

# **REVIEW**



**Review:****The Real Issue in Business Ethics? Institutional Ethics and the Free Market***by***Bruce Kaye †****1. Introduction**

Over the past five years there has been considerable interest in business ethics. We have also seen the publication in this period of codes of ethics for professional bodies, the stock market, Australian business generally, and the establishment of an ethics advisory hot-line for accountants. Established business leaders have increasingly called for better business practices and ethics.<sup>1</sup>

In one sense it is hard to complain about the promotion of business ethics as a topic of interest. The law cannot cover every possibility and the whole process of business relies on trust in our dealings with each other. In this sense then, we should welcome this interest in business ethics. But there is a nagging doubt that the ethics that is often talked about does not always relate to the substantive framework within which business is conducted, namely the institutional character of the market place. Personal ethical values are not always related, in the literature or in the public rhetoric, to the actual realities of the market place and the institutions that operate in it. There is no framework of reference by which to bring ethical considerations into relationship with the market and the social framework in which business takes place. Without a consideration of this institutional framework business ethics hardly gets beyond quieting the conscience of sensitive individuals, or misleading do-gooders into feeling that they are doing some good in the real world.

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1. In 1987 the then President of the Institute of Company Directors wrote in the October/November issue of the *Director* under the heading, "Ethics, ignore them at your peril". The general progress in the discussion of business ethics can be seen in the pages of the *Journal of Business Ethics*. In relation to codes of ethics, see Kaye (1992).

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We need to get a handle on the institutional character of our society in order to move beyond merely personal morality to a more profound appreciation of business or corporate ethics. A useful way into this question can be obtained by looking at the social theory of Adam Smith, the founding father of democratic capitalism and free market economics.

## 2. Sentiment and Institution in Adam Smith

According to Adam Smith, in his great economic treatise of 1776, *The Wealth of Nations*, the relationship between the individual's good, or at least his desires, and those of the community at large, are secured by the operation of an "Invisible Hand". In a famous passage in *The Wealth of Nations* he first makes the point that the annual revenue of a society is equal to the exchangeable value of the produce of its industry, and hence,

As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value, every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is, in this, as in many other cases, led by an *invisible hand* to promote an end which was no part of his intention (Smith 1937, p.423).

Individuals unintentionally promote the interests of society by maximising the annual revenue of that society. The individual does this, however, by seeking to maximise his own position. In other words the motive of self-interest has the effect, by the operation of this invisible hand, of working towards the common good, because of the economic framework within which that individual intent is pursued.

So one might say, in Milton Friedman's famous words "the business of business is to increase its profits". The making of profits is the social contribution of business. One might have hoped to be able to add, that by so doing it serves the common good. But Friedman has such a diminished sense of the common good, that such an addition would be misleading. He claims that the market operates on the principle of unanimity (no-one is coerced) whereas the political mechanism is based on conformity (everyone is coerced to some degree by the government).<sup>2</sup>

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2. The text of the famous article by M. Friedman, The social responsibility of business is to increase its profits, which is reprinted in J.R. DesJardins and J.J. McCall (1990).

His conception of business in the social and political arena is dramatically narrower and more demarcated than Adam Smith would have recognised.

But Adam Smith had a wider view of society than is represented by a narrow economic interpretation of this passage in *The Wealth of Nations*. Even in *The Wealth of Nations* Smith shows that he is alert to the ethical questions that his analysis raises. James Wilson has identified five moral problems raised by capitalism which are anticipated by Smith within *The Wealth of Nations*.<sup>3</sup>

- The affluence produced would impoverish the spirit of the procurers.
- Affluence will create cities which facilitate conspiracy to fix prices and thus disadvantage the distantly located.
- Public esteem for the wealthy undermines their commitment to virtue.
- Government can cause vice.
- The separation of ownership from management in large corporations creates problems, especially of responsibility.

Wilson contends rightly that Smith addresses these questions within the compass of *The Wealth of Nations*. But it is in *The Theory of Moral Sentiments*, written in 1759, that we find Adam Smith's more complete social philosophy. It is this more complete social philosophy which provides the context within which his free market approach and his understanding of economics is to be set. Despite some continental attempts to interpret these two works as in conflict with one another, Adam Smith himself clearly implies that *The Wealth of Nations* is an attempt to take further the point which he had established in *The Theory of Moral Sentiments*.

