

# Locating Responsibility\*

## An Extended Transaction Cost Approach

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Most debates in ethics, business ethics, and normative economics start with an (often implicit) exogenous premise that the level of normative responsibility is assigned to either individuals (theories of morality) or a certain “layer” of institutions like the state (theories of justice) or a corporation (theories of business ethics). We argue that this approach is too limited to allow for comprehensive view on the relationship between individual, organizational, and institutional responsibility and develop an approach that takes the assignment of normative responsibility as an integral part of an ethical theory. This approach is based on transaction-costs as the basic explanatory concept.

Keywords: Business Ethics, Institutional Economics, Transaction Costs

## Über die Verortung von Verantwortung – Ein erweiterter Transaktionskostenansatz

*Die meisten Debatten in der Ethik, der Wirtschaftsethik und der normativen Ökonomik gehen von der oft impliziten Annahme aus, dass die Ebene normativer Verantwortlichkeit vorgegeben ist, so dass sie entweder den Individuen (Theorien der Moral), oder einer bestimmten institutionellen Ebene wie dem Staat (Gerechtigkeitstheorien) oder dem Unternehmen (Theorien der Unternehmensverantwortung) zufällt. Wir argumentieren, dass dieser Ansatz zu beschränkt ist, um einen umfassenden Blick auf die Lage zu bekommen, wie sich das Verhältnis individueller, organisationaler und institutioneller Verantwortung ergibt. Dazu entwickeln wir einen Ansatz, der die Zuordnung von Verantwortung als einen integralen Bestandteil einer ethischen Theorie erlaubt. Dieser Ansatz basiert auf Transaktionskosten als basale Erklärungsvariable.*

Schlagwörter: Wirtschaftsethik, Institutionenökonomik, Transaktionskosten

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\* Beitrag eingereicht am 19.08.2014; nach doppelt verdecktem Gutachterverfahren überarbeitete Fassung angenommen am 16.10.2015.

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## 1. Introduction

For the past decades, globalization has been eroding the regulatory power of the nation-state, thus spurring a long and substantial academic debate that has been conceptualizing “global governance” as a multi-tiered effort carried out within complex institutions and regulatory arrangements involving nation-states, companies, consumers, and global civil society (e.g. Cutler et al. 1999; Teubner 2002; 2004; Sinn 2003). Against this background, several prominent scholars of business ethics have suggested that it is the responsibility of transnational corporations (TNCs) to step up as “citizens” or “political actors” to close regulatory gaps resulting from globalization (e.g. Scherer/Palazzo 2007; 2011; Matten/Crane 2005).

Political philosophers and welfare economists, as we will see in greater detail below, are *grosso modo* interested in the institutional settings that support justice as “basic structure of society” (see Rawls 1971) or the institutional “rules of the game” (see Kreps 1990; North 1991)<sup>1</sup>. Since the rules of the game are traditionally set by the nation state, political philosophy based on this concept and welfare economics are increasingly confronted with the challenge to reformulate their ideas in the face of post-national power structures and the question how to enforce rules in times of globalization.

Business ethics, political philosophy, and welfare economics obviously share some general interests in examining normative questions, although they do so from different perspectives (and sometimes also first normative principles, as long as no confusion is possible we use the term welfare economics loosely, summarizing all teleological approaches to economic justice). Against the background of this overlapping set of topics and intellectual interests it is quite remarkable that the debate amongst scholars in the respective fields of research is still very limited and has not yet “generated a particularly voluminous literature in either political philosophy or business ethics” (Heath et al. 2010: 427). Heath et al. (ibid.) as well as Blanc and Al-Amoudi (2013: 504), for example, point out that merely until recently (mainly published in this century), scholars in business ethics have hardly been paying attention to the debates in political philosophy, and, *vice versa*, political philosophers have not been overly interested in the business ethics debate. The same seems to be true for the relationship between welfare economics and business ethics: For example, Kitzmueller and Shimshack’s article “Economic Perspectives on Corporate Social Responsibility” (2012) in the *Journal of Economic Literature* more or less completely neglects the debate in business ethics and refers merely marginally to literature in this field of research.

The relationship between business ethics, political philosophy, and welfare economics is complex for at least two reasons: *Firstly*, it may concern different ethical approaches and value judgments related to different philosophical traditions – e.g. Kantian Ethics,

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<sup>1</sup> The mainstream approach in welfare economics is sometimes also called the “outside enforcement approach” because it neglects questions of rule enforcement. This approach culminated in the literature on mechanism design which provided many deep insights into optimal institution design and allowed it to develop an integrated perspective on formerly apparently disparate phenomena like externalities, public goods, etc. (Myerson 2008).

Virtue Ethics, Discourse Ethics, Utilitarianism, Rawls' theory of justice, or Communitarian approaches to name just a few – that may partly lead to contrary normative conclusions about moral behavior and just institutions. What makes things even more complicated is the fact that different normative conclusions are usually an amalgam of differences in normative principles and differences in the perception of the functioning of institutions (like for example labor markets or economic policies, like the role of price stability or public debt).

*Secondly*, and more relevant for this paper, the different disciplinary approaches usually have different “targets” for their inquiries. While business ethicists, *grosso modo*, are rather interested in the *morality* of acts of natural or legal persons (like firms) who act *within* the institutional frameworks provided by states (choice within rules), political philosophers and welfare economists tend to focus on *justice* realized through and represented by the design of the basic institutions of a society (choice among rules). They are not concerned about the morality of the acts of the “players” (which in welfare economics are assumed to be represented by some exogenous and often selfish preference relation which makes any question about the morality of acts obsolete, because individuals are conceptualized as lacking the ability to act morally), but locate the ethical problem at the institutional level and analyze conditions that could guarantee the justice of the rules of the game.

While we are aware of the fact that the above characterization between morality and justice tends to be an oversimplification in a complex field of research, we want to make the distinction between the morality of actions and the justice of institutions as the starting point of our paper.

We understand moral actions as activities by both individuals (the person, e.g., as consumer, employee, etc.) and organizations (e.g., firms). With the term institutions we characterize formal or informal systems of rules in which actions take place. We identify institutions like societal institutions (most prominently law) as well as institutions within organizations (e.g., job descriptions, corporate missions, codes of conduct). Institutions reduce the complexity for decision-making processes while making some decisions more likely than others. With this pre-framing of the “situation”, institutions also fulfill an important function to coordinate interactions between different actors; institutions can for example sanction actions that are not in line with their defined rules.

What is important in the context of business ethics is the question whether solving moral problems should focus on moral actions of the players or on institutions of the rules of the game. We argue that this is *prima facie* not clear, but depends upon certain circumstances.

*The key questions of this article are: Where to locate responsibility? Should we rely on actions, on institutions, or on both? How are actions and institutions interrelated? And what follows from this for business ethics?*

In this article, we focus on one dimension of the problem that gives at least a partial answer to these questions: the transaction-costs of distinct institutional settings. We define transaction costs as costs that arise out of the implementation of certain measures to solve a *given ethical problem*. As we will show later in greater detail, this can be costs on

the institutional level (e.g. due to the enforcement of certain rules or obligations) or on the level of actors (e.g. cognitive costs, due to complex decision-making processes).

The debate in business ethics can be differentiated in two streams of research: One emphasizes the normative-ethical dimension and deals with questions of moral reasoning; the other concerns descriptive-explicative approaches that pertain to the application or implementation of moral norms in organizational and/or societal contexts. The term responsibility is an important normative term with a long philosophical tradition. Against this background, we should be very clear about what we intend with this paper and how we understand the term responsibility in the context of this article.

Our ideas are clearly located in the second stream of research in business ethics. What we are trying to do in this article is an (extended) economic analysis (descriptive-explicative) of the question on what societal levels responsibility should be located. It is important to note that we are not doing moral reasoning of any kind in this paper. Again, we assume that there are given (reasoned) ethical problems that need to be solved, and our simple question is: how to do so? Consequently, the term “responsibility” in this article characterizes a very hands-on and metaphorical understanding: What is the most effective solution to solve a given ethical problem? Where (on what societal levels) should responsibility be located or assigned?

