THE MORALITY AND VIRTUES OF CAPITALISM AND THE FIRM: DEFENDING CAPITALISM IN THEORY AND PRACTICE

Perhaps the best summary statement on the morality of capitalism was issued by Milton Friedman. Focused on the voluntary nature of market exchanges that comprise it, he noted that capitalism is both "more favorable to the development on the one hand of a higher moral climate of responsibility and on the other to greater achievements in every realm of human activity." What exactly did he mean by that? In a famous *New York Times* column, Friedman provided part of the answer. Responding to demands that corporations pursue social goals outside their central profit-making mission, he noted:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.[1]

Friedman's criteria that the firm should "make as much money as possible" has been criticized frequently by critics who believe the firm should address a whole array of social concerns. But such criticisms miss the point. The economic genius of the market is that it enables a wide array of individuals, groupings, and associations to organize spontaneously and unconsciously to advance their various interests in a cooperative fashion that yields win-win arrangements for all involved.

As Friedman further clarified, the corporation, in order to thrive, must seek cooperation from all its economic partners—customers, employees, suppliers, investors, and the community:

> [I]t may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects.[2]

As a result, corporate managers' pursuit of sustainable profits helps to address many concerns of market critics without a conscious direction.

This essay analyzes how the search for *sustainable profits* encourages corporate managers to address a wide array of social concerns. Capitalism, we argue, is virtuous and the corporation, its most significant embodiment, hones and enhances those virtues within itself and with its economic partners, including employees, suppliers, investors, and customers.

A moral defense of capitalism needs to illustrate how capitalism not only makes people wealthier, but also advances other important values and concerns, such as fairness and justice. In fact, the failure to argue that case has left capitalism, and the firms operating within that system, vulnerable to popular and political attack by anti-market critics, demagogic office-seekers, and overzealous regulators.

Many businessmen may well articulate the quality of their products and services, as well as their record of cooperative relationships with employees, suppliers, and customers. However, they may not articulate quite so well the voluntary, self-organizing nature of the market that allows their businesses to thrive in the first place, or how the evolved human traits of self-interest and empathy are both virtuous and integral to their operations. The ability to communicate those achievements and values effectively is necessary to operate in a government-regulated environment, and to respond to attacks by critics, including hostile politicians and regulators. This essay aims to provide some important guideposts toward that goal.

Free markets address a far greater array of values and concerns than is generally recognized.

Free markets address a far greater array of values and concerns than is generally recognized. Business success depends on enlightened self-interest, but relies heavily on empathy—enlightened regard for the interests of others. Business leaders need to better understand these underlying foundational values in order to more effectively defend their profession as one that is both honorable and ethical.

However, not all businessmen are capitalists. Some engage in cronyism, seeking shortcuts to “success” in the form of subsidies or regulations that hobble their competitors. Those individuals are not capitalists engaging in legitimate business and creating wealth, but simply exploiting others for their benefit. This essay is not addressed to them. Rather, it is aimed at those business leaders who have sought and earned their success rather than having it politically granted to them, who are justifiably proud, and who recognize the value of trust and fair dealing with all their economic partners. The goal is to help them better communicate those values and achievements to the wider world in a way that helps gain public legitimacy for their firm and the free market more widely.

Policy analysts rarely talk about virtue and morality, leaving those esoteric topics to the clergy and moral philosophers. But the greatest policy analyst of all, Adam Smith, thought in both economic and moral terms and saw them as intertwined. The Balkanization of the intellectual community has driven those two elements apart. This essay seeks to reunite them and illustrate how the firm, the practical embodiment of capitalism, can act as an effective tool for advancing both. Firms can include dozens, hundreds, thousands, or even tens of thousands of workers and cooperative external networks of customers and suppliers. The search for mutually advantageous relationships with all these groups drives business leaders to sharpen their empathetic sense, to hone their virtues, and achieve the virtuous goals demanded by capitalism's critics.

In short, business leaders need to defend the institutions and values essential to their existence to counter the steady politicization of the market. Running a business in a politicized economy is not easy. It is up to capitalists to defend the morality of their own businesses and of capitalism itself, if free markets are to continue to thrive.

The Great Enrichment Needs Defending

That capitalism needs a defense when it seems the dominant force in the global economy may seem strange. Most observers across the political spectrum acknowledge the wealth-creating power of markets. But capitalism in its current form is a relatively recent innovation, and many innovations fail. The Industrial Revolution is generally dated around 1750. Prior to the Industrial Revolution, generation followed generation with little improvement in their standard of living. Change occurred around the mid-18th century, when increased productivity and better communications drove innovation, empowering entrepreneurial individuals to create wealth at a faster rate than population growth. Malthus was proved wrong.

Capitalism transformed the occasional upward blips into the sustained growth and improved living standards of the last two-plus centuries.

Capitalism transformed the occasional upward blips into the sustained growth and improved living standards of the last two-plus centuries. And, as commerce expanded, mankind obtained a more peaceful and non-coercive path to satisfy the human desire to act, to achieve. Self-interest was harnessed to achieve a public good.

The economist Deirdre McCloskey refers to this result as "The Great Enrichment"—an almost 30-fold increase in the per capita standard of living over this period.[3] During the early part of the Great Enrichment, the public recognized the value of that vast improvement in living standards. As a result, capitalism enjoyed widespread popular approval. However, as the greater wealth made possible by capitalism spread throughout society, a middle class emerged, and with it an increasingly powerful class of intellectuals hostile to commerce and capitalism.

