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FAKULTA SOCIÁLNÍCH VĚD  
INSTITUT EKONOMICKÝCH STUDIÍ

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# ON THE MORALS OF AN ECONOMIC MAN

VYPRACOVAL:  
KONZULTANT:  
AKADEMICKÝ ROK:

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PROHLÁŠENÍ:

Prohlašuji, že jsem diplomovou práci vypracoval samostatně a použil pouze uvedené prameny a literaturu.

.....  
28. dubna 2001, Tomáš Sedláček

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# 1. INTRODUCTION

*“It is written: ‘Man does not live by bread alone’.”*  
The Bible<sup>1</sup>

To speak of the ethical issues from the perspective of an economic science, is quite difficult. It is hard to measure ethics, impossible to point our finger to it and run sophisticated econometrical models with it. Yet it is there and it influences, in one way or another, our daily decisions.

All of us know that we do not live on bread alone, and that we desire a life primarily based on non-material, value oriented fulfillment in life. It is not the task of economics to discover or study these values, but it must take them into account. Although the study of ethics lies outside of the direct realm of economic science, economic behavior of individuals is directly dependant on it. Ethical problems, that the economists often neglect, come back like ghosts and with an increased magnitude re-appear in the practical application of these theories. Economics, whether we like it or not, must always deal with a man in his true being; no matter how much we substitute *homo sapiens* by *homo oeconomicus*, at the end of the day, economics will have to be what *homo sapiens* asks it to be. It must always be in service as a *means towards a goal*, never as the goal itself.<sup>2</sup>

## THE AIM OF THIS STUDY

*“No man is wholly destitute of moral feeling, for if he were totally unsusceptible of this sensation he would be morally dead.”*  
Immanuel Kant<sup>3</sup>

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<sup>1</sup> Jesus in the gospel according to Luke 4:4 quotes the Old Testament Deuteronomy 8:3

<sup>2</sup> Fortunately or unfortunately, the efficiency of the modern western economic system is so powerful, that it is sometimes admired *per se* and thus easily becomes an end in itself. Such a system would become truly become *inhuman*.

<sup>3</sup> Kant, I.: *The Metaphysical Elements of Ethics*, chapter A. The Moral feeling

This study aims to assess the importance of ethics both in economic theory and in practice. This question can be broken down to questions such as: is ethics an important factor, or can we marginalize it and explain economical behavior by other means? What role does ethics play in practical decision making? How does unethical behavior affect an industry?

In an attempt to provide an answer we wish to proceed in the following manner: The first part of the study is purely theoretical and the second attempts an application (with theoretical conclusions); the finalization of the paper is then summarized in a suggested theory.

The first part begins with a selection of historical highlights on the road to modern economic thinking with the emphasis on ethics (chapter 2 BRIEF HISTORY OF FORGOTTEN THOUGHTS). This section will be followed by an attempt to unite a toolbox, which an economist could use in assessing ethical considerations (chapter 3 TOOLBOX).

The second part of the paper is then devoted to practical application of the theoretical part. We will examine the impact of ethics on an industry level (chapter 4 TRANSFORMATION AND THE IMPACT OF ETHICS - A CASE STUDY FROM THE *Area of COLLECTIVE INVESTMENT*) - a theory of which is then suggested (chapter **Chyba! Nenalezen zdroj odkazů. CHYBA! NENALEZEN ZDROJ ODKAZŮ.**). The basic observations of this study are then summarized in the conclusion (chapter 5 CONCLUSION).

Finally, the author would like to apologize for tapping into areas “outside” of economics, i.e. his main field of study, and venture into other field of study, related to economics - to quote Jaroslav Vanek, “one is led to entertain many questions going beyond the confines of economic analysis... unfortunately or fortunately, one’s curiosity is not limited to one’s professional field.”<sup>4</sup> Let this serve as an excuse to the professional philosophers, who might read the following work and feel that it has not been written in the quality they are used to.

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<sup>4</sup> Vanek, J.: *The Participatory Economy*, page vii



**PART I**  
**THE ROLE OF ETHICS IN THEORY**

## 2. BRIEF HISTORY OF FORGOTTEN THOUGHTS

*Adam, Adam, Adam Smith  
Listen what I charge you with!  
Didn't you say  
In the class one day  
That selfishness was bound to pay?  
Of all the doctrines that was the Pith,  
Wasn't it, wasn't it, wasn't it, Smith?  
Stephen Leacock<sup>5</sup>*

The life of economic science had a very interesting development. It was born from philosophy and religion and almost always could be found somehow related to ethics. Economics had emancipated itself from its parent and become an indigenous field of study with the help of Adam Smith. In the hands of Smith, Hume, Locke, Mill, Malthus and others economics was still staying closely related to ethics.<sup>6</sup> Some two centuries later, we find these two relatives almost not talking to each other. The above quoted witty Limerick by Stephen Leacock is a nice testimony to the argument.

The following pages are not an attempt to solve this paradox, nor are they intended to give a thorough description of the development. Nor is the following text by no means a complete list of ethical thoughts in the history of the world; here we only focus on the main milestones of the development of the western thought, which had the major influence on the leading economic world powers today.<sup>7</sup>

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<sup>5</sup> Leacock, S.: *Hellements of Hickonomics*, in Sen, A.: *On Ethics and Economics*, page 21

<sup>6</sup> In support of the above argument let us quote Amartya Sen's excellent book *On Ethics and Economics*: "...the subject of economics was for a long time seen as something like a branch of ethics. The fact that economics used to be taught as Cambridge until recently simply as a past of 'the Moral Science Tripos' is no more than an instance of the traditional diagnostics of the nature of economics." Sen, A.: *On Ethics and Economics*, page 2

<sup>7</sup> The description of other cultures such as Buddhism, Confucianism and others, please refer to the selection from Max Weber's *The Protestant ethics and the spirit of Capitalism* in Weber, M.: *Autorita, etika a společnost*, page 268

## THE ACIENTS

The main influences on the Christian society, which is largely the cradle of our culture are two: the Hebrews and the Greeks. The Christian values and ethical stands are discussed elsewhere<sup>8</sup> and here we have to, for space reasons limit our enquiry to the two relatively less known aspects of the development of ethics. Furthermore, the teachings of Immanuel Kant are largely based on the leading Christian principle “do to others as you would them do unto you” as will be discussed below in the chapter 0 ETHICS OF IMMANUEL KANT - MORAL IMPERATIVES.

### 2.1.1. HEBREWS

Although the Hebrews had a crucial impact on the formation of the Euro-American culture as we have it today,<sup>9</sup> little attention is paid to them in the writings of the economic historians and the direct impact of their contributions to economic ethos is not widely recognized.<sup>10</sup> The Hebrews, from all of the below mentioned philosophies, had the most “earthly” and least ascetic view of the world<sup>11</sup> (i.e. the view that is a *sine qua non* for the development of the economy as we perceive it today). In many aspects the Hebrew economic ethos precedents the development of modern economy and even in the “dark” medieval times Hebrew thought commonly used the tools that were at the that time shocking - but later on have become almost the cornerstone of modern capitalistic economies.<sup>12</sup>

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<sup>8</sup> Weber, M.: *The protestant ethics and the spirit of capitalism*, Anzenbacher, Arno: *Úvod do etiky*, Peschke, Karl-Heinz: *Hospodářství z křesťanského pohledu*, Sedláček, T.: *Ekonomické smýšlení Tomáše Akvinského*, Sedláček, T.: *Křesťanský pohled na Hospodářskou politiku*, Skoblík, J.: *Přehled křesťanské etiky*, Sokol, Jan: *Člověk a svět očima Bible*, Williams, O. F, Houck J. W.: *The Judeo-Christian Vision and the Modern Corporation*, MacIntyre, A.: *A Short History of Ethic* sand others.

<sup>9</sup> Max Weber writes that “we cannot seriously deny the significant contribution of Hebrews to the development of modern capitalistic economy” Weber, M.: *Autorita, etika a společnost*, page 269

<sup>10</sup> This notion is not recognized in vast majority of the textbooks of the history of economic thought. The standard textbooks begin only with antique period and discard the development that the Hebrews formed as the foundation of the Christian culture that was influenced to a great extent by the Greek philosophies and ethos of life. This is the case of MacIntyre, A.: *A Short History of Ethics*, where the subtitle is “A history of moral philosophy from the Homeric age to the twentieth century”. A similar approach is taken by most of the other history books. The exception is, of course works of the sociologists Weber and Sombart.

<sup>11</sup> Weber even writes that their approach to world was “explicitly naturalistic... systematic ascetics was lacking completely”, Weber, M.: *Autorita, etika a společnost*, page 268

<sup>12</sup> “They [Hebrews] were money lenders ... they traded various goods... and were especially involved in trading the shares on the capital markets, they were the money exchangers and served as intermediates in money transfers, ... they functioned as bankers and were involved in money emissions of all kinds. To a

## Personal Ethics Matters

To our topic the most important aspect of the Hebrew thinking is the correlation between personal ethics (of the people of Israel, especially the kings and other representatives) and the level of economic performance of the nation. Throughout the Books of Prophets the cyclical economical<sup>13</sup> development was strongly related to the religious situation of the nation. If righteousness prevailed and justice was done among the people, the law was kept and the voice of the widow and orphans were heard, the nation prospered economically. If, on the contrary, the Hebrews indulged in mischief and unrighteousness and justice disappeared from the courts, economical consequences followed. In one sentence: the economical performance was a consequence of ethical situation of the nation. This is thus a unique description of the “mysterious “ economic cycle, which many modern theories attempt to explain.

This, of course, stands in a direct contrast to the predominant philosophy of our age. Today we perceive no relationship between personal ethical performance of the people in the nation and the performance of the economy. This development has been especially accelerated by the influential writings of Bernard Mandeville, where he in fact argues the exact opposite: *personal vices serve the purposes of public good*. Let it be said in the outset of the work, that Adam Smith, who is often mistakenly labeled as the originator of the thought, categorically disagrees with this Mandevillian system and explicitly distances himself from it. (This subject will be elaborated into more detail in chapter 0 THREE LEVELS OF ETHICS, 2.1.3 THE CLASSICS and 3.1.12 THE POWER OF MARKET METAMORPHOSIS). While the popular economical teaching does not recognize this relationship between the ethics and economic performance, in this study we will attempt to relate these two especially in the chapters 0 ETHICS AS A PUBLIC GOOD; chapter 4 TRANSFORMATION AND THE IMPACT OF ETHICS - a case study from the Area of COLLECTIVE INVESTMENT and chapter **Chyba! Nenalezen zdroj odkazů. CHYBA! NENALEZEN ZDROJ ODKAZŮ.**

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*modern western capitalism (unlike to the antique and medieval as well as East-Asian times) some forms of these activities are inherent (and crucially inherent) both from the aspect of law as well as economy.”*  
Weber, M.: *The Protestant ethics and the spirit of Capitalism* in Weber, M.: *Autorita, etika a společnost*, page 268

<sup>13</sup> as well as political and other

## Collective guilt

Another important aspect, which is linked to the first one, is the notion of collective guilt. The Hebrews held much less an individualistic view of action than we are used to today. They had surprisingly comprehended the interdependence of the social life and understood that while the division of labor works almost to the very last detail, the division of responsibility and guilt does not. Many of our individualistic actions affect the rest of the society without that being the motive.<sup>14</sup> We shall come back to this topic in the chapter 3.1.12 THE POWER OF MARKET METAMORPHOSIS.

## Love of the law

The attitude of Hebrews to law and rules was also different to the one prevailing today. The Hebrews were supposed to love the law, because it was good.<sup>15</sup> Moreover their attitude towards the law was not that of duty,<sup>16</sup> but that of gratitude. This is wonderfully illustrated by the very beginning (a sort of preamble) to the Ten Commandments: “*I am the LORD thy God, which have brought thee out of the land of Egypt, out of the house of bondage*”<sup>17</sup> Upon this principle the whole law is constituted. The Hebrews were asked to do good, not because of hope of a reward or fear of punishment<sup>18</sup> but because good has been done unto them in the first place. The causality, as we understand it today (i.e. we do good in order to receive external pleasure or avoid pain) was *reversed*. First comes the reward, then our *response*. This motive repeats itself many times in the Old Testament and to a certain degree is carried through to Christianity.

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In today’s language, we would refer to this problem in the terms of “externalities”. From individualistic perspective we have extreme difficulties solving the problem of “identification” of the “guilty *one*” - the problem is in institutional economics referred to as “internalization of externalities”. (Mlčoch, L.: *Institucionální ekonomie*, page 22)

<sup>15</sup> Psalm 119:97 “Oh how I love your law;” Psalm 1:2 “Blessed is the man ... his delight is in the law of the Lord and on his law meditates day and night;” Psalm 119:30 “I have set my heart on your law,” and innumerable other instances. The whole religiosity of the Hebrews is based on the principle to love the law.

<sup>16</sup> Duty is the basis of Kantian ethics, the ethical teaching that is most predominant today. “Kant stands at one of the great dividing points in the history of ethics. For perhaps the majority of later philosophical writers...ethics is defined as a subject in Kantian terms. For many who have not heard of Philosophy, let alone Kant, morality is roughly what Kant said it was.” MacIntyre, A.: *A Short History of Ethics*, page 190

<sup>17</sup> Exodus 20, 2

<sup>18</sup> The notion of after life suffering (hell) was not developed at all in the Old Testament times. Moreover the Hebrews were well aware that the righteous suffer the same (if not more than the unjust - which is the main topic of many Psalms and especially the book of Job.) In the worlds of the Ecclesiastic “The rain falls down on the just and the unjust” - the reward of doing good is not external. Goodness is to be done for its own sake: It is good to do good.

## Freedom of the Nomads

Connected to the word *bondage* in the previous paragraph, we can move on to another distinct characteristic of the Hebrew nation: the categorical preference of *freedom*. Hebrews, originally a nomadic nation, had preferences towards free life of constant movement instead of settled agricultural city life.<sup>19</sup> The very ethos of the Hebrew religiosity was in the ability to obey the command originally given to Abraham “get thee out of thy country and from thy kindred and from thy father’s house, unto a land that I will shew thee.”<sup>20</sup> The ability not to be bound to/by possession is one of the holy attributes treasured and exalted by the Hebrews. This of course has immense economical consequences. The nomadic tribes lived in a much more interdependent atmosphere, which had an impact on their perception of collective guilt, as discussed above, but more importantly - all their possession was what they could carry on their backs as they traveled. They were quite aware of the possessive tendency of our possessions and were afraid of the city life, which they viewed as binding.<sup>21</sup> While the later development of Judaism reverted to city life, this raised finger remained: while there is nothing wrong with possession, there is always the danger that we will once again, like the children of Israel that were just freed from the land of bondage, prefer the “flesh pots in the slavery in Egypt” to freedom that comprises the possibility of hunger.<sup>22</sup> It was the greatness of Moses to explain to the nation once and for all that it is better to be hungry but free than the “flesh pots in slavery”.<sup>23</sup>

## Holy and Profane

From this observation we wish to draw the last implication of the Hebrew thinking: the notion of holiness. There were aspects of daily life where it was forbidden to be profane, to economize.<sup>24</sup> The most obvious examples would be the Sabbath commandment. From an economic point of view this day could have been spent in much more productive manner; the message of the Sabbath, so relevant in the rush of today’s world, was that we are *not primarily here to be effective*. Some *holy* social aspects (like the dignity of men) and other rules were to be obeyed in order to achieve a righteous outcome of the “game”. In fact the emphasis on courts and justice was one of the most important factor of the *religious*

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<sup>19</sup> Sokol, J.: *Člověk a svět očima Bible*, page 30. Jan Sokol Argues that, to a degree, the founders of American society had the same wandering-settlers beginning and a similar preference of the idea of freedom.

<sup>20</sup> Genesis 12,1

<sup>21</sup> and their strict refusal of worship of property was connected with this

<sup>22</sup> see Exodus 16, 3

<sup>23</sup> Sokol, J.: *Člověk a svět očima Bible*, page 33

<sup>24</sup> See the writings of Eliade, M.: *Svaté a profání; Dějiny náboženství; Mýrus o věčném návratu*

*duties* of the Hebrews. The frequent accent appearing in the Hebrew scripts makes the reliance on the justice of courts one of the focal elements of religiosity and the word righteousness (which also embraces notion of social justice) is a *sine qua non* requirement of God.

### 2.1.2. ANTIQUE

*„Life full of pleasure is not possible without a life of understanding of morals and justice... Modesty is to be regarded as an estate ...“  
Epicures<sup>25</sup>*

Surprised to be surprised, the author found the most excellent description of the moral systems of the Greeks in the book of the very founder of economics, Adam Smith's *Theory of Moral Sentiments*. In the last section of the monumental book,<sup>26</sup> the most outstanding description and a critique (compared to all the other available sources) can be found. While there is little to add to what has been written but to recommend it to general attention, it would be appropriate only to briefly gather the main findings, which will be relevant to our later task.

Probably the easiest approach to the antique ethical teachings would be to divide them into two distinct and competitive systems in the same manner as Smith does.

THE STOICS basically saw no relationship between goodness and pleasantness (or utility).<sup>27</sup> Some good things were followed by a reward in the form of pleasure or utility others by punishment or pain. The morality of a man consisted in the following: not to break the rules of good conduct and to accept whatever comes his way<sup>28</sup> - not to *calculate*

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<sup>25</sup> Quote from *Filosofická čítanka*, page 51- 52.

<sup>26</sup> Smith, A.: *Theory of Moral Sentiments*, page 395-430

<sup>27</sup> "Happiness was either altogether, or at least in a great measure, independent of fortune; the Stoics, that it was so altogether; the Academic and Peripatetic philosophers, that it was so in a great measure" Smith, A.: *Theory of Moral Sentiments*, page 415

<sup>28</sup> "What are you? A man. If you consider yourself as something separated and detached, it is agreeable to your nature to live to old age, to be rich, to be in health. But if you consider yourself as a man, and as a part of a whole, upon account of that whole, it will behave you sometimes to be in sickness, sometimes to be exposed to the inconveniency of a sea voyage, sometimes to be in want; and at last, perhaps, to die before your time. *Why then do you complain?* Do not you know that by doing so, as the foot ceases to be a foot, so you cease to be a man? *A wise man never complains of the destiny of Providence*, nor thinks the universe in confusion when he is out of order. He does not look upon himself as a whole, separated and

with the results of his actions but to act well and leave the rest to Providence.<sup>29</sup> If a man has acted immorally “success can give him but little satisfaction.”<sup>30</sup> Goodness was to be carried out because of *propriety* - irrespectively of the calculations of costs and benefits.

We must also note here that Adam Smith, being largely a Stoic himself, expresses his admiration<sup>31</sup> to this philosophy and promotes it. It is important to note here that while the Stoics were supposed to make the best of the situation, there were boundaries that they were not allowed to cross, no matted what was the thread or benefit.<sup>32</sup> In the language of modern economics we could imagine the problem as follows: if we replace the standard budget restraint by a *moral restraint* and keep the term of utility un-deviated from the standard meaning, then we receive the “oplimalization problem” as follows: within the area inside the moral restraint is the responsibility of a man to find the best of the possible

detached from every other part of nature, to be taken care of by itself and for itself ... If it is life, he is contented to live; and if it is death, as nature must have no further occasion for his presence here, he willingly goes where he is appointed. I accept, said a cynical philosopher, whose doctrines were in this respect the same as those of the Stoics, I accept, with equal joy and satisfaction, whatever fortune can befall me. Riches or poverty, pleasure or pain, health or sickness, all is alike.” Italics mine. Smith, A.: *Theory of Moral Sentiments*, page 406

<sup>29</sup> “Human life the Stoics appear to have considered as a game of great skill; in which, however, there was a mixture of chance ... and the whole pleasure of the game arises from playing well, from playing fairly, and playing skillfully. If notwithstanding all his skill, however, the good player should, by the influence of chance, happen to lose, the loss ought to be a matter, rather of merriment, than of serious sorrow. He has made no false stroke ... he has enjoyed completely the whole pleasure of the game.

If, on the contrary, the bad player, notwithstanding all his blunders, should, in the same manner, happen to win, his success can give him but little satisfaction. He is mortified by the remembrance of all the faults which he committed. Even during the play he can enjoy no part of the pleasure which it is capable of affording. From ignorance of the rules of the game, fear and doubt and hesitation are the disagreeable sentiments that precede almost every stroke which he plays; and when he has played it, the mortification of finding it a gross blunder, commonly completes the displeasing circle of his sensations.”

Smith, A.: *Theory of Moral Sentiments*, page 409

<sup>30</sup> Smith, A.: *Theory of Moral Sentiments*, page 409

<sup>31</sup> “The few fragments which have come down to us of what the ancient philosophers had written upon these subjects, form, perhaps, one of the most instructive, as well as one of the most interesting remains of antiquity. The spirit and manhood of their doctrines make a wonderful contrast with the desponding, plaintive, and whining tone of some modern systems.” Smith, A.: *Theory of Moral Sentiments*, page 415

<sup>32</sup> “If I am going to sail, says Epictetus, I chose the best ship and the best pilot, and I wait for the fairest weather that my circumstances and duty will allow. Prudence and propriety, the principles which the Gods have given me for the direction of my conduct, require this of me; but they require no more: and if, notwithstanding, a storm arises, which neither the strength of the vessel nor the skill of the pilot are likely to withstand, I give myself no trouble about the consequence. All that I had to do is done already. The directors of my conduct never command me to be miserable, to be anxious, desponding, or afraid. Whether we are to be drowned, or to come to a harbor, is the business of Jupiter, not mine. I leave it entirely to his determination, nor ever break my rest with considering which way he is likely to decide it, but receive whatever comes with equal indifference and security.” Smith, A.: *Theory of Moral Sentiments*, page 406



solutions given “the cards he holds”. The area outside of the moral restraint is a ground where it is morally forbidden to tread.

THE HEDONISTS were on the opposite side of the argument with the Stoics. In contrast, their virtue consisted in calculation, in prudence.<sup>33</sup> For hedonists, also known as the Epicureans, “bodily pleasure and pain were the sole ultimate objects of natural desire and aversion.”<sup>34</sup> For them the goodness and utility equated.<sup>35</sup> It is important to stress here that Epicures was quite consistent at this point and argued that all pleasure was “ultimately derived from those of the body”.<sup>36</sup> On the other hand, the “bodily pleasures” are defined quite widely and even intellectual pleasures stem from them. The Hedonist was to use his reason to see the “end” of his actions in the “long run”. The Epicurean philosophy, even though it is thus understood in the common language, is not a sensational philosophy as the above used quote shows: “A life full of pleasure is impossible without a life of understanding, moral standards and justice and the life full of understanding, morality and justice without a life full of pleasure.”<sup>37</sup> And although the source of Epicurean ethics is egoism, prudence and calculation, there *are* exceptions to the principle; the principle of egoism is not held valid in cases such as friendship where we are motivated primarily by *sympathy*.<sup>38</sup>

Should we translate this perception into the language of modern economics, then the moral restraint disappears and in fact is equated with the rising utility curves. Only external restraints (such as a budget) come into play as the only limitation of human action. Furthermore, virtue was not pursued for its own sake, but virtue becomes *the means* to achieving pleasure. This is then a completely reversed belief of the Stoics. If virtue was the end of all their actions and satisfaction stemmed from the process of achieving it at all cost the Hedonistic school reversed the problem: It was virtuous to achieve pleasure.

