

Moral Sentiments in Market Economies*

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Abstract

This paper explores Smith's idea of a commercial society, which is often seen as offering a unifying idea between *The Wealth of Nations* and *The Theory of Moral Sentiments*. While there are various discussions around what Smith really meant by a commercial society, the aim of the chapter is to interpret it through the lens of contemporary economic theory, particularly an approach that emphasises the role played by *motivated agents*. We argue that even with a competitive market economy, there is an interplay between the pro-social motivations of economic agents with the pattern of market transactions, leading to an interplay between values and economic institutions. The chapter links these ideas to contemporary debates about how businesses pursue environmental and social goals. We also discuss the normative achievements of a commercial society and use this to reflect on the role of the state.

Keywords: commercial society, moral sentiments, motivated agents, markets

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1 Introduction

Adam Smith presents us with an apparent puzzle. In *The Wealth of Nations* (1776), he famously argues that individual pursuit of self-interest, guided by the invisible hand of the market, can generate collective prosperity: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.” Yet in *The Theory of Moral Sentiments* (1759), published seventeen years earlier, he opens with a very different observation:

“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.”

This tension – between self-interest and moral sentiments, between market incentives and ethical commitments – has echoed through economics for two and a half centuries. To many observers, it suggests an irreconcilable division in Smith’s thought, or perhaps a fundamental choice economists must make: do we model humans as self-interested maximisers or as moral beings? Do markets operate through calculation or through virtue?

We argue there is no such choice to make since the tension is an artefact of how economics has evolved, not an inherent feature of what Smith called *commercial society*. Modern economic theory has relied on three key separation assumptions that partition the world into distinct domains:

First, a *separation between markets and government*: markets allocate private goods through self-interest and the invisible hand, while government corrects market failures and pursues distributional objectives through taxation, regulation, and public provision.

Second, a *separation between consumption preferences and productive activity*: individuals have utility functions as consumers, but firms maximize profits independently of the preferences of workers, managers, or shareholders. Business is business and therefore separate from personal values or social commitments.

Third, a *separation between intrinsic and extrinsic motivation*: people may enjoy their work or believe in its value, but monetary incentives simply add to this baseline motivation rather than interacting with it. More pay means more effort, regardless of the task’s meaning.

Each of these separations has been useful for building tractable models and generating sharp theoretical insights. But each is also empirically incomplete and theoretically contingent. When we relax them – as economics increasingly does – moral sentiments emerge not as friction or constraint on market efficiency, but as integral to how markets function and can be made to function better.

This chapter develops three core arguments:

First, under plausible conditions, profit-maximising business strategies can also be socially responsible and sustainable in competitive markets. When stakeholders – workers, consumers, or investors – care about social objectives, firms respond through standard market mechanisms. This is not philanthropy at shareholders’ expense but a strategic response to heterogeneous preferences. Corporate social responsibility, properly understood, can be compatible with competitive equilibrium.

Second, even when social goals involve efficiency costs, pursuit of such goals through market mechanisms can complement government policy in achieving social objectives. Whether through private politics, stakeholder governance, or hybrid organisational forms, motivated agents operating in markets can extend the reach of social policy and reduce the burden on formal government action.

Third, moral sentiments are not exogenous constraints but evolve endogenously through cultural transmission shaped by economic and organisational structures. The values workers, consumers, and citizens hold are partially determined by the institutions they encounter – the missions of firms they work for, the products available in markets, the policies governments implement. This creates dynamic feedback loops where economic organisations shape values, which in turn shape economic organisations.

These arguments bear directly on contemporary debates. The current backlash against Environmental, Social, and Governance (ESG) investing, Diversity, Equity, and Inclusion (DEI) initiatives, and Corporate Social Responsibility (CSR) often invokes the Friedman Doctrine: that the social responsibility of business is to increase profits (Friedman, 1970). This is sometimes misleadingly attributed to Adam Smith’s insight that self-interest can serve social ends. But Smith’s commercial society was one where participants restrain their behavior in consideration of others through moral sentiments, not one where such restraints are systematically absent. Our framework shows how modern markets can embody this richer conception – not through sacrificing efficiency but through recognising that motivated

agents are integral to efficient production, especially in domains where outputs are multidimensional, difficult to measure, or inherently social.

Structure of the chapter. Section 2 provides historical context, examining how Smith’s ideas emerged in a pre-industrial commercial society and how subsequent economic thinking introduced the separation assumptions we now relax. Section 3 develops our core framework, showing how moral sentiments operate through three channels: motivated workers who accept lower pay for mission-aligned work, motivated consumers who trade private benefits for social outcomes, and motivated investors who incorporate externalities into asset demand. Section 4 extends the framework to government and hybrid organisations, showing how the same logic that makes moral sentiments productivity-enhancing in markets also makes them essential for effective state action and explains the emergence of organisational forms between pure profit maximization and pure nonprofit status. Section 5 examines the dynamics of moral sentiments through cultural evolution, showing how values and institutions co-evolve and considering the normative implications of endogenous preference formation. Section 6 concludes by synthesizing the static and dynamic arguments and reflecting on the future of commercial society.