The economist Joseph Schumpeter anticipated the problems such hostility would create. As he explained, intellectuals—those who craft the narratives that define a society's cultural views—would oppose the free market, in part, from envy, summed in the reaction, "If

When business leaders lose confidence in themselves, others lose confidence in them as well.

we're so smart, why are they so rich?" He also noted that their opposition would be reinforced by their self-interest, since a politicized economy would offer far more powerful and well-paid advisory jobs, positions granting intellectuals the opportunity to direct society rather than serve consumer interests.[4] Ignorance also was an explanatory factor. Intellectuals rarely work in business, and thus have little experience to temper their hostility. Karl Marx never visited a factory, and yet, condemned capitalism's satanic mills at length.

As anti-market intellectuals came into prominence in the mid to late 19th century, they rapidly gained control of the institutions that allow ideas to reach the public—the media, the academy, and the popular culture. As a result, business, even within business schools, came to be viewed as, at best, an amoral activity, useful but based on "greed" rather than any moral precept. Religious elites often echo that view. This increasingly negative portrayal of business leaders, Schumpeter argued, would lead even many in business to doubt their moral role:

> [Business] absorbs the slogans of current radicalism and seems quite willing to undergo a process of conversion to a creed hostile to its very existence. Haltingly and grudgingly it concedes in part the implications of that creed. This would be most astonishing and indeed hard to explain were it not for the fact that the typical bourgeois is rapidly losing faith in his own creed.[5]

And when business leaders lose confidence in themselves, others lose confidence in them as well. As Schumpeter noted, relentless cultural attack would wear down businessmen's confidence in their moral role and reduce their ability to respond to attack. Yet, he also believed that an effective defense was possible for those courageous enough to pursue it:

> They talk and plead—or hire people to do it for them; they snatch at every chance of compromise; they are ever ready to give in; they never put up a fight under the flag of their own ideals and interests. …
>
> Means of defense were not entirely lacking and history is full of small groups who, believing in their cause, were resolved to stand by their guns. The only explanation for the meekness we observe is that the bourgeois order no longer makes any sense to the bourgeoisie itself and that, when all is said and nothing is done, it does not really care.[6]

Business leaders need to push back against such "meekness" if capitalism is to gain the legitimacy its achievements merit. Business leaders must assert the pride, confidence, and knowledge needed to stand proud and resist political encroachments. The economic value of markets as the best way to advance prosperity has long been recognized by many. The challenge now is to illustrate how capitalism and businesses also advance a virtuous moral society.

The next section details how the primary institution of capitalism, the corporation, hones and enhances these moral principles in its operations. The final section provides some suggestions of how business leaders might incorporate these ideas into their management strategies. These insights should make it easier for business leaders to defend their role in society, to better express their pride. It should also allow them to more effectively respond to the criticisms of their associates, those in the media or the academy, their non-business friends, and even their family members. It is my hope that it will encourage business leaders to apply the same entrepreneurial skills they deploy in the private sphere to reach out to pro-market intellectual allies, and make investments for economic liberalization in the political sphere.

The Morality and Virtue of Capitalism

Capitalism is best defined as an extensive system of voluntary exchange within an institutional and cultural framework. It is based on the evolved institutions of private property, right to contract, and limited government that are prerequisites to liberty. It also relies on a cultural awareness that voluntary arrangements create wealth and knowledge and that commerce is a dignified pursuit. When society began to speak more favorably about commerce—when the "merchant" role became an honorable profession—capitalism took off swiftly. Those rhetorical changes weakened the cultural barriers against wealth creation, allowing merchants to converse with wealthy lords in search of mutual economic advantage.[7]

The value foundations for capitalism were outlined by Adam Smith in his two famous books, *An Inquiry into the Nature and Causes of the Wealth of Nations*, which developed the role of enlightened self-interest, and *The Theory of Moral Sentiments*, which developed the comparable role of empathy. Markets integrate these two evolutionary traits, recognizing that individuals are both self-regarding and other-regarding.

Key to understanding capitalism is an understanding of how markets integrate these two basic human traits. Self-interest is essential. Absent that drive, how would humanity have survived or evolved? The genius of Adam Smith was to show how markets channel self-interest into wealth creation, as articulated in his famous remark: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest."[8]

Voluntary market exchanges benefit all parties and result in the vast array of linked cooperative activities that comprise the market. Leonard Read's classic essay, *I, Pencil*, makes that point very effectively. In that essay, Read notes that no one can make a pencil, yet pencils are ubiquitous. The pencil manufacturer must rely on a different party for every element of the pencil—wood producers for the body of the pencil, graphite producers for the lead, still others to provide the metal band and the eraser.

Voluntary market exchanges benefit all parties and result in the vast array of linked cooperative activities that comprise the market.

Many of those people have no interest in pencils but they cooperate with the pencil producer to make pencils possible. As Read noted, that complex interplay of economic activities occurs because each link in the process is voluntary and mutually advantageous. Each link brings together one party in need of a specific item, the other with the ability to supply it. No one plans those interactions. They happen, as Smith noted, "as if guided by an invisible hand" of mutual self-interest.[9]

Adam Smith did not view self-interest as indicating that individuals would focus only on material gains, but as the drive that encourages us to pursue those things that motivate us. Individuals have many interests—achievement, recognition, a love of beauty—and any of these may encourage us to exchange with others. Entrepreneurs often seek to create something innovative and aesthetically pleasing—the iPhone being a case in point. Few business successes are driven by monetary gain alone.

In his other famous book, *The Theory of Moral Sentiments*, Smith argued that mankind also possessed another evolved trait: "sympathy," "fellow feeling," or "other-regarding." Empathy is the more contemporary word for this trait which allows an individual to grasp the pain and joys of others. Just as self-interest was necessary for individuals to survive, empathy was necessary for man to flourish as a social animal. Absent self-interest, how would humanity ever have evolved? Absent an ability to understand the goals and needs of others, how would society—even the family—ever have been possible?

In this regard Smith's views differed with those of Bernard Mandeville, who, in his work, *The Fable of the Bees or Private Vices, Publick Benefits*, argued that the vice of selfishness could prove societally valuable.