The article is structured in six sections: In Section 2 we will present a model that allows it to distinguish between five institutional “layers.” This model provides the foundation for addressing the problem of locating normative responsibility. In Section 3 we will develop a transaction-cost approach by, firstly, demonstrating some “ideal-world irrelevance results” (that assume zero transaction costs) (chapter 3.1) and then, secondly, including transaction costs into our approach (chapter 3.2). We argue that if one wants to understand the difference between societies and organizations that rely on the justice of institutions or on the morality of actors, one has to understand the idiosyncratic transaction costs of each institutional “layer” to solve the underlying *cooperation* or *coordination* problems<sup>2</sup>.

In Section 4 we will apply this approach to illustrate its potential. Based on some reflections on the process of globalization, we sketch vertical tendencies with respect to new governance mechanisms and the changing role of businesses. While our analysis and our examples up to this point might suggest that assigning responsibility to either the individual (morality) or some institution (justice) are largely independent and exclusive choices, we will argue that a more complex view is in fact necessary and adequate to fully understand the consequences of an assignment of responsibility, in section 5. The proposed dynamic perspective leads us to two observations: our view on “optimal” institutional design might differ significantly from the one suggested in economics; and

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<sup>2</sup> See Bowles (2006) for a discussion of these basic metaphors. Virtually all problems of institutional design and virtuous behavior can be reconstructed as a response to either cooperation problems, where individual incentives lead to sub-optimal social outcomes or to coordination problems, where society can end up in more than one stable equilibrium, the challenge being the coordination of expectations to avoid the dysfunctional ones.

the moral motivations of individual actors are not merely seen as moral problem-solving in a given institutional framework, but define the viable institutional. Section 6 summarizes the most important results of our investigation.

## 2. A Multi-Level Approach to Locate Moral Responsibility

The basic premise of this paper is that the discussion about corporate social responsibility (CSR) in specific and ethics in general suffers from a lack of conceptual localization of normative responsibility in the hierarchy of institutions that constitute society. In order to substantiate this conjecture we will first develop a multi-level model of institutions. This model will then be used to discuss ways to conceptualize the problem how to assign normative responsibility to those institutional layers.

The multi-level model that we use is an adapted and extended version of the taxonomic model of institutions introduced by Williamson (2000)<sup>3</sup>. For our purposes it makes sense to distinguish between five different institutional levels (see Figure 1).

The most basal one is level (L0) for which we follow Searle (2010) who – building on Anscombe (1958) – provides the ontology of institutions as a specific class of speech acts called “declarations”. Humans possess

“the capacity to impose functions on objects and people where the objects and the people cannot perform the functions solely in virtue of their physical structure. The performance of the function requires that there be a collectively recognized status that the person or object has, and it is only in virtue of that status that the person or object can perform the function in question” (p.7).

Institutions come into being by the repeated applications of specific linguistic representations (declarations), and they cease to exist as soon as people no longer collectively

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<sup>3</sup> Williamson (2000: 596f.) distinguishes four levels of analysis that he describes in hierarchical form: On the first level (L1) he locates societal values, norms, traditions (including religion). For Williamson, these dimensions represent the “embeddedness” of the economy and the society as whole. Values, norms and traditions change relatively slowly over time and their origin is rather “spontaneous” – as opposite to calculative planned – and, thus, of little concern for the author. For Williamson, they can be treated as exogenous constraints for most economic applications. Level two (L2) is called “institutional environment” and summarizes the “formal rules of the game” (constitutions, laws, the convention of property rights, etc.) and includes “the executive, legislative, judicial, and bureaucratic functions of government as well as the distribution of powers across different levels of government (federalism). The definition and enforcement of property rights and of contract laws are important features” (ibid.: 597). Williamson regards this level of analysis as crucial since it allows for what he calls “first-order” economization, that is: getting “the formal rules of the game right”. While L2 discusses the rules of the game, level three (L3) concerns the governance structures of organizations (like firms) whose basic structures are defined at L2. For Williamson, the implied reasoning is “second-order” economization with the purpose to get the “governance structures right”. It should be mentioned that organizations, like firms, are special cases of institutions according to this view. Finally, level four (L4) characterizes social interactions between individuals, from Williamson’s perspective especially agency problems, the process of resource allocation in general, and employment in particular. This “third-order” economization is only in so far of interest for Williamson’s transaction-costs approach, as it implicitly defines the potential outcomes of different L2 or L3 structures.

recognize their status. They are at the same time epistemologically objective and ontologically subjective. The hybrid nature of institutions distinguishes them from most phenomena studied in the natural sciences; they are products of “shared phantasies”<sup>4</sup>.

Acknowledging the specific ontology of institutions is normatively relevant because it creates an awareness of the fact that a number of important constraints in our normative thinking are the results of *prima facie* normatively arbitrary conventions. Any ethical theory has to acknowledge constraints that are objectively imposed by, for example, resource availability and the (physical) laws of transformation, but it is crucial to distinguish these objective constraints from merely self-imposed constraints that only exist because of a lack of awareness of their subjective ontology and which are therefore a means to achieve normative goals.

Examples for epistemologically objective and ontologically subjective phenomena that may constrain ethical thinking are the social concepts of gender (see Hacking 1999), nationality, religion, the dichotomy of man and nature, etc. (see Pinker 2002). Without an awareness of their character as “shared phantasies” they may enter as an objective constraint into the moral endeavor with far-reaching consequences for our perception of what is right and wrong. Especially when speech-act conventions become an integral part of the individuals’ social identities (as it is for example the case with nationality or religion), their *prima facie* arbitrary nature often remains unnoticed and unscrutinized and can therefore influence the moral gut feelings of the people<sup>5</sup>.

Level 1 is embedded in the speech-act conventions of a society. It summarizes the regulative normative ideas within a society. In a specific society there exist specific normative “blueprints” like religious beliefs that impose some normative reference system, a stock of normative theories about the good and the right, and a set of action-guiding social norms and conventions. In standard economic theory this stage is taken as given and usually summarized in some preference relation or utility function of the individuals. This simplifying assumption makes sense if the purpose of economic theorizing is purely positive and restricted to a better understanding of the functioning of specific institutions like markets or firms. However, from a normative point of view, it easily gets dysfunctional because it blurs the fact that part of the preference structure is in fact influenced by institutions (like schooling, L3) and social interactions as well as the basal language games (L0) because the regulative normative ideas of a society necessarily have the hybrid structure of (maybe competing) declarative speech acts (L0), and a theory of justice as a theory of institutions has to take this fact into consideration. The assumption of exogenous preferences has significant normative implications. By now there is an overwhelming body of literature that shows that this assumption is in many contexts empirically flawed (see Hansson/Grüne-Yanoff 2009), even under narrow market conditions (see Koszegi et al. 2014).

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<sup>4</sup> See also Pinker (2002: 202).

<sup>5</sup> See Greene (2013), Chapter 3, for a survey of the literature on behavioral tendencies – like perception biases – that tend to perpetuate identity-based perceptions of conflicts.