2 Historical Context

Smith lived and wrote before industrialisation and the advent of modern representative democracy based on wide political rights. His parable of the pin factory was a powerful allegorical representation of something that was to reach its apogee in the century that followed. However, much of his frame of reference was one where the lever of riches was enhanced by trade and commerce rather than mass industrial production. But that focus enabled him to gain insights that remain valuable. For example, he saw the importance of market power and open access to economic opportunities. His focus also allowed him to see the centrality of trust and legal institutions in a market economy, something that would become even more evident as the Industrial Revolution took off in the half century following the publication of *The Wealth of Nations*. A point of comparison with a past that would have seemed more recent to Smith was an economy and society where traditional, sometimes quasi-feudal relations were an inhibitor of progress and prosperity.

This framed his conception of a market economy as a place where open opportunities were available if the institutional structures were in place. In this sense, Smith was at the vanguard of classical liberal thinking that propelled forward what became the Industrial Revolution (see, for example, Mokyr (2016)).

Appeal to this historical context is a reminder that *The Wealth of Nations* and its ideas should be read in context. Moreover, the modern subject of economics did not exist and evolved only slowly for the next hundred years before thinkers such as Marshall, Hicks, Samuelson, Coase, Nash, Pigou and Arrow shaped a modern, more formal and systematic version that has come to dominate modern economic thinking as reflected in mainstream textbooks. With that has come greater use of formalisms to capture key ideas such as incentive problems in firms, organisations and markets. Notions of competition have also been formulated using game-theoretic apparatus.

Our exploration of Smith's ideas is mainly shaped by contemporary debates about the market system, which have moved on a great deal since the late 18th century. Indeed some of these ideas really only gained currency very recently. Only some of these debates are encompassed in conventional economic models. This is evident in the intense debates that continue to rage about the merits of a market economy. As in the standard interpretation of Smith in economics, discussions of general equilibrium models do not come close to doing these justice. This can be keenly appreciated when we are reminded that much of the postwar period saw the world divided into two broad camps. The Western liberal democracies championed a mixed market economy model, albeit with different institutional flavors (see, for example, Hall and Soskice, 2009). Others, both rhetorically and practically, rejected that model, embracing neither markets nor democracy. The system collapsed and there are few persuasive voices that wish to shift back to socialism. In the late 1980s, two remarkable and largely unpredicted changes happened: (i) China decided to develop its own brand of market economy, embracing international trade and capitalist incentive structures where enterprise is rewarded; (ii) the Berlin Wall came down, and subsequently socialism as an ideology suffered a largely terminal decline.

Perhaps on the back of this, there were fresh debates about the nature of the market system. A form of market triumphalism emerged that is often referred to as neo-liberalism with champions such as Margaret Thatcher and Ronald Reagan. In many ways, such views were the handmaiden of the traditional narrow economic view with a relentless emphasis on efficiency.

Such ideas were kept alive by the Mont Pelerin Society, founded by Friedrich Hayek but a place where varieties of economic liberalism were debated, and with different strands of thinking (see Burgin (2012)). Milton Friedman emerged as one of the leading thinkers in this new brand of market liberalism. He frequently cited Adam Smith as his inspiration:

“That is why, as Adam Smith put it, an individual who “intends only his own gain” is “led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.”

This chapter gives our own take on these debates using our take on what modern economic theory can offer to the idea of a commercial society supporting a vision of a market economy. It is an approach where values matter. Our argument should not be read as a claim that Smith valued moral sentiments *because* they increased efficiency. Smith’s concern was more broadly normative; a commercial society that generated material prosperity while eroding virtue, propriety, or self-command would, in his view, be deficient. Our contribution is different. We will show that modern economic analysis need not choose between Smith’s moral concerns and its own emphasis on efficiency. Moral sentiments are constitutive of a flourishing commercial society in Smith’s sense, and under plausible institutional conditions they can also shape market outcomes in ways that economists would recognise as efficiency-enhancing. Neither does our view subordinate ethics to efficiency, but demonstrates that the two are less antagonistic than is portrayed in standard economic models.¹

With this historical context in mind – appreciating both how Smith understood commercial society and how far we have travelled since the 18th century – we now turn to the core framework. We discuss the idea of an economy with motivated agents operating in markets, explicitly relaxing each of the three separation assumptions identified above. The next section shows how moral sentiments shape market outcomes when we allow workers, consumers, and investors to care about social objectives alongside private returns.