Mandeville had argued that private vices—selfishness—could yield public goods in the form of a productive economy. Yet, selfishness is not the characteristic most likely to promote the trusting, friendly, relationships that make business sustainable.[10]

Business is a social activity. Smith saw "empathy"—also known as "sympathy" or "fellow feeling"—as the trait that softens self-interest, ensuring that exchanges were mutually advantageous. Empathy complements self-interest, allowing us to put ourselves in the mind of the other, a trait critical to successful business negotiations—and to society itself. Businessmen who treat business exchanges as zero-sum games are unlikely to find many willing business partners. Humans are social animals, reflecting our ability to empathize with others. A good entrepreneur relates well to her business partners because she has both the skills and the incentive to better understand their goals, motivations, and interests.

Self-interest encourages people to seek out others, but empathy strengthens the social skills that make those encounters mutually beneficial.

Market exchanges bring the self-regarding and other-regarding qualities into balance, aligning private gains with public benefits. The result is a wide array of voluntary arrangements that enable individuals to achieve material success in a way consistent with their own values—and that is more natural and effective than such alternative economic organizations as feudalism, paternalism, and central planning. Smith's synthesis transforms Mandeville's "private vices, public goods" caricature into the more realistic "private virtues, public goods" reality. Self-interest alone might enable markets to emerge, but those markets are enriched by the "other-regarding" traits, which make it easier to share ideas and ideals. Self-interest encourages people to seek out others, but empathy strengthens the social skills that make those encounters mutually beneficial. The synthesis of the self and the other-regarding traits gives us both the incentives and the skills to "make friends of strangers."

As commerce reduced transaction costs, it enabled economic exchanges that also facilitated cultural and social contacts. Craftsmen

Capitalism has enabled billions of people to lift themselves out of poverty.

dialogued with engineers, which made society's dispersed and localized knowledge more widely accessible to more people. Those interactions of people and information allowed, in Matt Ridley's colorful phrase, *for ideas to have sex*. As Ridley notes, the fact that once commerce gained moral standing and legitimacy, the barriers between exchanging ideas declined sharply. Craftsmen and engineers, business leaders and academics could enter into conversation and exchange ideas. The localized knowledge that had been blocked by class barriers and the disdain of commerce flowed together, engendering new ideas, new innovations.[11] The resulting combinations led to ever more exchanges and exponential growth. The Great Enrichment resulted.

Institutions of Liberty

Capitalism is a revolutionary and disruptive force that put an end to the essentially static economy under which mankind lived for millennia. It has enabled billions of people to lift themselves out of poverty.[12] It has empowered people to innovate, to address scarcity and obsolescence by discovering new resources and developing new technologies. And as more people throughout the world engage in cooperative economic ventures, commercial interactions encourage greater tolerance and trust.[13] As family income increased, children could go to school, as survival no longer required that all family members toil as unpaid laborers in the field.

However, markets do not exist in a vacuum. Self-interest and empathy require both a culture and a set of rules and the institutions that make repetitive voluntary exchanges possible. These elements, which evolved over man's history, include private property, enforceable voluntary contracts, and a culture that respects and understands markets' wealth-creating role. Moreover, since capitalism is dynamic, these institutions must constantly co-evolve with shifts in tastes and technology.

Private property has long been recognized as an essential element of a free society. Markets create the information needed to guide market decisions. That information incentivizes firms to move resources to areas where society would most benefit. Attempts to replicate markets in the absence of property rights have consistently failed. If resources are not owned, the exchanges that convey the value of these resources, which managers need to make operating and investment decisions, will not occur.

Contracts allow individuals to determine the conditions of an exchange and often involve mutual risk-sharing strategies, which is especially valuable when the exchange is novel. Since all exchanges entail some degree of risk—such as a manufacturer's failure to transfer the product or to meet the agreed upon product quality standard—binding agreements are often essential if the exchange is to occur.

Cultural attitudes are clearly important. Mankind spent millennia viewing exchanges as zero-sum transactions—often a reality in subsistence tribal societies where economic growth was minimal. Yet, as people become aware that exchange creates wealth, not merely redistribute it, trust can arise, enabling equitable and self-enforcing sharing arrangements.[14] Repeat business becomes easier when one has faith and trust in the actions of one's business partners. In societies where zero-sum thinking remains dominant, trust is hard to achieve because neither party to the exchange believes that win-win possibilities exist. Therefore, trust becomes impossible and there can be no fair exchange.

Once capitalism has succeeded in granting many a material level of affluence, other values gain in relative importance.

How Capitalism Advances other Values

Once capitalism has succeeded in granting many a material level of affluence, other values gain in relative importance. Most critics nowadays concede that capitalism delivers the goods, but argue that business has neglected other values—civil and individual freedom, community stability, equality, diversity, poverty alleviation, environmental protection, and other concerns. Business leaders need to find ways to respond to these criticisms, by demonstrating how markets advance these other dimensions of the "good society."

Capitalism encourages respect and protection of a number of values and virtuous traits. As Deirdre McCloskey, whose work focuses on clarifying the virtues of a business-focused society, has noted, modern capitalism recognizes and incorporates the virtues of earlier social orders—such as early Christianity and feudalism—and guides them into the peaceful world of commerce. The result is an economy that advances both the classic virtues of prudence, temperance, courage, and justice, along with the Christian virtues of faith, hope, and charity. Commerce—"sweet" commerce, in McCloskey's term—encourages honesty, reliability, and creativity, which are all critical for a virtuous society. Moreover, those traits within the business world are likely to carry over into other social spheres, making society as a whole more virtuous.[15]

Capitalism's reliance on peaceful exchange encourages tolerance, making it less likely that value differences will flare into conflict.