Figure 1: Multi-level approach (Source: own research)

Level L2 summarizes the basic formal institutions of a society, e.g. the constitution, the basic laws, and the basic institutional roles (like senator, president, chancellor, judge, etc.) as well as the formal relationships between them. Traditionally these institutions are related to the ideal of the nation state. Our understanding of L2 institutions includes this dimension, but it is not limited to institutions of nation states. Depending on the research focus and depending on the moral problem, L2 institutions can also refer to structures “below” or “above” the state level, e.g. institutions on a supranational level (e.g. European Union). Moreover, these institutions do not necessarily have to be formally codified, but they have to be collectively recognized as informal institutions to the extent that they become epistemically objective from the point of view of a sufficient number of actors. Indeed, we can observe the emergence of an increasing number of such informal institutions in modern societies<sup>6</sup>. Voluntary social and environmental standards of businesses (e.g. SA 8000, AA 1000, BSCI), new governance mechanisms (e.g. the Global Compact or the reporting standard of the GRI) or product labels (FSC, MSC, etc.) are just some examples of new societal regimes that are not based on (formally) binding law but on (informal) aspects of legitimacy. What both – formal and

<sup>6</sup> This is not to say that non-codified institutions played no or only a superficial role in pre-modern times. A good example for a set of informal institutional agreements that were able to overcome state boundaries and thereby facilitate trade is the medieval commercial law *lex mercatoria* (see Berman 1983; Kolmar 2015a).

informal – L2 institutions have in common is their coordinating function between distinct (types of) actors in arenas or “organizational fields” (see DiMaggio/Powell 1983/1991: 64f.; Beschorner 2004; 2013) and we can thus call them inter-organizational institutions. Together they form the institutional context in which individual behavior is embedded.

The constitution and basic laws of society define and provide the blueprint for organizational actors like corporations (corporate law), political parties, foundations, NGO’s, etc. that constitute level L3. The basic structure of a specific corporation, for example, should be in accordance with the basic principles defined by corporate law (partnership, limited, etc.) but may – in market economies – have independent legal personality. If one addresses for example corporate social responsibility, one addresses an organizational actor – a firm – at level L3. Organizational actors are embedded in other L2-institutions like labor and competition law. In addition, the above mentioned non-codified and informal societal institutions of level L2 articulate expectations – grounded in belief systems (L1) and specific language games (L0) – towards these actors which might result in new types of organizations (e.g. social entrepreneurs) or in changes of the governance structure of existing organizations. Hence, level L3 concerns elements to constitute (different types and forms of) organizations as well as intra-organizational governance structures.

Finally, an important class of individual acts is summarized at level L4. The motivation and capability to act depends on the basic language games in which individuals perceive their social reality (L0), their specific system of beliefs, concepts of morality, and norms (L1), the foundational institutions of society (L2), and the specific constellations of organizational actors (L3) in which the individual is situated. In a market economy, those acts have for example the form of short-term contracts backed up by contract law (L2), voluntary exchanges backed up by custom, norms, or reputation mechanisms (L0, L1). These interactions constitute largely short-lived institutions that in their most extreme form come into and cease out of existence with the mutually articulated will to exchange some highly perishable good or service. In the context of this paper, level L4 is relevant for example for individual actions as consumers and employers/employees (within the regulatory framework of L2 and L3 governance structures).

So far it may appear as if we presuppose a “top down” causality of the above hierarchical structure (illustrated by the arrows to the right of the boxes in Figure 1). However, there exist potential “bottom up” causalities as well if incentives provided by “lower level” institutions cause acts that influence “upper level” institutions (illustrated by the arrows to the left of the boxes in Figure 1). The most obvious example is individual behavior in elections that may change the basic laws of society. Changes in power structures may indeed even overthrow constitutional frameworks (L4-L2). For example, a primary goal of the labor movement of the early 20<sup>th</sup> century was to create a class consciousness and new social movements on peace, environment or women’s rights in the late 20<sup>th</sup> century (for an historical overview see Alexander 2006). Its aim was therefore to promote ideas that influenced perceptions of reality and values at L0 and L1 (for examples see Chatfield/Kleidman 1992; De Steiguer 2006; Rowbotham 1997). The debate on corporate



citizenship stresses the moral and political role of businesses in societies which points to the relation between L3 and L2. And of course, to take another example, employees (L4) do not merely follow the rules of a given governance structure within organizations but are also influencing them by their individual actions. To sum up, the evolution of institutions can be conceptualized as an interdependent process where individual behavior influences and is at the same time influenced by the given institutional structure. The way to cut this Gordian knot of institutional interdependencies depends on the specific focus of the analysis. Whereas the top-down approach sees institutions primarily as incentive or coordination mechanisms that shape individual behavior, the bottom-up focusses on the emergence and enforceability of institutions.

In the following sections we will outline some selected relations between the different analytical levels in greater detail.

### **3. Transaction Costs: Tales about Ideal and Real Worlds**

So far we have bypassed the definition of transaction costs, a concept that goes back to Ronald Coase (1937). Allen (1995) was suspicious of the concept and his critics might continue: ‘And the term was formless and void and darkness was over the surface of the term’. Here are three examples for definitions that illustrate the problem. Coase (1937) defined transaction costs as (opportunity) costs of establishing and enforcing user rights. Hicks (1935), on the other hand, focused on the (opportunity) costs of transferring user rights. It turned out that these and many other definitions were too narrow, which motivated Arrow (1970) to define them as the (opportunity) costs of organizing economic activities. In the following Section 3.1 we work with Arrow’s definition and refer the reader who is interested in the debate about how to conceptualize them to Allen (1995).

#### **3.1 The Ideal World: Zero Transaction Costs**

One first theoretical possibility to locate responsibility would be to exclusively assign it to level L2, L3, or L4. In the absence of transaction costs such an approach would lead us to irrelevance results in the following sense: With ideal moral actors who agree on the standards of morality it is irrelevant whether we assign responsibility to individual actors (L4), to organizations (L3), or to societal institutions (L2). The intuition is straightforward: any “gaps” left open by, for example, ill-designed L2- or L3-institutions would be closed by individual moral actions which are made possible because zero transaction costs enables the individuals to perfectly act according to their moral standards. Potential externalities caused by imperfect higher-level institutions are literally internalized by the actors because their desire to act morally aligns individual and social interests. We call this scenario „Kantian worlds”, where every individual would follow the categorical imperative.

On the other hand, with ideal L2-institutions, individuals need not to act morally, but can focus on their narrow self-interest because the incentive system induced by the institutional rules can make sure that all potential externalities are internalized. This can always be done in the absence of transaction costs because L2-institutions can take every potential contingency into consideration. This way of thinking can be called the

“Rawlsian worlds”, and it is also the approach of mainstream economics that sees institutions as rules of a game.

By the same token, with ideal L3 organizations like firms, individual morality and L2-institutions remain irrelevant because firms can step in and close any gaps left open by imperfect L2-institutional design and/or imperfect morality of the individuals by creating adequately designed governance structures. This might, however, require deviations from the objective of profit maximization, which highlights the means-character of this objective<sup>7</sup>. This is the scenario of (morally) “good business worlds”, and the debate about corporate social responsibility and corporate citizenship has its habitat here.

And finally, the analysis shows that without moral behavior, corporate citizenship, or just societal institutions, potential externalities remain non-internalized, a situation described by philosophers in the tradition of Hobbes as chaos or war of all against all and which can be characterized as inefficient anarchy. Table 1 summarizes the above argumentation.

<b>L4 (individual morality)</b>	<b>L3 (corporate citizens)</b>	<b>L2 (constitutional design)</b>	<b>Scenarios / Implications</b>
moral actors	profit maximiza- tion	non-existent	“Kantian worlds”
selfish	profit maximiza- tion	<u>perfect constitution</u>	“Rawlsian worlds”
selfish	<u>corporate citizens</u>	non-existent	“good business worlds”
selfish	profit maximiza- tion	non-existent	inefficient anarchy

*Table 1: Locating responsibility in ideal worlds (Source: own research)*

We have dubbed the results from the above line of reasoning “irrelevance results” because they show that in a world with zero transaction costs the institutional level which becomes the focus of analysis is irrelevant with respect to the expected outcomes. The irrelevance results describe an analytical limit case that has two important implications. First, any “partial” analysis of institutions that starts with an ad-hoc assumption about the design or motivation on all institutional levels except the one under consideration

<sup>7</sup> From a social point of view, profit maximization is not an end in itself but must serve the purpose of promoting the social good. If profit maximization gets into conflict with this goal there is no reason not to require deviations from this objective. It is a widely shared misunderstanding (often by referring to Friedman 1970) that profit maximization is taken as an exogenously given objective around which other institutions have to be designed in order to make them compatible with the promotion of the social good when deviations from this objective are a more direct way to achieve the goal. Even Milton Friedman (2005: 2) states: “Maximizing profits is an end from the private point of view; it is a means from the social point of view”.

implicitly rests on the assumption that the implied institutional level of analysis is adequate, or to put it differently, that the comparative transaction costs are minimal at this level. Second, in order to address the best way to assign responsibility one has to explicitly analyze and compare the institution-specific transaction costs. Such an analysis allows it to build bridges between theories of morality, corporate social responsibility, and justice that gives debates about the assignment of responsibility a proper base. Without any theory of comparative transaction costs any partial attempt to address the question of responsibility remains necessarily *ad hoc*.

