the corporation's responsibility to other stakeholders of the firm besides shareholders. The new Statement on the Purpose of the Corporation, therefore, represented a delayed response to what Khurana saw as an urgent need for business leaders to return to the social and moral concerns of an earlier era. The COVID pandemic in 2020 led to further soul-searching among business leaders due to the unevenness of the economic hardship and the social unrest it unleashed. The shareholder primacy view promoted by the Chicago School, however, left corporate leaders with little moral legitimacy on which to fall back on. Consistent with Khurana's (2007) thesis, these leaders often caved to the progressive agenda of the far left to signal moral legitimacy and secure advantages in economic and political markets. The backlash from their more moderate stakeholders was as rapid as it was predictable.

Privately funded initiatives by business corporations provide further evidence of the continuing demand for a moral foundation for capitalism. I witnessed such a funding initiative while a member of the accounting faculty at Florida State University. In the summer of 2008, FSU received a $1,500,000 grant from BB&T Bank "to encourage a thorough discussion of the moral foundations of capitalism." The agreement letter between BB&T and the University, however, made clear that the bank supported a moral foundation built on narrow self-interest. The BB&T grant required the Economics Department at FSU to establish a new course on "Morals and Ethics in Economic Systems" featuring Ayn Rand's novel, *Atlas Shrugged* (Rand 1957). Even when providing valuable funds to support the search for a moral foundation for capitalism, therefore, BB&T was unable to escape the straightjacket of self-interest.

Fortunately, economists at FSU did not limit their discussion of the moral foundations of capitalism to Rand's novel glorifying self-interest or the Chicago School's narrow interpretation of Adam Smith's *Wealth of Nations*. To explain emerging evidence from their own experimental research, these economists applied insights from Adam Smith's other major work, *The Theory of Moral Sentiments*. As an accounting professor who conducted experimental economics research, I attended weekly workshops with the experimental economics faculty and joined the monthly workshop series funded by BB&T entitled, "Economics and Moral Sentiments" (EMS). I later learned that BB&T funded similar programs at over sixty colleges and universities across the United States including Chapman, Charleston, Duke, George Mason, North Carolina Chapel Hill, Virginia, and Wake Forest. Similar to FSU, many of the faculty at these schools found narrow self-interest an insufficient moral foundation for capitalism.[3]

Business leaders also communicate the need for a moral foundation for capitalism through conferences and workshops. For example, I was invited to attend a three-day conference sponsored by Koch Industries at their world headquarters in Wichita, KS, in July 2010. I was an associate professor at the time, and it was not unusual for me to attend conferences during the summer to present my research. At this conference, however, we listened to top executives at Koch and participated in group discussions among faculty who had been hand-picked and flown-in from across the country. This included faculty in accounting, economics, engineering, ethics, entrepreneurship, finance, law, marketing, and philosophy.

[3] Other researchers have questioned BB&T's private funding of a moral foundation for capitalism based on the Chicago School's straightjacket of narrow self-interest (see Beets 2015). Although I share their general concerns and have never received any direct funding from BB&T, I have personally benefitted from the valuable contributions made to the field through their funding initiative. BB&T merged with SunTrust Bank to form Truist Bank in 2022.

The purpose of the conference was to promote an innovative management system developed by Koch called "Market-Based Management" (MBM). Koch had recently established a new business unit called MBM University to teach its management system to faculty at colleges and universities across the country. The conference included presentations from leaders at the newly formed MBM University.

Surprisingly, much of the discussion at the conference involved the need to encourage virtue and integrity in business. In the opening session, the VP of Academic Programs warmed up the crowd by stating that the pursuit of profit was a moral pursuit. This statement was met by enthusiastic nods and noises of agreement from the audience. He continued by asserting that a lack of free-market thinking at colleges and universities was destroying *economics*. This assertion was met with more nods and noises of agreement. He also asserted that free-market thinking without virtue and integrity was destroying *business*. This assertion was also met with general agreement, but I sensed a noticeable reduction in enthusiasm. I could tell that the mere mention of virtue and integrity made many in the audience uncomfortable. Although capitalism had arisen in the West under a set of moral norms supported by religion (Weber 1905/2002; Tawney 1926/2017), most business school faculty had removed all discussion of such norms from their research and teaching.