¹As argued by Censolo and Morelli (2025), Smith was also quite pessimistic about the sustainability of liberal values in a market economy.

3 Moral sentiments in Markets

This section develops our framework for understanding how moral sentiments shape market outcomes. We proceed by examining how relaxing each separation assumption in turn generates new insights into the functioning of commercial society. We begin with motivated workers (relaxing the separation between intrinsic and extrinsic motivation), then turn to motivated consumers (relaxing the separation between preferences and production), and finally examine motivated investors (showing how both separations break down when shareholders care about externalities). Throughout, we show how these mechanisms operate through standard market forces – prices, quantities, entry, and exit – rather than requiring any departure from economic reasoning.

Economic action that flows from self-interest has been a dominant tradition in economics, in particular, analyses of the market economy. But even this is consistent with a range of motivations. For example, altruistic acts consistent with a standard economic model as, for example, in Gary Becker’s celebrated work on the economics of the family (see Becker, 1993). This is a moral sentiment when, for example, children benefit from the sacrifices that parents make.

3.1 Three Conceptions of Moral Motivation

It is helpful to delineate three main kinds of motivation.

The most common, according to modern economics, is the motivation to act to achieve a personal goal. But we can be open-minded about what that goal as a mix of psychic as much as material rewards. Thus, an entrepreneur could care intrinsically about producing a new good as valuable in itself so that, in a market setting, have access to a new good that might not exist at all but for the intrinsic motivation of the inventor. But this is a market-mediated effect, what is often called a pecuniary externality, i.e., it enhances the welfare of consumers through the price or qualities of the goods that they can buy in the marketplace.

The second kind of motivation is the desire to pursue the public good through one’s actions. This makes most sense when actions contribute to the production of a public good, i.e., a good that creates benefits for a particular group or society at large. This could be something quite local, such as, treating your co-workers well because you care about them, as in a stan-

dard approach to altruism. But it could also be societal, i.e., external to the organisation where one works, such as reducing carbon emissions. It is well-known that when goods have (at least partially) public good elements, then pure market incentives fail to achieve optimal provision. Even if individuals are altruistic to some extent, they will need to coordinate their actions among themselves, and there is no reason to believe that altruistic tendencies are strong enough to solve global public goods problems. Moreover, having people who, say, do not value reducing carbon emissions will make it near impossible to achieve a net-zero outcome. Standard welfare-economic propositions support a whole set of government interventions that could be proposed in the form of taxation and regulation that responds to this. But whether there are ways of harnessing pro-social motivation in market settings and what that can achieve is less well understood.

A third view, which is closest to what Smith says in the *Theory of Moral Sentiments* is based on motivation through *virtue ethics*, a character-centred ethical theory that focuses on the importance of developing moral virtues such as honesty, sympathy or trustworthiness that contribute to achieving a flourishing life. This view of Smith's ethical framework is suggested in McCloskey (2008). She notes that this view of the importance of moral sentiments was pushed underground by the rise of Kantian and in particular, Utilitarian theories of morality of the kind that now dominate in economics. But for Smith, the main virtues were love, courage, temperance, justice, and self-interested prudence. This way of thinking sees moral sentiments as forms of motivation that are embodied in our preferences. On this view, motivations are manifestations of virtues and hence are consistent with a model of motivated agents.² Moreover, one can see such moral sentiments being manifest in market interactions as workers, consumers or investors.

The fashion for consequentialist thinking in economics means that this view does not get much representation in mainstream discourse. However, it is not without its supporters. For example, the ethical framework put forward in Bowles (2016) is consistent with a virtue ethical framework. And it provides an interpretation of the motivated agents model of Besley and Ghatak (2005) in contexts where the motivation is towards prosocial ends but for intrinsic rather than instrumental motives. The more micro-founded approach in Bénabou and Tirole (2006) is similarly consistent with Smith's

²This view has some similarities to the standard view of altruistic motivation but puts much more weight on intrinsic motivation.

virtue ethics.

We now explore how these have force when economic agents act as workers, consumers or investors. We will show that inculcating such virtues can indeed have consequences for how a market economy works.

3.2 Motivated Workers

Traditional economic thought has long posited that economic agents are primarily driven by self-interest and that work is inherently “bad”, viewed as foregone leisure. This perspective is encapsulated in concepts like Adam Smith’s “toil and trouble” and Karl Marx’s “alienation” or “extraction of surplus value”. Within principal-agent models, fundamental to contract theory and organisational economics, this narrow view persists – workers are assumed to require inducement through incentives, monitoring, and even punishment, such as dismissal, because effort is imperfectly observable. However, recent work in economics is increasingly challenging this simplistic, self-interest-driven view of individuals within the economic domain.³

Economists are now moving beyond the stylised models of motivation based on a narrow view of *homo economicus*, who solely values money and leisure, embracing a wider perspective that incorporates a richer set of motivations. This broader understanding includes prosocial motivations such as a commitment to a mission, the role of identity, and commitment to an “in-group” like family, community, or tribe. Other non-pecuniary motivations include intrinsic motivation, reputational concerns and social norms, status rewards, and pure altruism. There is an increasing emphasis on these non-pecuniary motivations and how they interact with incentives and selection, especially in settings where outputs have significant social returns not fully captured by private returns, or where both outputs and inputs are difficult to measure, leading to agency problems.