Since none of the three options for perfect worlds is realistic, the location of responsibility must follow the restrictions with which real institutional design in this very broad sense is confronted with. All of the above ideal worlds are overly “optimistic”, if you like. The trust in L2- and L3-institutions emerges from a rather blunt view of the individual but has high hopes in the ability of institutions to solve conflicts of interest. On the contrary, the “Kantian” view of the individual does not need to bother about L2 and L3 institutions because of the implicit trust in the morality of individuals.

Three further preliminary results of this argumentation should be stressed at this point: *Firstly*, since zero transaction costs are obviously unrealistic it becomes clear that focusing on only one institutional level will hardly result in functional solutions (or maybe just in very rare cases), understanding the *interplay* between different institutional levels provides a more fruitful enterprise. *Secondly*, the analytical structure of the relationship between different levels of analysis exhibits “*self-similarities*” amongst different institutional layers. In other words, the interplay between L2-L3 (societal institutions and corporate citizenship) is structurally similar to the relationship between L3-L4 (organizational ethics and individual moral actions). *Thirdly*, the irrelevance results are (implicitly) based on the assumption of unrestricted ability of L2-and L3-institutions as well as individuals (L4) to internalize externalities, or, in other words, zero transaction costs. Including transaction costs as an additional category into the analysis will allow it to move from “*ideal worlds*” to “*real worlds*”, as we will show on the following pages.

## 3.2 The Real World: Transaction Costs Matter

The term “transaction costs” is closely related to institutions since transaction costs can be used to assess the relative “imperfectness” of different institutions. It is important to note that it is not adequate to define them – as some authors do – for the limited context of market transactions (Arrow 1970) but to go for a broader concept that also includes the costs „of measuring and policing property rights, of engaging politics in power, of monitoring performance, and of organizing activities” (Cheung 1992: 246); and we would add costs of implementing concepts of morality as internalized behavioral constraints of the individuals. This notoriously vague definition of the concept is good enough for our purposes to act as a working definition in the following, and we will add sources of transaction costs that are not directly related to L2-L4 institutions like bounded rationality (L1) or dysfunctional epistemologies (L0) later on.

Based on this definition, the trade off that has to be solved when assigning normative responsibility between the different institutional layers is clear: From the point of view of an (even perfectly moral) individual, figuring out what is the right thing to do in a specific situation is usually more costly than to just follow a rule. Hence, the creation of

rules that can then be codified at L2 frees resources for other valuable purposes, and the question becomes how costly the development, implementation, and enforcement of these rules is, and to what extent they are necessarily imperfect. In the absence of perfect L2 institutions individuals will make moral mistakes by simply following the rules.

A qualitatively similar trade-off exists with respect to L2-L3 and L3-L4 institutions: For example, simply following existing safety standards (L2) imposed by the Food and Drug Administration (FDA) may be a good thing for the food industry under normal circumstances. However, if firms or universities (L3) and individuals (L4) are involved in the development of hitherto hardly known processes and products, playing according to the rules may not be enough because the rules can because of the fundamental asymmetry in information only imperfectly cope with the normative challenges of scientific and technological progress. A good practical example how societies deal with this kind of challenge is §15 of the Rio Declaration (1992) which defines a precautionary principle for the approval of new pharmaceuticals or technologies whose side effects and long term consequences are only barely known. The declaration (L2) leaves a blank and delegates normative responsibility to the organizational (L3) or individual (L4) level<sup>8</sup>. With respect to intra-firm relations on the levels L3-L4, rules in the form of code of conducts for accepting gifts from suppliers, for example, might be an effective way to avoid corruption and bribery. In more complex situations, however, it might be more adequate to rely on the moral judgments of the employees because compliance measures or risk-management systems might lead to exorbitant transaction costs and are likely not able to even qualitatively cover all possible types of behavior.

Despite its intuitive appeal, the devil turns out to be in the details if one seeks to adopt the basic concept of transaction costs from institutional economics to the problem at hand. Given that we use transaction costs as the central variable for the assignment of responsibility between different institutional arrangements, we need a concept of transaction costs that is comparative (3.2.1) and that can (at least qualitatively) be operationalized (3.2.2).

### 3.2.1 A Closer Look at Transaction Costs: Comparative Approach

In order to be able to understand if certain views on the location of responsibility and the implied normative roles of (institutional) actors are functional or dysfunctional with respect to the underlying normative goals one has to be able to compare transaction costs that emerge from different institutional settings. We follow Williamson's (1985) strategy to conceptualize *comparative* transaction costs as a measure for the difference in performance of different institutions, which focusses on institution-specific differences in contractual and organizational arrangements and the implied inefficiencies (see Klaes

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<sup>8</sup> Another example is the 1950's debate about the scientists' responsibility toward humanity that crystalized around the initial refusal of J. R. Oppenheimer to participate in a program to develop the hydrogen bomb, see Hijiya (2000) for further reference.

2000), bearing in mind that not all institutional arrangements may be equally well-adapted and applicable for different organizations or societies.

Comparison and contextualization can take place in two different ways: horizontally and vertically.

*Horizontal comparisons:* Social or historical comparisons of relative transaction costs on the same analytical level (L2, L3, or L4) are called *horizontal*. Examples would be investigations of relevant L2-institutions in different national contexts (Matten/Moon 2008) or of different sector-specific CSR initiatives in one or more countries (Beschoner et al. 2013). A standard example from welfare economics is the debate whether externalities should be internalized by means of Pigouvian taxes, regulations, or the creation of new markets. Classical Examples on the firm level (L3) would be comparative analyses of CSR programs in different companies (e.g. comparisons between firms in different sectors, in different countries, or between SME and MNC, etc.). And last, not least examples on the individual level (L4) would be comparisons between normatively different leadership styles, moral orientations of CEOs, or the role of CSR managers. The key for horizontal comparisons is of course to hold other institutional settings constant. Without the *ceteris-paribus* clause it is impossible to causally identify transaction-cost differentials between different institutional arrangements at the same level.

*Vertical comparisons:* Far less present are, however, studies that are dealing with *vertical* comparisons of transaction costs between different institutional levels, e.g. L2-L3, L3-L4, or L2-L4. From a social or historical comparative transaction-costs perspective it can be for example asked: What assignments of responsibility between levels L2, L3, and L4 are likely to be more functional (efficient) to promote the normative goals within a given society? How have assignments of responsibility changed over time between the different institutional layers? What are the relevant constraints on the design of the different institutional levels, and what are the implications of these constraints for the assignment of responsibility?

### 3.2.2 A Closer Look at Transaction Costs: Operationalization

For using transaction costs as the crucial variable for the assignment of responsibility between different institutional arrangements it is necessary to identify sources of transaction costs to operationalize the approach. Attaching a price tag to transaction costs is a difficult task in general and it is even more difficult to do so with respect to normative issues as discussed in the context of this paper. Qualitative comparisons, however, are possible, and we distinguish between the following sources of transaction costs. The list is not considered to be exhaustive and the unifying principle to conceptualize transaction costs as endogenous, institution-specific deviations from a normative reference point (see Schweizer (1999) for a discussion of different approaches towards transaction costs).