At the end of the opening session, I took advantage of a short break to scroll through incoming emails on my laptop computer. I sighed as I observed the high volume of emails from MBA students complaining about their final grade in my recently completed summer course on financial reporting and managerial control. It seemed that students expected better grades for less work each passing year. As the faculty director of our MBA program, I was always attempting to hold the line on our academic rigor. More concerning, I noticed a growing lack of appreciation for topics related to professional ethics and corporate social responsibility. This should not have surprised me, however, since business schools as a rule rarely emphasized such topics. As with other leading business schools, FSU's finance and accounting departments relied heavily on the modern finance theory out of the Chicago School. That theory was based on narrow self-interest and provided little support for professional ethics. I wondered if business schools were contributing to the lack of virtue and integrity that the speaker said was destroying business. Perhaps that is why Koch had begun inviting business faculty to their MBM conferences instead of just economics faculty.

An important email caught my eye. One of my Ph.D. students had forwarded me a new draft of a paper we currently had on the third round at *The Accounting Review*. The paper presented the results of an experimental study we had conducted examining the effect of a code of ethics on manager trustworthiness and investor trust using the investment game in Berg, Dickhaut, and McCabe (1995). On the first two rounds at the journal, two reviewers had asked us to make relatively minor changes to our motivation and statistical analysis. After satisfying the two reviewers, however, the editor insisted that we develop a comprehensive theory that was able to explain our key result that the code of ethics only improved manager trustworthiness and investor trust when the manager signed off on the code. The stakes were very high on this round. My Ph.D. student needed the publication for a good placement upon graduation, and I needed it for any hope of promotion to full professor at FSU.[4]

The second presenter at the MBM conference was CEO Charles Koch. A tall, trim man who conveyed considerable authority camouflaged by midwestern charm, he welcomed us to the firm he had taken over from his father in 1967 at the age of thirty-two. Along with his younger brother David, he had built Koch Industries into a large industrial conglomerate that included holdings in petroleum, chemicals, energy, paper, and ranching. After graduating from MIT with a bachelor's degree and two master's degrees in engineering, he spent his spare time studying history, economics, and philosophy. This had left him with a strong belief in science, rationality, and free-market capitalism. As background reading we had each received a copy of his best-selling book, *The Science of Success: How Market-Based Management Built the World's Largest Private Company* (Koch 2007), as well as a list of readings from such free-market thinkers as F. A. Hayek and Michael Polanyi. Koch and the other conference speakers quoted freely from these sources, which emphasized the power of markets to achieve superior outcomes in the economy.

During the discussion sessions, it became clear that many faculty at the conference shared Charles Koch's unshakable belief in free-market capitalism based on scientific rationality and narrow self-interest. It appeared to be a sign of intellectual purity to claim to be a libertarian or

[4] Fortunately, we found the ideal comprehensive theory in Bicchieri's (2006) model of social norm activation. After being assigned to another senior editor, that editor not only accepted our paper at *TAR* but asked us to include Bicchieri's formal model in the paper (Davidson and Stevens 2013).

follower of Ayn Rand. While at FSU, I had been exposed to the use of Rand's "Objectivist Ethics" as a moral foundation for capitalism through BB&T's funding initiative. I felt uncomfortable with Rand's rationalist, anti-religious views and her glorification of narrow self-interest. Further, my theoretical and experimental research demonstrated that narrow self-interest was a poor behavioral assumption and that adding preferences for norm-based behavior made the theory of the firm more descriptive, prescriptive, and pedagogically useful. While I shared Koch's support for free-market capitalism, I was beginning to think that Chicago's neoclassical theory and Ayn Rand's moral philosophy were destroying *both* economics and business.

At one of the group sessions, I met a professor who was Distinguished Chair in Business Ethics from a Catholic university. He also was uncomfortable with Rand's moral foundation for capitalism because of its glorification of narrow self-interest and its anti-religion bias. He agreed with me that Koch Industries had no real theoretical support for their emphasis on values and integrity. He told me he used insights from classical moral philosophy and the Catholic religion to build a moral foundation for capitalism. I told him about the norm-based behavior emerging in experimental economics and how many of my colleagues at FSU had rediscovered Adam Smith's first book on moral sentiments. I also told him that my interactions with the experimental economists at FSU had motivated me to study Smith's life and writings in more depth. He told me he had not considered using Adam Smith's writings in his own quest to form a moral foundation for capitalism, but he thought it could be a fruitful area.