This shift represents a departure from one of the original dilemmas of economists – while Adam Smith’s *Wealth of Nations* famously suggested that economic actions stem from self-interest, not benevolence, his earlier work, *The Theory of Moral Sentiments*, acknowledged principles in human nature that lead individuals to be interested in the fortunes of others, deriving pleasure from their happiness. Economists, adopting a simplifying strategy

³See, for example, Akerlof and Kranton (2000); Bénabou and Tirole (2006); Besley and Ghatak (2005); Bowles (2016); Kamenica (2012)

that can be traced back to John Stuart Mill (Mill, 2006), have historically focused solely on man as a being desiring wealth, abstracting from other human passions.

In the context of pro-social motivation, recent theoretical work explores how financial incentives, such as performance pay, interact with these intrinsic drives. A key finding is that motivated agents often receive lower pay and performance bonuses than unmotivated agents, yet they remain at least as productive. This suggests that incentives and motivation can act as substitutes. Without considering the selection of workers based on motivation, one might mistakenly conclude that incentives merely lower pay without affecting effort in the provision of goods with social returns by pro-social agents.

A workforce committed to a pro-social cause can have beneficial consequences, highlighting the importance of worker formation beyond mere skills-based human capital. However, this leads to a “performance-pay penalty” for motivated agents, creating a selection problem where hiring a more pro-social agent results in lower bonus pay. This selection problem can be more pronounced where alternative employment opportunities are scarce, such as in developing countries. Conversely, as labour market options improve, the selection problem becomes easier to solve, potentially leading to higher quality public service provision.

There is a large and growing empirical literature examining the impact of incentives on performance in areas where pro-social motivation is relevant (see Besley and Ghatak, 2018). Field experiments are increasingly exploring these issues (for example, Ashraf et al., 2014). A central challenge moving forward, if intrinsic motivation is indeed crucial, is to understand how to “unlock” or create it and what organisational and contractual forms are best suited to utilise it effectively. This evolving economic perspective provides a more nuanced understanding of human behaviour and its implications for organisational design and public policy.

Motivation viewed through this lens is broadly conceived and can be manifested in many different ways. Entrepreneurs, inventors, and workers may be motivated by the love for the craft or what they produce irrespective of their social value. They may care about their social reputation and the desire to be seen to be contributing to worthwhile causes through their work (see Bénabou and Tirole, 2006). They may be driven by a sense of identity and wanting to do a good job in the capacity of the identity that their work or organisational affiliation attaches to them (see Akerlof and Kranton, 2005). They may be motivated by the mission of the organisation that they work for,

because they care about certain causes (see Besley and Ghatak, 2005). They may be motivated to solve problems that they have first-hand experience in or would help mitigate social and economic problems they care about. For example, homophily may lead inventors to create products tailored to people like themselves, and so creating a more diverse pool of inventors may foster innovation in new areas (see Jaravel, 2025). A similar mechanism applies if inventors are driven by a desire to help groups and causes they are sympathetic to or ideological leanings (see Dossi and Morando, 2023).

The general point is, workers, craftsmen, inventors, and entrepreneurs are not just driven by financial goals – they are willing to work more for less if they derive non-pecuniary benefits from doing the work they do, whether it is for their own enjoyment, social esteem, self-image or more other-regarding motivations. Such sentiments become part of standard “market forces” in the domains where they apply. They can substitute for monetary incentives, especially in places where there are attributes that are hard to measure and hence incentivise in conventional ways. Innovation in a world of radical uncertainty is a particularly important example. Who could have envisaged the power of the smartphone even thirtyyears ago? Although those who appreciated what it could do would have been rewarded with material riches, the direction that technological change would take was, and remains, impossible to specify completely.

Many of the future applications of AI are probably unimaginable today and will be, in not small part, driven by the motivations of those who are developing them. Of course, this raises countless concerns about their societal implications as we have learned with social media, but to confine the goals of those who work on these to narrow material motivations does not do justice to the underlying processes. And the state is most likely to respond *ex post* rather than being able to have material impact on *ex ante* incentives, leaving a large role for the motivations of those involved in the inventive process to matter.