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<sup>33</sup> “Prudence, for example, though, according to this philosophy, the source and principle of all the virtues.”  
Smith, A.: *Theory of Moral Sentiments*, page 434

<sup>34</sup> “That they were always the natural objects of those passions, he [Epicures] thought required no proof.”  
Smith, A.: *Theory of Moral Sentiments*, page 431

<sup>35</sup> “Pleasure might, indeed, appear sometimes to be avoided; not, however, because it was pleasure, but because, by the enjoyment of it, we should either forfeit some greater pleasure, or expose ourselves to some pain that was more to be avoided than this pleasure was to be desired. Pain, in the same manner, might appear sometimes to be eligible; not, however, because it was pain, but because by enduring it we might either avoid a still greater pain, or acquire some pleasure of much more importance.” Smith, A.: *Theory of Moral Sentiments*, page 431

<sup>36</sup> Smith, A.: *Theory of Moral Sentiments*, page 432

<sup>37</sup> Selection from the writings of Epicures, in *Filosofická čítanka*, page 52

<sup>38</sup> Even though the beginning of friendship can again be, according to Epicures, attributed to self-love. Selection from the writings of Epicures, in *Filosofická čítanka*, page 49

This is the philosophy that later, in the hands of John Stuart Mill<sup>39</sup> became the mainstream utilitarian thinking in economics. Let us stress here that Adam Smith concludes his chapter on Epicurean ethics by saying that “this system is, no doubt, altogether inconsistent with that which I have been endeavoring to establish.”<sup>40</sup> The polarism between the Stoics and the Epicureans was underlined again by Immanuel Kant who placed these two theories against each other as the prototypes of moral discussion.<sup>41</sup>

The criticism of Adam Smith of the Hedonistic philosophy was along these lines: “By running up all the different virtues too to this one species of propriety, Epicures indulged a propensity, which is natural to all men, but which philosophers in particular are apt to cultivate with a peculiar fondness, as the great means of displaying their ingenuity, *the propensity to account for all appearances from as few principles as possible.*”<sup>42</sup> Ironically, in this criticism Smith foretold the future development of economics as a science indulged in this very propensity.

## CURRENT SITUATION OF ECONOMIC SCIENCE

### 2.1.3. THE CLASSICS

*“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 pleasure of seeing it. Of this kind is pity or compassion, the emotion which we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner.”*

Adam Smith<sup>43</sup>

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<sup>39</sup> Mill, J. S.: *Utilitarianism*, page 6-8,

<sup>40</sup> Smith, A.: *Theory of Moral Sentiments*, page 436

<sup>41</sup> Kant, I.: *Introduction to the Metaphysic of Morals*.

<sup>42</sup> Smith, A.: *Theory of Moral Sentiments*, page 438

<sup>43</sup> Smith, A.: *Theory of Moral Sentiments*, page 3

The sentence quoted above is the very first sentence of Adam Smith's *Theory of Moral Sentiments*. The rest of the book is carried in similar tone: four hundred pages of a very elaborate discussion on ethics. The sentence does not sound as originating from the same pen that supposedly constituted the basis of economics on the notion of self-love.

The problem of ethics in economy had a very interesting development: how to pacify Smith's book *Theory of Moral Sentiments* with his second book *Wealth of Nations*?<sup>44</sup> A separate school of thought evolved in Germany trying to solve the problem under the term "Das Smithproblem". Great number of the prominent fathers of Economics science were highly interested in the field of ethics (Smith, Hobbes, Locke, Mill, Matus). From the view of an economist today there seems to be some discrepancy - ethics and economics may today well seem perfectly unrelated at all. However, for the originators of our science these two areas seemed to be complementary and it even seems that one would be unable to stand without the other. In this chapter we do not wish to solve the problem of disappearance of ethics from economics, but simply to stress the importance of ethics to the founders of economics. In this paper we shall only focus on the two first founders: Smith and Hume.

It is important to stress that unlike the modern mainstream economics, David Hume as well as Adam Smith assigns a great part of their writing to ethical considerations. To quote Hume's extensive *Enquiry Concerning the Principles of Morals*: „Those who deny the reality of moral distinctions may be ranked among the disingenuous disputants“.<sup>45</sup> He considers it beyond the doubt that human beings are influenced by moral decisions: „Let man's insensibility be ever so great, he must often be touched by with the images of Right and Wrong. And let his prejudice be ever so obstinate, he must observe that others are susceptible of like impressions.“ The people that argue otherwise against this "common sense" are best "left to themselves".<sup>46</sup>

The moral philosophy of Adam Smith is based on the principle of sympathy and he directly distances himself from the utilitarian and hedonistic principles. Of the system of Bernard Mandeville he speaks as "Of Licentious Systems" and deals with it in separate

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<sup>44</sup> Please see Etzioni, A.: *Morální dimenze ekonomiky* page 40; also Rawls, J.: *Lectures on the History of Moral Philosophy*, pages 8n.

<sup>45</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 195

<sup>46</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 195

chapters, giving it no or little credit.<sup>47</sup> Since the teachings of Adam Smith and David Hume appear in other chapters of this paper, let us only stress at this point that none of them used any assumptions concerning rationality or egoism.<sup>48</sup> It must also be stated, together with Herbert Simon, that Smith and the others “maintained the clarity and consistency that was sometimes eluded by his successors”.<sup>49</sup>

#### 2.1.4. STATE OF THE ART

*“Although economic activity is inextricably linked with social and political life, there is a mistaken tendency, encouraged by contemporary economic discourse, to regard the economy as a facet of life with its own laws, separate from the rest of the society.”*  
Francis Fukuyama<sup>50</sup>

Let us start with one of the hopeful expectations of Alfred Marshall: “It is a strong proof of the marvelous growth in recent times of a *spirit of honesty and uprightness* in commercial matters, that the leading officers of great public companies yield as little as they do to the vast temptations of fraud which lie in their way ... there is *every reason to hope the progress of trade and morality will continue...* and thus collective and democratic forms of business management may be able to extend themselves safely in many directions in which they have hitherto failed...”<sup>51</sup> It was an optimistic expectation that *with the rise of the spirit of honesty*, (instead of the pure selfishness) will provide a necessary conditions for growth. The development of the theory has, however, chosen a different angle of view: efficiency.

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<sup>47</sup> Please see Smith, A.: *The Theory of Moral Sentiments*, especially chapter IV *Of Licentious Systems*, pages 449 to 461. For example the introduction of the section: “There is, however, another system which seems to take away altogether the distinction between vice and virtue, and of which the tendency is, upon that account, wholly pernicious: I mean the system of Dr Mandeville. Though the notions of this author are in almost every respect erroneous, there are, however, some appearances in human nature, which, when viewed in a certain manner, seem at first sight to favour them. These, described and exaggerated by the lively and humorous, though coarse and rustic eloquence of Dr Mandeville, have thrown upon his doctrines an air of truth and probability which is very apt to impose upon the unskillful.”

<sup>48</sup> Simon, H.: *Empirically based economics*, page 5

<sup>49</sup> Simon, H.: *Empirically based economics*, page 5

<sup>50</sup> Fukuyama, F.: *The trust*, page 6

<sup>51</sup> In Simon, H.: *Empirically based economics*, page 12, italics mine

Marx's teaching of the economic base of society seems to have been accepted by the economic theory. That would be one feasible explanation of the shift of interests of economists from moral enquiries as basis of human action to the notion that economics is *really* the basis of a society and that all movement and action of the individuals stems from it. Smith's warning has come true: economics is trying to explain everything by a one single factor.

The many critiques of the mainstream economics attack the economic theory mainly from the standpoint of, as Etzioni calls it, *wrong reduction of a man*.<sup>52</sup> This reduction of man into a rational agent that optimizes his utility on the given budget constraint<sup>53</sup> has led into the alleys of mathematization of economics.

There are many streams of economics, all of them alternative, that call for the return of economics to its origins morals. Even Lord Keynes gives his voice to this request: "Keynes was calling for a return to the original perception of economics as a moral science and criticized scientific approach typical for the neoclassic economics, which tries to imitate the exact natural sciences."<sup>54</sup> There is, unfortunately little room in this study to devote to individual elaborations of ethical systems of some of the contemporary economists.<sup>55</sup>

The state of the art of today's base philosophy behind mainstream economic science is not, although it is so believed and proclaimed, even utilitarian (according to today's prevailing theory an individual *cannot* move *against* his indifference curves). The theory is, at its best, Hedonistic. Sometimes, however, not even that, considering the difference that

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<sup>52</sup> Etzioni, A.: *Morální dimenze ekonomie*, page 15.

<sup>53</sup> Please see Etzioni, A.: *Morální dimenze ekonomie*, chapters 1 to 6 for an elaborate description of this problem.

<sup>54</sup> Sojka, M.: *John Maynard Keynes a současná ekonomie*, page 89. Also see Herbert Simon's *Empirically based Microeconomics* pages 15 - 16.

<sup>55</sup> Of special interest to us are the concepts of James Buchanan. In his book *The Economics and the Ethics of constitutional order*, he classifies three different systems of ethics: „Cost of Violating Rules“ - i.e. the extreme liberal approach, which leaves no room for non-opportunistic behavior. Buchanan distances himself from it. The second model is „Overriding Transcendental Norms“ which he calls Augustinian - the origin of morals in external, transcendental norms. This explains some non-opportunistic behavior. The third model is „Enlightened Self-Interest“ which is based on the ethics of David Hume - the individual is aware of the feedback effect of his actions. The last model is the model of „extended rationality“ of David Gauthier, which uses the concept of Prisoner's dilemma as a basis for cooperationist behavior. See Buchanan, J.: *The Economics and the Ethics of constitutional order* Chapter "Economic Origins of Ethical Constraints", page 179. Among many others let us here mention just the main representatives of some other alternative attempts: A. Sen, F. Fukuyama, S. Zamagni, A. Etzioni, H. Simon and others.

the Hedonists placed on the importance and relevance of morals (to repeat the quote from Epicures „Life full of pleasure is not possible without a life of understanding of morals and justice... Modesty is to be regarded as an estate ...“<sup>56</sup>).

The difference is as follows: the Hedonists admitted that *not everything* could be explained by the principle of self-love and that areas such as friendship are *exceptions*. The establisher of the whole concept of egoism as a main driving engine of society, Epicures, admits: „In friendship the principle of benevolence toward our friend is applied - this concept is different from egoism.“<sup>57</sup> The modern economic thought does not seem to admit even that and strives to include self-love into each action of human life.

The state of the art as we have it today rules out any relevance of ethics thanks to the misinterpretation of Adam Smith. What economics really have developed was the system of thought of Bernard Mandevile, that everything goes, which was exactly contrary to the philosophy of our true founder Adam Smith. As Green argues, Adam Smith was even against the notion of *laissez-faire*.<sup>58</sup> On the contrary, to quote Petr Pithart, “Economic thought was born in a specific historical situation. It relied on the fact, that people are Christians. Specifically Scottish liberalism - Scotland was the most important workshop of capitalism - is an issue of deeply believing Christians. In other words it supposed that people have morals embedded deep inside which gave them boundaries that were unsurpassable”<sup>59</sup>

The study of economics has shifted from a moral science to merely a mathematically-allocative science. *It should have developed the latter but not neglected the former*. Had it continued to devote the same amount of mental energy to the ethical questions, it would be plausible to believe that some of the "dead end" questions that appear in the study of economics, and in the study of political economy in particular, would be solvable if not readily solved. Economics in general has been surprisingly uncommunicative with the ethical science, from which it originated. Economic theory has extensive problems in solving ethical issues of collective nature,<sup>60</sup> like some externalities

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<sup>56</sup> Quote from *Filosofická čítanka*, page 51- 52.

<sup>57</sup> Quote from *Filosofická čítanka*, page 49

<sup>58</sup> Green, D.: *Adam Smith a sociologie ctnosti a svobody*, page 41 - 48

<sup>59</sup> Pithart Petr in HN 5.1. 1998

<sup>60</sup> This all of course calls for an elaborate study of collective ethics, something that was neglected since the dawn of individualism, but what the ancient nations knew under the term "collective consciousness" or "collective guilt" (please see Chapter 2.1.1 HEBREWS). This field of ethical study has been underestimated

(for which the guilt does really not lie on the shoulders of a particular individual but often on the whole society) or even moral dilemmas connected with unemployment (if we can call that an externality).

In the following chapters we shall propose a Ethical Toolbox for accessing the problem of morality in Economics.

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and it results in the fact that we cannot study and operate with the terms like "ethical behavior of a whole" or "ethical behavior of a community".

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### 3. TOOLBOX

This work does not wish to comprehend all the ethical theories and their implications.<sup>61</sup> At this point we only wish to define and discuss some relations that are most relevant to economics and thus our main points of interest: what role and how important role does ethics play in economic decisions? In preparation to answer this question, we must first define a common language and a realm of discussion. We must, so to speak use a common toolbox.

#### 3.1.1. DEFINITIONS

In some of the terms it will not be possible to offer an exact unified definition, since every school of thought uses the terms differently. Let us understand under the term *ethics* adherence to the commonly held principles (implicitly agreed to rules of the game) of human conduct by which I affect myself and my surrounding (i.e. not only people, but also natural environment) - this will be developed into application details in chapter 0 THREE LEVELS OF ETHICS.

The term *trust*, which we will be often referring to, is related to the ethics. It is the reliance on the hope that *others* will adhere to the same commonly held principles. Trust is thus a derivative of ethics. While there are other influences of the tendency to trust, here we consider the *past experience* of the ethical behavior of others as the main source of trust.<sup>62</sup>

The definition of *utility* requires a thorough elaboration which will be provided in the chapter 0 UTILITY MAXIMIZATION THEOREM.

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<sup>61</sup> For interested readers the author must refer to other sources such as Rich, A.: *Etika Hospodářství*, Anzenbacher, A.: *Úvod do etiky*, Rawls, J.: *Lectures on the History of Moral Science*, Seknička, P.: *Úvod do hospodářské etiky* and others.

<sup>62</sup> For a detailed elaboration of trust and its development in Czech Republic, please see Sedláčková, M.: *Fenomén důvěry*



3.1.2. *HOLISM VERSUS DUALISM*

*“You cannot do with me just what you please. I am a human being and as such I am ungraspable.”*  
Milan Kundera<sup>63</sup>

No matter how much the author searched the literature for a sensible holistic description of a human being that would reconcile the ethical and economical decision-making process, he always ended up with a dualistic system (the teachings of Thomas Aquinas being the only exception – here St. Aquinas uses as a common denominator an elaborated conception of rationality - this concept has been elaborated elsewhere.<sup>64</sup>) The nature of men remained partialized and split, at best, in two fighting tendencies or opposing dualistic forces.

In this work, we shall also take a partial look at the human being. This approach is advocated by Martin Buber as well as Adam Smith<sup>65</sup> - they argue that human behavior is a “mixture” of a “degree of” each of these two tendencies.<sup>66</sup> We also note the same tendency in the writings of Amitai Etzioni, where he argues, that “there are two sets of preferences, that are in *conflict*. This leads us to the realization of an ‘economic man with two identities’.<sup>67</sup> Even Immanuel Kant seems to have adopted the dualistic view of man.<sup>68</sup>

It must be noted here that the search for a paradigm which would reconcile and unite these two “opposing forces” and escape from the trap of dualism is still under way. Once the economic science will be able to unite the reasons for human behavior and thus find a common denominator the scientific, partializing approach will gain much more realistic outlook.

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<sup>63</sup> Kundera, M.: *Laughable loves, story False Hitchhike*

<sup>64</sup> The exceptions are, for example, the teachings of Michael Novak. For a detailed discussion, please see Sedláček, T.: *Ekonomické smýšlení Tomáše Akvinského*, chapter “Reason and Faith” and “On Order”.

<sup>65</sup> But though these *two orders of passions* are so apt to mislead us, they are still considered as necessary parts of human nature: **the first** having been given to defend us against injuries, to assert our rank and dignity in the world, to make us aim at what is noble and honourable, and to make us distinguish those who act in the same manner; **the second**, to provide for the support and necessities of the body. Smith, A.: *Theory of Moral Sentiments*, page 392,

<sup>66</sup> Smith, A.: *Theory of Moral Sentiments*, page 446

<sup>67</sup> Etzioni, A.: *Morální dimenze ekonomiky*, page 40, Here he quotes MacIntire. Italics mine.

<sup>68</sup> “The impulses of nature, then, contain hindrances to the fulfilment of duty in the mind of man, and resisting forces, some of them powerful; and he must judge himself able to combat these and to conquer them by means of reason” **REFERENCE**

## I-THOU AND I-IT RELATIONSHIP

*“If I-It would not exist, life would be impossible. But the one who lives only in I-It, is no longer a human being.”*

Martin Buber<sup>69</sup>

In this paper we suggest a philosophical approach to the understanding of human action. This system was developed by Martin Buber, where he distinguishes between I-Thou relationship and so-called I-It relationship.<sup>70</sup>

### 3.1.3. TWO MODES

The basic idea of this division is that human beings move in two modes of the ethos of being, of perceiving and reacting upon the cognitive world. Both of these modes are distinctly separated, but a human being constantly passes from one to the other and back. In other words a human being oscillates between these two. Translated into Kantian terms,<sup>71</sup> the I-Thou relationship is a mode where I view the other as an *end* of my action; it is the realm of relationships, uncountable entities, emotions, a realm of friendship, family, deep moral values, believes, love etc. Comprehension of the rules that govern, let alone calculation, is very often not possible. Entities are observed and felt as a whole; they are not divisible into smaller units, which could help our reason in understanding the whole.

The mode of I-It is a classical mode known to economics: my prior concern of interaction is rational calculation of *means* to my certain goals. In this mode I look on the outer world (things and human beings) as *means* to my certain goals. This mode allows partial views of reality and its division for specific use; seek of exact mathematical relationships, laws, repeated empirical observations and the like.

This differentiation seems to be recognized by Smith. On the very outset of his book on moral sentiments, in the first sentence, he argues that “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

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<sup>69</sup> Buber, M.: *Já a Ty*, page 29

<sup>70</sup> The original concept is found in the book *I and Thou* by Martin Buber.

<sup>71</sup> Martin Buber was a follower of Kant. More details on Kant in chapter 0 ETHICS OF IMMANUEL KANT - MORAL IMPERATIVES

from it except the pleasure of seeing it.”<sup>72</sup> As has been stressed before, even the promoter of the concept of egoism, Epicures, allows for a differentiation: „In friendship the principle of benevolence toward our friend is applied - *this concept is different from egoism.*“<sup>73</sup> James Buchanan, together with other economists also recognizes this tension, present in each individual, of the two distinct tendencies.<sup>74</sup>

Both Arthur Rich and Amitai Etzioni attempt to include this picture of a dualistic decision process based on Martin Buber into the economic thought.<sup>75</sup>

#### 3.1.4. COLD MARKET AND WARM FAMILY

*“To argue that market has limits is to acknowledge that it also has its proper place in human life. There is a wide range of goods that are properly regarded as commodities.”*  
Stephano Zamagni<sup>76</sup>

The very properties of the I-It relation has become the main advantage of the economic system. There are no “neighbors”; the market relations are impersonal<sup>77</sup> - all are strangers - and that makes the system run on much more efficient basis. “The parties are free to change their trading partners at any time... The market is open to all indifferently, as long as they have money to pay.”<sup>78</sup> Buchanan, in *The Limits of Liberty*, describes the key advantage of the system: “I do not know the fruit salesman personally, and I have no particular interest in his well-being. He reciprocates this attitude. I do not know, and have no need to know, whether he is in direct poverty or extremely wealthy ... Yet the two of us are able to transact exchanges efficiently because both parties agree on the property rights

<sup>72</sup> Smith, A.: *Theory of Moral Sentiments*, page 9, italics mine

<sup>73</sup> Quote from *Filosofická čítanka*, page 49, italics mine

<sup>74</sup> Buchanan, J.: *Market, States and Extent of Morals*, page 272

<sup>75</sup> On elaborating this philosophy into economics then work Amitai Etzioni in his book *Morální dimenze ekonomiky* in chapters *Sociálně-filozofické základy: Já a My*. Other economics that uses this principle is A. Rich in *Etika Hospodářství* pages 39-59 in chapters *První základní vztah: Já-já sám (individuální aspekt); Druhý základní vztah: Já-ty/vy (personální aspekt)*. Both of these attempts are, however completely unnoticed by the mainstream economics and do not appear in any history books introductory books into economics.

<sup>76</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 30

<sup>77</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 21

relevant to them.”<sup>79</sup> And Zamagni adds “the beauty of the market is precisely in this: it works well even if people are indifferent toward one another.”<sup>80</sup>

There are however relations, that are not well described by the market logics. Even with complete strangers, we can become “neighbors” and build an I-Thou relationship. Such is not *only* the case of friendship, family or love, but also some economical dimensions. These relationships are based on the principle of *giving*, and sacrificing rather than on the commercial exchange. This stands is a “polar opposite” to the above described notion, as Zamagni notes.

We act in the I-Thou mode when we are animated by Keynes’ “anima spirits”, when we perform, economically “irrational” acts.<sup>81</sup> The whole behavior of businessmen could be perhaps better described by this adventurous “anima spirit” - they are the knights of modern society, the heroes and movers of the world. They often act in situations where they do not have perfect information (and not even an estimate of the probability as their deeds are often unprecedented, first shot actions in Schumpeterian sense) and thus have to rely on their “feeling for the situation”, on their “educated guess”. Some other theories have elaborated glimpses of the I-thought relationship in them (the implicit contract, the invisible handshake etc.)

The whole sphere of ideals and values (be it religious, political, or social) fall also under the I-Thou category. “This is to say that the realization of the same values demands that certain goods be produced, exchanged and enjoyed *outside* the market relations.”<sup>82</sup>

### THREE LEVELS OF ETHICS

The below offered division of ethics is by no means complete. In the reality almost each philosopher, that was concerned with ethical issues, developed his own system (for a

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<sup>78</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 22

<sup>79</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 22

<sup>80</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 31

<sup>81</sup> Sojka, M.: *John Maynard Keynes a současná ekonomie*, pages 112-124

<sup>82</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis* page 25

more complete list, please see recommended literature<sup>83</sup>). Smith, for example, has also three main categories of ethics, but he divides them differently than we chose to do here.<sup>84</sup>

### 3.1.5. SOCIAL ETHICS

The first system of ethics is a socially-economically-rational ethics. Smith calls this motive *prudence* (calculation, forethought). It holds that it is *profitable* in sense of utility for us to do good. This model of virtue can be made operational quite easily and it is perhaps this quality that has made it the basis of economics. This type of ethics is based not on the motive but on the result of an action. It is thus enforceable by external, objective law. Actions have as a goal the maximalization of pleasure. The Epicureans refer to the pleasure or utility of the actor; the utilitarian philosophers refer to pleasure or utility of the whole - i.e. not necessarily the utility of the actor. Now, it is important to note that John Steward Mill, the leading figure of economic utilitarianism, does admit the possibility of sacrifice of personal utility in order to enhance the utility of the whole.<sup>85</sup> It is thus very well possible, in the utilitarian system, to move *against* the upward-sloping direction of our individual indifference curves. (This system in a way thus offers a solution beyond Pareto Optimality: here individual actors are willing to sacrifice their own utility points provided it

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<sup>83</sup> For example Skoblík, J.: *Přehled křesťanské etiky*, page 29, names some 14 different systems of ethics, each one of them belonging to a different philosopher.

<sup>84</sup> Adam Smith distinguishes these three categories or classifications of virtue: *prudence, propriety and benevolence*. “The different accounts which have been given of the nature of virtue, or of the temper of mind which constitutes the excellent and praise-worthy character, may be *reduced to three different classes*...

According to some, virtue consists in the judicious pursuit of our own private interest and happiness, or in the proper government and direction of those selfish affections, which aim solely at this end. In the opinion of these authors, therefore, virtue consists in **prudence**.

According to others, the virtuous temper of mind does not consist in any one species of affections, but in the proper government and direction of all our affections, which may be either virtuous or vicious according to the objects which they pursue, and the degree of vehemence with which they pursue them. According to these authors, therefore, virtue consists in **propriety**.