*O1 Complexity:* Transaction costs are affected by the complexity of the decision problem. While for simple and repetitive decisions formal institutions or relatively easily applicable rules of thumb can help to internalize potential externalities, this might not be the case in complex situations which are often characterized by a larger number of alternatives from which one has to choose and a larger number of possible outcomes (for each chosen alternative). This leads to decisions under risk, uncertainty, and unawareness as

well as decisions in incomplete institutional environments. We exemplify this argument by three important classes of problems for which complexity is crucial.

(i) Complexity is likely to lead to situations where economic actors are asymmetrically informed about some aspect of the transaction. Asymmetric information can induce transaction costs for example on markets with a limited number of buyers and sellers (Myerson/Satterthwaite 1983) or with risk aversion (Rothschild/Stiglitz 1976, Stiglitz 1977), which makes a discussion about the assignment of responsibility in principle meaningful<sup>9</sup>.

(ii) Complexity also likely leads to the use of – from the perfect-world perspective – imperfect decision heuristics if individuals have only limited computational power. In the words of Simon (1986: 211): „If (...) we accept the proposition that both the knowledge and the computational power of the decision maker are severely limited, then we must distinguish between the real world and the actor’s perception of it and reasoning about it”. The use of heuristics builds a direct bridge to L0 because individual perception mechanisms shaping the individual’s internal representation of reality are no longer objectively given (see Kahneman/Tversky 1984). Furthermore, different L1-L4 institutions can vary in their support of individual decisions in ordinary decision problems and thereby influence transaction costs that emerge as costs of wrong decision making (see Ariely 2008).

(iii) It is a basic assumption in contract theory that especially for complex tasks, formal incentive mechanisms often do a poor job because important contingencies cannot be contracted upon (see Grossman/Hart 1986). Even residual-claimant mechanisms in the form of bonuses are often very complicated and difficult to enforce. Intrinsic motivation and identification with the employer can then be an important element to ensure that employees internalize the effects of their behavior on the organization (see Akerlof/Kranton 2000). Ensuring cooperative behavior by means of soft factors may reduce transaction costs since expensive control and incentive mechanisms can become redundant. In addition, explicit incentive mechanisms (if available) may crowd out intrinsic motivation, and if individuals adapt their preferences to the environment, a hysteresis effect can occur such that a return to an initial state of intrinsic motivation is no longer possible if explicit incentives are abandoned (see Gneezy/Rustichini 2000).

An important conceptual reason for why contingencies are not contracted upon is because they are unforeseeable (see Hart/Moore 1988; Hart et al. 1997; Heifetz et al. 2006). In all those cases when unforeseeable events may occur, individuals and businesses are necessarily left with discretionary power to decide what to do. Hence, in all these situations there is no alternative to relying on morality *ex post* because the right behavior cannot be anticipated *ex ante*.

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<sup>9</sup> It is a key result in the theory of mechanism design that for a large class of allocation problems central-planner like “direct mechanism” implement the second-best optimum as a consequence of the so-called “revelation principle” (see Mas-Colell et al. 1995).



*O2 Moral capabilities:* As mentioned above, we assume that individuals possess moral agency in the sense that they have the principle ability to act morally<sup>10</sup>. Since they may, however, be bounded in their moral capabilities (see Chugh et al. 2005), these capabilities are another important source of transaction costs. Moral thinking evolves from principles of universalizability (Hare 1981; Mackie 1977), which is easily at odds with our moral dispositions that are more in line with what is called *parochial* altruism or *tribalism* (see Choi/Bowles 2007; Bowles/Gintis 2011; De Dreu et. al. 2010; Kolmar 2015b for a recent survey). Moral reasoning that extends beyond the narrow bounds of kinship and group is a cultural achievement that does not easily follow from intuitive compassion but from the rational understanding of ones' prejudices and that therefore needs experience and education (and thereby causes transaction costs in the form of opportunity costs of time). Recent findings in psychology and the neurosciences paint a relatively coherent picture about the structure of our moral experiences and reasoning that is of importance for an understanding the transaction costs of moral reasoning (see Greene 2013).

In addition, moral capabilities – like with most mental faculties and manual skills – depend on practice, a point emphasized by most virtue ethicists. Individuals that are merely rule followers in their daily life, will most likely face difficulties to fully grasp and understand the moral implications of their decisions in their role as rule setters, for example during elections, be it as voters, politicians, journalists, or lobbyists. The ability to extend and universalize ones' view beyond the narrow the self-interest depends on one's involvement and confrontation with conflicting interests and moral dilemmas where it is not possible to retreat to the position of rule follower. "Moral literacy", like others forms of literacy, depends on "training"<sup>11</sup>. If we follow this line of argumentation we reach the conclusion that a complete delegation of normative responsibility to some abstract institutional level like L2 can be dysfunctional because it demotes individuals to rule followers. The fact that this view is dominant in economics follows from the assumption that individuals have exogenous preferences, which excludes the possibility to discuss the necessarily dynamic perspective of becoming virtuous. This anthropological *ad-hoc* assumption leads directly to the mainstream view that responsibility has to be assigned to the institutional level. That this view of institutions is not indisputable can be seen if it is compared to the Aristotelian view that "lawgivers make the citizens good by training them in habits of right action." (see Aristotle 2002/350bc).

Moral agency therefore extends beyond one's moral gut feelings but refers to (i) the ability to perceive a moral problem as a moral problem and the literacy with respect to

<sup>10</sup> We focus on individuals in this section and postpone a discussion about group agency until Section 4.3.

<sup>11</sup> This point borrows from Rawls' concept of reflective equilibrium (1971) and his "Kantian turn" that became more explicit in his later writings (for example Rawls 1995). Here he delegated responsibility back to the individuals. In a nutshell, the idea of a reflective equilibrium is to use the veil of ignorance as a heuristic that allows us to detect inconsistencies and flaws in the moral intuitions of the individuals. A reflective equilibrium is reached if the moral intuitions that feed into the design of the veil of ignorance are consistent with the institutions that follow from decisions under this veil. Rawls' reflective equilibrium can, however, be a purely theoretical concept; the quality of moral reflections does not depend on the individual's involvement in actual decision problems. We scrutinize the usefulness of this concept and rather think that the idea of reflective equilibrium must be thought of as a lifelong process of moral engagement and reflection.

(different and maybe also competing) moral principles, (ii) an understanding of the possible consequences of decisions, and (iii) the application of these skills in specific situations. L2, L3 institutions can play an important role in supporting moral actors by providing information and defining arenas for normative discourses in the form of democratic principles at the state level or be the implementation of normative orientation, structures, and processes to foster morality within firms.

*O3 Heterogeneous moral views of the moral actors:* We have assumed, up to this point, that all moral actors agree upon the same moral principles, which helped us evade some important and difficult problems. Once one allows for divergent moral views, the position developed in O2 easily gets complicated because it relies on a division between divergent moral views that are based on differences in moral gut feelings and divergent moral views that are a result of heterogeneous moral principles that pass the test of scrutiny in the “controlled” mode. And it is unclear how such a dividing line can be established if one accepts Hume’s (2000/1739) famous dictum that there is a significant difference between descriptive and prescriptive statements, that the “ought” does not follow from the “is” because it is unclear if different evaluations of specific situations or decisions rest on diverging evaluations of facts or on diverging normative principles. Given the absence of an “overlapping consensus” (Rawls 1971), a successful discourse about heterogeneous moral views requires some “meta morality”, a common currency which can be used to structure the debate. But if individuals cannot agree upon such a common currency, the whole process gets stuck. In addition, there is always a risk that normative principles are used to defend ones’ interests.