Charles Koch and the speakers at the MBM conference clearly supported free-market capitalism and rejected the Marxist ideology arising at American universities. By restricting their discussion to the self-interested view out of Chicago, however, they left capitalism vulnerable to its detractors in academia. Although I was well trained in the neoclassical theory out of Chicago, I knew that it could not explain emerging evidence of norm-based behavior in the lab or reliance on norm-based organizational controls such as a code of ethics. I had just published a formal model with a coauthor showing that the traditional theory of the firm was better able to explain contracting behavior with the assumption of a promise-keeping norm (Stevens and Thevaranjan 2010). Thus, I knew well that the neoclassical theory out of Chicago was unable to support Koch's emphasis on values and integrity in their MBM system. The MBM conference, however, represented a watershed event in my own search for a moral foundation for capitalism as it confirmed the continuing demand for such a moral foundation among business leaders.[5]

1.2 THE DEMAND FROM BUSINESS EDUCATORS

The founding of the university-based business school was a product of the search for moral legitimacy among business executives. There was a grave concern during the Second Industrial Revolution in America (1870–1920) that the emerging business corporations generated by early capitalism would use their great wealth and power to lord it over all of society. This concern was heightened by the opportunism displayed by "Robber Barons" in banking and industry and the failure of many corporate leaders to acknowledge any responsibility for the broader social good.[6] This crisis of moral legitimacy represented a threat to American democracy that generated two responses in the population. Populist sentiment sought to dismantle large corporations altogether while progressive reformers sought to use such corporations to address the vexing social problems that had arisen in capitalist society. In this environment, an influential group of business educators leveraged their social and economic resources to create a unique legitimizing institution for business management: the university-based business school (Khurana 2007).

University-based professional schools can be traced back to the original founding of colleges and universities in medieval Europe. Church-funded institutions of higher learning were founded primarily for the training of clergy through the teaching of theology and the liberal arts. State-funded institutions, on the other hand, were founded for the training of civil servants through the teaching of professions such as law, medicine, and later, accounting (Soll 2014). Similar to the first English universities at Oxford (1096) and Cambridge (1209), the first American universities were sectarian institutions of higher learning that focused on theology and the liberal arts. This included Harvard (1636), William and Mary (1693), and Yale (1701). By contrast, Benjamin Franklin encouraged the

[5] Other researchers have questioned Koch's previous funding of republican campaigns and efforts to stall climate change legislation (see Leonard 2019). Although I share their general concerns and have never received any direct funding from Koch, I have personally benefitted from Charles Koch's books and efforts to support responsible capitalism in America. I discuss Koch's recent contributions to this important effort in Chapter 8 (Koch and Hooks 2020).

[6] The opportunism of business leaders during the second industrial revolution is epitomized by J. P. Morgan's quip in 1901, "I owe the public nothing" (Marchand 1998).

founding of an institution of higher learning that, while based on the Protestant religion, was nonsectarian and included instruction in practical skills such as grammar, arithmetic, accounting, and other business skills. The new institution opened in his home state in 1751 and became known as the University of Pennsylvania by 1791 (Isaacson 2003).[7]

The first university-based business school was founded at the University of Pennsylvania in 1881 through a large donation by Joseph Wharton, a devout Quaker who had made a fortune in the steel and nickel industries. Wharton was motivated by what he perceived as the need for moral training and character formation in business education. In particular, he envisioned a business education that would elevate not only technical competence but also social consciousness and moral character worthy of a profession. Wharton's professionalism project took over the role formerly played by private business schools that had proliferated across the young nation and became the model for all university-based business schools founded over the next forty years (Khurana 2007). Similar to the professions of law and medicine, the founders of the university-based business school sought to transmit norms of business conduct from one generation to the next. These professional norms included integrity, honesty, and trustworthiness as well as transparency and accountability. A particularly important professional norm in the eyes of the founders was *disinterestedness* or the ability of the business professional to place the interests of those whom they worked for above their own (Stevens 2019).

The professionalism project of the founders of the university-based business school was granted greater urgency during the Great Depression. Upon becoming dean of the Wharton School in 1933, economist Joseph Willits portrayed the Great Depression as a summons to the newly formed business schools to direct their gaze beyond the problems of business to the broader needs of the nation (Sass 1982). In a meeting of the American Association of Collegiate Schools of Business that same year (AACSB 1933, 255–256), Harvard professor Clyde Ruggles emphasized the need for business schools to study and teach professional standards of business conduct:

[7] The oldest institution of higher learning has been traced back to the Buddhist university at Nalanda in modern day Patna, India. The university at Nalanda educated thousands of students each year from many countries in the world from the fifth century to the end of the twelfth century and was reestablished as Nalanda University in 2014 (Sen 2022, 105). Under the Frankish kingdom of Charlemagne in medieval Western Europe, there was a substantial cultivation of the liberal arts, Roman history, and early Christian history as far back as the late eighth and early ninth centuries (McKitterick 2008, 369).