Another set of authors make virtue consist in those affections only which aim at the happiness of others, not in those which aim at our own. According to them, therefore, disinterested **benevolence** is the only motive which can stamp upon any action the character of virtue.” Smith, A.: *Theory of Moral Sentiments*, page 393

Smith, perhaps surprisingly for a contemporary student of economics, holds and advocates the *third system*.

<sup>85</sup> “The utilitarian morality does recognize in human beings the power of sacrificing their own greatest good for the good of others. It only refuses to admit that the sacrifice itself is good. A sacrifice, which does not increase or tend to increase the sum total of happiness, it considers wasted ... As between our own happiness and that of other, utilitarianism requires him to be as strictly impartial as a disinterested and benevolent spectator. In the golden rule of Jesus of Nazareth, we read the complete spirit of the ethics of

adds more utility points to the well being of the whole.) The Epicurean system does not allow this. From the point of view of Martin Buber, the Epicurean approach is in the realm of I-It, everything that is done is done for my pleasure as the last end. The utilitarian system allows for the I-Thou motive.

Let us state at this point that Adam Smith explicitly distances himself from this socially based system of morals. When he describes the ethics based on *prudence* (please see chapter 2.1.2 ANTIQUE) he writes, “this system is, no doubt, altogether inconsistent with that which I have been endeavoring to establish.”<sup>86</sup>

### 3.1.6. MORAL ETHICS

The second system of ethics is to act according to certain (moral) principles, without any reference to the calculation of the costs of benefits. The action of a virtuous man should move across the utility curves regardless of any attention paid to the positive or negative slope of the derivation of utility. The action is thus directed by some lesser (or different) rationality of the agent that does not (or cannot) calculate the *results* of his actions and behaves according to some general principles. Our behavior is, in this system, decided upon next-rational (not irrational) perceptions. These impressions are in some way emotionally-cognitive intuitions,<sup>87</sup> imperatives, or, to use Smith’s term, *sentiments*.

These standards stem from within and are judged according to the *motives* of the action. They are thus not enforceable by the general law. This sort of ethics is “enforced” on the level of smaller units of society<sup>88</sup> or by conscience.<sup>89</sup>

utility. ‘to do as you would be done by’ and ‘to love your neighbor as yourself’ constitute the ideal perfection of utilitarian morality.” Mill, J. S.: *Utilitarianism*, page 16-17

<sup>86</sup> Smith, A.: *Theory of Moral Sentiments*, page 436

<sup>87</sup> At some point in the argumentation, every moralist appeals to intuition. Even Rene Descartes appeals to the next-rational basis of our action— mere reason is not enough, it needs something, which which it operates. Please see Sedláček, T.: *Ekonomické smýšlení Tomáše Akvinského*.

<sup>88</sup> Kant, I.: *Introduction to the Metaphysics of Morals*, chapter I. *Division of the Metaphysics of Morals as a System of Duties Generally*: “But no external legislation can cause any one to adopt a particular intention, or to propose to himself a certain purpose; for this depends upon an internal condition or act of the mind itself. However, external actions conducive to such a mental condition may be commanded, without its being implied that the individual will of necessity make them an end to himself.” In the similar manner writes Adam Smith, when he quotes the great Stoic Epictetos: “for beyond my undermost garment, beyond my body, no man living has any power over me.” Smith, A.: *Theory of Moral Sentiments*, page 411.

<sup>89</sup> “Every man has a conscience, and finds himself observed by an inward judge which threatens and keeps him in awe (reverence combined with fear); and this power which watches over the laws within him is not something which he himself (arbitrarily) makes, but it is incorporated in his being. It follows him like his

The Stoics would hold that goodness and utility are completely unrelated and that there is no relation between a goodness of an act and the utility from that action: sometimes doing good rewards us (emotionally, financially etc.) sometimes we suffer by it (punishments, extra costs etc.). Here we should refer the reader to the chapter 2.1.2 ANTIQUE for Smith's account of the teachings of the Stoics that he ascribes the motive of *propriety* as their ultimate motive.

Immanuel Kant, the greatest authority on modern ethics, would also be a representative of the ethics based on *duty*. He goes further than the Stoics and is ready to appreciate only behavior that we do for the goodness *itself*, not for any other motive: "whose highest, unconditional end consists in this: that virtue is its own end and, by deserving well of men, is also its own reward."<sup>90</sup> In the economic terms it could be translated into behavior that goes *against* the propensity of utility curves. Any other movement is not a moral act, since we did not act out of moral, but egoistic motives. In Adam Smith's terms the motive of *benevolence* would also fall under this category - a hint of self-love destroys the whole praiseworthiness. Morality is thus only possible as a sacrifice.

### 3.1.7. TRANSCENDENTAL ETHICS

The third level of ethics could be here called the transcendental, anti-rational (not merely extra-rational or irrational) and "unprofitable" ethics. This is the ethics that Kierkegaard seems to value the most. This third kind of ethics reveals itself in a total paradox both to ratios and to our „moral feelings“. This is the ethics that requires a leap of faith and is in no logical way directly profitable to the human being and to the society around him. To give a famous example that Kierkegaard uses, this ethics would describe the sacrificial act of Abraham, which went even against Abraham's moral feelings. On passing it is proper to note that Kierkegaard calls the first kind of ethics, *esthetic living* (one maximizes his utility, i.e. strives to please his esthetical feelings); the second *ethical living* (the individual satisfies his moral sense) and the third *transcendental ethics* (which requires a complete leap of faith - reliance on the goodness of God). This transcendental ethics is

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shadow, when he thinks to escape. He may indeed stupefy himself with pleasures and distractions, but cannot avoid now and then coming to himself or awaking, and then he at once perceives its awful voice. In his utmost depravity, he may, indeed, pay no attention to it, but he cannot avoid hearing it." Kant, I.: *The Metaphysical Elements of Ethics*, Chapter On Conscience

<sup>90</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter X: The Supreme Principle of Jurisprudence was Analytical; that of Ethics is Synthetical

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not much used in social concepts, since it is strictly individual and arbitrary. For completeness sake, however, it was appropriate to mention it here.

## ETHICS OF DAVID HUME

David Hume seems to praise the first ethical dimension, i.e. the social morals that are in some way beneficial either to the owner of them or to the society around him. He seems to discard what we here have called the third level ethics and some of the second level ethics. He has no respect, nor understanding for the “monkish virtues”: “Celibacy, fasting, penance, mortification, self-denial, humility, silence, solitude, and the whole train of monkish virtues; for what reason are they everywhere rejected by men of sense, but because they serve to no manner of purpose; neither advance man’s fortune in the world nor render him a more valuable member of the society; neither qualify him for entertainment of a company, nor increase his power of self-enjoyment? ... We justly therefore transfer them to the opposite column, and place them in the catalogue of vices.”<sup>91</sup> Hume has set as a measure of virtue pleasure and usefulness.<sup>92</sup> In this aspect he is agreeing with utilitarian philosophy. But it is not merely a private gain that one must take into account: “Usefulness is agreeable, and engages our approbation. This is a matter of fact, confirmed by daily observation. But, *useful*? For what? For somebody’s interest surely. Whose interest? Not our own only: for our approbation frequently extends further.”<sup>93</sup> We shall return to this point later, when we examine the notion of self-love.

## ETHICS OF IMMANUEL KANT - MORAL IMPERATIVES

*„No man is an island,  
entire on his own ...“*  
James Done

At this point it will be useful to elaborate on the ethical system developed by the greatest modern authority on ethics, Immanuel Kant. In the words of MacIntyre, “Kant stands at one of the great dividing points in the history of ethics. For perhaps the majority of later philosophical writers...ethics is defined as a subject in Kantian terms. For many

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<sup>91</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections, page 226

<sup>92</sup> Falckenberg, Fr.: *Dějiny novověké filosofie*, str. 296

<sup>93</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 214



who have not heard of Philosophy, let alone Kant, morality is roughly what Kant said it was.”<sup>94</sup> Not only is his teaching widely accepted, it is furthermore operational in terms of economics. A part of the teaching of Kant has already been mentioned in the previous chapters and his insights will be elaborated later on in this paper as well. Here, let us only briefly sketch the main Kantian principles, which could be useful to economics.

According to Kant, the driving principles of human action are: “A. *Our own perfection* and B. *Happiness of others*. We cannot invert these and make on one side our own happiness, and on the other the perfection of others.”<sup>95</sup> From this stem what we shall call here the two Kantian moral imperatives.<sup>96</sup> The *first moral imperative* is as follows: “The supreme principle of ethics (the doctrine of virtue) is: ‘Act on a maxim, the ends of which are such as it might be a universal law for everyone to have.’”<sup>97</sup>

We shall refer to the second moral imperative as to the principle: Perceive the humanity in yourself and in others always as an end of your action, never as a means to ends.<sup>98</sup> Not only are the other human beings to be the ends, never the means of our action, but even the very humanity in the breasts of the actor cannot be used (or sold) for ulterior motives.<sup>99</sup>

## THE RATIONALITY AND EXTRA-RATIONALITY

„As often as reason will be in  
opposition to men, so often will men  
be in opposition to reason“  
Thomas Hobbes<sup>100</sup>

Our discussion of ethical concerns should also contain a brief discussion on the relation of rationality to sentiments, since this aspect relates to the discussion on ethics. One of the most profound treatises on this topic comes from the pen of David Hume. His

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<sup>94</sup> MacIntyre, A.: *A Short History of Ethics*, page 190

<sup>95</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter IV. What are the Ends which are also Duties?

<sup>96</sup> There in fact is only one, the two are merely an expression of the one.

<sup>97</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter IX. What is a Duty of Virtue?

<sup>98</sup> “We should also make others our ends. Hence the happiness of others is an end that is also a duty.” Kant, I.: *The Metaphysical Elements of Ethics*, Chapter VIII. Exposition of the Duties of Virtue as Intermediate Duties:

<sup>99</sup> Gaarder, J.: *Sofiin svět*, page 331

<sup>100</sup> Quoted from Rich, A.: *Etika hospodářství*, page 20

purposely provocative statement “*reason is the slave of passions*” is meant to summarize the findings of his query – reason and passions do not combat each other and they are not in opposition to each other. Reason and passions are not on the same level – human action is driven by passions and reason comes into play only in the secondary terms, when we rationalize.<sup>101</sup> John Locke argues along similar lines: “reason does not really establish or formulate this natural law, it merely searches for it and discovers it ... reason is not really involved as much in creating the law as it is in interpreting it.”<sup>102</sup>

The critique towards the notion of homo oeconomicus is carried from the following standpoint: moral sentiments, not rationality, are a driving force of human action. Stated simply, *rationality is not enough to compel human beings to act*. Hume argues that our reason is “merely an instrument; it is not alone sufficient to produce any moral blame or approbation. *Utility is only a tendency* to a certain end; and were the end totally indifferent to us, we should feel the same indifference toward the means.”<sup>103</sup> Reason alone cannot motivate us to act.<sup>104</sup> “What is honorable, what is fair, what is becoming, what is noble, what is generous take possession of the heart and *animates it* to embrace and maintain it. What is intelligible, what is evident, what is probable, what is true, procures only the cool assent of the understanding; and gratifying a speculative curiosity, puts an end to our researchers. ... truths beget no desire or aversion, they can have no influence on conduct and behavior.”<sup>105</sup> Reason alone cannot motivate us to act.<sup>106</sup> That role is played by the *sentiment*, the role of reason is, so to speak only secondary. Moral distinctions are not observable by pure reason, they are *felt* by “moral sentiment” and reason comes into play only in terms of configuration (finding the best means to end), correction (correcting the impressions), specification, scheduling and weighting.<sup>107</sup> In the motivations “reason and sentiment concur in almost all moral determinations and conclusions.”<sup>108</sup> It is the feelings

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<sup>101</sup> Rawls, J.: *Lectures on the History of Moral Philosophy*, pages 29, 30

<sup>102</sup> Quoted from Hayek, F. A.: *Právo zákonodárství a svoboda*, page 40

<sup>103</sup> Hume, D.: An Enquiry Concerning The Principles of Morals, from David Hume Selections page 239 italics mine.

<sup>104</sup> The Antique school (Plato, Aristotle and Zenon), as Adam Smith reads it, would not agree with this system, since, they in the ideal case of perfect coordination of human virtues, had it that “reason directs and passions obey”. See Smith, A.: *Theory of Moral Sentiments*, page 397

<sup>105</sup> Hume, D.: An Enquiry Concerning The Principles of Morals, from David Hume Selections page 197, italics mine

<sup>106</sup> Immanuel Kant uses the same principle here: “Pure reason, however, cannot command any ends a priori” *The Metaphysical Elements of Ethics*, chapter IX. What is a Duty of Virtue?

<sup>107</sup> Rawls, J.: page. 31 - 32

<sup>108</sup> Hume, D.: An Enquiry Concerning The Principles of Morals, from David Hume Selections page 198

that are *sine qua non* of any action.<sup>109</sup> Concerning utility, Hume writes (as has been noted above): „Utility is only a tendency towards a certain end ... is requisite of a *sentiment* should here display itself, in order to give a preference ... *humanity* makes the distinction in favor of those which are useful and beneficial.“<sup>110</sup> Reason *alone* would prefer the destruction of the whole world to the scratching of a finger.

If we are to simplify the above suggested roles of reason we may liken the subtle role of sentiments and rationality to a vehicle: in such a case the role of sentiments would be that of the steering wheel that sets the direction and the role of reason to serve as breaks.<sup>111</sup> The role of reason is secondary only in terms that it is not the originator of the move; reasonable passengers would never use a car without the breaks. More on this topic below the line.<sup>112</sup>

About the ordering of means and ends, Kant writes: “Ethics, however, proceeds in the opposite way. It cannot start from the ends which the man may propose to himself, and hence give directions as to the maxims he should adopt, that is, as to his duty ... Indeed, if the maxims were to be adopted in accordance with those ends (which are all selfish), we could not properly speak of the notion of duty at all.” Let us briefly note here that this is exactly what homo oeconomicus is founded upon. “Hence in ethics the notion of duty must lead to ends, and must on moral principles give the foundation of maxims”<sup>113</sup>

In conclusion to the topic, let us stress here that the above lines do by no means imply that human beings act irrationally. No good philosopher could ever claim that. On the contrary, human reason is a *sine qua non* of an ethical act. Man must be aware of the impacts of his actions upon himself and upon others and in this aspect he should “use his reason as far as it goes.”<sup>114</sup> The question discussed above was: how far does it go? This particular issue will be elaborated upon in chapter 3.1.9 THE I-THOU LEVEL OF SOCIETY.

<sup>109</sup> The lectures of Karel Thien at FF UK *Soucít, směna a čas; Zrození kapitalismu jako filosofický problém.*

<sup>110</sup> Hume, D.: An Enquiry Concerning The Principles of Morals, from David Hume Selections page 239

<sup>111</sup> The reason verifies the logics of ideas inspired by our extra-rational part. The process of any motion could be described as interplay of the two parts. The reason sets *possible* direction from the offered set “invented” by the extra-rational part. At this let us only note that car without brakes is more dangerous than a car that is not moving at all.

<sup>112</sup> F. Fukuyama, calls the model of homo oeconomicus a “80% solution.“ Fukuyama, F.: *Trust*, page 20. For more on this topic see Etzioni A.: *Morální dimenze ekonomiky*, pages 39-50, Hayek F.A.: *Právo zákonodárství a svoboda* pages 36, 34, 35, Simon, H.: *An Empirically Based Economics*, pages 3-23, Mlčoch, L.: *Institucionální ekonomie*, pages 10-11

<sup>113</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter II. Exposition of the Notion of an End which is also a Duty

<sup>114</sup> This term has been used by G. K. Chesterton in *Svatý Tomáš Akvinský*, page 88

The focal point that this chapter wished to stress was that human beings do not choose their *ends* rationally, but only means to the ends. This distinction should help us in discussing the validity of the concept of an economic man, who behaves according to the maximization theorem.

## UTILITY MAXIMIZATION THEOREM

*If eudaemonism (the principle of happiness) is adopted as the principle instead of eleutheronomy (the principle of freedom of the inner legislation), the consequence is the euthanasia (quiet death) of all morality.*

Immanuel Kant<sup>115</sup>

The term *utility* is the key term in microeconomic theory and the whole paradigm of economics is constituted on the fact that human being maximize it. What exactly is, what human beings quest so hard to maximize, is not as clear-cut as the mathematical argumentations that follow from this assumption. We shall, in the following lines attempt to discuss some possible meanings of this “mysterious word“.

If the term utility only refers to the I-It world and the maximization of material well-being, the maximization theorem is a strong statement that is legitimate and verifiable. Such a statement deserves attention and close examination.

If, on the other hand, the term utility embraces in its meaning also the I-Thou world, with its impossibility of calculation and division, then the model of utility maximization is not verifiable and becomes a tautology.<sup>116</sup> This tautology would, in other words, attempt to imply that human being always act the way they choose to act. Buchanan writes about this principle: „In a tautological sense, all behavior, including that which I label as moral-ethical, can be analyzed in utility-maximizing model.”<sup>117</sup> Fukuyama goes even further: “This type of formal [all-embracing – T.S. comment] definition of utility

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<sup>115</sup> Kant, I.: *The Metaphysical Elements of Ethics*, chapter PREFACE

<sup>116</sup> Such are the attempts of Garry Becker in *Altruism in the family and Selfishness on the Market* and *Altruism, Egoism, and Genetic Fitness: Economics and Sociobiology*.

<sup>117</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory*, chapter Market, States and Extent of Morals, page 275, note 6.

reduces the fundamental premise of economics to an assertion that people maximize whatever it is they choose to maximize, a tautology that robs the model of any interest or explanatory power. By contrast, to assert that people prefer their self interest over other kinds of interests is to make a strong statement about human nature.”<sup>118</sup> Karl Popper would probably with great passion classify a theory based on this definition into the category of „models“ that explain „everything and thus nothing.“ Even Samuelson criticizes this notion of utility as „empty convention... without any meaning in any operational or empirical sense.”<sup>119</sup> Immanuel Kant also holds that eudaemonism (the tendency to „unveil“ pleasure behind every act of a man) is *tautological, a self-contradictory nonentity, pathological principle, circle of cause and effect.*<sup>120</sup>

In our discussion we must thus pay great attention to the way we use the term utility. We shall propose to use the valid, material meaning in the sense of I-It relationship.

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<sup>118</sup> Fukuyama, F.: *Trust*, Free Press Paperbacks, , page 19 *This type of formal definition of utility reduces the fundamental premise of economics to an assertion that people maximize whatever it is they choose to maximize, a tautology that robs the model of any interest or explanatory power. By contrast, to assert that people prefer their self interest over other kinds of interests is to make a strong statement about human nature.*“

<sup>119</sup> In Etzioni, A.: *Morální dimenze ekonomiky*, page 34.

<sup>120</sup> “If the philosophy of morals were nothing more than a theory of happiness (eudaemonism), it would be *absurd* to search after principles a priori as a foundation for it. For however plausible it may sound to say that reason, even prior to experience, can comprehend by what means we may attain to a lasting enjoyment of the real pleasures of life, yet all that is taught on this subject a priori is *either tautological, or is assumed wholly without foundation.* It is only experience that can show what will bring us enjoyment... For, although reason allows us to seek what is for our advantage in every possible way, ... yet the authority of her precepts as commands does not rest on such considerations. They are used by reason only as counsels...” Kant, I.: *Introduction to the Metaphysics of Morals* chapter II. The Idea and Necessity of a Metaphysics of Morals, italics mine.

“We may fairly wonder how, after all previous explanations of the principles of duty, so far as it is derived from pure reason, it was still possible to *reduce it again to a doctrine of happiness*; in such a way, however, that a certain moral happiness not resting on empirical causes was ultimately arrived at, *a self-contradictory nonentity.* In fact, when the thinking man has conquered the temptations to vice, and is conscious of having done his (often hard) duty, he finds himself in a state of peace and satisfaction which may well be called happiness, in which virtue is her own reward. *Now, says the eudaemonist, this delight, this happiness, is the real motive of his acting virtuously.* The notion of duty, says he, does not immediately determine his will; it is only by means of the happiness in prospect that he is moved to his duty. Now, on the other hand, since he can promise himself this reward of virtue only from the consciousness of having done his duty, it is clear that the latter must have preceded: that is, he must feel himself bound to do his duty before he thinks, and without thinking, that happiness will be the consequence of obedience to duty. He is thus involved in a *circle in his assignment of cause and effect.*” Kant, I.: *The Metaphysical Elements of Ethics*, chapter Preface, italics mine.

## ETHICS AS A PUBLIC GOOD

*„This money could not be stolen because it was too heavy for the thieves to carry, but wagons were needed for everyday transactions.“*  
Barry Eichengreen<sup>121</sup>

Ethics displays classical properties of a public good: it is non-exclusive,<sup>122</sup> it is not diminished by individual usage, it is scarce and it has positive externalities beneficial to all participants in an economy. “Shared values (such as trust, loyalty, solidarity) differ from commodity values in that their being good for a group of people cannot be fully analyzed in terms of their being independently good for each member of the group considered in isolation. Part of their being good consists in the fact that they are understood to be held in common ...”<sup>123</sup> Shared values, moreover, display a behavior of *free riders*, that misuse the general trusted level of ethics. As this behavior becomes common, the level of ethics and trust decreases and everyone suffers by the loss of the public good. Ethics and trust are therefore very vulnerable to any misuse - the greater the trust, the smaller will the *locker costs* be. And small lockers make it easy for anyone who wants to take unethical advantage of the level of trust in the society. By the term “locker costs” we mean all the expenses related with “enforcing” ethical behavior from other participants of the economy. It includes all the costs that an individual has to incur for not conducting his business in an ethical society or industry. It could for example mean cost of writing good contracts (that assures the enforcement of ethical behavior from the other party), costs of often-ineffective juridical control mechanisms, but also simple issues such as the bicycle lockers. Assurance of mutual ethical behavior would also eliminate the unfavorable outcomes of some game theories and thereby make some decision-making processes more efficient.

It is the argument of the author of this paper that *trust* among the participants of an economy makes economy run in much smoother conditions. Being able to rely on other

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<sup>121</sup> The description of copper money in *Globalizing Capital* in chapter 2 *The Gold Standard*, page 12.

<sup>122</sup> Except for the extreme cases of jailing or other common cases of exclusion of a participant from a certain social group.

<sup>123</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 25

participant's ethical behavior eliminates a great degree of transaction costs. In an extreme case a certain basic level of ethics is a *sine qua non* of any specialization within an economy – low levels of trust can choke any economic profitability as will be later shown in the case that we are examining (chapter 4 TRANSFORMATION AND THE IMPACT OF ETHICS - A CASE STUDY FROM THE AREA of COLLECTIVE INVESTMENT ). On the other hand, if it could be generally trusted that law is not broken, then the "locker costs" would dramatically decrease. "Each of these transactions is made easier if the parties believe in each other's basic honesty: there is less need to hedge against unexpected contingencies."<sup>124</sup> As Kenneth Arrow puts it, "trust is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people's word... Trust and similar values, loyalty or truth telling, ... they are goods, they are commodities; they have a real, practical economic value; they increase the efficiency of the system, enable you to produce more goods or more whatever values you hold in high esteem. But they are not commodities for which trade on the open market is technically possible of even meaningful."<sup>125</sup> Lubomír Mlčoch applies it to the Czech situation "The Czech society needs to understand the one crucial fact: that morality is not a luxury that we so far just cannot afford, but the very source of the wealth of nations."<sup>126</sup>

Thus Fukuyama writes, in connection with formation of social capital, that societies with a high degree of social trust will have a natural advantage, because the transaction costs will decrease. "The moment that trust breaks down among members of a business network, relations have to be spelled out in every detail, unwritten rules codified, and third parties brought to resolve the differences."<sup>127</sup> This factor of trust-break-down can have, in extreme cases, fatal impact on the industry and there can appear instances, where the extent of the locker cost suffocates the industry. This could mean bankruptcy. This will be elaborated on the case study example in the second part of this work.