One of the best and most important examples is the process of internationalization made possible by low transportation and communication costs. Finding solutions to international or even global problems makes it necessary to cope with cultural diversity within firms and societies insofar as diversity is reflected in different normative perceptions of the problem at hand. Normative problems of an international scale also accentuate our genetic inheritance to distinguish between “us” and “them”. The search for a common currency of rational normative reasoning seems to be most pressing – but at the same time most challenging – to address. These problems, the combination of cultural diversity, parochialism, and social and economic problems that extend beyond “tribal boundaries”, create a constellation where any kind of functional solution gets easily blocked.

The irrelevance results break down if one constitutes that there may be rational disagreement about normative principles. Given that L2 and L3 institutions necessarily have to solve conflicts of interest in a specific way, they have to lean in favor of one or the other normative position. Even if they comprise different principles in general, they have to foresee a specific normative principle for any specific situation. Hence, there are situations – and likely very many of them, in societies as well as in businesses – where some moral actors can legitimately disagree with the principles upon which L2 or L3 institutions regulate a conflict, and it is no longer obvious if a moral actor should follow the L2/L3 institution or her own moral principles.

What we can see here is that a complete absence of what Rawls calls the “overlapping consensus” would lead to exorbitant transaction costs without any chance of solving moral problems. We regard such circumstances in concrete practices, however, as exceptions rather than the rule. Instead, we assume different degrees of “overlapping” that can be identified empirically and the greater the consensus, the lower the transaction costs or the more moral diversity, the greater the transaction costs, respectively.

*O4 Enforcement:* As long as L2 and L3 institutions are not enforced, they remain merely declarative speech acts with symbolic meaning, but apart from that without practical consequences (if they do not merely act as coordination devices for the individuals). Societies usually tackle this problem in the way that L2-institutions define formal and general rules together with L3-governance structures like the bureaucracy, judiciary, and executive systems with the purpose to further specify, enact, and enforce the set of L2 rules. By the same token and related to the first argument, governance structures within firms (L3) define institutions for the actions of employees (L4) to act in accordance with the company’s goals. Depending on the complexity and range of the regulated and managed field (in societies or businesses), the enforcement of formal rules can be a simple, difficult, or even an impossible task. At any rate, it creates transaction costs as costs of creating the institution mostly in the form of persons and resources devoted to the enforcement of institutions that could otherwise have done something directly productive or have been used differently.

To sum it up, we regard the transaction costs O1 – O4 as crucial variables for the assignment of responsibility between different institutional arrangements. Assuming these transaction costs can be qualitatively determined (which raises some methodological problems that are, however, not impossible to solve) with respect to a given moral problem, they can be used for a (horizontal or vertical) comparison of (two or more) cases. The normative recommendation solves the moral problem through the institutional arrangement with the least transaction costs.

We are aware of the fact that this argumentation sounds contradictory to the classical understanding of responsibility. Indeed, in the liability model it is argued that individual or organizations that cause harm have a special responsibility: They are responsible for their actions. We do not want to reject this plausible argument. Nevertheless, as recent debates clearly show responsibility cannot be limited to this liability model since in complex societies it is (increasingly) difficult to identify the causal responsibility of a certain actor. This, however, does not mean that there is no responsibility as Iris Marion Young states:

“Our responsibility derives from belonging together with others in a system of interdependent processes of cooperation and competition through which we seek benefits and aim to realize projects. Even though we cannot trace the outcome (...) (of) our own particular actions in a direct causal chain (...) we bear responsibility because we are part of the process” (Young 2007: 175).

In this sense we understand our approach as a contribution to what we can call “systemic responsibility” and an invitation to further investigate its relationship to causal responsibility.

## 4. Locating Responsibility: Vertical Tendencies and Illustrations

This section is devoted to an illustration of the potential of our approach. After some reflections on the process of globalization (section 4.1) we will outline some vertical tendencies in the evolution of institutions for a better understanding of the potential role of new governance mechanism (section 4.2) and the changing role of businesses (section 4.3) in economies and societies that are currently in the process of profound transition.

### 4.1 Globalization and Vertical Tendencies

Modern states with their monopoly of force created means to develop an L2-institutional framework with the associated enforcement agencies to align individual and social interests that equilibrates national norms, values, technological peculiarities of their economies, and the state's enforcement power (Grechenig/Kolmar 2014). This view of the state became dominant in modern welfare economics as well as in the ordo-liberal tradition. In today's *transnational societies* an additional aspect of nation states is becoming more and more visible. The still leading paradigm conceptualizes the state as having the only legitimate monopoly of (physical) force (which goes back to Weber 1958/1919). This concept of a state requires a congruency between the reach of social and economic activities and the reach of the rights of the state. Globalization increasingly undermines this congruence which implies that states are increasingly competing against each other, for example for mobile tax bases. Political economists would argue that this type of competition has potentially positive consequences because it acts as a disciplinary device that constrains the governments' appetite for tax revenues and trims inefficiencies. But as with traditional markets, functional (or efficient) competition relies on good rules and regulations to avoid inefficiencies and unintended redistributive consequences<sup>12</sup>.

On top of this, globalization comes with (the perception of) higher diversity of moral views (O3) that can be tackled less and less by formal L2-institutions (O1, O4). But it is not only different moral views but also the limited reach of moral sentiments that becomes problematic (O3). Capital owners may be willing to accept social standards and working conditions in far-away sweatshops that they would consider appalling in their own neighborhood simply because spacial distance makes it easier to ignore them (O1). In addition, parochial altruism implies that individuals distinguish in their moral sentiments between in- and out-group members (O2). It requires the use of reason to scrutinize our moral gut feelings and to universalize our moral reach to include out-group members, and the return of national, ethnical, and religious stereotypes in national and world politics shows that there is still a long way to go (O1).

In other words, different societal systems like the economy, the political, or the legal system became increasingly dysfunctional to handle trans-national externalities over the last decades and evolved and adapted with different paces. While the economic system

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<sup>12</sup> See Sinn (2003) for a good overview of the problems connected to this “new systems competition”.

is highly internationalized, politics and law are still mainly grounded on national territory, which implies a tremendous increase in O4-type transaction costs.

#### 4.2 Vertical Tendencies (1): The Case for New Governance Mechanism

In comparison to community-structured societies that are primarily characterized by face-to-face interactions and that were to a large extent reputation based, modern societies are more complex and anonymous. One important aspect of this development is the much longer and more complex causal chain that links actions with consequences. As a result, it is difficult if not impossible to understand the moral implications of ones' behavior, and one has to rely more heavily on explicit "incentive mechanisms" which enable the individuals to internalize the social costs of their behavior. This argument points into the direction of focusing exclusively on L2 or L3 institutions. The information provided by these institutions is crucial for the individuals as moral agents. It enables them to act morally because the decentralized acquisition of information necessary to act morally would be prohibitively costly.

This situation seems to be very relevant for a lot of anonymous markets where individuals have no clue where the products are coming from and how they are produced. Current trends by certain producers to disclose the supply chain and the willingness of certain consumers to pay "fair" prices can then be seen as market reactions to morally motivated consumers. The *Fair Trade* label is a good example of what is sometimes called *market-driven ethical consumption*, where ethical consumption can be defined as the purchase of products that concern a certain ethical issue.

Take the market for coffee, the second most important commodity traded worldwide<sup>13</sup>. In the traditional coffee business, local producers received between 1.6 and 5.7 percent of the retailer price, and Farmers earned less than USD 600 a year in 2003 (Levi/Linton 2003). The lion's share of profits went to exporters, importers, and roaster-distributors. Consumers who buy Fair Trade coffee do this at a so-called fair price that is above the market price for qualitatively similar, traditional coffee. Hence, the fair-trade attribute is a means for retailers to differentiate products and thereby to discriminate prices. Keeping quality constant, the most likely reason for buying a more expensive product must be the consumer's willingness to increase the income and living conditions of the local producers, and the Fair Trade label provides the information necessary to do so. As such, product labels or any kind of social or ecological standards, can be interpreted as *new governance mechanisms* that reduce complexity for consumers (what products should I buy? which company should I trust?) and, thus, decreases O1-transaction costs. These governance structures are usually not completely backed and enforced by L2-institutions but they do provide, nevertheless, (soft) sanction and incentive mechanisms. It is also important to note that they are not limited to national territories and related to national law but they operate as transnational (soft) law.

