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# Linking Ethics and Economic Growth: a Comment on Hunt

Nicolai J. Foss<sup>1</sup>

## ABSTRACT

Hunt (2012) builds on his work concerning ethics and resource-advantage theory to link personal ethical standards, societal norms, and economic growth but offers few details concerning the precise mechanisms that link ethics and growth. This comment suggests a number of such mechanisms – for example, the influence of prevailing ethical norms on the aggregate elasticity of substitution and, therefore, total factor productivity and growth.

**KEY WORDS:** ethics, trust, competition, productivity, economic growth, resource-advantage theory,

**JEL Classification:** D40, O40

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## Introduction

In “Trust, Personal Moral Codes, and the Resource-Advantage Theory of Competition: Explaining Productivity, Economic Growth, and Wealth Creation,” Professor Shelby D. Hunt addresses what should rightly be one the key questions in social science – namely, the aggregate implications of ethical beliefs and judgments that, while having an obvious collective-level dimension, are in the end held by individuals. Important philosophers and economists may have been preoccupied with this issue – David Hume, Adam Smith, Frank Knight and Friedrich Hayek come to mind – but one rarely witnesses a management (marketing) scholar offer important reflections on the matter. Hunt rightly notes that “...a consensus is developing that societal-level moral codes that promote *social trust* promote wealth creation” and sets out to “...contribute to our understanding of the *nature* of the kinds of societal-level moral codes that are thought to promote social

trust,” as well as examine the mechanisms that link trust-promoting, societal-level moral codes to wealth creation (Hunt, 2012, p. 1). He seeks to account for these mechanisms in terms of the resource-advantage theory of firms and competition, which he has pioneered in marketing research and may be loosely described as resource-based theory that explicitly accounts for heterogeneous demand dynamics.

I believe Hunt is absolutely on the right track in his attempt to construct a complex, multi-level story of the influence of the so-called “informal” but all-important institutional structures of society on the overall well-being of society. It also makes much sense to link this work to work in moral philosophy, notably descriptive ethics. Ethics is, of course, a perennial classic of philosophy, and any moral philosopher worth his salt has been aware of the social functions and ramifications of ethics. Finally, I agree that understanding the influence of morals on wealth creation requires that attention be paid to the dynamic nature of competition. Thus, I do not register any disagreements with Hunt on the overall level. (I may disagree here and there on interpretive issues, e.g., in connection with neoclas-

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sical economics, but I consider those disagreements insubstantial in the larger picture.) However, I think Hunt's theory requires greater attention to detail and "modelling" in the sense of more carefully accounting for theoretical mechanisms. In the spirit of constructive criticism, I offer various suggestions that may add some content to Hunt's theory in places where I feel this is needed. I organise my comments under the two headings of "Growth Economics and Societal Ethical Norms" and "Heterogeneous Resources, Transaction Cost, and Ethics."

## Growth Economics and Societal Ethical Norms

The economics of growth has been primarily concerned with labour growth and capital accumulation as the main drivers of growth, accounting for unexplained technological progress as an add-on, albeit an essential one (Solow, 1956). Solow's (1957) empirical finding that most growth is caused by exogenous factors stimulated the emergence of growth accounting as a sub-field in economics and made endogenising technological progress a pressing issue on the research agenda of the profession (partly achieved by Lucas, 1988; Romer, 1990). A fundamental insight that emerged from this body of work is that a key reason why countries differ in terms of development is rooted in their different levels of productivity: Countries grow not only by deploying more inputs to production but also by better allocating resources and introducing productivity-enhancing innovations (Temple, 1999). The notion of "total factor productivity" accounts for those changes in total output not caused by changes in "traditional" inputs, such as labour and capital. While often treated as a residual, total factor productivity is by no means unimportant. For example, Klenow and Rodriguez-Clare (1997) show that differences in total factor productivity are the primary determinant of growth differences in a cross-country sample from 1960 to 1985. In turn, an emerging literature has begun exploring the "deeper" determinants of growth, that is, which factors cause differences in total factor productivity.