While the previous lines looked on the assessment of the theoretical problems of the ethical environment of the economy, the following study seeks to find an empirical approach to accessing the direct relationship of the level of ethics and growth. In this study the growth of economy is accessed on the Corruption Perception Index (CPI) measured by

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<sup>124</sup> Fukuyama, F.: *Trust*, page 151

<sup>125</sup> Arrow, K.: *The Limits of Organization*, page 23 quoted from Fukuyama, F.: *Trust*, page 152

<sup>126</sup> Mlčoch, L.: *Jaký model pro český kapitalismus?* In Potůček, M.: *Česká společnost na konci tisíciletí I.*, page 25

<sup>127</sup> Fukuyama, F.: *Trust*, page 342

the Transparency International. The work has been carried out by The World Bank.<sup>128</sup> “In this study a negative correlation between the CPI and the level of GDP has been shown [meaning the lower the corruption the higher the growth]. For a sample of 97 countries in 1997 the countries with higher perceived corruption tend to have lower real per capita GDP. Or, putting it differently, countries with low per capita income tend to have higher corruption. The correlation coefficient is -0,080 which is statistically significant.”

Second there is a negative association between corruption perception indexes and economic growth as measured in real per capita GDP.”<sup>129</sup> The conclusion directly states that „this paper provides some evidence that there is a positive and significant association between the allocation of talent to unproductive activities and corruption. Given that corruption has a negative impact on growth, this misallocation has negative direct and indirect effects in growth of about 0,4 percentage point.”<sup>130</sup> The authors of the study have used econometric models to argue the “causality is from corruption to growth.”<sup>131</sup>

## SELF-LOVE AND SOCIETY

*Utilitarianism, therefore, could only  
attain its end by the general  
cultivation of nobles of character.  
John Stewart Mill<sup>132</sup>*

In this chapter we wish to elaborate on the extent of the embrace of self-love. How benevolent is my utility function? Here we shall use the utilitarian approach to utility.

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<sup>128</sup> Tanzi, V. and Davoodi, H. R.: *Corruption, Growth, and Public Finances*, IMF Working Paper, November 2000

<sup>129</sup> Tanzi, V. and Davoodi, H. R.: *Corruption, Growth, and Public Finances*, IMF Working Paper, November 2000, page 4. The authors stress that “Similar results are obtained using other corruption indexes. Recent studies of causes of corruption interpret this correlation as causation running from per capita GDP to corruption see Treisman (2000).“

<sup>130</sup> Tanzi, V. and Davoodi, H. R.: *Corruption, Growth, and Public Finances*, IMF Working Paper, November 2000, page 22

<sup>131</sup> Tanzi, V. and Davoodi, H. R.: *Corruption, Growth, and Public Finances*, IMF Working Paper, November 2000, page 6

<sup>132</sup> Mill, S.: *Utilitarianism*, page 11



## 3.1.8. INDIVIDUALISTIC LEVEL

*“Our self-love cannot be separated from the need to be loved by others.”*  
Immanuel Kant<sup>133</sup>

*”In the general tenor of life, in every human breast, self-interest is predominant over all other interests put together... Self-preference has place everywhere”*  
Jeremy Bentham<sup>134</sup>

The model of maximization of *strictly individualistic* utility (others concern me only as far as they can contribute to my happiness) presents as its only problem the optimal trade-off between personal freedom and the assurance of the law that the others will respect the same legal or ethical constraints. Buchanan notes that such model “does not allow any place to any other but opportunistic behavior” and gives the model the name Model of Cost of Violating Rules.<sup>135</sup> The individual has no motive to abide by the constraints placed on his behavior by the society except the fear of the punishment. The subordination of an individual to rules happens only on the basis of cost-risk-benefit analysis.

This view is a perfect example of the I-It view of the world where everything that is, exist in my cognitive sphere only if is beneficial to increase or decrease of my personal interests. Perfectly anti-Kantian view is adopted: I view everything (including other people) not as an end, but as the *means* to an end; and this end is not the happiness of others or my perfection but my own happiness.

Victor Vanberg writes in this context that ethics is based on the “idea that that there exist rules of moral conduct, and that people are not permitted simply to pursue their own

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<sup>133</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter VIII. Exposition of the Duties of Virtue as Intermediate Duties

<sup>134</sup> In Economics writings, III page 421, quote from Screpanti E, and Zamagni S.: An outline of the History of Economic Thought. Page 67

<sup>135</sup> i.e. the extreme liberal approach, which leaves no room for non-opportunistic behavior. Buchanan distances himself from it. See Buchanan, J.: *The Economics and the Ethics of constitutional order* Chapter *Economical Origins of Ethical Constraints*, page 179, see also comment made in this paper in the chapter 2.1.4 STATE OF THE ART.

interests, but are obliged to conform to these rules.”<sup>136</sup> Buchanan holds the view that “no man is a island.”<sup>137</sup> He calls the state in which human beings only follow their own interests without any reference to moral obligations, the state of “moral anarchy“ and in parenthesis inserts a thought that such a state could not even be called a society.<sup>138</sup> Buchanan comments that in this state the individuals trespass against the second Kantian moral imperative.<sup>139</sup> Life in such a state would be, in the language of Thomas Hobbes „poor, nasty, brutish and short.“<sup>140</sup> Buchanan agrees with Thomas Hobbes that such egoistic individuals would have to be controlled by a strong hand of the governor and the role of the state would have to be quite significant. “Men who do not feel a sense of community with others, nor respect others as individuals in their own right must be ruled.”<sup>141</sup>

As noted above, David Hume is also opposed to the notion of homo oeconomicus, whose sole source of all actions is self-love. He writes, in his sarcastic manner, that “self-love is a principle in human nature of such extensive energy, and the interest of individual is, in general, so closely tied with that of the community, that those philosophers were excusable, who fancied that all our concerns for the public might be resolved into a concern for our own happiness and preservation.”<sup>142</sup>

In this context, Hume writes that „Rude, untaught savage regulates chiefly his love and hatred by the ideas of *private* utility and injury ... but we, accustomed to society, and to more enlarged reflections, consider ... serving our own country and community... we correct, in some measure, our ruder and narrower passions.“<sup>143</sup>

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<sup>136</sup> Vanberg, V.: *Constitutional Economics and Ethics – On the relation Between Self-Interest and Morality*, page 1.

<sup>137</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Market, States and Extent of Morals, page 268.

<sup>138</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Moral Community, Moral Order or Moral Anarchy, page 291

<sup>139</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Moral Community, Moral Order or Moral Anarchy, page 291

<sup>140</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Moral Community, Moral Order or Moral Anarchy, page 292

<sup>141</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Moral Community, Moral Order or Moral Anarchy, page 292

<sup>142</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 214

<sup>143</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 230.

## 3.1.9. THE I-THOU LEVEL OF SOCIETY

*We should also make others our ends.  
Hence the happiness of others is an  
end that is also a duty.*  
Immanuel Kant<sup>144</sup>

In certain social aspects, in the world of I-Thou, we do not use the maximization philosophy. A family, close unit of friends, or a voluntary organization could provide us with an example. In these social units, the members strive to promote the goodness of the whole, not of themselves.<sup>145</sup> Inside of such a unit different rules than economic prevail.<sup>146</sup> Buchanan speaks of a “*moral community*,” which “exists among a set of persons to the extent that individual members of the group identify with a collective unit, a community, rather than conceive themselves to be independent, isolated individuals. In one sense, of course, moral community always exists. No person is totally autonomous.”<sup>147</sup>

Hume holds the same argumentation: „Human heart ... will never be wholly indifferent to public good“<sup>148</sup> and elsewhere: “No character can be so remote as to be ... totally indifferent to me. What is beneficial to the society or to the person himself must still be preferred.”<sup>149</sup> On yet another occasion, Hume writes: “It appears that a tendency to public good and to the promotion of peace, harmony and order in society, does always ... engage us in on the side of the *social virtues*... These principles of humanity and sympathy enter so deeply into our sentiments, and have so powerful an influence as may enable them

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<sup>144</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter VIII. Exposition of the Duties of Virtue as Intermediate Duties

<sup>145</sup> In a way the firm works on this level as well - not all the parts of the firms are profitable, nor do they act so as to promote their own income - but these units are *part of the larger whole*, whose profitability is maximized. Ronald Coase's transaction costs would be too large if each separable unit would behave according to the maximization theorem. The system or *rules* substitutes the system of renegotiation of terms in each moment of change and becomes more efficient.

<sup>146</sup> I zde by se našli ekonomové, kteří by jistě dovedli i tyto vztahy “pojmenovat” tak, aby odpovídaly modelu homo oeconomicus ve smyslu neoklasickém. Brzy by začaly padat termíny typu “směna důvěry”, “užitek z dětí” atd. Otázkou však zůstává, jestli takto rozšířený model spíše nebourá na matematické eleganci, která je, jak se zdá, jedinou omluvou za jeho existenci.

<sup>147</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Moral Community, Moral Order or Moral Anarchy, page 290

<sup>148</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 229

<sup>149</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 230

to excite the strongest censure and applause.”<sup>150</sup> Here again we are closer to a model of human being that bases his actions on the principle of social honor more than personal gain.

A *socially rational being* could be referred to as an alternative to strictly individualistic homo oeconomicus. A socially rational being incorporates social aspects of his decision-making. He is reasonably (he will never be fully - as Hayek showed) able to foresee the ends of his actions and adjust them in a way as to take into account the social dimension of his deeds. He is thus *able*, and that is of crucial importance, to distinguish his actions in the sense of his first Kantian imperative. He is *rational enough* to see what would be the social results of his action, if everybody behaved in the likely manner. Furthermore he is able to feel empathy (in the sense of Adam Smith) and weight his deeds according to the impact on the humanity of others (in the sense of second Kantian imperative to act with the respect to the humanity of others as an end, never as a mean).

### 3.1.10. ORIGINS OF SOCIAL VIRTUES ACCORDING TO DAVID HUME

As for the origin of social virtues, David Hume opposes the two prevailing theories of his days: The first one is Hobbesian and it claims that morals are „invented and afterwards encouraged, by the art of the politicians, in order to render men tractable, and subdue their natural ferocity and selfishness, which incapacitated them for society.“<sup>151</sup> Against this theory he argues that some new sentiments can be thus created, “but that *all* moral affection or dislike arises from this origin, will never surely be allowed by any judicious enquirer... nothing can be more superficial than this paradox of the skeptics” [italics in the original].<sup>152</sup> Social virtues, Hume argues, must be allowed to have a natural beauty and amiableness, which engages the affections of human beings.

The second theory that Hume wished to dispute is the theory of social contract. In this theory man trades liberty for order and sacrifices his freedom by subjecting himself to rules of the society that he expects all others to respect. The theory is again based on self-love and Hume writes that “this deduction of morals from self-love, or regard to private interest, is an obvious thought ... yet the voice of nature and experience seems plainly to oppose such a selfish theory.”<sup>153</sup> He argues that we praise actions where “the utmost

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<sup>150</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 219, italics mine.

<sup>151</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 211

<sup>152</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 211

<sup>153</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 213

subtlety of imagination would not discover any appearance of self-interest or find any connection with present happiness”.<sup>154</sup> We applaud deeds that are unrelated to us in space or time, for no other reason save their appeal to our moral feelings that find them praiseworthy. Private interest cannot stand as a sole basis or even a theoretical building stone of morals in a society. There are occasions where “private interests are separate from public; in which they are even contrary: And yet we observe that moral sentiments to continue, notwithstanding the disjunction of interests.”<sup>155</sup> This is a crucial thought and it tears down the till-today predominant theory of moral origins, the theory of social contract. Hume says here that the moral propensity of an individual is stronger than that of a society and that society - not the individual - must change in case the conflict arises. The moral sentiments thus existed *before* the state and are by no means completely explainable by the social contract theory. “Compelled by these instances, we must renounce the theory, which accounts for every moral sentiment by the principle of self-love.”<sup>156</sup>

Hume then goes on to produce his own theory of origins of moral norms in the society. Hume views the human being as a *zoon politicon* and thus argues that it is *natural* for a human being to be in a society; in other worlds, the human being does not “choose” the society because it profits him (as the contractual theory would suggest) but because it is in his nature.<sup>157</sup> A human being has a natural tendency towards good<sup>158</sup> and has strong public affection. “Everything which contributes to the happiness of a society, recommends itself directly to our approbation and good-will. Here is a principle that accounts, in great part, for the origin of morality.”<sup>159</sup> Exactly why we have this propensity to humanity and to share fellow feeling with others, he does not study further and simply calls it a “principle in human nature.”<sup>160</sup> Adam Smith carries on from this point and studies this issue in a yet grater detail in his Theory of Moral Sentiments in the introductory chapter Of the Propriety of Action. We shall not elaborate on this point any further at this moment; a quotation of

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<sup>154</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 213.

<sup>155</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 215.

<sup>156</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 215.

<sup>157</sup> See Thomas Aquinas: „... *man is naturally a social animal*...” *Summa Theologica I.*, Q97, A4, corpus; also in *Summa Contra Gentiles III*. Book, Chapter 117. The notion of *zoon politikon* is taken from Aristotle’s first book of Ethics 7, 6: 1097b. See Sedláček, T.: *The Economic Thought of Thomas Aquinas*.

<sup>158</sup> Rawls, J.: *Lectures on the History of Moral Philosophy*, page 43, contributes a whole chapter called The General Appetite to Good to thos topic. Hume calls this one of the call passions that is sometimes mistakenly taken as the action of rason. This notion is in a direct contrast with the picture offered by Hobbes of the *homo homini lupus*, where human beings are painted as having a natural tendency towards evil. See Sedláček, T.: *The Economic Thought of Thomas Aquinas*, page 21.

<sup>159</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 215.

<sup>160</sup> Hume, D.: *An Enquiry Concerning The Principles of Morals*, from David Hume Selections page 216.

the introductory sentence of Adam Smith's second greatest book should be merely enough to sketch the point: "However 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 pleasure of seeing it."<sup>161</sup> This is the notion of *sympathy*, which an extensive part of the book is devoted to.

## LAW AND MORAL ORDER

*"To keep one's promise is not properly a duty of virtue, but a duty of right, and the performance of it can be enforced by external compulsion. But to keep one's promise, even when no compulsion can be applied to enforce it, is, at the same time, a virtuous action, and a proof of virtue."*  
Immanuel Kant<sup>162</sup>

### 3.1.11. MORAL BASE

The law should in its basic message, reflect the ethical preferences of individuals within this given society.<sup>163</sup> The law should always react to the moral feelings and be in the dialogue with the public. If this process will not take place and the discrepancy will appear to be too large and unbearable (the situation of the communistic regime) there will be a tendency to change of the law.<sup>164</sup> Buchanan writes that "attempts must be made to modify the *institutions* (legal, political, social, economic) with the objective of matching these more closely with the empirical realities of man's moral limitations."<sup>165</sup> The legal system should, in the ideal case, be in the harmony with the moral system.<sup>166</sup> If the system is constituted in such a way that "If people are systematically and constantly being penalized for behaving "morally", i.e. in a socially desirable manner, it means that the general system

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<sup>161</sup> Smith, A.: *The Theory of Moral Sentiments*, page 3.

<sup>162</sup> Kant, I.: *The Metaphysical Elements of Ethics*, chapter III. The Division of a Metaphysics of Morals.

<sup>163</sup> Cepl, V.: *Law Enforcement and Business Ethics*, page 26.

<sup>164</sup> Compare with Vanberg, V.: *Constitutional Economics and Ethics – On the relation Between Self-Interest and Morality*, page 4.

<sup>165</sup> Buchanan, J.: *A Contractarian paradigm for Applying Economic Theory* in chapter Market, States and Extent of Morals, page 269.

<sup>166</sup> It is the task of the Constitution economics to discuss the process of creation of such laws that would be beneficial for human conduct within a complex society. Vanberg, V.: *Constitutional Economics and Ethics – On the relation Between Self-Interest and Morality*, page 1.

contains flaws ... people who are particularly open to such [moral] appeals would only expose themselves to exploitation by more cynical agents.<sup>167</sup>

Legal regulations alone are, however, by no means sufficient for effective running of the market.

It is by no means necessary or even desirable, that the law should govern all of human action. On the contrary, in the ideal case, the law should only provide abstract and general rules of justice.<sup>168</sup> In a state where the individuals hold on to common principles that are internalized on their personal level, and view themselves as a part of the whole, the role of the state as a legal regulator is minimized and the individuals become freer. This regulatory “leap of faith” can, however be only done on the assumption that the individuals are self-governing<sup>169</sup> from the point of society (and not merely from their own standpoint) and that their rationality in the knowledge of the market process in a society is sufficient for them to reasonably foresee the results of their actions. Thus we propose that *if* members of a society have internalized ethical standards *and* are socially rational,<sup>170</sup> the state has a lesser regulatory role to play and that the members of such society are freer.<sup>171</sup> Government is substituted by self-government.<sup>172</sup>

At this point we should also add a very deep insight of Immanuel Kant. As already noted in the chapter 0 THREE LEVELS OF ETHICS, Kant distinguishes between two levels on which order is enforced: juridical and ethical.<sup>173</sup> The juridical level is enforceable by

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<sup>167</sup> Vanberg, V.: *Constitutional Economics and Ethics – On the relation Between Self-Interest and Morality*, page 4.

<sup>168</sup> Cepl, V.: *Law Enforcement and Business Ethics*, page 26.

<sup>169</sup> Mlčoch, L.: *Respektování společného dobra v ekonomice*: “Adam Smith was also an ethical philosopher and his Theory of Moral Sentiments had on me personally a whole life influence. Smith’s “homo oeconomicus” does follow his own interests, but has his “internal moral boundaries”, his ethics is internalized.” In HN 10.1. 1995, page 16.

<sup>170</sup> The concept of social rationality is fuller developed in the chapter 3.1.5 SOCIAL ETHICS AND especially THE I-THOU LEVEL OF SOCIETY.

<sup>171</sup> Freer in the sense that they act of their own motive and are less regulated by an outside force. Freedom, in fact lies in the existence of inner boundaries and the absence of outward ones.

<sup>172</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 24

<sup>173</sup> Kant, I.: *The Metaphysical Elements of Ethics*, chapter Introduction to The Metaphysical Elements of Ethics: “Thus the system of general deontology is *divided* into that of jurisprudence (*jurisprudentia*), which is capable of external laws, and of ethics, which is not thus capable, and we may let this division stand.” italics mine.

external pressure (the law);<sup>174</sup> the second is, by definition, not enforceable on any other level than *personal voluntary* restrictions of a free being.<sup>175</sup> Not only is it not desirable to enforce *personal, motivational* ethics by the law, it is *impossible* to do so.<sup>176</sup> Kant uses the law of ethical *subsidiarity* when we writes that the more is ethics enforced on the level of conscience, and less on the level of law, the better. Kant relates it even to the notion of freedom of man: “The less a man can be physically forced, and the more he can be morally forced (by the mere idea of duty), so much the freer he is.”<sup>177</sup> Let us use this thought and develop it further to say, that the lower levels of the subsidiarity provide a better and *freer* environment.<sup>178</sup> The more personal level of functioning *moral force* there is (starting at the level of individual conscience, then extending to family, reference groups, voluntary organizations, public press etc. all the way to the highest earthly instance, the law) the better will the system perform.

If the law does not reflect the moral sentiments in the nation (this immediately speaks of imperfection in the creation of law: it has been created in non democratic environment or has been inherited from the past one, or created too fast for a backward dialogue to take place) a greater number of legal discrepancies will appear and higher legal tension will exist. Such society will exhibit tendencies like disrespect to law or/and cynicism. We also need to distinguish that moral sentiments are more robust than law and

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<sup>174</sup> Kant, I.: *Introduction to the Metaphysic of Morals*, chapter I. Division of the Metaphysics of Morals as a System of Duties Generally: “Juridical duties are such as may be promulgated by external legislation; ethical duties are those for which such legislation is not possible.”

<sup>175</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter I. Exposition of the Conception of Ethics: “Now, as man is a free (moral) being, the notion of duty [ie. the true morals] can contain only self-constraint .... The notion of duty then must be an ethical one.” And else in the same chapter “That ethics contains duties to the observance of which one cannot be (physically) forced by others.”

<sup>176</sup> Kant, I.: *Introduction to the Metaphysic of Morals*, chapter I. Division of the Metaphysics of Morals as a System of Duties Generally: “But no external legislation can cause any one to adopt a particular intention, or to propose to himself a certain purpose; for this depends upon an internal condition or act of the mind itself. However, external actions conducive to such a mental condition may be commanded, without its being implied that the individual will of necessity make them an end to himself.” In the similar manner writes Adam Smith, when he quotes the great Stoic Epictetos: “for beyond my undermost garment, beyond my body, no man living has any power over me.” Smith, A.: *Theory of Moral Sentiments*, page 411.

<sup>177</sup> Kant, I.: *The Metaphysical Elements of Ethics*, Chapter 1. Exposition of the Conception of Ethics.

<sup>178</sup> “The less a man can be physically forced, and the more he can be morally forced (by the mere idea of duty), so much the freer he is ... man proves his freedom in the highest degree by this very thing, that he cannot resist the voice of duty.” Kant, I.: *The Metaphysical Elements of Ethics*, Chapter 1. Exposition of the Conception of Ethics.



in cases of discrepancies the law is more likely to change.<sup>179</sup> This issue will be briefly developed in the following paragraph.

### 3.1.12. THE POWER OF MARKET METAMORPHOSIS

„ Private vices are themselves public benefits ...the lowest of the host of vices serves the public good. “  
Bernard Mandeville<sup>180</sup>

„The eye never has enough of seeing,  
nor the ear its fill of hearing. “  
Bible<sup>181</sup>

While the genius of Bernard Mandeville (although this thought had its significant predecessors<sup>182</sup>) consisted in informing us that the personal vices have implicit positive effects on public good (for quotes please refer to the comments under the line<sup>183</sup>), little has

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<sup>179</sup> It has been the wish of many constructionist to direct human action by directions from the side of the law. Such cases can be seen for example in Georfe Orwell's 1984.

<sup>180</sup> Mandeville, B.: *“Fable of the Bees, or Private Vices, Public Benefits”* (1714) Quoted from Frances Hutchenson's *Remarks upon the Fable of the Bees*, (1750) letter to Hibernicus.

<sup>181</sup> Ecclesiastes 1, 8.

<sup>182</sup> Hayek quotes the ancient poet Aristophanes, which argues that all our efforts, be they vain and plain, contribute to the common good. *Ecclesiastusae* is quoted by Hayek in *New studies in Philosophy. Politics economics and the history of ideas*, page 254. On page 252, Hayek deals with Bernard Mendeville's concept appearing in the writings of Thomas Aquinas: „Had not even Thomas Aquinas had to admit that multitudae ulilitates impedirentur si omni peccata districte prohiberentur - that much that is useful would be prevented if all sins were strictly prohibited?“ The quote was taken from *Summa Theologica* IIA-IIae. Q78, A.2.