<sup>13</sup>

Fair Trade certification is an attempt to help the local producers. The four internationally accepted criteria for Fair Trade coffee are to (i) purchase directly from small farmers, (ii) guarantee a floor price, (iii) offer farmers credit, and (iv) develop long-term relationships.

The question, however, is how *reliable* the information provided by an organization like *Fair Trade* or any other information provider is. According to the standard view, competition between information providers solves this problem, but this conclusion is likely to be inadequate: Competitive pressure is only sufficiently strong to guarantee truthful information revelation if the number of information providers is very large (see Milgrom 2008), a requirement that is clearly counterfactual in most information markets because of the technology of information acquisition that is characterized by substantial economies of scale. In addition, the credence-good character of information makes it unlikely that the consumer can accurately assess the quality of information, which makes such an industry vulnerable to special interests, so that their players must meet high standards of moral responsibility (see Emons 1997).

One potential way to create reliability of information (and maybe reputation for the seller) is by including special “non-for-profit players” who act as mavericks in information markets. The basic idea is that information of agencies with objectives that deviate from profit maximization is more reliable than information provided by traditional for-profit firms. *Fair Trade* in Switzerland (called *Max Havelaar*), for example, is a non-profit foundation. *Stiftung Warentest* is a German foundation involved in investigating and comparing goods and services. Given that non-for-profit actors face incentive problems of their own, it is ultimately an empirical question whether such mavericks have a positive effect on the market.

#### 4.3 Vertical Tendencies (2): The Case for Corporate Citizenship

The above examples have revealed that the process of globalization has in fact created a change in the extent to which L2-institutions are in principle able to cope with normative problems, and this conclusion is unaffected by the general view on governments. Even from the rather narrow perspective of economic efficiency it can be discerned that the current system of international competition is suboptimal and that traditional L2 state actors are not able to cope with these problems in the foreseeable future. If one accepts this view as a paradigmatic starting point, the question becomes how this vacuum can or should be filled. Apart from new governance mechanisms (L3, see above), another candidate puts himself forward: corporate citizenship.

A reduced form of the transaction-costs approach developed above is to start with the concept of discretionary power that is itself determined by the underlying transaction costs but that can be used to locate responsibility directly. The prerequisite for assigning responsibility is moral agency. Moral agency requires that (i) individuals can choose (ii) from a sufficiently large set of alternatives, and that (iii) the choice of alternatives potentially impacts upon other individuals. The mainstream premise is that moral agency can only be attributed to persons, be them natural or legal, not to abstract institutions. The term *corporate citizenship* (CC) captures the idea that corporations administer bundles of individual citizenship rights (see Matten/Crane 2005). According to this view one can conceptualize firms as moral actors with liberal rights and republican duties.

The view that legal persons are treated similarly to natural persons in normative matters is not undisputed. Elster (1992: 452) for example, argues that functionalist explanations



*“postulate a purpose without a purposive actor”*, and therefore require some form of objective teleology. It is *prima facie* alien to this way of thinking that power and responsibility can be delegated to an abstract institution, and the idea of corporate citizenship is therefore alien to this thinking as well. However, this view is neither more nor less alien than the established view that responsibility is assigned to L2 institutions, and in the same sense that Rawls’ theory of institutional justice, welfare economics, and the *ordo-liberal* view is alien. If one considers L2 and L3 institutions as potentially cooperation-enhancing and transaction-costs reducing societal mechanisms, moral agency of these institutions can be reconstructed as being delegated by individual actors; such “moral agency” in fact refers to two different declarative speech acts, one that establishes the individual as the ultimately responsible actor, and one that establishes the normative status of L2 or L3 institutions that borrow authority solely from their *collectively recognized status*. List and Pettit (2011) develop an important argument in favor of the view that group agency is compatible with methodological and normative individualism. Since there is no risk of confusion, we will continue to use the term *moral actors* for both, individual and organizational actors. By the same token, if the term *power* refers to organizational actors, this term is assumed to be used as a convenient shortcut that summarizes the aggregated discretionary power of the individuals when they act in their institutionalized roles (as manager, politician, employee, voter, etc.).

The relevant result of the above-mentioned process of globalization can be summarized as a reallocation of discretionary power from L2 institutions to L3 organizations like multinational corporations (and from individuals whose qualifications are becoming less scarce to individuals whose qualifications are becoming more scarce); the overlap of legal and de-facto power (see Acemoglu/Robinson 2006) is shrinking. If moral responsibility follows from discretionary power, it necessarily implies that this process has to be accompanied by a process of reevaluation of the normative role of organizations (as collective actors): corporate social responsibility increases in relative importance as a means to cope with the current challenges; corporations must be considered as corporate citizens because in a world with globalized markets and regionalized policies no other institutional “layer” can assume this role as effectively as they can.

If the responsibility of especially multinational corporations and other L3-organizations is acknowledged in addition to traditional L2 actors like states, together they form a network of responsibility, and each actor plays its special, indispensable role in this net. It is crucial to think about institutional responsibility in this overarching sense.

The shift in power and the associated shift in responsibility does not imply that (national/regional) L2-institutions are obsolete in transnational societies – and a lot of research has been going into the question of how to reform them in order to reestablish their functionality (see Sinn 2003) – but it clearly points to the fact that a temporal or systematic vacuum has emerged that can only be filled if responsibility is assigned to either L3 or L4. If neither firms as collective actors nor individuals step in and assume moral responsibility, the global system remains dysfunctional; the classical liberals knew

it right from the beginning: liberty and moral faculties are two sides of the same coin<sup>14</sup>, and the lack of awareness of this fact is a remnant of the mainstream view on institutions as expressed in for example welfare economics.

## 5. Morality and Justice: Independent, Vicious Circles, or Virtuous Circles?

So far our examples might suggest that assigning responsibility to either the individual (morality) or some institution (justice) are largely independent and exclusive choices. This view would oversimplify matters; it is likely that the types of institutions that are in place interact with the morality of the individuals that live in the society in complex ways. This complex interaction has already been suggested in Figure 1 where the arrows between the different institutional layers point to the possibility of complex interdependencies. The idea that justice and morality are interdependent is in fact very old. As mentioned above, Aristotle argues that “(l)awgivers make the citizen good by inculcating habits in them, and this is the aim of every lawgiver. If he does not succeed in doing that, his legislation is a failure. It is in this that a good constitution differs from a bad one.” (Aristotle 2002/350bc).

In order to make sense of such a view one needs, however, a view of the nature of human beings that is more complicated than the one underlying the standard approach used in economics. If it is assumed that individuals have exogenous preferences, institutions can only influence outcomes by changing the constraints under which individuals choose; they are *incentive mechanisms*. If one, however, assumes that human beings are neither willing to unconditionally act morally nor are they inclined to follow their narrow self-interest, there is room to follow up Aristotle’s idea if one assumes that individuals are in fact hybrid beings whose willingness to act morally depends on the specific social and institutional context and therefore interacts with the rest of the institutional structure<sup>15</sup>.

Recursive relationships between individual actions and institutions are well-known conceptions in sociology (e.g. what Giddens (1993/1976) calls “duality of structure”) but also discussed in institutional economics (e.g. North 1990; 1993/2001; Denzau/North 1994; Hodgson 1998). The basic idea is simple: “Both individuals and institutions are mutually constitutive of each other. Institutions mold, and are molded by human action” (Hodgson 1998: 181).