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> The business schools have a clear challenge to study standards of business conduct, and to furnish instruction which will give a clear perspective of the social responsibility of business men… (U)niversity education in business will be incomplete in a vital respect if our studies of the field of business do not recognize the obligations of these schools to aid in raising the standards of business conduct. If the business schools do not accept this challenge, they will not only fail to justify their existence as part of modern university education but they will also fail to make the greatest possible contribution to business itself.

The university-based business school was founded by institutional economists at a time when their own departments were becoming increasingly dominated by neoclassical economists. Institutional economists used primarily case studies and plant visits in their research and emphasized the role of power, values, belief systems, and historical contingency. Neoclassical economists, in contrast, used primarily mathematical models and large data sets in their research and emphasized the role of markets, contracts, trade, and property rights. Given the large difference in emphasis and methodology, the founders of the university-based business school rooted their curriculum in institutional economics and made deliberate decisions to maintain independence from economics departments within their universities. Similar to the mother discipline, however, the influence of neoclassical economists soon swamped the influence of institutional economists in the newer business disciplines.

The demand for a moral foundation for capitalism continues to inspire and motivate business educators. While at FSU, for example, I was heavily involved in a special dean's committee to encourage discussions of business ethics at the business school. The committee was called the "Business Ethics Roundtable" and was funded by alumni and corporate organizations including the Cecil B. Day Foundation. I was a member of the Business Ethics Roundtable from 2006 to 2008 and was its chair from 2009 to 2011 before becoming faculty director of the MBA program from 2011 to 2013. Over this time, I recruited speakers from academia and practice to discuss business ethics at faculty and student workshops. I found that academic speakers applied abstract theory from moral philosophy with little direct application to business practice. Practitioners, in contrast, presented practical insights from their work experience or involvement in large fraud cases such as Enron and WorldCom but provided few insights that could be applied to business theory.

During this time, I was attending weekly research workshops with the experimental economics faculty at FSU. Thus, I was being exposed to the latest experimental research revealing preferences for social norms such as reciprocity and fairness. Further, my own experimental research examining predictions from the theory of the firm was revealing preferences for social norms such as honesty, responsibility, reciprocity, and fairness. I was also working on a principal-agent model with an agency theorist at Syracuse University demonstrating how the model could be enhanced by incorporating a norm for promise-keeping. Our model, which was eventually published in *Accounting, Organizations, and Society* (Stevens and Thevaranjan 2010), demonstrated that adding social norms made the theory of the firm more descriptive, prescriptive, and pedagogically useful. I began to use my theoretical and experimental research in my graduate courses and in presentations to business groups to encourage professional ethics in business.[8]

The ongoing effort by business educators to promote professional ethics has been supported by the Association to Advance Collegiate Schools of Business (AACSB). The AACSB was established in 1916 by an elite group of business deans committed to supporting the professionalism project of the founders of the university-based business school.[9] This group included Edwin Gay of Harvard University, Leon Marshall of the University of Chicago, and A. E. Swanson of Northwestern University. These business deans were all progressive reformers who sought to legitimize management education by attaching it to the high-status institutions of science, the professions, and the university. In particular, they viewed the establishment of the university-based business school as consistent with the general goal of the university to use social science and research as the means to a better society (Khurana 2007).

The demand for a moral foundation for capitalism is particularly strong in my own discipline of accounting, which includes the specialties of auditing, financial accounting, managerial accounting, and tax accounting. As an independent profession within the business school, accounting programs across the globe have their own AACSB accreditation standards. Because of its importance to the profession, accounting programs must demonstrate instruction in professional ethics to achieve AACSB accreditation. The theoretical frameworks commonly used to teach professional ethics, however, are incompatible with the underlying economic theory used by accountants in their research. As the Director of the School of Accountancy at GSU from 2018 to 2021, I helped design a program to teach professional ethics in our undergraduate and graduate

[8] I present further details of the principal-agent model in Stevens and Thevaranjan (2010) in Chapter 2 on Adam Smith and his moral foundation for capitalism.

[9] Because of its original focus on American business schools, the organization was initially named the "American Association of Collegiate Schools of Business."