3.3 Motivated Consumers

There has been increasing interest in modelling how consumers care about attributes of goods and services beyond quality and price. Consumers may care about how the good or service is produced, for example, whether producers follow environmentally sound practices or treat workers fairly. Consumers may therefore shop around based on their political and ideological beliefs.

This raises the two questions: (i) how does this relate to firm objectives, e.g., whether a firm cares only about profits; (ii) is it desirable from a welfare point of view.

Besley and Ghatak (2007) explores such issues, suggesting that corporate social responsibility (CSR) can be understood as the private provision of public goods in a market setting. Firms may respond to heterogeneous social preferences in the way that they produce and market their products. In this case, CSR is consistent with profit maximisation and producers adopt social objectives to reflect consumers' willingness to trade off private benefits for socially desirable outcomes. In Besley and Persson (2023), this logic is extended to a dynamic setting in which environmental values shape consumption choices, technology choice, and political support for policy. The common element is that values are reflected in market outcomes through consumer choice even when the firms are profit-maximising. From this perspective, markets do not just allocate resources to reflect consumers' tastes; they also aggregate and respond to moral sentiments.

3.4 Motivated Investors

Parallel to non-pecuniary motivations that drive workers and consumers, there is also now a growing literature on “ethical investment” that clarifies how investors' moral preferences can shape firm behaviour through standard market mechanisms, a logic closely related to the shareholder-welfare view articulated by Hart and Zingales, 2017a and Hart and Zingales, 2017b. When investors care about social or environmental outcomes, these concerns are reflected in asset demand, ownership, and voting behaviour, thereby affecting firms' cost of capital and governance. Firms can remain profit-maximising, but with pressure from shareholders, the relevant objective can become the maximisation of shareholder welfare.

Such models of ethical investment operate through prices and control, not managerial altruism, and are disciplined by competitive capital markets and arbitrage. In this sense, moral sentiments enter firm decision-making indirectly via investor preferences, reconciling ethical investment with standard models of firm behaviour while highlighting how values expressed in financial markets can influence the direction of innovation and economic activity.

3.5 Norms, Trust, and Civic Culture

Moral sentiments also constrain opportunism in economic relationships. In standard rational-choice models, such discipline is explained through formal enforcement or through repeated interaction. The game-theoretic logic works when producers value future payoffs sufficiently so that cooperation can be sustained under the threat of future punishments. The literature on relational contracts show that a wide range of cooperative outcomes can be self-enforcing under appropriate informational and temporal conditions.

This logic has been extended into studies of how economic institutions work. In his pioneering work in economic history, North (1990) emphasised that institutions consist not only of formal rules but also of informal constraints embedded in shared belief systems. Greif (2006, 1993) and Aoki (2001) go further in modelling institutions as equilibria sustained by common expectations. On this view, institutions are not imposed from outside; they are patterns of behaviour that endure because agents believe others will behave accordingly.

Greif (1993) illustrates this mechanism in his study of Maghribi traders. He shows how this supported cooperation in long-distance trade; a trader who cheated was collectively ostracised. Provided that sufficiently many agents believe that others will adhere to this norm, it becomes rational for others to comply, and institutions are viewed as self-enforcing systems of shared expectations.

Although compelling, this account is incomplete. It can explain why opportunism may be strategically unprofitable but not why individuals often experience cheating as shameful even when detection is unlikely. Thus the account can be enriched by appealing to Smith's moral psychology. Individuals comply with standards of propriety, disciplining themselves even in one-shot or weakly monitored interactions. Moral sentiments therefore operate not only through external sanctions but through internalised constraints.

On this account, trust is not just the expectation of future punishment; it is the belief that others are guided by similar internal restraints. Where such moral constraints are widely shared, cooperation can be sustained with low monitoring and enforcement costs. A society with a greater proportion of trustworthy citizens is not simply normatively preferable; it is economically more efficient. Moral sentiments thus reduce the resources that must be devoted to policing, verification, and formal enforcement, thereby enlarging the domain of mutually beneficial exchange. Institutions also function more

effectively not only because incentives are aligned, but because character is socially cultivated.

The motivated agent framework developed in this section shows how moral sentiments enhance market efficiency through three distinct channels. Workers motivated by mission reduce agency costs; consumers motivated by social objectives drive firms toward socially responsible production; investors motivated by externalities allocate capital toward projects with positive spillovers. But markets do not operate in isolation – they interact with government, which both shapes and responds to these motivations. Moreover, the boundary between market and non-market provision is itself endogenous. The next section examines how motivated agents operate in government and in hybrid organisations that combine elements of both.