It has long been recognised that the institutional matrix impacts economic growth by influencing, for example, individuals' incentives to expend work effort and accumulate capital rather than enjoy leisure (e.g.,

North, 1990; Glaeser, La Porta, de Silanes, and Shleifer, 2004). Less interest has been devoted to understanding how the institutional matrix impacts total factor productivity, that is, output changes that are not caused by changes in the "traditional" (measured) inputs of labour and capital. Increasingly, institutions capture the interest of growth economists, and some scholars (e.g., Rodrik, Subramaniam, and Trebbi, 2004) go so far as to claim that "institutions rule": Institutional quality overwhelms other determinants of growth.

A main reason to expect institutional quality to positively affect growth is that institutional quality entails lower transaction costs through reduced uncertainty in economic transactions and productivity-enhancing incentives. As North explains, "[t]he major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction. The overall stability of an institutional framework makes complex exchange possible across both time and space" (North, 1990, p. 6). In turn, higher certainty implies lower transaction costs, as the costs of entering into, bargaining for, monitoring and protecting contractual and ownership rights are reduced. This development increases the expected value of projects, which increases the likelihood that such projects are undertaken. By offering incentives for productive behaviour, efficient institutions stimulate individuals to engage in those actions for which the private return resembles the social return.

Thus, institutions can be taken into account through, for example, arguments such as that which is provided above (Bjørnskov & Foss, 2012). However, there are certainly important dimensions to the impact of institutions on economic growth that are not easily captured by traditional measures of institutions. Hunt (2012) places much emphasis on trust, which is indeed important. In terms of the argument concerning the reduction of transaction costs entailed by "good" institutions, trust eases transactions and increases investment incentives. There are additional effects, however, of a "good" ethical societal matrix that may stimulate economic growth: Helping behaviours and other pro-social behaviours, while not easily reduced to transaction cost issues, are greatly influenced by the prevailing ethical matrix in a society (Bowles, 1998). If ethical norms assist in establishing and maintaining generalised reciprocity norms and "good Samari-

tan" norms, this relationship furthers trust and may save resources to the extent that Samaritans and other benevolent institutions of civil society can substitute for an often inefficient state apparatus financed by growth-reducing taxes. Helping behaviours entail that information and knowledge, for example, is effectively shared and transmitted at low costs to the benefit of the growth process. Other aspects of the ethical matrix may also positively influence growth. As Hayek (1973) observed, generalised norms that recommend celibacy (e.g., the American Shakers) are not exactly conducive to long-run growth. Norms that encourage individuals to have more children are conducive to growth (*ceteris paribus*) because an increasing population allows for an increasing division of labour, which, as Adam Smith observed, is conducive to growth. Stable families and low divorce rates may also be conducive to growth, as both-parent families tend to be better positioned to handle investments in education and may produce offspring less prone to become criminals.

The discussion above suggests many reasons why we would expect prevailing ethical norms to influence economic growth. While these reasons may not (yet) be an integral part of the economics of growth, the relevance of moral norms for society-level economic performance has long been recognised in political philosophy and political economics and is increasingly recognised in social psychology and management research. With respect to the latter, a rather large number of papers, not the least in international business research, recognise that there is cross-country variation in ethical norms (e.g., Langlois & Schegelmilch, 1990; Carroll & Gannon, 1997). This fact is recognised in management research in fields that specialise in international human resource management and intercultural communication and competence. Most of these papers may not directly link societal ethical norms to economic performance, but some do. Thus, Franke and Nadler (2008) proffer an index that measures "national ethical attitude," which they define as people's "cognitive, affective, and behavioural predispositions to react to issues and activities involving social standards for what is morally proper and virtuous" (p.255). Such attitudes, in turn, derive from societal ethical norms. They link national ethical attitude, derived from the World Values Survey, to economic performance (GNP data) and show that national ethical attitude is a significant pre-

dicator of cross-country variation in GNP. Franke and Nadler may thus be seen as offering an empirical counterpart to Hunt (2012) (although they do not make use of Hunt's ethical classifications when discussing cross-country variation in ethical attitudes).