### 3. The Social and The Institutional

What then is Adam Smith's view of society and of the Moral Sentiments? He understands human beings as essentially societal in character. This is because we seek the approbation of others and we act according to a shared sympathy. A fellow-feeling is communicated from one person to another by an act of imagination. To the extent that we enter into that experience of sympathy we also further experience the "Sentiment of Approbation". It is approbation, or approval, in the context of this shared fellow-feeling with others that is the foundation of his idea of virtue. This is because the sympathy he is referring to is conditioned by the approval of a person's actions by other members of the community. The approval of others is given because the actions are consistent

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3. See Wilson (1989). One might add to this list that of the corrupting effects of the division of labour.

with propriety.

In other words, Adam Smith sees people as basically gregarious and community creatures. Virtue is founded on proper relationships between such societal people. That virtue is understood in the context of sympathy and fellow-feeling which is enabled by an act of imagination and mutual approval according to the connection between people and the propriety of their actions.

Thus, he opens *The Theory of Moral Sentiments* by declaring,

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasuring of seeing it (Smith 1982, I, i, 1, p.9).<sup>4</sup>

But Adam Smith clearly understood that for its continuance through time such human community depends upon a social system—a set of organisational arrangements which provide the continuing framework for social life. This framework is like a mechanism, indeed he calls it a system. This social system is what we know as civic society. In providing an operating framework for human life this civic society is in constant interaction with the more personally conceived human community.

The human community is characterised by sympathy, approbation, fellowship and the practice and cultivation of virtues. On the other hand, the social system is founded on the principle of justice. Justice in Smith's analysis has a variety of aspects. As a virtue it stands alongside other virtues such as industry, prudence and circumspection, and its practice is rewarded most properly by "the confidence, the esteem and the love of those we live with".<sup>5</sup> Yet, on the other hand, justice is part of the system necessary to the support of society, and thus may potentially be set over against compassion for an individual, compassion characterising or being an element of the relations of humans in a human community.<sup>6</sup>

The ambiguities of human social experience are well brought out by Smith's analysis. On the one hand, he emphasises the moral quality of personal relations and the subjective characteristics of moral sentiments. Yet on the other hand, he recognises that institutions, organisation, civic arrangements are necessary for continuing social life. These institutional arrangements often sit uncomfortably with particular personal moral sentiments. Justice, in his analysis, is an example of this problem. More than this, there are certain qualities in human interaction which foster the organisational system of society but are not morally attractive. Ambition

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4. One might compare the compassion of man in nature in Rousseau (1973, p.68).

5. *op. cit.* III, 5, 8, p.166.

6. *ibid.* II, ii, 3, 7, pp.88f.

helps the social system endure, as does a concentration on effects or outcomes rather than motives. But both these are corrupting of our moral sentiments as Smith has outlined them.

It is these ambiguities that arise in the relationship; between the moral sentiments of human community and the organisational qualities of the social system which present Smith (like his contemporary Rousseau) with a profound problem in his analysis. For example, the ambitious who concentrate on outcomes rather than motives will prosper economically, economics being an aspect of the civic system. These people will prosper economically even though the very qualities which enable them to do so are, on Smith's account of moral sentiments, morally corrupting.

But even when these people accumulate an excess of wealth they provide labour and provision for others in the very process of accumulation. "They are led by an invisible hand to make nearly the same distribution of the necessities of life which would have been divided into equal portions among all its inhabitants".<sup>7</sup>

So the invisible hand once again becomes an important key, a notion of providence, which enables Adam Smith to sustain the ongoing interaction between community and the social system, between moral sentiments and economics.

Smith understood that economics and the social system were antithetical to human community, and corrupting of moral sentiments, but believed that the two things constituted together a total system of how human societies work and that they would balance and control each other for the continuing good of individuals and of the society.

The moral sentiments of community constrain the social system while the social system facilitates the continuance of the community. Edward Coker is surely right in saying that Smith was too astute a social commentator to abandon the insights of *The Theory of Moral Sentiments*, when he came to *The Wealth of Nations*, and also correct in identifying that Smith was convinced "that society's shortcomings could be overcome because the common man was basically good" (Coker 1990, p.140).

But have the two been sufficiently linked by Smith? Do we not observe that it is only the social system which, over time, has triumphed? Smith was an optimist in regard to moral sentiments and ethics in relation to the social system. He thought that they would naturally persist because of the character of the human person. What we witness in contemporary rationalist economics are the unhappy consequences of this ill founded optimism. One could put this around the other way and say that Smith had an aversion for organisations, of whatever type.<sup>8</sup> In

7. *ibid.* IV, 1, 10, p.184.