4 Beyond Pure Markets: Government, Non-profits, and Hybrid organisations

Thus far we have analyzed how moral sentiments operate within market settings. But Smith’s commercial society was never purely about markets – it was embedded in a broader institutional framework which can include government and civil society. This section extends our analysis in these two directions. First, we show that the motivated agent framework applies equally to government, where public service motivation can make state action more effective by reducing agency costs and improving objective alignment. Second, we examine organisational forms between pure profit maximisation and pure nonprofit status – social enterprises, benefit corporations, and hybrid organisations – that allow motivated agents to pursue profit with purpose. The common thread is that moral sentiments matter across all organisational forms, not just in markets (see Ghatak, 2021).

4.1 The Role of Government

An important stream of thinking in economics has become one where moral sentiments in government and markets are starkly different. Those who operate markets are selfish and ignore the negative and positive impacts that they have on others through externalities, while those who run the government are benevolent and focus on the public interest. The government then

becomes a force for fixing market failures and attending to distributional issues. This view has been the dominant force in the field of public economics with Atkinson and Stiglitz (2015) remaining a classic reference.

Such views were always subject to critiques, with the Public Choice school and the Chicago School being powerful influences. They tried to level the playing field by applying self-interest to the operation of government. For example, James Buchanan, one of the founders of the field of Public Choice says:

Individuals must be modeled as seeking to further their own narrow self-interest, narrowly defined, in terms of measured net wealth position, as predicted or expected' (Buchanan, 1989, page 20).

Not surprisingly, this kind of approach leads to a much more sceptical position on the role of government and argues that any attempts to make the market economy work better through government intervention should be weighed against the prospect of political failures. The modern political economy literature takes a much more balanced view of the operation of government recognising that moral sentiments are important in government (see, for example, Besley, 2006). But one should not be naive about this, blindly believing in the benevolence of government. Instead, the question is how institutions can work to bring about better performing government. This means disciplining policy-makers to foster prosocial actions creating better incentives while also ensuring that those with stronger prosocial motivation are elevated to positions of responsibility.

Just as market sentiments play an important role in market economies, they also facilitate effective government intervention. Relying on curbing self-interest alone in government and giving up on trying to recruit appropriately motivated workers does seem like too narrow and pessimistic a view for the basis of government. And this idea has origins in the *Publius* view that was influential in the Federalist Papers, which is nicely encapsulated in the following quote from James Madison:

“The aim of every political Constitution, is or ought to be, first to obtain for rulers men who possess most wisdom to discern, and most virtue to pursue, the common good of society; and in the next place, to take the most effectual precautions for keeping

them virtuous whilst they continue to hold their public trust.” –
James Madison (The Federalist Papers, LVII)⁴

The idea that a virtue is pursuing the “common good of society” when in government stresses that moral sentiments among citizens can play a key role in government and is consistent with the vision of the market economy articulated by Smith. But it also emphasises that investment in the state is important, just as it is for private business. This means tangible investments in infrastructure and the plant and machinery needed for the government to deliver. However, it also stresses the importance of non-tangible investments in organisational capital, now referred to as “state capacity”. The fact that such capacities of the state need not be built leads to focusing on the role of motivation and institutions in this process. A key challenge is to avoid the state becoming the focus of purely private interests that narrowly maximise the interests of a specific group. Such common interests could be facilitated by constraining the behaviour of policymakers or building norms and values that support public service motivation.

We see these ideas as being relevant at all levels of government, whether its political aspects or its bureaucracy. Just as in our account of motivated agents in the private sector. There is the potential to make government work more effectively via solving agency problems, but also by affecting the objective pursued by government. Recruitment and design of organisations become critical in making this vision a reality.⁵ This vision of the operation of government relates to a large literature on public organisation. Wilson (1989) developed the idea that government worked by focusing around key missions that could focus delivery efforts and could be internalised in agent motivation.⁶

These ideas have implications for the scope and role of government. To the extent that selection and incentives problems in government can create more effective government intervention, there is a case for a wider role of government in the economy. This is because government is more likely to pursue the public good rather than favouring special interests. It can also lead to more effective intervention if it promotes effort among public servants.

⁴The Federalist papers were written only shortly after the Wealth of Nations, between October 1787 and August 1788 by Alexander Hamilton, James Madison, and John Jay to persuade New Yorkers to ratify the new U.S. Constitution, appearing anonymously in newspapers under the name “Publius” before being compiled into books.

⁵See Besley et al. (2022) for a discussion of the issues.

⁶Tirole (1994) develops these ideas in a formal framework.

4.2 Between Markets and Government

Institutions that serve a public purpose cannot be neatly compartmentalised into public or private. For example, many public goods are provided in charities and non-profits. There is also much interest in the potential of firms that operate in a market context but pursue pro-social missions, whether it is helping the local community or fighting global challenges such as climate change by using green technologies. These have a potential role in securing an outlet for moral sentiments in a market setting as we now discuss.