Capitalism's reliance on peaceful exchange encourages tolerance, making it less likely that value differences will flare into conflict. That value is reinforced by the vast array of competing organizations in a capitalist society, a factor mentioned by Voltaire, one of the world's first economic liberals. In *Letters on England*, he noted that competition, with its diversity and multiplicity of goods and choices, encourages tolerance in areas outside of business. He noted that Spain, which allowed only one religion, launched the Inquisition. In France, where two were tolerated, there was civil war. In England, with its multiplicity of religions, doctrinal disputes became akin to the struggles of rivals on the stage, where once the curtain was drawn, the erstwhile opponents adjourn to a tavern.[16]

In a market economy, people must be persuaded to accept your offer; they cannot be legally coerced. The negotiation skills developed in market transactions carry over into other parts of life, making it easier to resolve disputes in the political, religious, and other areas.

Markets also offer more peaceful career paths. Mankind, Voltaire asserted, must "act." In pre-capitalist periods, that meant joining the military or the Church. Those career paths often led to war and doctrinal conflicts. Capitalism added a new, less-conflict oriented path—

commerce. Commerce, he argued, provided careers that depended on peaceful persuasion and voluntary agreement.[17]

Capitalism also ennobles work, the activity in which we spend much of our lives. Work in previous ages was seen very differently. To the religious, it was the penance mankind had to endure because of Original Sin. To aristocrats, work was the unpleasant activity relegated to the peasants. The Calvinists and other Reformation doctrines honored work, viewing it as doing God's will on Earth. But it was capitalism and the cultural changes it made possible that truly ennobled work in and of itself as a moral and virtuous activity, making it no longer a duty, but an activity worthy of respect.

Finally, capitalism advances an important form of democracy, where industry produces what consumers want, not what elites believe they should want. Consumers, not politicians or bureaucrats, determine what merchants put on their shelves.

Thus, capitalism not only allows individuals to self-organize to produce the wealth and knowledge that make modern civilization possible, it encourages a host of virtuous trends, promoting a more moral society. But capitalism remains an abstract concept to most people. It is the firm or corporation that is targeted by anti-market critics today. For instance, some communitarian critics of capitalism argue that bringing some goods and services into the market reduces their "moral" value and threatens community cohesion. In reality, markets expand the choices available to everyone, including the poor, of vital services and goods.

The Role of the Firm

Capitalism operates in the real world through its key institution, the firm or corporation. The firm is where most businessmen—the target audience for this essay—spend a large part of their lives. Yet, less attention has been given to the morality of the firm compared to the morality of the market. Many might accept "capitalism" as a concept, but still view business as morally suspect. Thus, the moral case for capitalism must be extended to the morality of the firm.

To generations of economists, the firm was largely a black box, treated much like any other individual actor in the market. It purchased goods and services and sold its products. Mainstream economists largely ignored key questions about the firm—how the firm came to be, why it takes on some tasks but not others, how its managers decide which tasks to include within its ambit and which to purchase from others, how its internal decision processes are structured and managed.

Ronald Coase, who earned a Nobel Prize in part for his work competition, social costs, public goods, and the firm, brought needed attention to those questions. Coase quotes D.H. Robertson, who describes firms as "islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk."[18] The firm is a hierarchic organization. Individuals join the firm voluntarily and accept adhering to management demands in return. The firm's reliance on such "conscious power" differs significantly from the unfettered freedom of both parties in face-to-face market transactions.

Firms are organized to provide some set of goods or services and tend to divide the necessary work for that goal into specific subtasks assigned to different workers. Smith noted that even the production of an item as simple as a pin requires numerous suppliers and involves numerous operations—cutting the pin, creating the head, sharpening the point, polishing it, placing it on a sheet—performed by numerous workers who must be directed and rewarded.

Managing the pin factory entails what Coase termed "transaction costs," costs incurred in reaching a number of agreements, including:

- Search and information costs, finding investors, suppliers, workers, and markets;
- Bargaining and negotiation costs, to gain agreement with these parties; and
- Monitoring and enforcement costs, to ensure that all the parties engaged in the activity perform per agreement.

Coase was the first to note that, if one expected to perform these tasks frequently, the transaction costs might be higher if they are performed via repeated market exchanges than within a firm, an institution organized via longer-term negotiated contracts to achieve these results over time. Firms, he noted, are institutions created to lower costs when:

- The activity requires multiple steps;
- The capital and work skills are specialized;
- The scale of these exchanges is large;
- The exchanges occur frequently; and
- The skills to produce them require training.

The firm can expect to lower many of these costs when one has worked with the same parties and equipment for some time. Coase noted that the boundaries of the firm were defined by where market transactions outperform the firm's employees at the same activity. In modern economies, those boundary lines are shifting constantly. For example, janitorial services may be bid out to specialized service companies, while computer specialty firms may be replaced by new IT departments.

Making the moral case for the corporation should not be difficult for those working in a firm—or anyone involved in business.

Making the moral case for the corporation should not be difficult for those working in a firm—or anyone involved in business. Business leaders should be able to answer their critics by observing how their own firm operates. As *I, Pencil* effectively illustrates, every firm is primarily a cooperative venture that must consider the values and wants of everyone in its community—the customers they hope to attract and retain, the workers they seek to employ and motivate, the suppliers from whom they wish to buy, and the investors from whom they seek the funds to operate. Effective managers are aware of the extent to which knowledge is localized. The worker on the assembly line or in the office may well have knowledge that might improve the overall performance of the firm.

Still, the fact that the firm's intent is to ensure sustainable profitability for its shareholders makes many people suspicious. Addressing those suspicions requires business leaders to sharpen their other-regarding or empathetic skills. They need to clarify that their goal is to have all parties to an exchange to state: *She's a good person to do business with!*

The cooperative nature of the firm means that profits—the surplus, if any, between the costs incurred in providing a product or service and the revenue earned by its sale—are allocated among the various economic partners according to which employees have contributed the most to the firm. Firms that fail to achieve such meritocratic allocations—or fail to convince key cooperators that they have done so—are likely to experience loss of workers, sales, investors, and suppliers.