8. So, for example, "When Smith does concentrate on organisations—whether guilds, business corporations, universities, political groups, or religious orders—his verdict is uniformly and passionately negative" (McCraw 1992, p.134).

part this may be an aspect of Smith's dislike of mercantilism, and the alliance between merchants and princes. Even though Smith had a place for social institutions such as the family and religion, and the point remains that he was unsympathetic with organisations and complex social institutions of any size. This is apparent in his account of the institutionality of the civic system. His account is, as a consequence, flawed at this crucial point.<sup>9</sup>

What is lacking in his analysis is a better understanding of the human and ethical character of what Smith has called the civic system. The civic system is really the regularised and continuing pattern of relationships in society. It is institutions and collections of institutions which go to make up the social system. His work has within it the seeds of this more extensive and consistent analysis. His portrait of the human person as societal and moral would have been greatly enhanced if he had more systematically addressed the ethical significance of institutions. Institutions are not separate from a consideration of what it is to be human, rather, as H.C. Coombs (1970) declared in his Boyer Lectures, "Institutions maketh the man". Smith's reluctance to move his analysis to a consideration of the moral quality of institutions is probably related to his insistence on motives and sentiment in his account of the moral. Were he more willing to see morality as learned, or internalised from externally shaped behaviour, then he would have been more disposed to encompass institutions in his analysis.

Smith, however, has the very great virtue of recognising the inter-relationship between good and evil in human affairs. Too great a concentration upon one will lead inevitably to one kind of tyranny or another. Clearly, Adam Smith has more to contribute to an understanding of market economics than a narrow "economic rationalist" misinterpretation of one part of his work. His analysis of moral sentiments cannot be ignored because of the critical rôle it plays in establishing the framework for his discussion of economics. One cannot properly understand *The Wealth of Nations* without the prior understanding of *The Theory of Moral Sentiments*. None the less, a better basis for understanding the moral value of the social system, of institutions and communities has to be found.

Individuals whose behaviour is ill judged and unethical are, in part, creatures of this unhappy and lopsided understanding of our social life. We lack a proper sense of the basis of social moral judgements, of the traditions which continue to affect and shape our moral outlook. As a consequence our view of what it really means to be a human person in our kind of plural society is diminished and inadequate.

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9. For a recent sympathetic account, see Muller (1993), and for an account of the impact of Smith on the development of political economy at the end of the eighteenth century, see Waterman (1991).

#### 4. Vocational Institutions: The Case of Religion

One of the great intellectual and moral traditions in Western culture has been Christianity. Because it has existed over many centuries, it has necessarily institutionalised its vital spirit, both religious and ethical. As a consequence it has been compelled to address the question of the ethical character of institutions and their relationship to religious and ethical sentiments. Christianity has also been concerned from the earliest times with the issue of good and evil in human society. What has this tradition to contribute to our question? This is not a question of the current practice or dispositions of the churches, but rather of their longer traditions of thought and practice.

In modern times, the Christian churches have tended to retreat from the social and institutional dimensions of this question and have focused their ethics down to the arena of personal morality. This is the more surprising because Christianity has as part of its ideology an institutional understanding, what it calls ecclesiology or its theology of the church. Ecclesiology has been a subject of theological dispute for several centuries. The dispute has not been as obvious as other doctrinal questions such as the Trinity or Christology but, none the less, the church has been subject to theological analysis in both its ideal and actual institutional form. Christianity is essentially about God's relationship with his creatures, and the appropriate life of those creatures in their natural and social relationships. In terms of the church this has meant that the spiritual community, the fellowship, has been expressed and sustained in the institutional life of the church. The issue can be clearly seen in Roman Catholic discussion of "collegiate" and "hierarchical" ideas of the church. Ecclesiology, therefore, has had to deal with the relationship between fellowship and structure, between community and institution.<sup>10</sup>

Perhaps the bureaucratising tendencies that we see in churches imply that this theology of institutionality is losing some of its force, or is being eclipsed. As the church is bureaucratised, so the spirit of Christian faith seems to be detached from organised religion. In fact the very process of bureaucratisation leads to an isolation of the individual in their personal beliefs. These beliefs then tend to become their private beliefs. When that happens they are little different from any private dispositions, for the purposes of social theory, or for interpreting social institutions.<sup>11</sup> That whole process can be seen in the maintenance of personal

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10. For an account of the early period of Christianity in relation to this question, written from a Lutheran perspective, see von Campenhausen (1969). A more profound and searching analysis of this question is provided from a different period by Richard Hooker (1977–1981), *The Laws of Ecclesiastical Polity*. The issues have been given a famous treatment by Troeltsch (1931).

11. For a discussion of this phenomenon in general terms, see Shils (1981).

religion as if it were in fact private religion, and at the same time the radical non-practice of Christian ethics in institutional relationships. This tendency is surely a very great problem for the churches since it significantly raises the level of incoherence in their community life. It is also a pity for broader social thought since this ecclesiological tradition does have something to contribute to those broader current dilemmas. We can identify that contribution by looking at the broader historical range of the tradition.