The following lines make it clear that Thomas Aquinas was familiar with the problem long before Mandeville: „Nor was it fitting for the common good to be destroyed in order that individual evil be avoided, especially as God is so powerful that he can direct any evil to a good end.“ *Summa Theologica* I. Q92, A1, R.O.3. Also see *Summa Theologica* IIA-IIae Q.78 A4 Corpus: „I answer that, It is by no means lawful to induce a man to sin, yet it is lawful to make use of another's sin for a good end, since even God uses all sin for some good, since He draws some good from every evil ...“ See also *Summa Contra Gentiles*, Book III, Chapter 71 – compare with *Summa Theologica*: “Human laws leave certain things unpunished, on account of the condition of those who are imperfect, and who would be deprived of many advantages, if all sins were strictly forbidden and punishments appointed for them.” *Summa Theologica* IIA-IIae, Q78, A1, R.O.3

Further more, to return to Hayek, he writes that „Mandeville's reduction of all action to open or disguise selfishness may indeed have seemed little more than another version of Hobbes“ Hayek F. A.: *New studies in Philosophy. Politics economics and the history of ideas*, page 257.

<sup>183</sup> “Private vices are themselves public benefits:” or, “private vices naturally tend, as the direct and necessary means, to produce public happiness:” or, private vices by dextrous management of governors may be made to tend to public happiness:” or “private vices natively and necessarily flow from public happiness:” or lastly, “private vices will probably flow from public prosperity through the present corruption of men.” Quoted from Frances Hutchenson's “Remarks upon the Fable of the Bees,“ (1750) letter to Hibernicus.

been said about the other side of the coin: sometimes even the good intentions have negative effects on public good. We are talking of complex institutions that are out of economic control of the individual, that have the power to metamorphose and reverse our intentions; sometimes they convert a bad motive (egoism) into partial engine of our economy; sometimes they revert good intentions to undesirable effects. Is the market such an institution?

Human made institutions are not physical laws that are unchangeable and human beings are responsible for creating such institutions as to assure morally agreeable results.<sup>184</sup> The concept of a wrong institutional structure (the social encyclicals refer to it as the “sinfull structures”) are defined in the following manner: “If I find myself existentially pressured or forced to act in a manner that goes against my moral individual, personal or ecological responsibility, that we cannot avoid, because they are given by the structures of the society”<sup>185</sup> the we are dealing with the sinful structures. In the words of Arthur Rich „in this situation we cannot simply blame the outcome on the „force majeure“ that overlap the sphere of personal responsibility.”<sup>186</sup> At this point we can agree with Karl Marx in his quote: “If a human being is created by the circumstances, we must create the circumstances in humane manner.”<sup>187</sup> The blame is in this place carried by the whole society. Modern ethics has problems finding the tool how to connect individual responsibility and outcomes of the sinful structures (for example the ecological situation: the whole society is responsible for it simply by, say using electricity, yet nobody wishes for the outcome). The Hebrew mentality, sketched in chapter 2.1.1 HEBREWS, coped with the issue by the notion of collective guilt. In our individualistic market structures division of labor works fine - division of guilt does not. Market structure sometimes has the *blame removing effect*. Few of us would pollute a river directly, but all of us do so indirectly. Sometimes the market structures blind us towards something that we would never do out of our own motive.<sup>188</sup> But what is more, one does not have the control over it *through the market structures*.

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<sup>184</sup> While it is not the main thrust of our paper, we should, on passing, briefly comment Marx’s social ethics and the dialectical influence of morals and intuitions. He believed that institutions (in this case for example capitalistic economy) were responsible for man’s moral behavior and were a primary force in the formation. Here we thus present an opposing theorem: first comes the change of moral base and then comes the change of the economic base, which we here view as secondarily dependent on the moral and social base.

<sup>185</sup> Rich, A.: *Etika hospodářství I*, page 53.

<sup>186</sup> Rich, A.: *Etika hospodářství I*, page 53.

<sup>187</sup> Quote from A. Rich *Etika hospodářství I*, page 54. Save, we cannot, of course agree with the assumption that Marx makes, that *human being is created by the circumstances*. We can, however agree with the implication as for the responsibility that human beings hold for creating such inhumane institutions.

“Even more specifically we cannot vote on the pollution of air and water. These decisions are “delegated” to business managers; largely without constraint or direction through our purchases ... I cannot protect myself by “voting” with dollars. In the mechanism of the market, there is no procedure for democratic or consumer control over these delegated decisions.”<sup>189</sup> Accordingly the alleged superiority of the consumer is challenged. For us to cease to partake in such collective activity is often impossible - one would have to exit from the society.<sup>190</sup> “The older assumption that delegation decisions did not matter to consumers is therefore no longer valid. They care; and within the rules of market authority, they can do nothing about it.”<sup>191</sup> The market forces thus have a way of getting out of control of the consumers - the consumer thus ceases to be omnipotent.<sup>192</sup>

While we hold that human beings play a primary role in forming institutions, we must also distinguish the *feedback effect*, in which the institutions form's its actors. Since the market system of I-It relations tends to prefer certain modes of behavior, if we believe in the evolutionary tendency of the market, the market is most likely to “keep alive” that mode of being, which it fancies the most. “Since the invisible hand ... builds upon the competition of the egoists, it is bound to give the palm to the most able egoist who succeeds in defeating competition...”<sup>193</sup>

In this sense the economic system in which human beings live must correspond to all aspects of humanity, not only to the aspect of homo oeconomicus. This must be done sooner before this aspect will be the only one that is left. *Should economic interests be the true core interests of mankind, then metaphysically speaking, our race ceases to be interesting.*

<sup>188</sup> Kohák, E.: *Dopisy přes oceán*, „the consumer meets the estranged product of his work: a human without a meaning in a world without a meaning.“

<sup>189</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 27.

<sup>190</sup> Compare Sedláček, T.: *Ecology as an Ethical Problem of Economic Science*.

<sup>191</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 28.

<sup>192</sup> Consumers can only control, through the market structures, which product they buy. The manager then chooses the lowest cost of the product. Producers do not have to care for the damage caused, as long as they keep to the legal standards. The customers that do care have no market provided access to the information. The information about the damage that might be caused by this specific production is carried, not by the market price signals, but by other channels - often *non-governmental* organizations. Should a customer wish to change the the outcome, he would have to choose another producer. But that is not often possible, since the whole industry might be using the same harmful methods of production. In such a case, only direct political of voluntary action can force the correction of the outcome.

<sup>193</sup> Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 34.

### 3.1.13. THE VISIBLE AND INVISIBLE HANDS AND OUR SENTIMENTS

The wonderful work of the invisible hand of the market is a symbol of effectiveness - there is little doubt among economists that *it* is the strongest allocator of resources within an economy. Even Marx, the most prominent critic of market economy, knew this; his argument against capitalism was never against efficiency - he too well knew that his suggested system would never overcome capitalism on this (today almost holy) ground. "It has accomplished wonders far surpassing the Egyptian pyramids, Roman aqueducts and Gothic cathedrals ... The bourgeoisie during its rule of scarce one hundred years, has created more massive and more colossal productive forces than all previous generations together" writes Marx as his praise of the market capitalism in his Communist Manifesto, before he tares the system down with his critique.<sup>194</sup> Let us only comment here that these words have been written hundred years ago, i.e. from today's perspective in time, where the market economy was only beginning to show its power.

The invisible hand of the market is effective, *but we do not always wish it to be so*. The effective situation of laissez-faire happens to sometimes interfere with our ethical social concerns, as stressed in the chapter above, 3.1.12 THE POWER OF MARKET METAMORPHOSIS. The very *raison d' être* of public sector is that there is something about the running of free market forces that we feel is not *right*. We view some of the outcomes of the free market as market failures. We often do not want to find the most effective usage for our city parks and gardens and we do not always want to allow the invisible hand to distribute the national wealth only according to *economic* abilities of the people. Invisible hand thus seems to be somewhat a *blind hand*: blind towards the collective needs of the society (public goods) and towards ethical-social believes or ideals of the society (social equity). We have areas in the market, gardens within a busy business area, which we purposely *keep out of the range* of the vast powers of the invisible hand. We subsidize culture and education because we fear that the market could not provide optimal level of it. We feel the urge to institutionalize the help for those who, for various reasons, cannot support themselves - pure market economy neglects them.<sup>195</sup> In short, it seems that public sector, with its quite significant spending power, must exist because modern economy is

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<sup>194</sup> In Zamagni, S.: *On the limitations of the implicit morality of the market: a perspective from the modern economic analysis*, page 20.

<sup>195</sup> In the words of Prof. Nutzinger, in the view of neoclassical economics if anyone is starving, he is *starving in Pareto optimal state*.

build in such a way that the interaction of millions of individual free wills needs correction (for ex. redistribution) or at least direction (for ex. provision of infrastructure).

The above-described defects of markets can be partially remedied by political forces, the force of the visible corrective hand of the government. It has never been seriously suggested in the history of economic science, that this role could be omitted.<sup>196</sup> Since the time of moral philosopher Adam Smith, the father of economics, it has been admitted that there *must* be a body within the economy, which has a significant power to "adjust" the outcome of laissez-faire economics.<sup>197</sup> Individuals have freedom to do whatever they please (within the legal framework) with their net income and have limited freedom (or different kind of *political* freedom) over the amount that they must pay in taxes. This power is at the disposal of public finance. Decision making process in this sector is radically different from the decisions made by the market<sup>198</sup> and its main goal is, generally speaking, to "soften" the market outcome.

We allow for this, with the clear knowledge that the full market potential of some areas will not be at their potential maximum. The attempts of some visible correcting hand to alter the "unethical" outcome of the pure market economy have been proven to be, in terms of neoclassical economy, ineffective. We are all aware, and the study of public finance has made this observation clear, that there are unavoidable inefficiencies both in the income part of the public finance (dead weight losses) and in the expense part (for example Niskanen's study).<sup>199</sup> No matter how much criticism it reaps from various economists, we are still ready to use it - even at the cost of such inefficiencies. On these grounds, the visible and invisible hands could have a friendly and an invisible handshake.

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<sup>196</sup> Green, D.: *Adam Smith a sociologie ctnosti a svobody*, page 41: "Adam Smith ... has never been the advocate of laissez-faire, or the notion of the minimal state."

<sup>197</sup> The theories of social anarchy have never gained a significant standpoint within the economic theory.

<sup>198</sup> Niskanen, W.: *Bureaucracy and the Representative Government*.

<sup>199</sup> Also Milton Friedman, 1998 (quoted in Holaman's book *Dějiny ekonomického myšlení*, page 441).

## PART II

# THE ROLE OF ETHICS IN PRACTICE

### *3.1.14. INTRODUCTION*

While the first part attempted to show that the role of ethics in economic theory as significant and not avoidable, the task of the second part will be to show, on an empirical observation, that ethics plays an important role also in the practical daily business-making.

It is quite difficult to draw some generally applicable conclusions based on the empirical findings, since the areas of practical research in this field is not yet in the sufficient stage. However some relevant research on the topic of ethics is slowly becoming quite popular now a days, especially in the transforming economies. While these findings are extremely interesting, they are yet only partial and not quite sufficient for a production of an attempt of a holistic picture of the relevance of ethics on a macro level. Most of the argumentation is thus largely verbal and not supported by numbers. The ambition of the author is not to access the relevance of ethics on a macro-level (some findings are, however, mentioned in the appendix A). The following pages have focused on a single case study elaborating the ethical impacts in a transforming market on an specific industry.

Let us also note here that the following section is by no means meant to be an assessment or an analysis of the transformation. Here we only wish to take a (partial) view on the ethical impacts of some aspects of transformation, specifically on the area of collective investment. It should be stressed that at the time of the transformation there was no single economic theory that dealt with the “creation of the market”. All standard economic theories already take the market institutions as given and do not analyze their emergence as a process. From a theoretical perspective, the situation was absolutely unprecedented and thus extremely difficult. Here we only wish to use the precious past experience to suggest some relevant conclusions.

## 4. TRANSFORMATION AND THE IMPACT OF ETHICS

### - A CASE STUDY FROM THE AREA OF COLLECTIVE INVESTMENT<sup>200</sup>

#### CAUSES

##### *INTRODUCTION - MARKET, REGULATION AND MORALS*

Zdeněk Kudrna argues in his paper<sup>201</sup> that the experience from Western markets suggests that there are three major institutions that can serve as *robust* guarantors of market players' ethical behavior<sup>202</sup> and that have the potential to be successful in the long run.<sup>203</sup>

1. Functioning market mechanisms and the competition from the close substitutes
2. Effective regulation by the government
3. Personal moral values of the managers.<sup>204</sup>

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<sup>200</sup> This paper is a concluding component of a larger study “On the morals of an economic man,” which begins by outlining the history of ethics and economics from the Hebrews to Kant. The second part is a development of a theoretical framework to handle ethical questions in economics. The third part is the case study presented here.

This paper uses findings from a case study titled “UNIS ČR - An Industry Response to Ethical Needs.” The authors of this case study are Tomáš Sedláček, Charles University, Prague, Czech Republic; Ondřej Vychodil, Central European University, Budapest, Hungary; assisted by Radek Špicar and Ilona Katzová, Charles University, and Dariush Afshar, Georgetown University, Washington, D.C., U.S.A; with supervision from professors Stanley Nollen, Georgetown University, and Michal Mejstřík, Charles University. We are indebted to the Connolly Program in Business Ethics and the John T. Garrity bequest at Georgetown University for their support. The author also wishes to thank David Hofman for critical comments.

<sup>201</sup> See Kudrna, Z.: *Seberegulace odvětví a její omezení*

<sup>202</sup> By ethical behavior we mean behavior which follows the Kantian imperative, as follows: “The supreme principle of ethics (the doctrine of virtue) is: ‘Act on a maxim, the ends of which are such as it might be a universal law for everyone to have.’” Kant, I.: *The Metaphysical Elements of Ethics*, Chapter IX. What is a Duty of Virtue?

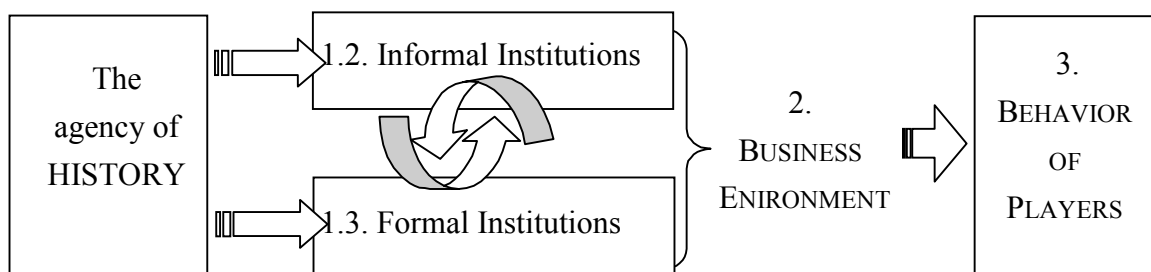
<sup>203</sup> Taken from Kudrna, Z.: *Seberegulace odvětví a její omezení*

<sup>204</sup> See Mejstřík, M.: *Správa velkých akciových společností: Teorie a česká praxe*, page 4. For a role of personal values please see Katzová, I., Špicar, R.: *SEPAŠ Štětí: Strategic Leadership During Transition*.

In the case of transforming economies the first point is *by definition* absent, because all of society is still on the path towards the formation of effective and functioning market mechanisms and, in the case of voucher privatization, the effective competition from foreign firms was lacking<sup>205</sup> The second point is not necessarily absent *by definition* but it was absent in the early stages of Czech capital market existence. Thus, in the case of the Czech Republic, the *only* long-term motivator of morality on the capital markets was the third option. This paper therefore endeavors to analyze this issue and to study the interaction of these three main determinants.

Due to the above-mentioned lack of supervision, the formation of the *de facto* rules of the game was left to market forces alone. What should have been done by the regulatory hand and the invisible hand of the market together was done instead by only the former. The capital market was largely left alone without any regulation.<sup>206</sup>

Incentives provided by formal and informal institutions constitute the two basic factors that influence actors in a given market. They are both in turn affected by the agency of history, which affects each of them in a specific way. The graph below portrays this relationship and refers to the chapters that deal with the subject. Furthermore, the formal and informal institutions affect each other, resulting in a dynamic relationship.



### *INFORMAL INSTITUTIONS*

Western countries have undergone a long evolutionary process of creating their own specific formal and informal institutions. In this slow evolutionary process, where formal and informal institutions developed hand in hand and had time to dialectically influence each other, there was little discrepancy between the two and the path dependence of the informal institutions was not in a major conflict with the evolution of formal institutions.

<sup>205</sup> The bank savings could not be classified as competitors during the privatization since the competing asset was vouchers, not real money. Banks became a substitute *after* the privatization, when the funds competed for money -- not voucher – investors.

<sup>206</sup> For a detailed analysis please see Mejstřík, M.: *Správa velkých akciových společností: Teorie a česká praxe*.



In the case of Czech Republic the informal institutions of market economy were partially damaged by discontinuity on the 40-year desert of communism, during which time an entire generation was systematically instructed to “learn to forget” the workings of market economy.<sup>207</sup>

The influence of *path dependence* has been so strong that it hindered and slowed the transformation process.<sup>208</sup> The concept of path dependence has a strong influence especially during periods of abrupt and dramatic change in formal institutions, which are in disharmony with the informal institutions. The informal institutions exhibit robustness towards formal institutional upheavals and rapid changes thereof.<sup>209</sup>

The principle of “dependence on the past path” sheds light on the fact that ideological, social, religious and historical factors play a crucial role in market formation.<sup>210</sup> The actors in the economy should not to be properly approximated by the never-changing homo oeconomicus; “extra-economical” aspects must come into play in order to properly understand the difference in the economic performance of those economies that historically have not followed the same path as Western economies.<sup>211</sup>

Applying the concept of *learning by doing* to our situation, we discover that, along with its benefits, the concept has also negative aspects: the Czech nation has in the course of 40 years learned how to live and survive under the command economy and forgotten how standard economy functions. The “survival” mentality of substituting for the dysfunctional centrally planned economy mechanism is theoretically well described in the works of Lubomír Mlčoch.<sup>212</sup> In the communist era this *shadow economy* helped the whole system subsist and function, but in a market economy the unethical shady behavior becomes much more fatal to the system.

A nationwide antipathy towards the law was also inherited from the previous system. The law was often in conflict with the moral and other feelings within the society. Under this totalitarian regime it had been, in a way, noble to boycott the law, just as it would be if the country was occupied by a foreign army.

Another aspect which affected the voucher privatization was the fact that neighboring countries display a propensity towards the German-Japanese corporate governance model (i.e. the relatively low popularity of investing savings into shares

<sup>207</sup> Možný, I.: *Proč tak snadno?*, page 24 also likens the communist experience to the wandering of the Children of Israel in the desert. As we know from their journey, 40 years was enough for God to make His nation forget the “chains of Egypt” - the same period of time was to a large degree sufficient for Marxist ideology to make people forget the relatively successful market period of the interwar “first republic.” Also in Sedláčková, M.: *Fenomén důvěry ve společnosti*, page 23.

<sup>208</sup> Within the phrase *path dependence* we understand the social inertia contained in mainly the informal institutions that have been present for an extended time period. These prevailing “habits” learned from the past have a strong influence on the present and future and are unique in time and space (the agency of history). Mlčoch, L.: *Zastřená vize ekonomické transformace*, page 77.

<sup>209</sup> See also Newman, K.: *Organizational Transformation During Institutional Upheaval*.

<sup>210</sup> Mlčoch, L.: *Zastřená vize ekonomické transformace*, page 78.

<sup>211</sup> For a detailed elaboration see Fukuyama, F.: *Trust*.

<sup>212</sup> Kameníček, Jiří – Kouba, Karel: *Trh versus plán*, please see Mlčoch’s article.

compared to bank saving ). Furthermore, the Czechs traditionally relied on the banking system.<sup>213</sup> Last but not least, the general population was uneducated in the processes of the market economy, let alone in the subtle functioning of the sophisticated rules of capital markets. It was thus possible, as we will see later on, to take an advantage of people's neglect and partial ignorance of the (often weak) warning market signals.

### FORMAL INSTITUTIONS

*“Conservative motives are the reverence towards institutions and the attention devoted to their construction, the rule of the law, maximum scope for spontaneous (on the state independent) activities, i.e. the force towards civic society and decentralization. Small, but strong state. Which is exactly what we did not succeed on building and what president Havel remarked upon when he said that our state is large and weak.”*  
Pithart Petr<sup>214</sup>

In the words of Mr. Brabec, the UNIS ČR founder, investment funds in the Czech Republic were strongly influenced by the following formal institutions:

1. Voucher privatization
2. Lack of supervision over capital markets and fund business
3. Certain defects in legislation<sup>215</sup>

In the following section we will consider each of these in turn.

#### **Ad 1: Voucher privatization<sup>216</sup>**

The first institution that had an influence on the behavior of the actors was privatization.<sup>217</sup> Let us only briefly summarize here that the privatization was a typical one-

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<sup>213</sup> While in the U.S.A 50% of savings are in shares and in Western Europe the average is around 30%, in the Czech republic it was 3% by the end of 1996.

<sup>214</sup> In *HN 5.1. 1998*.

<sup>215</sup> Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentaion.

<sup>216</sup> For a history of the privatization and the role of the investment funds, please see the complete version of the study.

<sup>217</sup> For a detailed description of the privatization please see the full version of *The Response of an Industry to its Ethical Needs*.

shot game, never to be repeated again. In two “waves” of voucher privatization, CZK 192 billion (USD \$5,6 billion) of assets in stated-owned companies were privatized using “investment vouchers.” Each Czech citizen was allowed to buy, for a symbolic price (1000 Czech crowns, less than 1/3 of an average monthly salary), 1000 “investment vouchers” for the first “wave” and another 1000 for the second “wave”. Each Czech citizen could either use these 2000 “investment vouchers” directly to buy shares of privatized companies in several rounds of auctions in each wave of voucher privatization, or he could invest all or part of his “investment vouchers” through Investment Funds; more than one hundred of these funds were established at that time for the sole purpose of voucher privatization.<sup>218</sup> Investment Privatization Funds (IPFs) were introduced as an instrument of collective investment that would help Czech citizens allocating their vouchers and popularize them.

Another problem was that people invested vouchers instead of money, and funds had to convert the collected vouchers into shares of privatized companies. In the beginning all funds were therefore 100% equity funds with no cash whatsoever and in order to restructure their portfolios, they had to sell first in order to gain cash to finance purchases of other assets.

The funds became very popular as Czech citizens placed more than 50% of their investment vouchers in the hands of funds. This resulted in an “overnight” concentration of power in the hands of numerous funds.<sup>219</sup>

To complicate the issue, the property of everyone who wanted to take part in the great voucher “giveaway” privatization *had to* end up on the capital market. Furthermore, people were not taking part in the game “with real money” but merely with abstract coupons that they had received at a symbolic price.

### **Ad 3: Supervision**

Financial systems in Western economies can be divided into two types: arm’s-length, such as those of the U.K. or U.S., and control-oriented, as in the case of most of continental-European developed economies and Japan. Each of the financial systems needs a different set of supervision and regulation. In the arm’s-length financial systems, associated with the external corporate governance mechanism, financial markets are large and highly liquid, ownership is dispersed, the investors are mostly portfolio-oriented, they decide by exit rather than voting and the role of managements is very important; hostile takeovers, leveraged buy-outs and proxy fights play a potentially important role.

In the control-oriented financial systems, associated with internal (i.e. organization-based) corporate governance mechanism, financial markets are small and less liquid, ownership is concentrated, investors seek control rather than portfolio diversification, they prefer voting to exit, and the role of managements, hostile takeovers, leveraged buy-outs and proxy fights are thus limited.

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<sup>218</sup> Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

<sup>219</sup> Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

As mentioned above, these two different systems require different regulation and corporate law. The Anglo-Saxon corporate law is aimed at reaching a high level of transparency and liquidity, and as such it includes strong protection of minority shareholders, a highly-refined regulation of the takeover process, strict disclosure requirements and accounting standards, and severe sanctions for insider trading and market manipulation. The law discourages holdings of large stakes by institutional investors. On the other hand, the corporate law in control-oriented financial systems largely neglects securities market regulation and minority shareholders' protection and provides no explicit takeover regulation. Generally, it does not really focus on financial markets, since they are very small and weak in these countries. Thus, there is a lot of space for conflicts of interest of universal banks investing in their debtor firms, while in the Anglo-Saxon financial systems investment banking is divorced from the commercial one.