The corporation has helped society move beyond tribal morality—the face-to-face instinctive moral demands that stem from the family—to the morality of civilization. There are few, if any, cultural barriers blocking the firm from seeking to make economic friends with strangers. Firms are always reaching out for new consumers, qualified workers, and interested investors.

Businesses work diligently to maintain their reputations and strengthen their cooperative arrangements. Consider the ways in which firms seek to ensure positive relations with their customers, providing warranties, take-back offers, product insurance, 800-complaint numbers, and websites designed to gain feedback on "how are we doing?" And then there are the reputation ratings of books and services and products on Amazon, Yelp, and Trip Advisor, with safeguards against self-rating and reputational sabotage. Similar management techniques are used to monitor and maintain positive relations with their employees, suppliers, and investors.

The Role of Specialization

The firm is structured to achieve a specialized set of goals—firms are not general-purpose organizations. Specialization, as Adam Smith well explained, allows management and workers to gain the skills needed to produce that good or service efficiently. The firm then develops the specialized tools, skills, practices, and corporate culture to further that result.

A firm that seeks to "do everything" will end up being effective at nothing.

Some critics argue that the fiduciary responsibility of ensuring profits for investors might lead to short-termism. Managers, it is argued, might shortchange workers or customers or suppliers to provide shareholders higher dividends. However, sacrificing one's cooperative arrangements with customers, workers, or suppliers has a significant long-term cost. The result is that most business leaders and investors seek sustainable profits, which encourages fair dealing with all of the firm's economic partners.

Just as no person knows how to make a pencil, no firm can act as a general-purpose agency, addressing all societal concerns, such as how to eliminate discrimination, address pollution, or reform education. The firm *can* address local manifestations of all these problems—and has every incentive to do so. But a firm that seeks to "do everything" will end up being effective at nothing.

The Role of Competition

Business decisions can be wrong, stupid, or even dishonest. Thus, the firm, like all human institutions, must be regulated. However, that does not mean government is the appropriate agent for that role. The bureaucratic disciplines of politics are far less likely to prove effective than are the competitive disciplines of the market. Competition forces businesses to monitor the performance of their competitors and how

Competition encourages firms toward greater cooperation with all their economic partners.

changes in government policy and their institutional environment might affect them. Competition also encourages firms toward greater cooperation with all their economic partners. Firms compete to gain the favor of customers or to attract a competitor's employees, investors, and suppliers. Such competition benefits consumers, who get the best deals possible, but also workers, suppliers, and investors who are offered more attractive opportunities.

Thus, while competition is often seen as harsh and non-cooperative, it serves an important and steady market-disciplining force. In practice, it becomes less a strategy for destroying one's competitors than a force encouraging all firms to become more attractive to customers, workers, suppliers, and investors. Competition drives the firm to be attentive— to consider how customers might gain better and more affordable products, how employees gain safer and more satisfying work, how suppliers obtain greater predictability and better terms, and investors higher and more reliable returns. Profits provide the guidance to see how well the firm is achieving these goals.

Sharp dealing with suppliers or customers does exist, but such practices are disciplined by competition, the need to preserve reputation, and the realization that such practices rarely lead to sustainable profitability. The business community contains its share of sharp dealers, frauds, and incompetents. Cronyism—the practice of politics to gain special privilege—discredits business, harming the ability of *all* firms to defend themselves. Yet, the firms that others wish to emulate are those that have acquired either a reputation for fair dealing or a creative flair for innovation. The public admires those who have earned their success, rather than gained it by political special favors or sharp dealing. Not all cronyists get caught, and not all experience public disapproval. Tesla has gained much from federal and energy tax credits, but it too has been harmed by other cronyists, mainly auto dealers in New Jersey, who have blocked the company's ability to sell its vehicles direct to consumers in that state.

The public admires those who have earned their success, rather than gained it by political special favors or sharp dealing.

Failure is an unavoidable aspect of a dynamic economy. Failures alert the surviving firms of the risks that led to that failure, encouraging them to greater prudence and temperance. Unexpected circumstances that can lead to failure—changes in tastes or public policy or mistaken business decisions—may require a firm to relocate or even lay off workers. Competition provides the incentive to take those painful but necessary steps to survive. In doing so, that firm and its economic partners can continue to provide goods and services to the public, employ some workers, buy from some suppliers, and reassure investors. Stasis is impossible in a dynamic economy. At the same time, creative destruction increases the likelihood that there will be somewhere for displaced workers to land. The opposite of innovation is not stability but stagnation.

A corporation, like the market, can gain public legitimacy only if it is seen as acting in a way that is consistent with the society's prevalent values.

Moreover, as America's economy has grown more dynamic, firms are seeking ways to anticipate and address such downturns.

Some firms now seek to find ways for their employees, including those laid off, to learn from their work experience as part of a longer career. Other firms, aware that their employees may move on if opportunities are not available, arrange opportunities for workers to take academic or work skills courses. The goal of such activities is to make employment at such firms more attractive. Capitalism cannot ensure stability, but it can ensure sustainable growth, which is the best form of stability in a dynamic world.

The Role of Values and Virtues

A corporation, like the market, can gain public legitimacy only if it is seen as acting in a way that is consistent with the society's prevalent values. In today's multicultural world, values vary. The challenge is to demonstrate how the firm's activities are consistent with—in fact, reinforce—those diverse values. In this section, we do not seek to expand on the centuries-old exploration of the question of the ethics of commerce by philosophers, religious leaders, economists, and other social scientists. Rather, we focus on the role of cultural values as heuristic devices to expedite how individuals reach their decisions regarding the ethics of business.