There is an extensive literature that explores the case for non-profits as an organisational form. These organisations are rigid due to the non-distribution constraint. And it has been argued that it reduces incentives for managerial rent-seeking (see, for example, Hansmann, 2000; Glaeser and Shleifer, 2001). Their operation can be further enhanced by selecting employees who are committed to the cause as observed, for example, by Weisbrod (1988).

There is now much interest in more flexible organisational forms which combine “profit with purpose”, securing the right trade-off between pro-social behaviour and efficiency. These hybrid forms of organisation, are often referred to as “social enterprises”. There are many different types of firms that operate under this label (see, for example, Martin and Osberg, 2007, for discussion).

Besley and Ghatak (2017) discuss how such organisations can work to achieve social benefits in a market setting and take advantage of motivated agents. They show that, if managers are sufficiently motivated, non-profits and social enterprises are equivalent, as managers always put more weight on mission than on profits. However, for moderately motivated managers, the flexibility of social enterprises mitigates the mission-profit trade-off and also generates greater effort incentives. This gives a role for social enterprise that sits between for-profits and non-profits. It also reinforces that we need to consider economic activity that depends on selection of agents with appropriate motivations to achieve a trade-off between profit and wider social goals. There are now legal frameworks in place in many countries that recognise such organisational forms in market economies (see, Katz and Page, 2010, for discussion).

There is significant popular discussion of the role of social enterprise, with many real world examples. For example, Lendstreet Financial pursues the social mission of helping indebted people reduce their debts by delivering financial literacy programmes and incentives that encourage responsible re-

payment (see Battilana and Lee, 2014). The commercial microfinance sector is another good example where the social mission of relaxing borrowing constraints of the poor has come head to head with profiting at the expense of the poor, raising the spectre of “mission drift” (for example, Yunus, 2011). Ben and Jerry’s, is an ice-cream brand which was established to pursue strong ethical norms alongside more commercial ends. For example, the ice-cream is manufactured in Vermont using hormone-free milk sourced from local farms.

The analysis to this point has taken values and motivations as given. We have shown how markets, governments, and hybrid organisations can harness pre-existing moral sentiments to improve outcomes. But moral sentiments themselves are not immutable. They are shaped by socialization, cultural transmission, and the very institutions we have been analysing. This raises a deeper question: how do markets and organisations shape the values that agents bring to them? Section 5 turns to this dynamic question.

5 The Dynamics of Moral Sentiments

The framework developed in Sections 3 and 4 is fundamentally static. We analysed how markets and organisations function when agents have particular values and motivations, but we took those values as exogenous. This section relaxes that assumption. We examine how moral sentiments evolve through cultural transmission shaped by economic and social environments – where we work, what products are available and what policies governments implement. This creates dynamic feedback loops: organisations that adopt pro-social missions attract motivated workers, who socialise others into similar values, which makes pro-social missions more profitable, attracting more motivated workers. Understanding these dynamics is essential for assessing both the long-run sustainability of commercial society and the normative implications of institutional design.

We now sketch how we can think of moral sentiments being dynamic, responding to the way in which societies are organised. To do so, we draw on the extensive literature on cultural evolution that began in anthropology and has shaped the field of evolutionary psychology, beginning with seminal work by Boyd and Richerson (1988) and Cavalli-Sforza and Feldman (1981). They model cultural evolution as a process of social learning whereby behaviours are transmitted either consciously or subconsciously across populations. For example, citizens may be predisposed to adopting modal behaviours in groups

to which they belong or may be following trendsetters in elite positions. The approach has been particularly influential in exploring the basis of unselfish behaviour in kin groups or more extended social groups. They consider the role of cultural parents who influence the behaviour of their offspring. The idea of a cultural parent is much wider than biological or foster parents. It can include a range of peers in social life and educational institutions who shape the behaviour of others.

The canonical example in this work is the decision of whether to contribute to a public good, setting aside one's personal interest to free-ride. They highlight three key evolutionary processes: mutations, genetic drift, and natural selection. Central to Boyd and Richerson (1988) is "conformist transmission" where individuals imitate the more common behavioural types among their cultural parents which creates a force leading to common types in the population.

In classic models of cultural evolution, it is behavioural traits that evolve directly as a manifestation of culture. But in economics, we tend to think of behaviour as grounded in preferences and constraints. Thus, culture is embodied in evolved preferences. This is consistent, for example, with the classic account of caste identities as being embodied in preferences for some agents and in the economic self-interest of others who are afraid of repercussions of breaking caste-norms (Akerlof, 1976). The indirect evolutionary approach was first introduced in economics by Guth and Yaari (1992) who proposes that preferences would respond to payoffs in settings with repeated interaction. They explored the possibility that an equilibrium of a game with cooperation would diminish the taste for cheating opportunities. The importance of the indirect cultural evolution is emphasized in the context of classic work on collective action such as Ostrom (2000). She argues that, by changing preferences, societies can be more or less cooperative and hence able to solve collective action problems.