The Czech case, however, represents a hybrid<sup>220</sup> of the two distinct types. One of the declared objectives of the architects of the privatization was to create a strong market for control, which would, after an initial maturing period, resemble that in the U.S. or U.K. Indeed, voucher privatization has resulted in an abrupt emergence of a large capital market. There were more than 1,500 companies listed overnight on the newly-established market. The overall net asset value of the listed companies represented about a half of the country's GDP, which is by far the highest ratio among all transition countries (followed by the Slovak Republic and China). Thus, in accordance with the designers' objectives, the capital market started to play an enormously significant role in corporate governance, resembling the case of Anglo-Saxon economies.

The other side of the coin, however, was the lack of both transparency and liquidity and a high concentration of ownership in the portfolios of the few most important IPFs -- which ever so often sought control and delegated their own people to the companies' boards (preferred voting to exit) rather than portfolio diversification.<sup>221</sup> These characteristics are normal in Germany or Japan (in these countries relatively few companies are listed and the capital markets' role is being played by large universal banks). This similarity is further strengthened by three other facts that increase the role of banks. First, many of the most important IPFs were founded and managed by Czech banks (more precisely, by investment companies controlled by Czech banks). Second, most of the savings were allocated in banks, rather than on the capital market, due to the "path dependence"<sup>222</sup> of the citizens' behavior. And third, investments were also generated mostly by the banking sector since the companies preferred debt to equity financing due to low transparency and liquidity within the capital market.

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<sup>220</sup> For a detailed discussion of the "Czech hybrid" see e.g. Mlčoch (1996, pp. 67-76), Mejstřík, M.: *Správa velkých akciových společností: Teorie a česká praxe* and Coffee (1996).

<sup>221</sup> The description of two distinct types of financial systems, associated with distinct corporate governance mechanisms, regulation and corporate law, is based on Mayer *Financial Systems, Corporate Finance and Economic Development*, Dharwadkar et al. *Privatization in Emerging Economies: An Agency Theory Perspective*, Mlčoch *Institucionální ekonomie*.

<sup>222</sup> For the concept of "path dependence" see Stark *Path Dependence and Privatization Strategies in East Central Europe*.

The reason for the emergence of this hybrid can be seen in the regulation and corporate law design for the new post-privatization environment in the Czech Republic. Protection of minority shareholders, regulation of the takeover process, disclosure requirements, accounting standards and sanctions for insider trading and market manipulation – all that constitute necessary prerequisites for large capital markets to function smoothly, were largely neglected. Strong concentration of ownership and the lack of knowledge and legal protection of minority shareholders contributed to sub-optimal results. The approach of Czech lawmakers can be successfully called an *ex post regulation* approach, as one may easily see in the emergence and development of the capital markets regulations.<sup>223</sup>

The most striking fact illustrating the issue is that the Czech Securities Commission (SEC) was established as recently as 1998, five years after the emergence of the capital market. The consequence of this approach was that during this period the market was left largely unguarded.

### Ad 3: Legislation

The newly-created IPFs were given substantial power without the actual corresponding responsibilities. One of the largest problems created by the above-described hybrid was the insufficient protection of minority shareholders. The weak protection of minority shareholders rights created a control-ownership asymmetry in which the IPFs could gain inadequate control over the whole company. This motivated some funds to consolidate their positions in selected corporations with the aim of achieving a majority, even though there was no justification for this in terms of portfolio structure and diversification. In addition, funds attempted to enter into shareholders agreements with other funds and thus took active part in log-rolling. The *insufficient regulation* initially gave the IPFs strong incentives to reap private benefits at the expense of the other (inexperienced, diversified and thus less organized) owners.<sup>224</sup> This created the temptation for IPFs to abuse the position of majority owner, and it restricted the liquidity of the affected companies' shares in the capital markets.<sup>225</sup>

## RESULTING BUSINESS ENVIRONMENT

*Many of the company managers that did not strictly abide by their personal ethical values gave in to this rational temptation that was caused and amplified by the rigid, imperfect and*

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<sup>223</sup> See Ježek, T.: *Komise pro cenné papíry - její vznik, první kroky a plány*,

<sup>224</sup> Some economists warned about the dangers of this process as early as in 1992, see Respekt 5, 1992, Mejstřík, M., Kýn, O., Bláha, Z., Mládek, J.: *The three knots of voucher privatization*.

<sup>225</sup> Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

*weakly enforced legal framework.*  
Michal Mejstřík<sup>226</sup>

The results of the above-described issues could be easily imagined: a number of fund managing companies failed to live up to the role of responsible asset managers and began to defraud funds (or corporations in fund portfolios) in various ways, without being made accountable for their actions. There were many ways to do this, so here we shall quote only the most common ones: the simple methods included cheap selling of assets to a firm owned by a manager's acquaintance and the expensive buying back of those assets a couple of days later at unfavorable prices, as well as purposefully defaulting on contracts, triggering obligations to pay enormous penalties to affiliated entities and abusing the position of majority shareholder in a corporation in the fund's portfolio.<sup>227</sup> For a full description of these tunneling games, please see Jitka Kábelová's *Privatization Loan and Investment Games During the Large Privatization*.<sup>228</sup>

The industry of collective investment thus suffered a great transformation challenge,<sup>229</sup> being one of the ethically most fragile sectors of the economy and extremely dependent at that time on a very scarce public good: trust. The above-described shortcomings resulted in unethical behavior of some of the fund managers and threatened the whole industry of collective investment – a continuation of these adverse practices could have led to a complete breakdown of trust, which could have been followed by a bankruptcy of the whole industry.

Because of the weak institutional framework and inefficiency of judges, the transaction costs were so high that Coase theorem seemed to result in the exact opposite of what it originally suggested. Not the best, but often the worst owners were being selected (perhaps the terms “hostile” or “stepmother”<sup>230</sup> ownership would be appropriate). Predatory behavior evolved and such conduct even was accorded specific names - the most famous one is “tunneling,” a term which is now known worldwide. With majority voting power it was possible to legally strip assets from a privatized company or from an IPF through numerous legal methods, including self-dealing and misuse of insider information.<sup>231</sup> Moreover, even in the cases when such practices were illegal, weak law enforcement proved to be a crucial barrier to punishing the “tunnel-makers.” It is worth noting that the

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<sup>226</sup> Mejstřík, M.: *Správa velkých akciových společností: Teorie a česká praxe*, page 4. For a role of personal values please see Katzová, I., Špicar, R.: *SEPAŠ Štětí: Strategic Leadership During Transition*.

<sup>227</sup> In the words of Jiří Brabec, „an indication that some managers considered the assets in the funds as their own is the fact that the right to manage funds was often sold at enormous price. It was clear that what was being sold was not the right to manage the fund, but the right to loot it.” Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

<sup>228</sup> Kábelová, J.: *Privatizační, úvěrové a investiční hry v průběhu velké privatizace*, Bakalářská práce, IES FSV UK

<sup>229</sup> In Ježek, T.: *Komise pro cenné papíry - její vznik, první kroky a plány*.

<sup>230</sup> Kábelová, J.: *Privatizační, úvěrové a investiční hry v průběhu velké privatizace*, Bakalářská práce, IES FSV UK

<sup>231</sup> In some of the most striking cases, these who were asset stripping were even publicly visible but they kept arguing that technically they did nothing wrong or illegal .

methods used were often very simple, and were theoretically described as early as 1932 by Berle and Means.<sup>232</sup>

A Corporate Governance Risk<sup>233</sup> study (CGR) that analyses the quality of the general ethical environment identifies the two main bottlenecks for the effective exercise of corporate governance in the Czech Republic:

1. Slowness of legal processes
2. Low effectiveness of the law-enforcing institutions and a little respect for them.

Other studies that attempt to diagnose the level of business environment show similar results.<sup>234</sup>

### *THE LEAK OF FAITH*

Although this widespread behavior was generally not punishable and often not sanctioned by law, it was widely noticed by the Czech citizens who had invested their vouchers in the funds. The majority of the “voucher investors” had lost the value of their vouchers and have seen little of the promised share of the national wealth. This of course resulted, in the words of Jiří Brabec, in a “gradual loss of people's confidence in funds and fund management companies in general.”<sup>235</sup> Therefore, the IPFs were steadily losing the trust of the “voucher” clients and were absolutely not able to become an attractive alternative to traditional bank savings.<sup>236</sup> To make matters worse, the foreign portfolio investors that were attracted by the vision of big opportunities in the emerging market started to leave the country en mass in 1996, causing further damage to the level of confidence. Mejstřík argues<sup>237</sup> that the foreign investors have relocated their investments from capital markets to direct investment into firms, because FDI was much better protected than portfolio investments. This process was triggered in 1996, he writes, at a

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<sup>232</sup> Berle and Means *The Modern Corporation and Private Property*. For a description of “modern” methods of tunneling used in the Czech Republic, please see the paper of Jitka Kábeleová.

<sup>233</sup> From *Corporate Governance Risk in the Czech Republic*, joint project of ČSOB and the Institute of Economic Studies, Faculty of Social Sciences, Charles University. Authors: Zdeněk Kudrna, Ilona Katzová, Tomáš Sedláček, Ondřej Vychodil. The study has attributed to the Czech economy 11 points from the possible 28 points; the standard level of CGR in western economies is between 21-28 points.

<sup>234</sup> PWC, Transparency Project, Survey Research Center, Bethesda, Maryland, January 2001, For a complete version please see [www.opacityindex.com](http://www.opacityindex.com). Also please see [www.transparency.cz](http://www.transparency.cz) for a Corruption Perception Index.

<sup>235</sup> Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

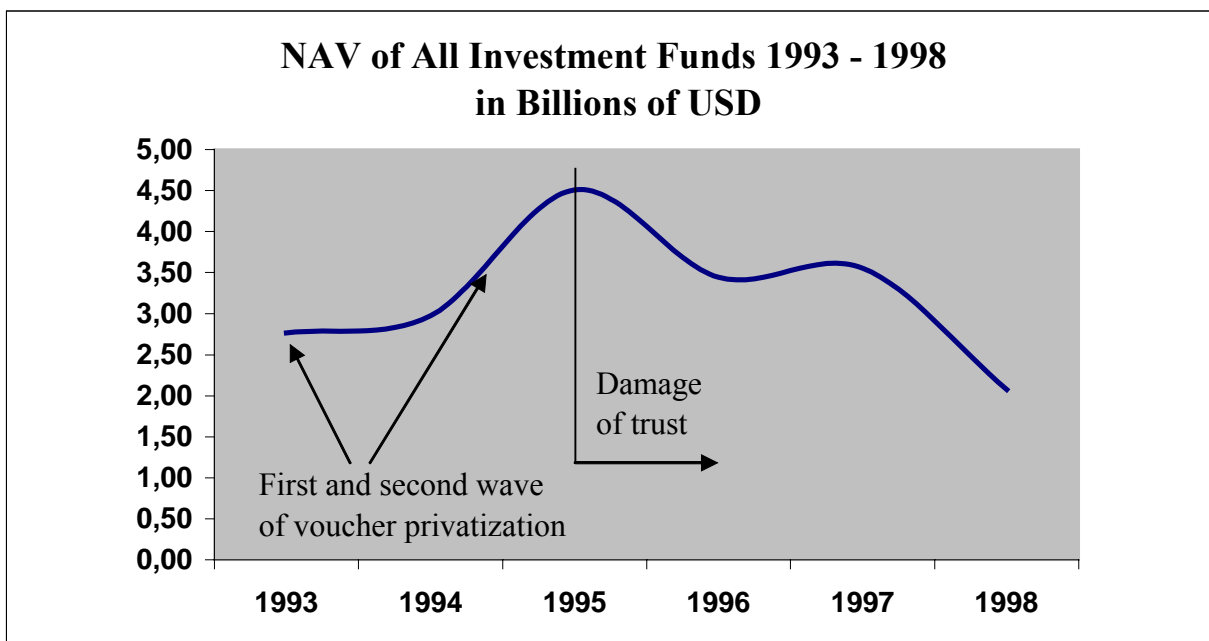
<sup>236</sup> A good example of a good fund manager so affected is the Investment Company Credis, a 100% subsidiary of the world famous company CSAM. Credis set up a fund in the Czech Republic for the second wave of voucher privatization. The fund obtained a large number of investment points, indicating that investors held it in high regard at that time. The fund created an attractive portfolio, which it continued to improve. Credis kept its promise to open the fund; however, the opening took place at a time of widespread distrust of funds in general. As a result, a large majority of investors immediately redeemed their shares, and the fund nearly ceased to exist.

<sup>237</sup> Mejstřík, M.: *Test recesí vyčistil kapitálový trh*, Acta Universitatis Carolinae Oeconomica 2 - 1999

time when the foreign firms would no longer tolerate the burden of low quality capital markets.

The whole industry of collective investment thus came to a point where it faced a serious and generally acknowledged “crisis of confidence.” And confidence, as was later shown, was exactly the crucial cornerstone of this industry. The graph below shows the development of the net asset value of the investment funds in the period from 1993-1998 and clearly shows the “crisis of confidence” that evolved in the years from 1995-1998.

Graph 1 - NAV development



source: UNIS ČR

Graph 1 depicts the development of the fund’s property between 1993 and 1999. Here we can see several trends. The years 1993, 1994 and 1995 were the years of the development of the funds caused by the voucher privatization; 1993 was the start after the first wave of the voucher privatization, the year 1995 witnessed a peak which followed after the second wave was over. At that time an unbelievable number of 265 investment and 194 equity funds existed and they were governed by more than 100 investment companies. In 1996 the first crisis occurred, caused by the transformation of 89 investment funds into holdings, and was followed by a decline in the managed property. Although in 1998 some positive changes took place in the legislative framework and the self-regulation of funds was introduced, the crisis of confidence continued – confidence, of course, takes time to establish and therefore trails the actual events.

In the mid-1990s the industry was confronted with a crucial question: How to gain trust when it could not rely on the underdeveloped institutional framework?



## RESPONSE: ESTABLISHMENT OF UNIS ČR

Very soon after the beginning of “the Czech way” of transformation it became clear that, due to the considerable lack of regulation, the fund managers with long-term intentions had to help themselves. It was clear that something *had to be* done by the managers themselves.

UNIS ČR, the Union of Investment Funds, was established in 1996 – the year when “the reputation of the investment industry was at the lowest level.”<sup>238</sup> Right from the very beginning the Union declared that one of its fundamental goals was to foster ethics and transparency in the capital markets and the collective investment industry. In the early period the Union’s practical efforts were concentrated primarily on cooperation with government institutions in drafting amendments to legislation governing capital markets and collective investment.<sup>239</sup> While the Ethical Code<sup>240</sup> has been one of the two documents that the members had to adhere to from the very beginning, the establishment of a practical emphasis on ethics had to wait one more year for the Ethics Commission’s founding in 1997. The other binding document was standard by-laws.<sup>241</sup>

The basic philosophy of UNIS ČR stems from the realization that restrictions to the behavior of funds and investment companies imposed upon them by the law are often not sufficient in the ethical dimension. The basic role of UNIS ČR is to provide guidelines for moral practices in commercial relations and fair-play competition rules. The aim of UNIS ČR is to help raise the level of credibility and lucidity in Czech capital markets. The bottom line of all of the above is that collective investment cannot exist in the long run without these “legally non-required” principles and that, even in the short run, unethical behavior raises transaction costs. The idea that additional self-regulation<sup>242</sup> is necessary for the industry to survive has prevailed ever since. The leading protagonist was Mr. Brabec, one of the founders of UNIS ČR and general director of the ŽB - Trust fund, who contributed enormously to the whole process as a president of the association from its beginning until his resignation in the year 2000.

There are five ways in which UNIS ČR seeks to contribute to building a more favorable environment:<sup>243</sup>

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<sup>238</sup> Fichtner, V.: This reputation crisis did not yet result in the NAV.

<sup>239</sup> UNIS ČR report 1998/99, page 6

<sup>240</sup> Please see [www.uniscr.cz](http://www.uniscr.cz) for a complete version of the Ethical Code.

<sup>241</sup> The main aim of UNIS ČR is quoted in the first sentences of the by-laws: “The Union shall take part in creating conditions and rules, **the purpose of which** is to help establish ethical principles, foster honest business practices, and strengthen the general level of trust in this market. The Union shall direct, regulate, and monitor the activities of its Members in accordance with applicable legislation, these By-Laws, the Code of Ethics, and the Binding Instructions.” paragraph 3 Objectives, BY-LAWS, UNION OF INVESTMENT COMPANIES OF THE CZECH REPUBLIC, June 2000.

<sup>242</sup> The difference in legal meaning of the word “self-restriction” is large between the European and the American law. In the European tradition, the self-regulation is not enforceable through the legal framework, whereas in the American tradition even the self-regulatory laws are respected by the law.

<sup>243</sup> UNIS ČR report 1998/99, page 17.

PRESSURE ON LEGAL UNITS. UNIS ČR sees active promotion and *lobbying*<sup>244</sup> as legitimate tools by which it can influence the environment in which investment companies and funds operate. One of the successes of the lobbying pressure was the creation of the Czech Securities Commission itself.<sup>245</sup> The Union puts forward and supports various legislative initiatives concerning capital markets and collective investment and since its creation has cooperated with the Czech Securities Commission, the Czech Ministry of Finance and other major institutions such as the Securities Center, the Prague Stock Exchange and the RM-system.<sup>246</sup> The cooperation led to an extensive amendment to the Investment Companies and Investment Funds Act, which came into force on June 8, 1998, and tightened up the loose supervision.<sup>247</sup>

SELF-REGULATION. Of no lesser significance is the cultivation of the Union's relationship with its own members. The Union has two basic documents, which all members must adhere to without exception: by-laws and the Code of Ethics. The purpose of these documents is to establish principles of self-regulation (extra disclosure requirements, duty of the members to provide regular information, etc.) The Union introduced in 1997 a rather strict self-regulation of its members. The introduction of self-regulation led to a gradual improvement in public confidence in the fund business in general and in funds managed by Union members in particular.<sup>248</sup>

IMPROVE THE NEGATIVE PERCEPTION OF THE GENERAL PUBLIC. The Union strives to improve the overall reputation of mutual funds and at the same time prove to the public that being a Union member involves accepting certain regulations. The Union is thus active in *public relationships* by promoting confidence in the investment sector to the wider investment public (and also foreign institutional and portfolio investments).<sup>249</sup> For this reason, the Union maintains a sophisticated web page (<http://www.uniscr.cz>), which contains detailed and updated disclosure information available to everyone.<sup>250</sup> It further publishes this information in daily press.

EDUCATION. Last but not least, the concern of UNIS ČR is to provide *professional education* for the members and other interested parties. They present their views at various

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<sup>244</sup> See Goals of UNIS ČR I. 7) and By-laws Paragraph 4 a)

<sup>245</sup> This led to the establishment of a Securities Bureau by the Ministry of Finance in 1997 and a Securities Commission as of April 1, 1998. Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

<sup>246</sup> UNIS ČR report 1998/99, page 17.

<sup>247</sup> Specifically the new legislation tightened up the requirements placed on fund managers in terms of professional competency and disclosure; increased the oversight authority of depository and custodian banks; allowed for the opening of funds established as public joint stock company (which had not been possible under the former legislation); required all closed-end funds to be open-ended when their discounts reached a certain level; required all closed-end funds established before the effective date of the amendment to be opened no later than the end of 2002. Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

<sup>248</sup> Brabec, J.: *Investment funds in the Czech Republic 1993 – 1999*, ŽB-TRUST Investment Company presentation.

<sup>249</sup> UNIS ČR report 1998/99, page 17.

<sup>250</sup> See By-laws Paragraph 3.

conferences, some of which they host themselves.<sup>251</sup> In this respect they also cooperate with other similar institutions abroad.<sup>252</sup>

#### *MEMBERSHIP STRUCTURE AND ITS DEVELOPMENT*

The philosophy of what was to become UNIS ČR attracted many and resulted in founding the Union on June 4, 1996, by 39 members of various associations. The membership ranks grew to 46 members soon after and UNIS ČR managed to create a single association, which represented the collective investment industry in the Czech Republic. The vast majority of Czech investment companies and funds found the membership in the Union attractive for many reasons. In the first place, they could increase their credibility and reputation, because the membership itself confirms their willingness to abide under strict rules. Further, it could increase their lobbying power, provide them with common educational programs, bring some cost reductions from economies of scale connected with publishing disclosure reports, etc.

Immediately after the coupon privatization, more than 100 investment companies administered 614 funds. Today there are only 37 investment companies, of which a maximum of 20 are active. The number of funds has also dramatically declined from hundreds to dozens. The same development can be observed in the membership base of UNIS ČR. While the three parallel organizations, from which UNIS ČR was formed, had a sum of some 100 members, the Union had 54 members at the time of its formation. Today, after the establishment and gradual intensification of self-regulatory rules, it has only 16 members. However, interestingly enough, these 16 members govern more than 90% of fund property in the Czech Republic.

That means that the change in the membership quantity resulted in the change of the membership quality. In the words of Jiří Brabec, “The introduction of self-regulation has led to a sharp decrease in the number of Union members. While some weren't able to meet all the requirements, others were unwilling to comply with such strict requirements for various other reasons.”

The growth of 1999 is based solely on the growth of open-end funds<sup>253</sup> – funds which are common in developed economies. Although the aggregate value of property is at the same level as in 1993, its quality is completely different, since 50 % of the property is managed by the newly-established funds and is not connected to the voucher privatization.<sup>254</sup> The following table and corresponding graph show the development of the net asset value of UNIS ČR member funds.

*Table 2 - The development of the net asset value of the Open-End UNIS ČR member funds (In CZK millions).*

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<sup>251</sup> See Goals of UNIS ČR II. 1) – 3) and By-laws Paragraph 4 c).

<sup>252</sup> Such as FEFSI, see Goals of UNIS ČR III. 3), 4) 8), 10).

<sup>253</sup> Although the aggregate sum fell in the year 1998, that year saw a quality difference in the growth of new open-end funds that were *not linked to the voucher privatization*.

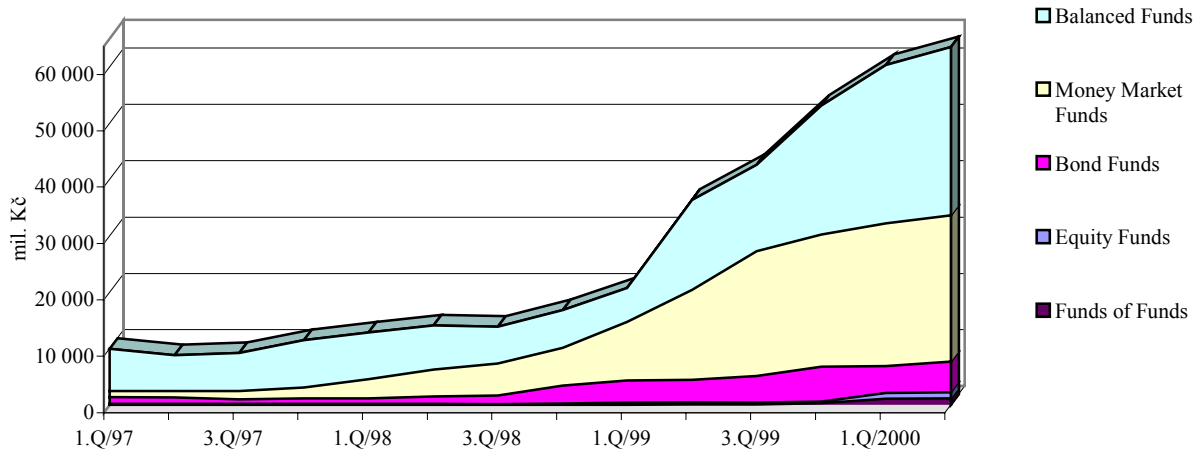
<sup>254</sup> Brabec, J.: (2000, pp. 1).