Cultural value theorists have developed a typology of such values. The political scientist Aaron Wildavsky and the cultural anthropologist Mary Douglas noted that a rational approach to persuasion can be effective when addressing a party directly affected by the issue being discussed.[19] However, most issues—and nearly all in public policy and politics— are affected by the phenomenon of *rational ignorance*. It is not that these issues are irrelevant to any given individual (though many may well be), but that the way such decisions are made allows most individuals little direct influence over them. In such a situation, a rational individual may express an opinion, but since she seeks to allocate her scarce time intelligently, she will adopt a position of *rational ignorance*—that is, not devote scarce time to issues over which she has little influence. As I have long said in the political and policy field: *People aren't stupid, because they're stupid. They're "stupid" because they're smart. So, if we try to make them smart, we're being stupid!*[20]

Yet, people express opinions. But since information cannot explain those opinions, whence do they emerge? Wildavsky and Douglas—more recently joined by a growing number of cultural theorists, such as Jonathan Haidt[21] and Dan Kahan[22]—argued that rational ignorance, as a sensible response to information overload, has led to the evolution of several distinct sets of cultural values through which different people process information. Douglas and Wildavsky created a classification scheme which they called Group/Grid.

Group measures the extent to which a subject sees herself as an individual vs. a member of some community. Grid addresses the extent to which a subject views independence on a range from egalitarian to hierarchic. That resulted in four cultural types: Individualists, Egalitarians, Communitarians, and Hierarchists. Other studies in this field added one more category, Fatalists, those with no group loyalty and no belief in causality. This group is rare in developed nations and politically inactive, and thus is not discussed here.

Cultural theory argues that individuals use their cultural beliefs as heuristics to decide on the myriad issues that confront average citizens. If the candidate or issue seems to threaten their belief, they oppose it; if it supports their belief, they endorse it.

Egalitarianism. Egalitarians place great weight on fairness and justice, especially for the least fortunate in society. As mankind gained mastery over the natural world, family groupings merged into tribal societies, which have a strong ethos of mutual aid for their members. Wealth creation was rare, and zero-sum thinking was dominant. Increased wealth by one party was seen as taken from someone else in the community. Thus, resources were to be shared as equally as possible. Moreover, innovations that would disrupt the established order were largely discouraged. Although achievement might be valued, the entrepreneur was expected to share the returns. Egalitarian values remain significant in most societies, although today, they are often pursued at the national level via the impersonal and bureaucratic administrative state.

Hierarchy. Hierarchical values include respect for tradition and authority. Innovators are valued but not if they are excessively disruptive.

Individuals are free to act within the constraints of culture and custom but expected to defer to the experts. Hierarchical values rose in importance as the reality of different people having different skills became widely recognized. More valued individuals gained special status and authority. The "head" of a leading family became the "head" of the tribe, and a tiered hierarchy and bureaucracy evolved. All organizations resort to some form of hierarchic structure to organize the varied skills needed to achieve the group's common goals. Capitalism and markets rely heavily on firms, which are elaborate structures for achieving efficiently varied purposes. Hierarchists respect those who have risen up through the system—in effect, paid their dues.

Individualism. Individualists are opposed to the rules of hierarchy and the wealth redistribution policies of egalitarians. Freedom is their most sought value. As recognition of the value of specific individuals in society increased, so did the recognition that many—perhaps all—people possessed creative capabilities that might prove societally useful. The realization that no one knows who is likely to prove the most effective at various societal tasks encouraged the individualistic value of "let them try." The entrepreneur is the ideal individualist and, thus, a critical force in capitalism and economic growth.

Communitarianism. This group sees civil society, especially community organizations, as the key factor in the good world. They value markets' wealth-creating capacity, but see market transactions as in need of being reined in, lest they become overly individualistic and disruptive. Communitarians, broadly, want to see individual freedom tempered by group solidarity.

The challenge for business leaders is to demonstrate how their firm's activities advance not only the self-interest of people as consumers, but also the vision of the "good society" they seek as citizens.

While seemingly wildly disparate, these cultural values are not necessarily in conflict when a specific policy is being considered. Egalitarians might admire a corporation's efforts to extend services to low-income neighborhoods. Hierarchists might admire the efficiency with which that firm operates. Individualists might appreciate innovation by a firm. Communitarians might appreciate the evolved culture of firms. In a free society, these cultural values can each thrive alongside one another.

The challenge for business leaders is to demonstrate how their firm's activities advance not only the self-interest of people as *consumers*, but also the vision of the "good society" they seek as *citizens*. By allowing each individual the freedom to pursue both of those goals, capitalism can bolster the egalitarian values of fairness and justice, the traditionalist or hierarchic values of stability and respect for custom, the communitarian focus on community and solidarity, and the individualist values of freedom and responsibility. Defenders of capitalism should view egalitarians and hierarchists as challenging audiences.

All of these values are important, but different individuals will weigh their relative importance differently—much like different customers seek different things from a product or service. To appeal to each of these various cultural value types, the corporation must demonstrate that its activities are consistent with all of their values. Since each cultural type has very different values, the firm may need to craft different strategies to communicate how it advances their different goals. *Different strokes for different folks, as it were!* Consider the following narratives seeking that outcome:

Nothing has done more to increase global equality than capitalism.

The Egalitarian Value—Fairness. Nothing has done more to increase global equality than capitalism. Firms have contributed to that process by increasingly relying on global trade, offering the neediest people in the world a ladder out of poverty. Free markets allow the poor to explore opportunities where their talents can provide them the greatest return. The resulting innovation and entrepreneurship enable creative people to explore new opportunities to offset any losses that might occur in mature and fading industries, ensuring that both better products and newer jobs are available for the future. Producers and unions may suffer setbacks, but consumers benefit. Moreover, the potential for more profits encourages firms to continually explore the possibility of reaching out to underserved regions, as Walmart did in rural and suburban America, or as many firms set up programs to find jobs that disabled individuals can fill.