## Heterogeneous Resources and Transaction Costs

Hunt's reasoning involves a complex interplay of micro and macro levels. As he (Hunt, 2012, p. 13) explains:

*"If (at the micro-level) the primary objective of firms is superior financial performance (e.g. more profit than last year or a return on investment greater than one's competitors), but (at the macro-level) a key factor distinguishing wealthy from nonwealthy societies is trust-promoting institutions, the challenge for any theory of markets and any dynamic theory of competition within markets is to explicate the process by which such macro-level, trust-promoting institutions as moral codes can contribute to (or from) firm-level, superior financial performance."*

Hunt's seeks to explicate this process in terms of resource-advantage theory, building on the "foundational premises" of that theory, which are the following (Hunt, 2012, p. 14):

- P1. Demand is heterogeneous across industries, heterogeneous within industries, and dynamic.
- P2. Consumer information is imperfect and costly.
- P3. Human motivation is constrained self-interest seeking.
- P4. The firm's objective is superior financial performance.
- P5. The firm's information is imperfect and costly.
- P6. The firm's resources are financial, physical, legal, human, organisational, informational, and relational.
- P7. Resource characteristics are heterogeneous and imperfectly mobile.
- P8. The role of management is to recognise, understand, create, select, implement, and modify strategies.
- P9. Competitive dynamics are disequilibrium-provoking, with innovation endogenous.

Hunt spends considerable time explaining these propositions and perhaps too little time explaining how exactly "R-A theory can explain how macro-level, trust-promoting institutions such as personal moral codes can contribute to (or from) firm-level, superior finan-



cial performance" and how this translates into positive contributions to the society-level growth process.

Thus, Hunt reasons in terms of examples involving firms with employees who hold different ethical codes (because they are located in different geographical regions, each characterised by different ethical norms) and simply argues that the firm-level analysis can be scaled up to the level of nations.

Concerning the firm level, Hunt specifically argues that firms populated by utility-maximising consequentialists will perform worse than firms populated by deontologists. I accept his overall conclusion, but Hunt does not explain much of the underlying logic. The argument holds true under a number of conditions that economists would summarise under the headings of incomplete contracting, imperfect enforcement, and asymmetric information (P5 of RA theory). If these imperfections do not hold, it is questionable whether there would be any performance differences between a firm populated by utility maximisers and one populated by deontologists, as easily enforceable perfect contracts could be implemented to achieve the same outcome in either firm. Moreover, there are subtle issues involving the endogeneity of employee preferences (Bowles, 1998) and goals (Lindenberg and Foss, 2011) that imply that firms can, to a certain extent, choose the moral orientations of their employees. Hunt neglects these points, and this commentator, at least, would like to see them included in a rigorous RA logic.

The problem of moving from the firm level to the national level is overcome simply by analogy: In the same way that one may perform a *Gedanken experiment* with firms populated by employees with different ethical stances and examine their differential competitiveness, nations may be characterised by the prevailing societal ethical norms that hold similar implications for competitiveness, albeit at a much higher level of aggregation:

*... just as employees having a moral code stressing deontological ethics constitutes a firm resource, a society having a dominant culture with a moral code stressing deontological ethics has a societal resource upon which firms can draw. Thus, R-A theory—alone among theories of competition—can explain how such macro-level, informal institutions as moral codes can contribute to (or from) firm-level, superior financial*

*performance. In so doing, it contributes to explaining how societal institutions that promote social trust also promote the wealth of nations."*

(Hunt, 2012, p. 16).