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accounting programs based on Adam Smith's moral foundation for capitalism (see Chapter 2). That program includes important historical context and the latest theoretical, experimental, and archival research incorporating social norms into the traditional theory of the firm (Stevens 2019).

1.3 THE DEMAND FROM POLICYMAKERS

The societal effects of capitalism have always posed a challenge for public policy. This was especially true during the two industrial revolutions spawned by early capitalism. The first industrial revolution occurred primarily in Great Britain from 1760 to 1840, and the Second Industrial Revolution occurred primarily in the United States from 1870 to 1920. As the result of the Second Industrial Revolution, the United States surpassed Britain as the world's strongest economic power and New York surpassed London as the world's center of banking and international trade (Burk 2007). Both industrial revolutions brought in their wake profound social and psychological dislocations due to rapid technological change and the urbanization of society. The resulting societal challenges included the breakdown of traditional communities, the decline of traditional religious belief, economic depression, immigration, and labor violence. These challenges required the implementation of a more active public policy than had previously existed in the West.

The great wealth and power concentrated in large corporations during the Second Industrial Revolution, along with the opportunistic behavior demonstrated by key business leaders, was seen as a threat to Western democracy. This led to a general mistrust of big business in America. As the excesses of the 1920s gave way to the economic hardships of the 1930s, this distrust was magnified, and business regulation became a major theme of public policy. Leon Marshall, one of the business school deans who helped found the AACSB, would play an important role in shaping New Deal policies as a member of the National Industrial Recovery Board. In 1933, the US Congress enacted the Glass-Steagall Act, which separated the activities of investment and commercial banking to prevent investment banks from putting depositors' funds at risk. In 1934, the Roosevelt administration established the Securities and Exchange Commission (SEC) to standardize accounting and reporting for publicly traded companies. These regulations were added to prior business regulations including the establishment of the Interstate Commerce Commission in 1887 to regulate the railroad industry and the Sherman

Antitrust Act in 1890 designed to break up the great monopolies and trusts that had put too much power into too few hands.

The importance of high professional standards in business as an antidote for overly active public policy can be seen in the comments of Wharton's Dean Joseph Willits at the 18th meeting of the AACSB (AACSB 1936, 12–13):

> It may not be unfair to say that the chances of obtaining a wise and rational policy by government … are increased in direct proportion to the extent to which the ethical standards and social mindedness of business men are of a kind that society can approve. In the long run, short-sightedness and unsocial practice by business will lead to political reprisals of a not very discriminating kind by those who have little understanding of business activity. All of business will continue to suffer for the conduct of a few until business learns specifically to condemn and control the practices that do not measure up.

Many policymakers at the time blamed the economic hardships of the Great Depression on an uncritical embrace of laissez-faire economics. This led to a new philosophy of public policy determined to curb the excesses of unbridled capitalism. In response to this new philosophy, Harvard modified its required courses to acknowledge the legitimate role of government in capitalist economies. Wharton also instituted the new "Wharton Assembly" to gather together the entire Wharton community to hear prominent public officials speak about the economic and social challenges facing the nation and the role of business in solving those challenges. During this time, the shift in business and government relations occasioned by the New Deal became a major theme of policymaking debates. These policy debates soon shifted to the role of industry and business management should the United States enter the war breaking out across Europe and Asia (Khurana 2007).

The scientific rigor of neoclassical economics would soon prove its worth during World War II and the postwar period. A vigorous economy was needed to meet the growing demands of the war effort as well as to demonstrate the virtues of American capitalism to the world. The war effort not only demonstrated the ability of science and industry to meet the defense needs of a rising superpower, but it also lifted the United States out of the Great Depression. Unlike other major industrial nations, the United States entered the postwar period with its economy intact and its technological assets preserved. Thus, its domestic production was buoyed by foreign demand. Further, the United States stood as the world's defender against communist aggression as well as its main creditor and currency provider, as the dollar had become the world's currency by default and by the multilateral agreements at Bretton Woods. These strong economic tailwinds assured that the United States would enter a period of unparalleled economic growth that lasted throughout the 1950s and 1960s.