The Hierarchic Value—Stability. If one views an institution as moral, then one naturally seeks to see it survive. The family, religious beliefs, and pride in locality, and ethnicity are viewed by many as moral forces. People who value these institutions seek their survival and devote resources to their defense. Business leaders and their top managers are usually proud and appreciative of their firm and seek its survival. To do so, the firm must remain aware of its internal economic condition—to seek ever improved efficiencies—and external challenges—changing consumer tastes, the quality and prices of the equivalent products

Markets strengthen civil society by providing a template on which individuals can forge social links.

offered by competitors. That competitive discipline forces the firm to continually evolve. Established firms are not immortal, but they can provide stability in a changing economy.

The Communitarian Value—Solidarity. Markets strengthen civil society by providing a template on which individuals can forge social links. At my place of work, several couples have met and married. Is my experience unusual? People are social animals and, when working cooperatively together—whether as employees or as economic partners, they rarely converse only about economic details. They learn about each other's passions and beliefs, their hobbies and pastimes, and sometimes they find mutual interests. One might join a ski club in which the other is a member; they might take a hike or have lunch together. In doing so, the economic links stemming from the economic cooperation of the market blends into the vast array of social networks.

The Individualist Value—Freedom. Consumer sovereignty in the marketplace clarifies for the individual the broader concept of liberty in other fields and tends to foster liberty elsewhere. Capitalism, by dispersing power among many competing private entities and leaving most power with individuals to make their own choices of location, resource use, employment, and purchases, acts as a significant check on the monopoly power of the state as well as established firms. Not all market economies achieve political freedom, but no political democracies exist in the absence of economic liberty.[23]

Cultural values may predispose an individual to approve or oppose capitalism, but much depends on how the issue is presented. In a world of rational ignorance, such value differences are real. Those seeking to defend the corporation should explore ways of presenting the corporation in such cultural value terms to each of these cultural types.

There are actual and potential critics and defenders of capitalism in all these cultural value categories. Some individualists view the corporation negatively, seeing it as too proscriptive and controlling, even as they admire its voluntary nature, efficiency, managerial and technical skills, and productivity. Some hierarchists may see capitalism as too destabilizing and disruptive, while appreciating its capacity to generate order out of uncoordinated action. Some egalitarians may view working and salaries as rights, while appreciating firms' job- creating and welfare-enhancing potential. And communitarians may perceive capitalism as too indifferent to community solidarity, while recognizing businesses' ability to bring people together.

The McCloskey Virtue Arguments

Deirdre McCloskey, a defender of markets, argues persuasively that capitalist morality—which she terms the "bourgeois virtues"—builds upon, and essentially integrates, the Christian virtues of faith, hope, and charity, and the aristocratic virtues of courage, justice, temperance, and prudence.[24] These values are certainly evident in the corporate world. Every entrepreneur relies on hope and faith—she has a dream and rushes courageously to achieve it. Established business leaders exercise prudence daily and, seeking stability, tend toward temperance in investments and justice to their economic partners.

Capitalism's drive for dynamic efficiency creates a powerful slipstream that advances many social values.

In practice, this means a corporation must seek to maintain cooperative win-win arrangements with its customers, employees, suppliers, and investors. In that sense, business managers allocate resources among their partners according to the contribution each makes to the firm's success. Thus, the firm needs to keep its key partners—loyal customers, faithful employees, reliable suppliers, and steadfast investors—on board by treating each in a way that is just—and is seen as just.

That integration is integral to the market process. Capitalism's drive for dynamic efficiency creates a powerful slipstream that advances many social values—for example, reduced waste, outreach for employment to lower skilled or disabled individuals, and greater acceptance and tolerance for ethnic and religious minorities—empowering the firm's various partners to better advance such goals.

Partners for Liberalization

Finally, business executives favorable to capitalism need to put these lessons into practice. Good managers are always alert to entrepreneurial investment opportunities to advance their firms' goals. That should include the political and intellectual. Such investments should include campaigns to gain economic liberalization. Firms have great experience in dealing with *economic* partners. They should exert similar effort to relate and cooperate with an array of *policy* partners if they and all their partners—customers, employees, suppliers, and investors—are to secure the freedom to grow and prosper well into the future. To that end, businesses have much to gain by reaching out to potential free market policy allies in order to promote economic liberalization as a long-term investment.

The nation's freight railroads provide a good example of that type of policy investment. Railroads were one of the first industries regulated at the federal level, a policy that began with the creation of the Interstate Commerce Commission (ICC) in 1887, which set rates for the industry. In the first decades of the ICC's existence, the agency's lack of knowledge of rail operations led it to seek, and often follow, the advice of railroad CEOs. However, as time passed and ICC staff gained greater knowledge, rail regulations became increasingly burdensome. Agencies are sensitive to interest groups, of which the railroads were one, but shippers were also interest groups, and there were many more of them. Shippers soon came to dominate ICC policy, which was characterized by price controls.

By the 1970s, this regulatory straitjacket had brought the nation's freight railroads to the brink of collapse. In response, freight railroads began to fight for economic liberalization, seeking the freedom to price their services, which they had been denied for almost a century. That effort succeeded in pushing through the Staggers Act of 1980, which allowed that once-moribund sector to return to profitability. The result was improved transportation services and increased investment in rail infrastructure. Few purely private investments could have yielded such returns. Other heavily regulated industries could learn from the railroads' experience.[25]

The Great Enrichment is capitalism's greatest triumph.

Conclusion

The Great Enrichment is capitalism's greatest triumph. As commerce reduced transaction costs, it facilitated social contacts between craftsmen and engineers, making society's dispersed and localized knowledge more widely accessible to more people. The localized knowledge that had been blocked by class barriers and the disdain of commerce flowed together, engendering new ideas, new innovations. The resulting combinations led to ever more exchanges and exponential growth. The Great Enrichment resulted.