It is not as if there is no discussion of this theme in the history of Christianity. The whole of Roman Catholic ecclesiology is pre-occupied with it. In the long history of that tradition, the central institutional arrangement of the papacy as not only a teaching magisterium but also the pinnacle of clerical jurisdiction, seemed to have been secured at the end of the nineteenth century. Vatican II and the ecclesiology of Pope Paul VI during the last thirty years have demonstrated that this institutional profile is not secure against the dynamics of the religious tradition itself.<sup>12</sup> The balance, however, in this tradition still falls firmly on the side of the organisational aspect. That the balance in the tradition is disposed in this direction can be seen in the religious, sacral character ascribed to the clergy from the Pope down and in their extensive control of the instruments of salvation.<sup>13</sup> The great strength of this Roman Catholic tradition is that the institutional character of the religion is overt in the religious community. This means that it can more easily and openly be part of the religious community's discussion of its own purpose and of the maintenance and expansion of the faith. This has the effect of giving validity to institutional questions. The danger is that the organisational aspect comes to have too strong a hold on the life of the community because it can arrogate to itself the powerful rhetoric of the religious impulse. The danger in such a development would be too much coercive compliance.

In the Australian environment the second largest church (the Anglican) displays a quite different profile. Here institutional officers do not have an exclusive monopoly on the means of salvation, though very high priority is given to the sacraments which are in the hands of the clergy. The Anglican profile looks more like institutionalised argument with no arrangement or group holding the joker, or even a long suit of trumps! It works by a combination of a belief in providence (God has led us to where we are) and the application of a principle of utility (arrangements must not work to the ill).<sup>14</sup>

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12. See the interesting exposition of this theme in Hebblethwait (1993).

13. Access to this area of discussion can be obtained through Kung (1968), but see also Hill (1988).

14. This is the classic Anglican position developed by Hooker. An overview of the issues has recently been provided by Avis (1989), though his interpretation of Hooker is distinctly tendentious.

The great strength of the Anglican pattern is that the organisational aspects are not regarded as absolutely significant. Neither of the two important institutions in Anglicanism, ministerial order (Bishops, Priests and Deacons) and the canon of Scripture, have ever quite succeeded in gaining absolute significance. Temptations to the divine right of bishops and sola scriptura (Scripture alone) have always foundered on the social reality of the laity in church life and the place given to reason and social engagement in the church tradition. The great danger in the Anglican model is that the organisational aspect comes to have an effective dominance because it is not so overtly on the discussion agenda in the faith community.

These two particular examples demonstrate that the division between individual and institution towards which Adam Smith drifted leads to heightened social conflict in the designated community. Such a divide has not survived in either the Anglican or the Roman Catholic tradition. Their capacity to fend off that divide has undoubtedly contributed greatly to their survival. Both have come to a theological interpretation of the institutional character of religion. The two interpretations are quite different, even though there are certain similarities or points of contact. Within each tradition the contours of the interpretation are not uncontested by the dynamics of the religious tradition, though the Anglican model invites more internal argument than does the Roman Catholic. Each of these interpretations of Christianity and their experience through history makes it clear that the institutional aspect must be kept in constant relationship with, and subject to the value commitments of the religion. Furthermore, from the point of view of these religious values, this institutional aspect is as much corruptible as any other aspect of the human condition.

Within the framework of this illustration we might identify two clues to the problem of the ethical interpretation of social institutions. In both forms of Christianity there is a clear commitment to particular kinds of internal patterns of relationships. In different ways these have to do with leadership and direction, as well as the kind of authority that operates within the institutions. Second, both forms have directed the institutional arrangements in their tradition to serve the purpose of the religion, even though that is construed somewhat differently in each case. In this context, of course, the purpose of the institution is conceived of in terms of the human qualities and values which are enshrined in the religion.

What then does this illustration from organised religion tell us about institutions and ethics and in particular the ethics of business corporations? Perhaps we can approach an answer to this by way of the question of compliance. The large corporation regularly looks to reducing transactional costs by integrating transactions into its own area of control. It is the presence of a structure of compliance in the corporation which contributes to the reduction of these costs. Compliance by hierarchical control is a key feature of the social institutional character of the business corporation. Compliance is precisely the issue at stake in organised religion. There, however, the religious dimension highlights the

necessity of bringing into the arena of discourse and argument the validity and justification of the institutional hierarchy. By doing this they survive over a very long period of time. Where compliance becomes the sole justification for the hierarchy then the soul has gone. In both the Roman Catholic and Anglican examples the very terms of the religion will not allow that to happen. It is no doubt more difficult in the case of the business corporation. There the issue is clouded by a range of unexamined consequentialist arguments which keep off stage the need to justify the hierarchy in terms of human values and qualities. None the less, these human values necessarily pervade any human social activity, including institutional arrangements such as the hierarchies in business corporations.