Period	Equity Funds	Bond Funds	Money Market Funds	Balanced Funds	Funds of Funds	Total
1.Q/97	192	1 146	1 085	7 444	0	9 867
2.Q/97	189	1 140	1 132	6 269	0	8 731
3.Q/97	170	786	1 490	6 712	0	9 158
4.Q/97	165	986	1 937	8 366	0	11 454
1.Q/98	147	1 003	3 342	8 291	0	12 783
2.Q/98	193	1 254	4 769	7 823	0	14 039
3.Q/98	97	1 557	5 593	6 549	0	13 796
4.Q/98	209	3 143	6 737	6 706	0	16 794
1.Q/99	386	3 852	10 414	6 018	0	20 670
2.Q/99	387	3 930	16 009	16 001	36	36 364
3.Q/99	340	4 651	22 191	15 287	49	42 518
4.Q/99	277	6 125	23 497	22 843	307	53 049
1.Q/2000	1 011	4 751	25 372	28 071	1 073	60 278
2.Q/2000	1 052	5 408	26 010	29 835	1 162	63 467

Source: UNIS ČR

Graph 2 - The development of the net asset value of the Open-End UNIS ČR member funds (In CZK millions).

## 1997 to Present

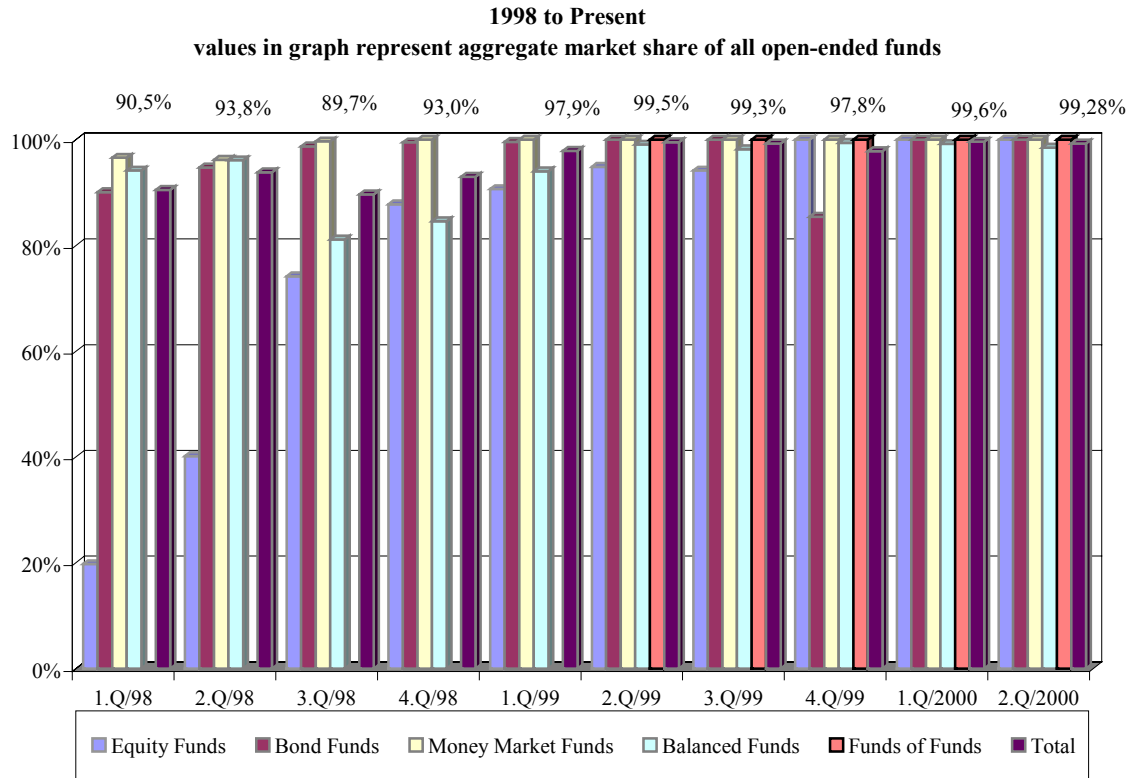


Source: Unis ČR

Despite the diminishing membership, the share of UNIS ČR total assets in the Czech Republic hardly declined at all, and today stands at 98%, as the table below shows. This is a consequence of the addition of assets in newly-formed open-end mutual funds managed by the Union members, as well as a decline in assets managed by former members.<sup>255</sup>

Graph 3 - UNIS ČR Member Share in Aggregate Open-Ended Fund NAV in the Czech Republic

<sup>255</sup> UNIS ČR report 1998/99, pp. 8

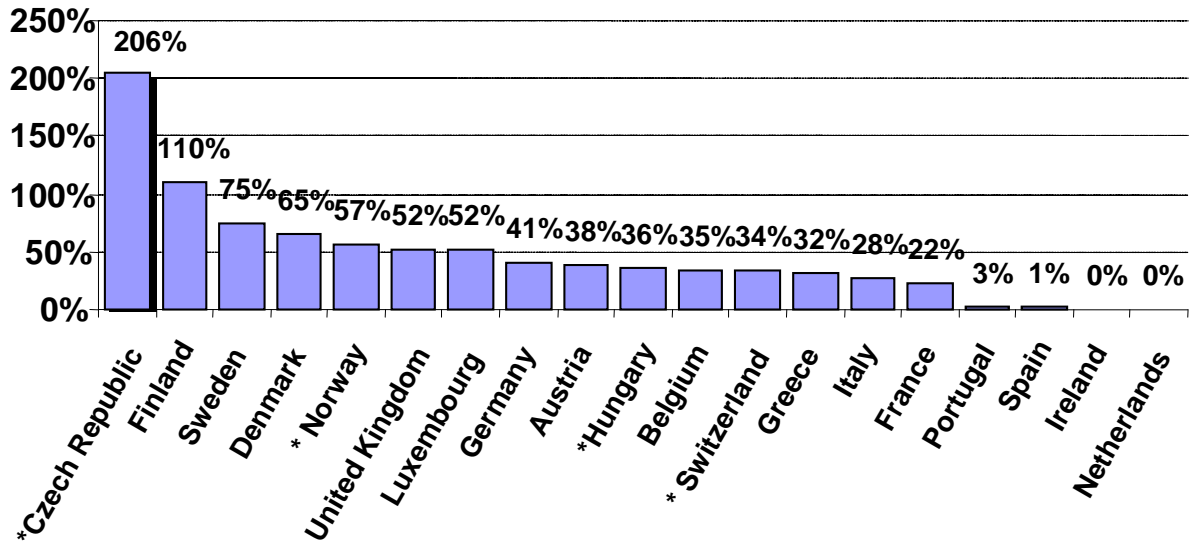


source: UNIS ČR

It should also be noted here that the growth in the NAV in the percentage change from the year 1998 to 1999 was growing at a much greater pace in Czech Republic than in the other European countries which are members of FEFSI<sup>256</sup>.

<sup>256</sup> FEFSI (Fédération Européenne des Fonds et Sociétés d'Investissement) is the pan-European umbrella organization of the investment funds industry of the 15 Member States of the EU, the Czech Republic, Hungary, Norway, Poland and Switzerland. Official information at <http://www.fefsi.org>.

**Incremental Growth in NAV of Open-end Funds  
In FEFSI Countries  
(1999 / 1998 in %)**

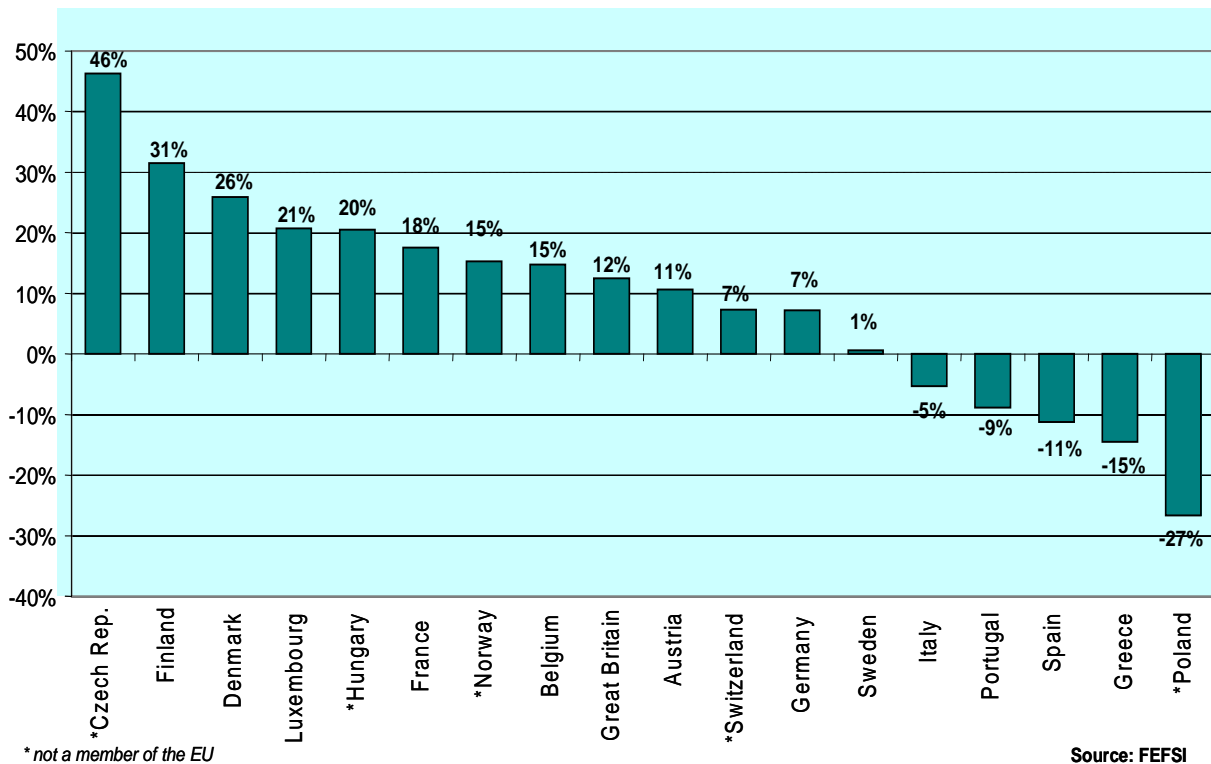


\* not a member of the EU  
FEFSI

source:

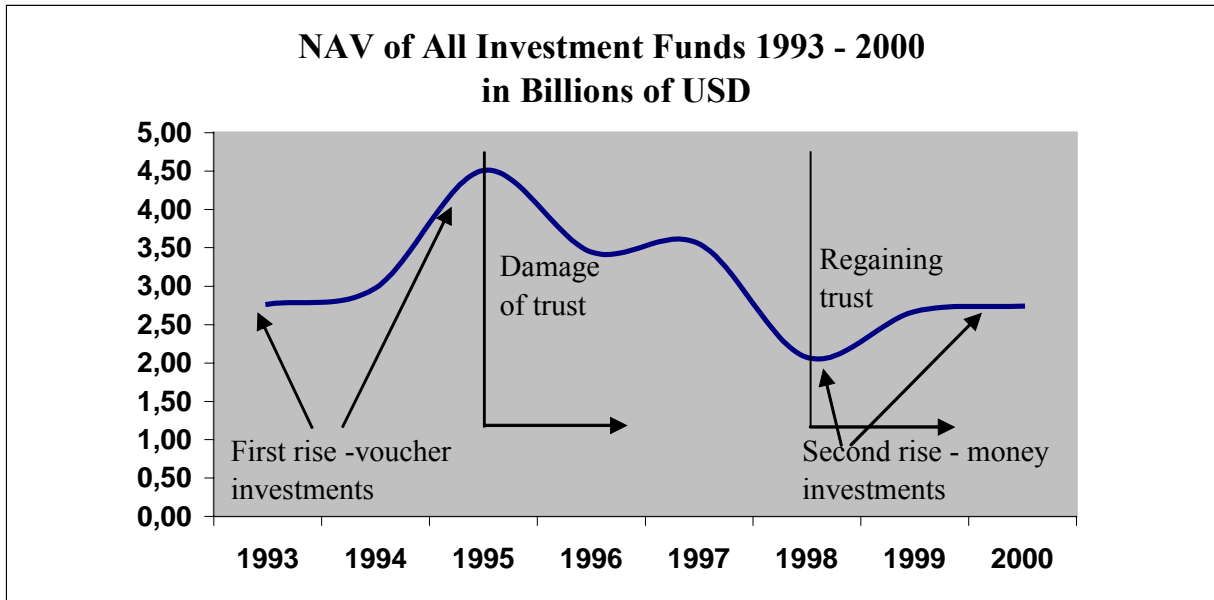
The growth of the Open ended funds in the Czech Republic continued in the following year as well.

**Incremental Growth in NAV of Open-end Funds in FEFSI Countries  
(2000 / 1999 in %)**



During the time of regaining trust, the NAV started to slowly rise since the year 1998, but never reached the levels it had in the early years of privatization. This new rise of NAV in 1998 was, unlike the first one (from 1993 to 1995), solely based on the real money investments. The first rise of the capital market was based on vouchers which were received almost for free and had no other use but to end up at a capital market. The second, smaller but more fundamental, rise of the capital market was based on real money that people relocated from their consumption or alternative saving schedules.





### *FOCUS ON SELF-REGULATION*

*“The doctrine of this cannot belong to jurisprudence, but to ethics, since this alone includes in its conception self-constraint according to moral laws. For this reason, ethics may also be defined as the system of the ends of the pure practical reason.”*  
Immanuel Kant<sup>257</sup>

As mentioned in the previous chapter, binding self-regulation became one of the main focuses of the Union. In February 1997 the Union formed an Ethical Committee to further develop the Code of Ethics and other UNIS ČR documents and deal with violations of these documents. Also in 1997 the Union passed binding instructions requiring members to provide regular information on managed funds “above and beyond the scope of legal disclosure requirements.”<sup>258</sup>

Special professional commissions and work groups were created to solve and work on problems. They were formed either on a permanent basis or “ad hoc” to deal with

<sup>257</sup>Kant, I.: *The Metaphysical Elements of Ethics*, chapter I. Exposition of the Conception of Ethics.

<sup>258</sup> UNIS ČR report 1998/99, pp. 17.

specific issues. These groups then report back to the Board of Trustees that deals with Union-wide problems.

In order for the members to adhere to these binding rules, control mechanisms had to be established. New members are required to go through a thorough external audit by one of the Big Five auditing firms. This audit has been compulsory since 1999, although all members had already been using these audits voluntarily.<sup>259</sup> If such an audit is positive, the membership in UNIS ČR is open to all applicants with a reputable history. Otherwise no regular audits are required – except in a case of suspicion.<sup>260</sup> When an accusation is made against a UNIS ČR member, such as through a newspaper allegation about wrongful conduct, the “burden of proof” is on the accused member fund to prove otherwise. In such a case the audit is carried out at the expense of the member in question and the accused member has to prove its innocence. If the accused fund is unable to substantiate its objection to the accusation of ethical misconduct, then it must leave UNIS ČR or its membership is suspended until it puts everything in order.<sup>261</sup> The Ethical Commission then evaluates the accusation.<sup>262</sup> In case the suspicion remains, the membership of the fund in question is suspended and not renewed until things are cleared out. In 1999 there were about four ethical misconduct accusations brought to the Ethical Committee; in the first half of the year 2000 there were two. In the history of UNIS ČR, no member has been expelled -- accused funds always stepped down voluntarily after their membership was suspended or threatened.<sup>263</sup>

In case one of the members or even non-members discovers that a Union member is breaking the laws of the Czech Republic, such behavior is reported to the Czech Securities Commission (SEC). The SEC then carries out the investigations itself. This ideal approach implies, however, two problems: First, the SEC can only investigate behavior which violates Czech law and cannot punish behavior which trespasses only the internal regulations of UNIS ČR. Second, although the cooperation with the SEC is better than some years ago, the SEC is still sometimes slow to react.

## RESULTS

UNIS ČR managed to create an attractive long run program for funds that were interested in sending out a signal that they want to adhere to certain moral rules of conduct. In the absence of effective government regulating and controlling bodies, the Union’s main philosophy was to instigate the change *from below*. Through self-regulation, UNIS ČR aspired to achieve a situation where their higher standards would eventually become a norm. In order to do this, they needed to create a critical mass to reverse the negative trend.

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<sup>259</sup> Fichtner, V.: (interview 2000).

<sup>260</sup> Klučková, V.: (interview 2000).

<sup>261</sup> Klučková, V.: (interview 2000).

<sup>262</sup> Fichtner, V.: (interview 2000) “It is in the best intentions of the accused fund to prove himself not guilty. If such a fund is unable or unwilling to do so, something is not right.”

<sup>263</sup> Klučková, V.: (interview 2000).

In this the UNIS ČR succeeded -- with 99% of the property of the open-end funds coming under the management of Union members.

Today UNIS ČR plays an important role in the formation of new rules and communicates with similar international organizations. UNIS ČR is credited as one of the significant forces behind the stabilization and solvency of the Czech industry of collective investment, which is today viewed as a regular alternative to the classical (and for 40 years the only) bank savings model.

## ANALYSIS OF UNIS ČR ESTABLISHMENT

*If the owners of land, share in a company, or intellectual property cannot buy or sell their property without the confidence that the government powers oversee the keeping of the law and its enforcements and serve thus as the guarantor and the defender of these rights - in such a country there are no conditions for healthy and dynamic growth.*  
Hernard de Soto<sup>264</sup>

The crisis of confidence has come about due to the massive abundance of non-ethical behavior of the investment funds. The room for such moral hazard was created by the combination of the resulting high benefits from non-ethical behavior and the negligible risk of being punished for it.<sup>265</sup> The consequent deep crisis of confidence in the mid 1990s, combined with the fact that many unethical funds left the industry, (when there was nothing more to “tunnel”) led to the loss of the “coupon clients”. The remaining funds thus needed to attract new “real money investors” – not voucher investors -- which was far more difficult. These new investors could be attracted only if they were assured that the unethical behavior and frauds within the portfolio investment industry was present no more. *Ethics became crucial*; it was a *sine qua non* for the funds to regain trust and confidence.

One of the clear purposes of establishing UNIS ČR was the survival of the industry. It wished to lobby for stronger legal regulation and, if unsuccessful -- substitute for them.

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<sup>264</sup> De Soto, H.: LN, Sobota 14. April 2001.

<sup>265</sup> While the low risk of punishment stems from insufficient legal framework and its enforcement, the substantial benefits stem from the fact that the funds acquired control over a large part of the then-state-owned assets. Since the individual investors received their vouchers almost for free, they had nothing to lose. Partly as a result of an aggressive investment campaign full of promises of 10- to 15-fold profits and partly as a result of people’s lack of knowledge of how to (or willingness to) diversify their portfolios within several privatized companies, 70% of the vouchers were invested in the funds.

For those players that wanted to play repeated games and thus remain in business in the long-run, *earning trust was necessary*. For players that were interested in one-round games (of which a privatization was a perfect example) ethical behavior could have been neglected and typical *predatory motives* have prevailed. Playing one-round games would however mean a short-lived life of the industry. Transaction costs would become so large that the customers would no longer use the capital market as a way of investing their savings.

### MEMBERSHIP STRUCTURES

There are various costs associated with UNIS ČR membership, the most obvious being membership fees (derived from the size of the fund) -- on average it cost about CZK 1 million (\$25,000). Next to the time and effort expended, member funds are required to bear much higher transparency costs than non-members. Some dealings are forbidden for the members and the members must be subject to more frequent audits by expensive auditors.

Members, however, are also offered many advantages. To quote Vladimír Fichtner, Pioneer Trust fund manager: “It is both costly and not always necessary to be transparent; it is however more costly to operate in an unreputable industry”. Sooner or later the “external” costs of doing business in the “unreputable” industry with high transaction costs would be internalized and managers would realize that the costs of operating in an ethically unhealthy atmosphere are greater than the possible benefits. Therefore, although UNIS ČR membership does include financial obligations (membership fees) as well as time and effort sacrifices for the members, it is profitable to benefit from bettering the ethical situation of the stock market.

This advantage, however, suffers the classical *free rider problem* (credibility of the stock market is a common good) so that even the non-members of UNIS ČR can benefit from the higher reputation of the industry. By this incentive alone UNIS ČR would probably be able to attract only members with altruistic motives (members who would be willing to carry the costs on behalf of the non-member funds). This would probably not be enough to attract a sufficient number of members to generate momentum for the creation of a *critical mass*,<sup>266</sup> which would reverse the negative general trend. UNIS ČR therefore decided to offer a pack of other, purely cost-effective advantages.<sup>267</sup>

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<sup>266</sup> Or the “islands of certainty” as they are called in Mejstřík, M.: *Správa velkých akciových společností: Teorie a česká praxe*, page 7.

<sup>267</sup> The Union publishes disclosure reports and **bears** the cost. Collective publishing experience economics of scale and it is thus cheaper for the individual members to publish collectively. This is also true of any other PR activities that the Union is involved in. Furthermore the additional information required by UNIS ČR is as low maintenance for the member as possible – members are only required to submit minimum **amount** of data and the Union bears the responsibility **for** calculating the rest of the relevant figures. Furthermore, UNIS ČR member can exercise a certain level of influence in the process of collective decision-making. Since unanimity is one of the basic principles, bigger funds cannot outvote smaller **ones** and their voice has, so to say, equal power. Even the smaller funds thus have access to influence on

Not only does the whole industry benefit from the higher credibility, but member funds can also take advantage of their higher *comparative* credibility stemming from their adherence to higher proclaimed ethical standards, which constitutes yet another motive for membership. As Mr. Fichter notes, the Union “wants to reach a state where our reputation is such that our potential retail clients ask whether a fund is a member of UNIS ČR or not.”<sup>268</sup> In the past, this goal had not been fully reached and the market did not punish companies for not being UNIS ČR members.<sup>269</sup> It took some time before the Union rose in significance enough that the market “punishes” a member for being expelled from the Union. Nowadays, external sources confirm that investors do often ask whether a fund is a member of the UNIS ČR.<sup>270</sup> It is the main declared future goal of UNIS ČR to further improve voluntary member self-regulation, steadily supplement and clarify the Binding Instructions to bring them closer to the standards applicable in the European Union and to improve the enforcement and application of sanctions in the event of violations.<sup>271</sup>

#### POSSIBLE PROBLEMS WITH SELF-REGULATION

While, as Zdeněk Kudrna<sup>272</sup> argues in his paper, the principle of self-regulation is one of the few hopes that are left in a situation where the state fails to provide the regulation, there are some potential problems associated with it. For example, the above-mentioned extra enforcement costs (i.e. the “penalty” for the substitution of the “violence monopoly,” as Max Weber puts it, of the state) that the member funds have to assume on behalf of the non-member funds (the free rider problem) could be in some cases *prohibitively large*. There are, for example, extremely high costs of an *objective* and *independent* Ethical Committee that could substitute the role of the courts. In the case of UNIS ČR, the costs were so high that the objective and independent court was substituted by a less-expensive *internal* committee comprised of representatives of the member funds and governed by the principle that the accused funds had to “prove themselves innocent” and thus carry all the costs of proof.