The new social contract between business and government was so successful that it became fashionable by the early 1960s for economists to speak on "the end of the business cycle" (Bernstein 2001). In addition to the policy experience derived from the war, the growing confidence in the ability of policymakers to advance effective public policy was buoyed by a revolution in macroeconomics brought about by British economist John Maynard Keynes. Most of the increase in status and legitimacy earned by economists during this period, however, accrued to neoclassical economists and not institutional economists. In the increasing pursuit of scientific rigor, graduate instruction in economics became increasingly dominated by advances in mathematical modeling and statistics (econometrics). As a result, literacy in economic history and the classic texts began to wane, and the social, institutional, and cultural insights of institutional economists were largely removed from consciousness (Stevens 2019).[10]

At the same time neoclassical economists were rising in status, however, the university-based business school came under increasing scrutiny. In 1959, the Carnegie and Ford Foundations issued book-long reports that were highly critical of business school education (Pierson 1959 and Gordon and Howell 1959, respectively). The Carnegie and Ford Foundations believed that strengthening the management of business organizations was integral to their postwar missions. Both of their reports were unanimous in their condemnation of the quality of the business schools that had been established at research universities. Less than half of business school faculty held Ph.D. degrees, and there was a glaring lack of research and scholarly activities. Teaching loads were heavy with approximately forty percent of courses taught by part-time instructors. While both foundations sought the continuance of the professionalism project of institutional economists through multidisciplinary research based in the social sciences, the end result of their two reports was the further promotion of the narrow research paradigm of neoclassical economists (Khurana 2007).

[10] As discussed in Chapter 5, this growing lack of consciousness regarding economic history and the classic texts would enable neoclassical economists associated with the Chicago School to distort Adam Smith's legacy in defense of their economic theory based on narrow self-interest.

Economic trends in the United States would soon be used by neoclassical economists associated with the University of Chicago to discredit the role of public policy in the economy. The economic tailwinds that fueled the postwar prosperity of American capitalism in the 1950s and 1960s became strong headwinds during the 1970s and 1980s. Recovering industrial nations began to meet their own production needs and, in turn, became formidable competitors in the new global economy. Further, the Bretton Woods international monetary agreements expired, and many nations began to rely on their own financing and currency. When combined with other socio-economic shocks, such as the 1973 oil embargo by the Organization of the Petroleum Exporting Countries (OPEC), these trends led to an extended period of economic stagnation in the United States. The previous confidence in an active public policy inspired by Keynesian economics was severely shaken as the economic stagnation and accelerated inflation of the late 1960s and 1970s, named "stagflation," were blamed on fiscal interventionism and big government programs (Bernstein 2001).

Given the neoclassical assumptions of narrow self-interest and highly efficient markets, the logical solution to the economic stagnation in the United States was to subject self-interested managers to the discipline of the financial markets. Further, neoclassical economists associated with the Chicago School increasingly viewed the government as just another self-interested group focused on expanding its power through increased taxes and regulation (Stigler 1971b). From this view, "most government policies (even those prohibiting insider trading, as some of the more extreme members of this group argued) typically destroyed incentives for sound economic and social behavior. Thus, the solution to the problems of American competitiveness entailed minimizing the government's role in the national economy" (Khurana 2007, 301). In the hands of these economists, public policy was too often reduced to a choice between free-market capitalism and socialism. This truncation of the public policy debate concealed the ongoing demand for a moral foundation for capitalism, which became clear during the crisis of capitalism in 2007–08.

In their book, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity*, Baumol, Litan, and Schramm (2007) analyze various forms of capitalism found around the world. They define an economic system as capitalist if most of its means of production are in private hands rather than being owned and operated by the government. Their detailed economic analysis highlights the following basic facts regarding capitalist economic systems. First, all capitalist systems require some form of government support.[11] Second, capitalist systems have provided significantly more economic growth and prosperity than socialist systems that place the means of production fully in the hands of the government. Third, the economic growth provided by capitalist systems differs by the form of capitalism and the time period examined. In contrast to the truncated view of public policy out of the Chicago School, Baumol, Litan, and Schramm conclude that government plays an essential role in the successful functioning of capitalist economies.

Baumol, Litan, and Schramm (2007, 60–61) identify four forms of capitalism based on the power and influence of big business versus the size and scope of government:

1. *State-guided capitalism*, in which government tries to guide the market, most often by supporting particular industries that it expects to become "winners." (Examples include economies in India, Japan, and South Korea.)
2. *Oligarchic capitalism*, in which the bulk of the power and wealth is held by a small group of individuals and families. (Examples include many economies in Latin America, in the former states of the Soviet Union, in the Arabic Middle East, and in Africa.)
3. *Big-firm capitalism*, in which the most significant economic activities are carried out by established giant enterprises. (Examples include the United States, the United Kingdom, Australia, and many economies in Continental Europe.)
4. *Entrepreneurial capitalism*, in which a significant role is played by small, innovative firms. (Examples include periods of technological innovation in the United States – such as the automobile industry in the late nineteenth century and the computer industry in the late twentieth century – and periods of deregulation in Ireland, Israel, and the United Kingdom.)