The example of institutional religion thus demonstrates what was clear from Adam Smith's difficulties with the relation between the civil society and the civic system. The ethical and value elements cannot properly be divided from the organisational and institutional. In fact the institutional itself has an ethical character which ought to be brought into the arena of debate about the business corporation.

## 5. Ethical Institutions

**S**o what might we say about the ethical significance of institutions? We need to begin an answer with some idea of the nature of institutions. Institutions essentially are about maintaining similar relationships between people and/or things for a given purpose over a period of time.

In so far as institutions are expressions of these kinds of relationships and purposes, they inevitably assume, and often quite directly express, values. The way in which they are organised for a given purpose and the character of the relationships that constitute the institutions demonstrate this. Institutions are also in a position to influence, cultivate and change values, because of the impact they have on those who work in them, or who relate to them.

Just as it is easy to forget that professional privileges are delegations in the service of social values, so also with corporations and organisations it is easy to forget that the values which they imply and facilitate in the market place, and beyond, are subject to the social values which enable them to exist. The confidentiality of the relationship between a solicitor and his client is a privilege, but it is not a privilege that overrides the obligation of the solicitor to the court, of which he is an officer. The court is, in its turn, a social creation. So the existence of social institutions and, in particular, economic organisations such as business corporations, depends upon the host society and their powers are delegations from that society.

The host society of which we speak here is, of course, the nation-state. That nation-state is itself a humanly created institution. It implies a jurisdiction, associated with a particular area of territory, within which social life can take place according to a shared tradition.<sup>15</sup> The business corporation is similarly a human

institution, but one which is developing in ways which bring it into potential conflict with the nation-state. The delegated, or servant status of the corporation is, therefore, patent of further development and possibly of conflict with the nation-state. This issue will emerge more as large corporations become more transnational and global in character. But within any particular nation-state, such as Australia, the delegations of the state, as expressed in the rule of law and the sovereignty of the people through parliament, are still powerful.

Social interaction degenerates when it is construed narrowly in terms of legal obligations. When social interactions are conducted in a narrow legalistic way, we know that we are in trouble. The law is a framework and a guide as to the character of the civic system, but is not the adequate dynamic for the civil community. Anyone who has worked in the legal system knows that the attitudes and moral sentiments which people bring to the legal process make a huge difference to the operation of this system, which directly bears on the character of social relationships.

Similarly, within institutions, the effective dynamic goes beyond the narrow legal definition of requirements. If the members of a corporation, whether it is a business or a union or a profession, act only in terms of a narrow or minimalist interpretation of the legal obligations of the company, or the internal rules of company policy, then that corporation is in trouble. The “ethos” or culture of the institution is a vital motivating and shaping factor in the civil community which the institution exists to create and serve. Thus, if a company construes its place in the civic system and in particular in the free market economy, in narrow legalistic or mechanistic terms, it will not create community within its own life, or in its relationship to the host society, that will enable it to fulfill its basic purposes.

In the case of Australia, there is still a strong tradition of support for the free market. But a free market mentality based on only one part of Adam Smith’s philosophy will not produce ethical behaviour in individuals or institutions. Adam Smith knew that and was more realistic in recognising the necessity for a mixed, dynamic understanding of human society and the social system. A minimalist or mechanistic view of the social institution of the market will not only be self-destructive for business, but will eventually lead to contradictions with the host society.

A better appreciation of the nature and moral significance of institutions would help us. It would provide a better basis for understanding the market, and its operation and the inevitable ethical character of our social life. It would also provide a better basis for understanding “bad” business behaviour, to which the

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15. For the place of tradition in shaping and constituting a society, see Shils (1981), MacIntyre (1988), and in relation to the Australian legal system Keith Mason’s *New College Lectures* (1990). Compare also the writings of Anthony Giddens on the institutional nature of the nation state, for example, Giddens (1990).

current concern with business ethics is an understandable and laudable responsible, but which is only a symptomatic treatment of the question.

Such an appreciation would examine more carefully and evaluate more broadly the ethical values which these institutions presuppose and promote. It would also encompass a more broadly conceived idea of the social purposes of these institutions. A narrowly personal conception of ethics will not be adequate for such an appreciation. For these reasons the real question in business ethics is the moral character of the business corporation and the market as social institutions, and the place they have in our idea of society.

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