The second danger stems from the first; the member funds are in fact competitors and as such will be very reluctant to reveal their *internal information* to an in-fact competitor. There is thus the risk of *conflict of interests* within the membership base. The principle of conflict of interest can also take a different form in the relation to the non-member funds, which will be dealt with in the coming paragraph.

The third danger thus lies in the fact that the *goals* of the self-regulation have a character of a *position good* (benefit from the influence). From the perspective of the industry there could appear the possibility of the so-called *regulator seizure*, where the

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political decision-making. Moreover, since the communication of the member funds is made easy, the members can benefit from *learning by doing* of other members (and avoid the same mistakes) and the collective educational programs.

<sup>268</sup> Fichtner, V.: (interview 2000).

<sup>269</sup> Klučková, V.: (interview 2000).

<sup>270</sup> Michálek, L.: SEC representative responsible for the area of collective investment (interview 2001)

<sup>271</sup> UNIS ČR report 1998/99, pp. 14-15

<sup>272</sup> Kudrna, Z.: *Seberegulace odvětví a její omezení*, page 1.

lobby group gains such power that it in fact *becomes the only regulator* and misuses the situation for the benefit of the member funds against the non-member funds. In the case of UNIS ČR, this has not been the case so far.<sup>273</sup>

The fourth danger is an amplification of the free rider problem: free-riding can be done also by the member funds (not merely in the relation to outside players in the industry). In this aspect, the member fund can use the ostentatious (or *conspicuous* in Veblen's sense) membership as a means of concealing unethical business and later even use it to blackmail the other members of UNIS ČR. Should the investors' trust be misused *in one single case* and the membership in a self-regulatory organization did guarantee investors' protection, then all of the member funds in the organization would suffer greatly. This factor reveals the extreme (in some cases fatal) sensitivity of self-regulation to *one-time failure*; this then can be misused in the sense of blackmail and there is a tendency to conceal such behavior.

If the number of ethically-aware players was too small,<sup>274</sup> the voluntary self-discipline would not have succeeded. In the following chapter we shall look at the speculation of the alternatives.

#### ALTERNATIVE SCENARIOS

In this section it's interesting to sketch basic alternative scenarios of the Czech capital market development. The funds and investment companies could cope with the situation in one of the following ways:

##### 1) Wait for government intervention

This "wait and see" philosophy would result in low individual costs and efforts of the funds. Many free-rider problems could be avoided. The problem of self-enforcement of the internal rules would be solved since the state with its "monopoly on violence" could better enforce it..

On the other hand, it was too risky to wait for government intervention for a very basic reason: it could simply be too late. The government procedures of *external regulation* could take too long to become effective and since nothing happened for the past several years, there was no guarantee that anything would happen now. Furthermore, the trust towards the industry would be lower since the funds would be *forced* to behave according to rules.

##### 2) Wait for market forces (relevance to Coase theorem)

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<sup>273</sup> Michálek (Collective Investment Deputy, Czech Securities commission) interview on March 6, 2001

<sup>274</sup> The decisive factor is not the number of the players but their weight at the market. In case of UNIS ČR we can measure it by the volume assets in their control.

In one sense UNIS's establishment can be attributed to market force and in another it cannot. Individual effort would probably be useless and some sort of a higher collective body had to be established. Here again we come to the trouble of setting a clear distinction between market and non-market forces.

The standard assumption of the "market destruction" is that ineffective owners are creatively destroyed (in the Shumpeterian sense) by more effective ones.<sup>275</sup> Quite the contrary happened in this case: from the point of view of restructuring, governance and shareholder interests, the worst funds were on the winning side. With each *foul* in the game, the level of trust decreased and transaction costs increased. This *suffocation* of the whole industry happened at a faster rate than the exit of the short-sighted players. Hence the famous saying of Keynes that "we will all be dead in the long run" gains a new emphasis in our case, where a "bankruptcy" of the whole industry stands for the death or the "exit" from the market.

From the viewpoint of Hayekian order, however, since the government did not help in UNIS's creation, the rules that were created were spontaneous and therefore could be attributed to the market forces. The clear conclusion is that on the basis of individual action the situation would not be solvable and that the only way for the market to resolve the situation is a collective action. Whether this is a market solution or failure is left to the reader to decide.

### **3) Optimize the current situation and leave**

In the view of 1996, when the whole industry looked like it would experience "exit," the rational short-run game (since long-run regards would not make sense in view of the approaching collapse of the whole industry) would be to optimize the current situation and leave for a different market. The future of the industry of collective investment would thereby be sealed and the whole process would have to start all over again -- this time with enforceable rules. It would further have to be very economically attractive for people to forget the negative past experience and invest their real money -- not "mere" vouchers of negligible nominal value -- on the capital market.

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<sup>275</sup> Let us here define effective ownership as the ownership that provides the owned company assets with prospective long-run profitability.

## THEORY OF CONSTITUTION OF MORAL ORDER

The final part of this paper suggests a theoretical framework which describes the process of spontaneous rule creation of a given market using the existing theories and offering a theoretical model.

Order<sup>276</sup> is developed in the process of a market game. Each firm is faced with a cartel-like situation: there is general agreement on the rules of the game and, for the individual firm, it is extremely tempting to trespass this agreement, for on the other side of the “moral constraint”<sup>277</sup> awaits *terra nova* -- new land (much in the sense of an *innovation* in the Shumpeterian sense) and thus also abnormal profit revenue. To translate into the words of standard microeconomic theory, we keep the standard isoprofit curves and in our problem substitute the budget constraint by a *moral constraint* (by which here we mean the limits drawn by the first Kantian principle<sup>278</sup>). Since the levels of profit are cardinal, we may say that beyond the implicitly agreed moral constraint, the profit curves are steeper.<sup>279</sup>

In such cases the firms will be tempted (after a careful cost-riskbenefit analysis) to trespass the generally accepted norms of business conduct.<sup>280</sup> They will, however, categorically *not* “act on a maxim, the ends of which are such as it might be a universal law for everyone to have” and they will thus be in direct opposition to Kantian first moral imperative. As in the case of Shumpeterian innovation (we are dealing here with an innovation!), other firms will follow this *individually profitable* behavior and the profit curves in this *new land* will become flatter with every new inhabitant. This will have an impact on the flattening of the profit curves even in the *old land*. This process will be amplified in a situation where it will become known that the trespassing of the moral constraint is not punished by the law, or more importantly, by the customers. This is quite likely since, from the perspective of the law, the deed is unprecedented and the law is not expecting such behavior. From the perspective of a customer the logic is as follows: a customer that is used to *trusting* the industry has no suspicion. A typical customer

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<sup>276</sup> We by no means mean *morals here*. People enter the market game with moral feelings; the market has no propensity to *create* them. While it is true that some virtues are preferred by the market process and that our moral feelings can be influenced by the market process, we do not wish to study this concept here. We also differentiate here from law -- some sort of law could have existed before the market game started. *By order we here mean the adhered to, generally recognized behavior patterns that are predictable in the Hayekian sense.*

<sup>277</sup> “The notion of duty is in itself already the *notion of a constraint* of the free elective will by the law; whether this constraint be an external one or be self-constraint.” Kant, I.: *The Metaphysical Elements of Ethics*, Chapter I. Exposition of the Conception of Ethics

<sup>278</sup> “act on a maxim, the ends of which are such as it might be a universal law for everyone to have” Kant, I.: *The Metaphysical Elements of Ethics*, Chapter IX. What is a Duty of Virtue?

<sup>279</sup> The argument would hold even if the profit curves kept their gradient and were linearly extrapolated beyond the moral constraint.

<sup>280</sup> The game theory could be applied at this point of the model.



furthermore suffers from the rational *veil of ignorance* and it is often costly and sometimes not possible to attain insider information about the product. In the following round of the game another adventurous firm will not resist the temptation to venture further into *terra nova*, even more distant from the original borders of decency. The game is thus played again with looser and looser constraints.

This game with *de facto* changing rules (the *de jure* rules might well remain constant -- as long as they are not enforced, they are irrelevant since nobody is economically restrained by them) will be played as long as some, for whom the game is no longer morally acceptable, leave the industry. (Should a player wish to adhere to his *inward* moral constraint, the firms that play the adventure games and earn higher profits will *crowd out* the ones not willing to play with them.) Thus an *adverse selection* occurs. Another problem of this “riches for free” issue occurs when this behavior trespasses a certain threshold, becomes visible and the industry as a whole begins to lose customers. Those firms that expand beyond the *implicit- agreed constraint* trespass the implicitly-agreed order in the sense of *free riders* and they free-ride on a crucial and indispensable *public good* -- ethics. If any member of the industry misuses the *trust* that the customers entrust them with, the whole industry loses on its profitability. (In this scenario the situation is similar to the case of inflationary money: fortunate are the first users of this money, which still holds its full value, and ill -fated are those who use the money last, because it has on the whole lost its value.) The industry becomes unprofitable even though (or just *because*) it tried to maximize the profits beyond all boundaries. This cannot lead to anything else but the bankruptcy of the industry as a whole and the exit from the *market field*, in which the given industry did not have enough ethics to keep competing for the confidence of the customers. So the market spits it out.

Before such a moment, in the twilight of bankruptcy, a reverse trend can take place. Among the players of the industry new, often very strict rules emerge. These rules are created spontaneously from *within the industry*, and for this reason have the potential to be far better and react faster than the official ones because they can, so to speak, address the very specific problem better than the outside regulator who does not have the insider information.

During this period, voluntary organizations that enforce ethics and thus substitute the courts are spontaneously created. They serve to establish binding rules and guarantee them. These new rules try not only to stop the customers' *leak of faith* but to regain this trust -- for this reason the rules are often stricter than would be necessary in standard situations. In a sense, it is a variation on Thorsten Veblen's eye-catching *conspicuous consumption* -- in the process of reversal of the negative trend it is necessary to *conspicuously demonstrate* that the ethical constraint is binding. After the standard level of trust is regained the situation can in time return to the normal level of strictness of the constraint.

It seems that the spontaneous constitution of order progresses through a cycle, through a swing. It is in this crisis that the industry in question realizes the value of adhering to a common standard and where “repentance” takes place. This cycle is, however, not desirable and does not have the same cleansing effects as the standard

business cycle. This “realization” could come too late or the attempt to regain the trust could be unsuccessful -- in which case the industry sinks and it will take some time before it is established anew (before the trust is regained). This could be the case of *transformation trap*, in which some emerging Eastern markets have fallen.<sup>281</sup>

Translated into the language of constitutional economics, the swing does not have to hit the bottom, exit the market and start anew with Hayekian spontaneous creation of new rules – *provided* that during the moral decline of the industry a decisive number of players *agree*, in Buchanan’s sense, on the change of *de facto* constraint. The change of rules will then be established on the level of voluntary agreement. Chaos could be avoided and, if a crucial mass of the players would be willing to bear the costs of voluntary self-regulation, the chaos could be even reverted. The energy of chaos could then be used for good. Not only in the sense of realization (hopefully once and for all in the industry) of the importance of ethics but also in the sense of creating better rules. The enforcement of such rules would happen on the lowest possible level, according to the rule of subsidiary. There is, however, a less costly and less risky way.

The avoidance of such an ethical swing (that is most likely to take a place in the periods of radical institutional “upheavals,” i.e. in the transformation) could be achieved by the creation of an extremely strict legal enforcement mechanism. Thus the temptation to trespass *low-quality laws* (it is impossible to create perfect law without interaction with the market) would be eliminated. Hand in hand with this comes the discussion with the business sector on the change of the law (or perhaps in clearer words: official rules for lobbying would be institutionalized). The energy of spontaneous creation of order would then be concentrated primarily on the change of the rules *for everybody* (and thus be in line with first Kantian moral imperative to “act on a maxim, the ends of which are such as it might be a universal law for everyone to have.”) All the “creative” energy of the players would be devoted to creating the best possible legal framework for the rules of the game.<sup>282</sup> Low-quality laws (possibly inherited from the previous systems) would change according to the Kantian moral principle. Creation of rules of the game applicable to all would not have to happen in “the valley of the shadow of death” and the industry would not have to venture through the negative ethical swing. As Buchanan<sup>283</sup> writes, players always choose from the possible scenarios; if trespassing the order is a possible scenario, then the players will have the tendency to optimize even in this sphere and the development will follow a pattern similar to the one described above. If, however, trespassing the law were not an option, then the players will be motivated to pressure the change of the legal framework to the optimal situation. Furthermore, all players will be able to participate, not only the ones

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<sup>281</sup> Compare with Mlčoch, L.: *Institucionální ekonomie*, page 111: “Too large changes in the system might destabilize the order to the degree that order is sacrificed on the altar of efficiency -- the economy then, instead of developing in the direction toward a market economy heads towards chaos, anarchy and to abnormal or even criminal forms of trading.” See also Newman, K.: *Organizational Transformation During Institutional Upheaval*.

<sup>282</sup> This concept presupposes the existence (or at least the potential for existence) of a civil society that is able to form itself and present its opinion. The behavior of lobby groups is studied by Constitutional Economics, especially by Olson, M.: *The rise and Decline of Nations*.

<sup>283</sup> Buchanan, J.: *The Economics and the Ethics of Constitutional Order*, page 154.

who were left in the industry after the morally-constitutional swing. The case of strict enforcement of rules, be they imperfect, is better than no enforcement of better ones. From the experience of the Czech Republic, it would seem, quite the contrary has happened.

## SUMMARY

The purpose of this paper was to analyze the relationship between market and regulation. the behavior of players in respect of ethics and rules. It was concluded that in the situation where the regulatory body does not provide the market with clear rules, the subjects at the market are likely to create their own. The leading players in this rule creation are those, who are playing the game with long-run intentions and in manner of a repeated game. This process of spontaneous rule-creation has, however, many problems and possible pitfalls. The given market does not necessarily succeed in regaining trust back and in this case the whole industry can run bankrupt.

The creation of capital market in the Czech Republic was used as an example. This market was created quickly and with weak regulation and within a couple of years suffered a crisis of confidence, which stemmed from the unethical behavior of many of its players. During this period of crisis, spontaneous rule creation by the fund managers started. This paper wished to describe the dynamics of this process and draw an theoretical framework. The creation of these self-regulatory bodies could be seen as one of the key reasons for the survival of the Czech capital market as a whole.



## 5. CONCLUSION

The level of trust, sufficient for basic market functioning has been historically present in the Czech Republic and after the break-up of communism in 1989 has been able to avoid the transformation trap. However, more sensitive markets, such as the above-described case of the industry of collective investment, had to go through the “swing” of trust. Due to a slack in the legislative regulations and similar slack in the gentleman behavior on the market, the industry had to go through a spontaneous process of trust formation described above.

As the factor of market trust was substituted during the communist regime by the directive centrally planned system, the country had to start (not from the point of zero though) walking its own way to the degree of decency and trust, common in the western democracies.

It was the aim of the second part of this study to show on the example of the industry of collective investment how such a process evolves. Although, at a time, the industry was in the “valley of shadow of death” the end of the story is a success. Should the rest of the areas of the society follow a similar arrangement and the voluntary civic non-profit organizations enforce ethics on the lowest possible level, then we can be optimistic as of the transformation of the system to a high-trust society.

### 5.1.1. FUTURE EXTENSION OF THE WORK

It is the wish of the author to be able to extend the model to the macro-level of the society and to be able look upon the transformation not only from the perspective of single industry, but from the view of society as such. It would be also desirable to include the experiences of trust-creation in other transforming markets that is on the path to market democracies. A highly valuable angle would be gained by studying the behavior of countries that have fallen into the transformation trap and have generally made the exit from the system of highly specialized and trust-reliant society into basic self-sufficient family oriented agricultural system. An incorporation of the system to the mathematical formulations of game theory and other models (such as suggested in *The Economics of Altruism* by Stephano Zamagni) would also be a possible future focus of the extension.

### 5.1.2. *THE AIM OF THE STUDY SUMMARISED*

The aim of the study was to suggest a relationship between the economic and the non-economics parts of the human being and the society. The first part of the study summarized and tried to develop the historical economic thought that involved the ethical considerations. If the study showed that ethics played significant role in the history of economic thought to the present day, then it has reached its aim.

The second part of the study was devoted to the examination of the generation of trust in the case of highly trust-dependant industry of collective investment. The spontaneous market creation of enforceable ethical standards was examined and elaborated into a theoretical model of ethical swing on the level of industry. It was the aim of the author to study the behavior on the capital markets that was created *artificially* by the voucher privatization and a situation where all the companies traded by the voucher method, *had to* end up at a capital market, which was not well *regulated* and where *enforcement* of legal right was *slow*. The industry was in a large degree left to itself - it was up to the players to create its own *de facto* rules and arrange for their own enforcement.

We could see, that after initial turbulence the order was established and that today the area of collective investment players a more-or-less standard role within a market structures. Some of the discussions still continue, but in the standard manner, and the relevant problems are to the large extent the same ones addressed in the western democracies.

## 6. APPENDIX A - CGR

### CORPORATE GOVERNANCE RISK SURVEY IN CZECH REPUBLIC<sup>284</sup>

The globalization of world markets sets new requirements on investment decision-making. While there were often only two parties in the early capitalism (creditor-bank vs. debtor-entrepreneur), many intermediaries are present today. The growing number of relations between an owner who offers capital, and a company that uses it, indeed, increases the risk and mutual dependence of the parties involved. Another cause of the increasing risk lies in the fact that the parties often operate in different legal frameworks and cultural environments, so that to co-operate they need to mutually behave according to basic principles that, moreover, should be enforceable. If the entrepreneurial environment in a given country does not fulfill this requirement, a creditor has to either rely on the credibility of his or her partner or expect a very high risk-premium.

Investors consider several risks connected with investing in a foreign environment and create instruments to assess macroeconomic or political risks. Corporate Governance Risk is an instrument that has emerged on the basis of recent investment experience in Central and Eastern Europe. This concept enables a structured assessment of the entrepreneurial environment quality at a macroeconomic level and offers an index, which is comparable both in time and place.<sup>285</sup>

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<sup>284</sup> From *Corporate Governance Risk in the Czech Republic*, Joint project of ČSOB and the Institute of Economic Studies, Faculty of Social Sciences, Charles University. Authors: Zdeněk Kudrna, Ilona Katzová, Tomáš Sedláček, Ondřej Vychodil.

<sup>285</sup> The study is based mainly on the following two sources. *OECD Principles of Corporate Governance*<sup>285</sup>. Crichton-Miller and Worman's work called *Seeking a Structured Approach to Assessing Corporate Governance Risk in Emerging Markets*, Winning Essay in 1999 Essay Competition in honor of Jacques de Larosiere, The Institute of International Finance. The OECD Principles deal with the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board. The Essay of Crichton-Miller and Worman is based on the OECD Principles but it operationalises and applies them on emerging markets conditions. All quantified results in this study are based on aggregated responses on the questions. The sources of commentary are direct interviews with respondents and additional notes written in the questionnaires. All the source data for respondents are available at <http://tucnak.fsv.cuni.cz/~cgr>.

*6.1.1. AIM AND RELEVANCE OF THE SURVEY*

The purpose of the survey was to measure the immeasurable and quantify the unquantifiable. While not nearly as ambitious to hope to measure the quality of business environment, the study was performed in order to provide at least basic guidelines to the discussion of how the perception of ethics and other “soft” factors of the institutional framework by leading businessmen affect the performance of their companies and thus the economy as such. The index can be used as a proxy variable to assessing the level of ethics in the area of joint stock companies and thus indicates a level of ethical safety of the investment. An additional objective can be seen in identifying the most relevant issues that affect the risk.<sup>286</sup> The index may reach maximum 28 points, where the standard within the G7 countries lies between 21 and 28 points. The authors interpret the index of corporate governance risk as follows:

<b>Index</b>	<b>Risk</b>
0 – 5	Very high
6 – 10	High
11 – 20	Modest
21 – 28	Low

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<sup>286</sup> The present situation in the Czech Republic is monitored by a survey. The respondents are mostly managers of substantial companies operating in the Czech Republic, who have also experience from developed economies. Practically all respondents are employed in a company with foreign capital participation, which enables us to describe the corporate governance risk in the Czech Republic from the vantage point of foreign investors.

### 6.1.2. THE RESULTS OF THE SURVEY

The results of the survey showed the following results:

Maximum achievable points	28
Average points per questionnaire	11
Average points in the four sections	
Corporate Law (max. 7 points)	3,1
Legal Processes (max. 7 points)	1,5
Regulatory Regime (max. 7 points)	4,0
Ethical Overlay (max. 7 points)	2,8

The results of the survey, which involved 50 respondents, especially managers of important companies operating in the Czech Republic, evaluate the index at 11 out of maximum 28 points. According to Crichton-Miller and Worman's scale, which assigns the level of 21 through 28 to the G7 countries, 11 points represent the minimum value for the "modest risk" category.

The questions in the questionnaire were divided to four sections that characterise four elements of corporate governance risk. The worst-assessed element, which in the same time increases corporate governance risk to the highest degree, is Legal Processes. Not even one question of this section was answered positively by more than a half of respondents. In other words, this survey supports the claims of those who see the main barrier of entrepreneurship in an insufficiently functioning infrastructure of law enforcement.

The best-assessed element is Regulatory Regime where five out of seven questions were positively answered by a majority of respondents. Hence, it is obvious that the emergence of the Security Commission and its first steps, the independent role of the Central Bank in regulation, but also the self-regulatory efforts of the Union of Investment Companies, for example, together with the increasing demand for high-quality information



confirmed by an independent audit strongly contributed to the improvement of corporate governance risk.

The most important element for our purposes, the Ethical Overlay, has not scored very high with its 2,8 points out of possible 7.

If we were to identify three the most crucial factors that increase the corporate governance risk in the Czech Republic today, they would be:

3. the slowness of legal processes;
4. the low effectiveness of the law-enforcing-institutions and a negligible respect towards them;
5. the situation of an ineffective and slow course of bankruptcy.

We can see that the two of the three above mentioned bottlenecks are directly related to ethics and justice. As the business practitioners see these issues as the most important slow-downs of their companies our above mentioned theoretical speculations gain empirical confirmation from the people that are in contact with the real problems in their daily work.

On passing we should mention the comparative situation of some of the Central European Countries. In spite of many limitations the concept of the measurement of corporate governance risk has an advantage in its international comparability. So far, there are publicly known only two countries' indexes that were used by Crichton-Miller a Worman as examples in their essay (see the following table). We remind here that the standard level of CGR in the developed economies of G7 are 21 to 28. Nowadays, the World Bank is carrying out surveys on ten emerging markets in Central Europe, SouthEastern Asia, Africa and Southern America, using the same methodology so that the results should be comparable.

<b>Country</b>	<b>Index of CGR</b>
Russia	4
Czech Republic	11
Poland	16

Source: Crichton-Miller a Worman (1999), this survey

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Other precious sources were the following lectures: Jan Sokol *Člověk a náboženství* (PedF UK), Tomáš Halík *Křesťanské sociální smýšlení* (FSV UK), Erazim Kohák *Etika* (FF UK) a *Ekologická etika* (FF UK), Jan Jeníček *Descartes a novověká filozofie* (FF UK), Lubomír Mlčoch *Etika hospodářství* (FSV UK) a *Institucionální ekonomie* (FSV UK), Milana Machovc *Úvod do filozofie* (FF UK), Milan Sojka *Dějiny ekonomických teorií* (FSV UK), Ondřej Schneider *Veřejné finance* (FSV UK) Karel Kouba *Konstituční ekonomie* (FSV UK), Karel Thein *Soucít, směna a čas; Zrození kapitalismu jako filosofický problém - D. Hume a A. Smith* (FF UK), Milan Sojka *Dějiny ekonomických teorií, Mimo hlavní proud soudobé ekonomické teorie, Postkeynesiánská ekonomie a Nová keynesiánská ekonomie*.

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