In order to be able to cope with interdependencies it is useful to integrate our reasoning into a dynamic model by introducing a time variable  $t = \dots -2, -1, 0, 1, 2, \dots$  where 0 denotes the presence, negative number the past, and positive numbers the future. Larger

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<sup>14</sup> See Mill (1980/1859) who writes in a controversial passage that “(i)t is, perhaps, hardly necessary to say that this doctrine (of liberty) is meant to apply only to human beings in the maturity of their faculties”.

<sup>15</sup> Konow (2003) relates findings in behavioral economics to the standard theories of justice that have been put forward in order to understand how people perceive normative issues. Choi and Bowles (2007) and Bowles (2009) develop a theory of the evolution of moral dispositions as a form of parochial altruism, and De Dreu et al. (2010) show that the Neuropeptide Oxytocin regulates parochial altruism.

numbers (in absolute terms) denote greater distance from the present. The dynamic perspective is important to understand the interdependencies between different institutional layers but also to “track” changes in transaction costs over time.

We will illustrate this approach by sketching a short (intra-organizational) example on compliance management that explains the systematic interplay between action and institutions: We assume that a company has been involved in corruption cases at some period of time  $t=0$  and undertakes measures (e.g. implementing a set of compliance rules) to prevent future incidences. From a static perspective it could be argued that the introduction of a compliance system creates an intra-organizational institution of corporate governance (L3) which reduces transaction costs at  $t = 1, 2, \dots$  by defining common values (O3) and decreasing the complexity of the (moral) decision-making process (O1) for employees interacting at level L4. On the other hand, a compliance system increases O4-transactions costs by the need to take measures of implementing and enforcing the organizational rules.

For systematic reasons a compliance system cannot cover all possible situations by its defined organizational rules, it is not *state contingent*. Businesses are aware of this fact and consequently compliance measures, such as codes of conducts, sometimes include a final paragraph which articulates that moral awareness and moral actions of each and every employee remain important. In technical terms we can say that an L3-governance gap is identified which needs to be filled by moral action at the L4 level. This aspect points to possible consequences for O2 transaction costs (moral capabilities). Depending on the specific design of the compliance system, moral capabilities can increase (and transaction costs decrease) if it is supported by certain (reflexive) institutional measures that allow moral learning processes. Or moral capabilities can decrease (and transaction costs increase) as consequences of “moral crowding-out” (Gneezy et. al. 2011) towards a strict rule-following routine without much moral reflections.

What we have described above has been assumed to take place in  $t=1$ . However, it can easily be imagined that the effects of the system change spill over into the more distant future, for example  $t=2$ . Even if the new governance structure has positive short-run effects in  $t=1$ , there may be unintended long-run effects that only show up from  $t=2$  onwards, like for example “moral crowding-out effects”. One way for the company out of this dilemma would be to invest even more in compliance measures and their enforcement, driving transaction costs further up. Given that crowding out is an issue, the problem would likely continue even with stricter rules and improved enforcement measures (O4). Instead, fostering moral capabilities (O2) of the employees by raising awareness and improving moral decision making processes on the other hand might be a more efficient measure to reduce transaction costs.

In addition, it is important to stress that L3- and L4-institutions are not merely inferior “gap-fillers” for L2-institutions – which is the traditional view of compliance and integrity approaches (see Paine 1994) – but they are potentially recursively linked with each other. In our example, developing moral capabilities in  $t=0$  might not merely be more efficient in  $t=1$  and  $t=2$ , but there is also the possibility that they contribute to better L3-governance structures in  $t=1, 2, \dots$ , for example by a previously unattainable extension of the code of conduct beyond the prevention of corruption cases or measures that

are even closer related to the core business of the company (e.g. social responsible supply chain management, ecological production process, etc.).

Whether these repercussions and dynamic interactions exist and their direction of causality, is ultimately an empirical question that is up to now largely unanswered (see Gneezy et al. 2011). What is important here is that the above-sketched dynamic perspective allows us to conceptually integrate repercussion effects into the analysis, which is not possible with the standard “institutions as rules of the game” perspective.

It is important to note that the systematic consequences of our short example are not limited to the interplay between the levels L3 and L4 but can be extended to other levels too:

With respect to L2-L3, for example, it can be argued that the idea of corporate citizenship is not restricted to the establishment of moral practices within the organization. It includes an active involvement and an active contribution of the firm to just societal institutions, as widely discussed in business ethics (e.g.: Zadek 2001; 2004; McIntosh et al. 2003; Matten/Crane 2005; Scherer/Palazzo 2007; 2010; Wettstein 2010; 2012; Beschorner 2004; 2014). By the same token, however, the possibility of interdependencies points at a dimension of the problem rarely discussed in business ethics, namely that different L2-institutional designs may foster or hamper the development of corporate citizenship through the development of certain “moral capabilities”.

To sum up, with a more complex anthropology than usually assumed in economics, neither employees, nor companies, nor consumers can be assumed to be puppets on the string of the given L2-institutional structures, as traditional welfare economics implicitly suggests. It is important to focus on governance mechanisms between different L-levels that take into account the (long term) “developability” of both actions and institutions, of morality and justice.

## 6. Summary

In this paper we have suggested a multi-level approach to locate normative responsibility in societies that is build on an extended transaction-cost approach. The transaction-cost perspective allows us to develop horizontal and vertical comparisons between different institutional layers that are based on four sources of transaction costs: limited cognitive abilities in complex decision making situations, (bounded) moral capabilities, heterogeneous moral views, and enforcement costs of rule-enforcement. The main points developed in this paper are as follows:

1. Contributions that merely focus on a single institutional layer (L3, L2, or L4) face the danger of reaching too short. They look at the problem of finding functional social institution that effectively address normative institutional issues from the wrong angle.
2. In most cases, normative responsibility needs to be located on different institutional layers simultaneously. The analysis of comparative transaction costs in a given (historical and cultural) context provides guidelines for a functional division and location of responsibilities.

3. Due to „self-similarities” amongst different institutional layers, our transaction-cost approach can be applied with respect to the interplay between L2-L3 (societal institutions and corporate citizenship) as well as between L3-L4 (organizational ethics and individual moral actions) institutions.
4. The process of globalization and the implied transition from national to post-national problem structures clearly point to the importance of addressing the vertical allocation of normative responsibility and thereby underpin a well-known argument in business ethics: The less a traditional normative consensus expressed by L2-institutions is enforceable by nation states, the greater becomes the relevance of and the need for new forms of governance and moral responsibility of (individual and organizational) actors (e.g. corporate citizens).
5. The suggested multi-level approach allows for a deeper understanding of the dynamic processes and recursive relationships between individual actions and institutions, between morality and justice. Individual moral epistemes are embedded in institutional contexts, and institutional contexts are influenced by the moral epistemes of the individuals. From this point of view, L2 or L3 institutions can only be very rarely accurately conceptualized as incentive mechanisms, and moral behavior can not merely be seen as moral problem-solving in a given (dilemma) situation caused by “gaps” in higher-level institutions.
6. From a dynamic perspective, our analysis points to the relevance of governance mechanisms between different institutional “layers” L0-L4. From the point of view of an epistemology that conceptualizes individuals as potentially moral agents who adapt to their social and natural environments, it would be a surprise if optimal institutional designs were traditional “incentive mechanisms” as suggested by traditional welfare economics. On the contrary, the moral exoneration of the individual, that is implicit in this view, is guilty of a concept of the human being that degrades it to a simple machine and that denies its ability and dignity of developing its moral potential (as, for example in Aristotelian virtue ethics or Buddhist philosophy).
7. Consequently (with respect to 5. and 6.), the morality of individuals as well as the morality of organizational actors are not just regarded as filling “governance gaps” of higher-level institutions L2 or L3. Actors have, if you like, political duties to change the institutional structure within their sphere of influence.

Our analysis shows that in a number of contexts it is inadequate to see morality and justice as substitutes or to rely exclusively on the justice of institutions or the morality of acts for two different reasons. Firstly, it is very unlikely that transaction costs support such an exclusive focus. And secondly, morality interacts with its institutional environment in complex ways.

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