Baumol, Litan, and Schramm devote an entire chapter to defending their use of economic growth as a key measure of success in their analysis of capitalist systems. They argue that economic growth is essential because humans want an opportunity to better their lives. They also cite studies documenting that economic growth leads to reduced poverty. While evidence does not support a direct link between economic growth and happiness,

[11] In the US economy, for example, critical utilities are provided by a combination of municipal governments and the federal government and previous attempts to privatize utility markets have often resulted in disaster (e.g., Enron).

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that is likely due to confounding effects such as increased expectations and social comparisons.[12] Critics on the Left have argued that economic growth depletes natural resources, but such growth has led to technological innovations and efficiencies that have served to preserve the world's resources. Further, strong economic growth leads people to demand the preservation of natural resources. Baumol, Litan, and Schramm (2007, 33–34) conclude: "Economic growth is and continues to be important, indeed, morally necessary if individuals and society care about improving the living standards of peoples around the world."

Baumol, Litan, and Schramm analyze the economic performance of each of the four capitalist systems, using economic growth and other economic performance measures such as disparities in wealth and income. They conclude that the optimal form of capitalism ("Good Capitalism") is a blend of entrepreneurial and big-firm capitalism. In particular, optimal economic performance occurs at the efficiency frontier where there are incentives for entrepreneurs to innovate and yet the opportunity for large corporations to form and profit from such innovation. Yet, each form of capitalism requires sound public policy and high moral standards to maintain its benefits while minimalizing its shortcomings. For example, big firm capitalism can lead to bloated corporations that use their wealth and power to reduce competition and seek beneficial public policy from government ("crony capitalism"). Big firm capitalism also leads to the classic principal-agent problem where professional managers act in their own self-interest rather than the interest of the owners of the firms they manage. Finally, a lack of transparency and accountability can lead to opportunistic behavior that threatens capitalist institutions and increases government regulation.

According to Baumol, Litan, and Schramm, state-guided capitalism shares many of the key weaknesses of oligarchic capitalism. Thus, the Chicago School's suspicion of government involvement in the economy remains valid. When government picks the winners and losers, or subsidizes certain companies and industries, it inevitably leads to inefficiency and corruption. This susceptibility to corruption helps explain why both state-guided and oligarchic capitalism are often characterized by lackluster economic growth and greater income inequality. The shutdown of world economies due to the

[12] Baumol, Litan, and Schramm point out that relative income appears to be more important to happiness than income. Scitovsky (1976/1992) was one of the first economists to question the central tenet that higher income leads to greater happiness. He applied theories of behavioral psychology and concluded that *increases* in income provided greater happiness rather than income levels per se.

COVID pandemic has led to a new era of debate over the role of government in the economy. This fiery debate has been stoked in the United States by recent evidence of big government colluding with big business and big media to silence opposing viewpoints and political speech. Thus, the role of government continues to be an important and contentious issue in capitalist economies.

The sudden collapse of FTX in November of 2022 uncovered widespread investor fraud at the cryptocurrency exchange. Although the details of this investor fraud continue to unfold in bankruptcy court, the FTX case represents the worst of crony capitalism. Sam-Bankman Fried (SBF) allegedly used investor funds at FTX to support president Biden's presidential campaign in 2020 and the midterm campaigns of many democrats in 2022, which bought him important access and political influence. At the same time SBF was using the unregulated cryptocurrency industry to bilk investors of billions of dollars, he was meeting privately with US politicians to help shape regulations for that industry. Recent revelations at Twitter after the takeover of the social media giant by Elon Musk also suggest a troubling alliance between big government, big tech, and big media. These troubling examples demonstrate the risk of crony capitalism arising in developed as well as developing economies. These examples also demonstrate the need for vigilant public policy to increase responsibility, transparency, and accountability in both business and politics.