Yet, the continuance of the Great Enrichment is endangered. Over the last century, cultural narratives about commerce and business have become steadily less favorable toward free markets. Overly burdensome regulations are slowing or blocking innovation, capitalism's lifeblood. In effect, a form of economic puritanism seeks to stop ideas from "having sex." All this threatens the gains of the last centuries, and a return to the steady-state stagnation of the past.

Apologetic approaches will not work. You get no applause for doing less of a bad thing unless and until you have first garnered legitimacy for your core role. The morality of capitalism is based on its voluntary nature, its creative synthesis of the two basic human evolutionary traits: self-interest and empathy. Those moral traits are incorporated and enhanced by capitalism's most significant institution, the firm. To achieve any sustainable success for capitalism and the firm, it is essential that the morality of these institutions be widely understood and accepted.

Originally published by the Competitive Enterprise Institute in 2016.

NOTES

1 Milton Friedman, "The Social Responsibility of Business Is to Increase its Profits," *New York Times Magazine*, September 13, 1970, https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.

2 Ibid.

3 McCloskey uses this term in many of her writings. See, for example, Deirdre Nansen McCloskey, "The Great Enrichment," *National Review*, November 15, 2015, https://www.nationalreview.com/magazine/2015/11/19/great-enrichment/. McCloskey, like many, finds the term "capitalism" awkward and has suggested various alternatives, such as "modern capitalism," "market tested innovation," and "innovationism."

4 Fred Smith, "Countering the Assault on Capitalism," *Economic Viewpoints*, Institute of Economics Affairs, 2012, https://cei.org/sites/default/files/Fred_Smith--Countering_the_Assault_on_Capitalism.pdf.

5 Joseph Schumpeter, *Can Capitalism Survive?* (originally published as *Capitalism, Socialism, and Democracy*) (New York: HarperCollins Publishers, 1942), p. 190.

6 Ibid., p. 191.

7 The notion that changes in rhetoric and language helped propel the Industrial Revolution is explored in depth by Deirdre McCloskey in her trilogy on "bourgeois" morality and mores: *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago: University of Chicago Press, 2006), *Bourgeois Dignity: Why Economics Can't Explain the Modern World* (2010), and *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (2016). For a shorter treatment of the topic, see Deirdre N. McCloskey, "It was ideas and ideologies, not interests or institutions, which changed in Northwestern Europe, 1600–1848," *Journal of Evolutionary Economics*, Vol. 25, Issue 1 (January 2015), pp. 57–68, https://www.deirdremccloskey.com/docs/pdf/McCloskeyJEvolEcon2015.pdf.

8 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Fifth Edition (1904), (London: Methuen & Co., Ltd.), first published 1776, Vol. 1, Chapter 2.

9 Leonard Read, *I, Pencil* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1946, https://fee.org/articles/i-pencil/. See also the Competitive Enterprise Institute's animated film based on the essay, http://ipencilmovie.org/.

10 Bernard Mandeville, *The Fable of the Bees or Private Vices, Publick Benefits*, 2 volumes, with a Commentary Critical, Historical, and Explanatory by F.B. Kaye (Indianapolis: Liberty Fund, 1988)m Vol. 1. 9/27/2016, http://oll.libertyfund.org/titles/846.

11 Matt Ridley, *The Rational Optimist: How Prosperity Evolves* (New York: Harper, 2010).

12 Ronald Coase and Ning Wang, *How China Became Capitalist* (New York: Palgrave Macmillan, 2012).

13 Matt Mitchell, "Trust Me on this One," Neighborhood Effects Blog, Mercatus Center, October 24, 2011, http://neighborhoodeffects.mercatus.org/2011/10/24/trust-me-on-this-one.

14 For a discussion of such arrangements, see Peter Leeson, *Anarchy Unbound: Why Self-Governance Works Better than You Think* (New York: Cambridge University Press, 2014).

15 Deirdre McCloskey, *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago: University of Chicago Press, 2006), http://www.deirdremccloskey.com/docs/bv_selection.pdf.

16 Voltaire, *Letters on England* (London: Penguin Classics, 2005) (first published January 1, 1889).

17 Ibid.

18 Ronald Coase, *The Firm, the Market, and the Law* (Chicago: University of Chicago Press, 1988).

19 Mary Douglas and Aaron Wildavsky, *Risk and Culture: An Essay on the Selection of Technological and Environmental Dangers* (Berkeley, Calif.: University of California Press, 1983).

20 The term "rational ignorance" was coined by Anthony Downs, an economist at the Brookings Institution. Anthony Downs, *An Economic Theory of Democracy* (New York: Harper and Row, 1957). See also, Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton, N.J.: Princeton University Press, 2008).

21 Jonathan Haidt, *The Righteous Mind: Why Good People Are Divided by Politics and Religion* (New York: Pantheon, 2012).

22 For more on Dan Kahan, see the website of the Yale University Cultural Cognition Project, http://www.culturalcognition.net.

23 Robert A. Lawson, "Examining the Hayek–Friedman hypothesis on economic and political freedom," *Journal of Economic Behavior and Organization*, Vol. 74, Issue 3 (June 2010), pp. 230–239, http://www.sciencedirect.com/science/article/pii/S0167268110000430.

24 It is difficult to do justice to the richness of McCloskey's work on capitalism and virtue. Her research and writings are impressive and merits greater attention from the policy community. One of her major themes is that the utilitarian/efficiency/prudence arguments for capitalism are inadequate, and that capitalism cannot survive on such narrow grounds.

25 For more on railroad deregulation, see Fred L. Smith, Jr. and Marc Scribner, "Reviving Capitalism—Lessons from the Near-Death and Rebirth of American Railroads," *Profiles in Capitalism* No. 2, Competitive Enterprise Institute, November 2015, https://cei.org/content/reviving-capitalism.