However, this procedure of aggregating by analogy, as it were, risks obscuring some of the key mechanisms that drive the growth process. In what follows, I describe a view that, while consistent with Hunt's theorising, is more explicit about the mechanisms that bring us down to the firm level from the macro level of societal ethical norms and up again to society level economic growth.

Drawing on Austrian capital theory (e.g., Lachmann, 1956), Knight's (1921) theory of entrepreneurship, and the resource-based view of the firm (Barney, 1991) (all elements that could be argued to be part of or closely related to Hunt's RA theory), Foss and Klein (2012) argue that transaction costs include the costs of entrepreneurs searching for, combining, and adapting heterogeneous resources in the pursuit of profit under uncertainty. The lower the transaction costs, the more such activity will take place. In turn, entrepreneurial experimentation with new combinations of heterogeneous resources is one of the drivers of growth. Drawing on this understanding, Bjørnskov and Foss (2012) link the growth process to increases in total factor productivity resulting from new processes, new modes of organisation, better ways of allocating resources to preferred uses, and so on – that is, from processes involving start-ups and the entrepreneurship exercised by established firms.

Given this development, the *flexibility* with which such changes can be carried out becomes highly important. In terms of economic production theory, this flexibility is captured by the notion of the elasticity of factor substitution (Klump & De La Grandville, 2000) – that is, the percentage change in factor proportions due to a change in marginal rate of technical substitution (e.g., in the extreme example of a Leontieff technology, the elasticity is 0). At the level of a country, the (aggregate) elasticity of substitution is a measure of the flexibility of the economy with respect to, for example, external shocks. It is also clear that the elasticity of substitution is affected by a number of forces. For example, an argument for liberalising such trade is that this trade may expand the possibility set with respect to the input combinations faced by a country's entrepreneurs.

This suggests that the elasticity of substitution is endogenous (Arrow et al., 1961). Although certain inherent technical constraints imply that resources will never be perfect substitutes, the aggregate elasticity of substitution is to a large extent endogenous to institutional variables. Certain institutions promote a high elasticity of substitution, which in turn implies high factor productivity because resources are more easily allocated to highly valued uses and new modes of organisation and new processes are more easily implemented. Underlying the positive impact on factor productivity of high elasticity of substitution is a high degree of certainty in dealings and, therefore, low transaction costs of searching for contract partners, bargaining, and monitoring and enforcing contracts. Huge literatures in economic history concerning intellectual property rights and innovation stress the importance of well-defined, enforced property rights for entrepreneurial activity at the micro level and economic development at the macro level (e.g., North, 1990). Well-defined and enforced property rights reduce the transaction costs of carrying out the entrepreneurial activities: Well-defined property rights imply that contracting costs are relatively low, which implies low costs of searching for, negotiating with, and concluding bargains with the owners of those inputs that enter into entrepreneurial ventures. In short, the transaction costs of processes of resource mobilisation and orchestration are low. Moreover, well-defined and enforced income rights imply that the risk of undertaking entrepreneurial activities is reduced, which may also stimulate the supply of entrepreneurship (Foss & Klein, 2012). Bjørnskov and Foss (2012) test these arguments, focusing on formal institutional variables.

However, it seems clear that informal institutions – notably, societal ethical codes – can similarly influence the aggregate elasticity of substitution and, therefore, total factor productivity. Morals that support more formal institutions of property and ownership evidently play such a role. However, morals that support pro-social behaviours in general may also play an important role. An economy characterised by a great deal of helping behaviours, civilised manners, and the like is also likely to be an economy with little friction, controversy, and destructive disagreement – one that promotes flexibility and adaptability, leading to higher total factor productivity.

## Conclusions

Shelby Hunt has produced a characteristically stimulating paper that seeks to extend his RA theory. It is one among a number of papers over the last few years that have tried to link the informal institutions of society to the growth process. The purpose of this comment has been to note that some of the key mechanisms in Hunt's new theory are deserving of elaboration. There are plenty of relevant insights from which to draw on in accomplishing this task.

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