1.4 CONCLUSION AND OUTLINE OF THE BOOK

As reflected in the recent actions of the Business Roundtable, top business leaders continue to promote initiatives to regain the "stakeholder view" of the corporation that existed before the influence of the Chicago School. Further, business educators continue to promote the professional norms that inspired institutional economists to establish the university-based business school. Finally, policymakers continue to seek sound public policy that maximizes the benefits of capitalism for all members of capitalist society. This behavior reflects the continuing demand for a moral foundation for capitalism. The search for such a foundation has a long history, going back to Adam Smith and the Scottish Enlightenment. Yet few are aware of this search or its importance for the future of capitalism. The purpose of this book is to tell the story of this search through the lives and writings of its leading characters.

Albert Hirschman (1977/1997, 59) argued that the triumph of capitalism in the West "owes much to the widespread refusal to take it

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seriously or to believe it capable of great design or achievement." The economists and philosophers in this book, however, took capitalism seriously by addressing its vulnerabilities and excesses. In Chapter 2, I discuss the moral foundation for capitalism provided by Adam Smith, the great philosopher of the Scottish Enlightenment. Although he is frequently invoked by economists as the father of their discipline, I show that Smith's life and writings have been widely distorted by both classical and neoclassical economists. In Chapter 3, I address religion as a moral foundation for capitalism by discussing the lives and writings of Max Weber and R. H. Tawney. Weber was a German political economist who is best known for his emphasis on the role of the Protestant Reformation in the founding of capitalism. Tawney was a British economist who is best known for his association with the Christian socialist movement that was popular in late nineteenth-century Britain. Both economists wrote major works addressing the importance of religion to the development of capitalism in the West.

In Chapter 4, I address humanism as a moral foundation for capitalism by discussing the lives and writings of Karl Polanyi and John Maynard Keynes. Polanyi shared Tawney's deep Christian faith, but he moved away from Tawney's moral foundation based on that faith and developed a moral foundation for capitalism based on the infinite value of humanity. Polanyi was initially attracted to the early arguments of Marx, but he ended up rejecting the narrow utilitarianism of both Marx and the classical economists. His search for a moral foundation for capitalism led him to rediscover Adam Smith's moral foundation based on social norms and culture. Keynes initially adopted the radical humanism of his elite friends at Cambridge University and the Bloomsbury group, but he shifted to a more traditional form of humanism later in life. Similar to Polanyi, Keynes rejected the narrow utilitarianism of both Marx and the classical economists and formed a moral foundation for capitalism based on responsibility and duty.

In Chapter 5, I address self-interest as the foundation for capitalism by discussing the Chicago School and Ayn Rand. Neoclassical economists after Alfred Marshall continued the narrowing of their discipline begun by classical economists. Whereas Polanyi and Keynes emphasized responsibility and duty in their moral foundation based on humanism, neoclassical economists associated with the Chicago School eschewed all social and moral responsibility and made narrow self-interest the dominant behavioral assumption in economics. I show how Rand's moral philosophy (rational egoism) represented a natural extension of the straightjacket of self-interest out of Chicago. Similar to the Chicago School, her moral foundation for capitalism provided no legitimate role for government involvement in the economy. In Chapter 6, I address how neoclassical economists have joined the search for a moral foundation for capitalism by discussing the lives and writings of Vernon Smith and Michael Jensen. In his attempt to explain norm-based behavior emerging in experimental tests of neoclassical theory, Vernon Smith rediscovered Adam Smith's moral foundation for capitalism. Jensen, one of the engineers of the neoclassical theory of the firm out of Chicago, abandoned the underlying behavioral assumption of narrow self-interest after the near collapse of the global financial system in 2007–08. He now promotes values and integrity as necessary components of business management and education.

In Chapter 7, I discuss the life and writings of another neoclassical economist who has played a major role in the search for a moral foundation for capitalism. In particular, I discuss Amartya Sen's childhood in colonial India and his rise to the top academic institutions of the West to rescue capitalism from the capitalists. Similar to Karl Polanyi and Vernon Smith, Sen's journey led him to discover Adam Smith's moral theory and incorporate that theory into neoclassical economic theory. In Chapter 8, I conclude by discussing the promise of capitalism revealed by those who have joined the search for a moral foundation. I first discuss how both classical and neoclassical economic theory have proven to be incomplete and in need of revision. Next, I summarize key insights from the nine leading characters discussed in this book. I also discuss three responses to the recent crisis of capitalism in 2007–08 and how they reflect the continuing influence of the Chicago School and yet leave the theoretical landscape ripe for theoretical development and innovation. After presenting insights from my own research, I discuss my recent experience at an international research conference in Australia to describe current efforts to recover Adam Smith's moral foundation for capitalism and establish a "New Chicago School."