Such ideas have been developed further in economics following the seminal paper of Bisin and Verdier (2001) who propose an approach where parents socialise in order to affect their children's well-being but weighing this against the "social distance" that it creates between parents and children. It has been applied fruitfully, for example, to studying the evolution of morality and cooperation in Tabellini (2008). But there are now wider applications, not least to the sustainability of institutions. This is interesting as moral sentiments such as the importance of democratic values can contribute to making such institutions more resilient in the face of governments that try to

undermine constraints on executive power or compromise elections (Besley and Persson, 2019; Bisin and Verdier, 2024). This is because democratic values can support collective action in response to such abuses. Such ideas may also be important in understanding how state capacities evolve that depend on trust in government as articulated in Besley (2020) building on the historical analysis of Levi (1988).

Applying these ideas to studying how market economies work is less common. But we believe that such issues are first order, an idea that we have developed in Besley et al. (2025). The key challenge is how pro-social goals can be sustained among firms. A standard view is that profit maximisation will create a race to the bottom. And if this means that rivers are polluted and there is no effort to reduce carbon emissions, then the only option is government intervention. However, as stressed above, there are investors and workers who care about such causes and would prefer to invest in or work in firms that share such goals. But more importantly, this can have economic benefits to such firms.

But the dynamic benefit that can change the dynamics of motivation come through the fact that if firms adopt missions that are attractive to motivated workers who care about social causes, then this can produce a cost advantage and higher profits in the long run. Moreover, motivated workers receive psychic payoffs that make it attractive to become a motivated worker. This can shift the arc of capitalism where pro-social businesses can contribute to making more pro-social societies. This can create a positive feedback loop as firms that adopt more pro-social missions encourage pro-social motivation, which reinforces the adoption of a pro-social mission. This is one way of thinking about how DEI policies at an organisational level become entrenched. To take a concrete example, suppose that a firm adopts a mission that encourages low carbon-technologies, then if workers are supportive of the mission, they can be motivated to work hard for such firms without requiring monetary incentives. Workers who join the firm can then be socialised into sharing such values, which make it profit-maximising for the firm to adopt such missions.

This can happen inside firms and organisations but it can also happen in the market economy as a whole. Citizens will be more attracted to green causes when it is less costly to “go green”. A good example is how the falling price of electric-powered vehicles makes it less costly to go green, while higher taxes on fossil fuels have the opposite effect. Besley and Persson (2023) study cultural evolution in such contexts and consider the possibility that having

citizens who are motivated to consume greener, i.e., less polluting, leads to a policy outcome (through democratic processes) to increase carbon taxes, creating a positive environment for becoming an environmentally conscious consumer. This will, in turn, encourage more firms to invest in environmentally friendly technologies that induce a green transition. This creates a rather different dynamic process compared to standard price theory, where the focus is on how changing prices changes consumption. Here, it is shifts in demand curves that matter and interact with price changes.

Economists have clung to the idea that preferences are not malleable but without being clear where they come from. However, it seems highly implausible to think that values and, by extension, motivations to act in particular ways are something that we are born with. That preferences are formed would not be mysterious to sociologists. In a classic sociological account, Bales and Parsons (1955) put this as follows:

“If .. the essentials of human personality were determined biologically, independent of social systems, there would be no need for families ... It is because the human is not “born” but must be “made” through the socialization process that in the first instance families are necessary. They are “factories” which produce human personalities.... We therefore suggest that the basic and irreducible functions of the family are two: first the primary socialization of children so that they can truly become members of the society into which they have been born; second, the stabilization of the adult personalities of the society.” (pages 16-17)

On this view the family is the key institution in socialisation. But we can also think of many social institutions such as schools, workplaces, and clubs as key elements in determining what people value and hence how they act.

Work in this space is still in its infancy in economics. However, it holds the promise of unifying areas of social science. In Smith’s time, there were few distinct branches of social sciences and they were largely meshed into the broad discipline of political economy. But there is now more hope than ever of creating a form of total social science that is based on issues rather than disciplinary silos.

But it opens a new set of issues and challenges. Being able to study the dynamics of motivation empirically is extremely challenging since we would expect such forces to be slow-moving and finding specific empirical

correlates of change is extremely difficult. But we do have a hint in much recent historical literature that there is a long shadow of history. A good example is Nunn and Wantchekon (2011) who find that places in Africa that were more exposed to slavery have lower levels of trust today, as measured in attitudinal data.

Perhaps a wider set of issues raised by exploring the dynamics of moral sentiments is how we think about the ethics of policies and practices that have express aims of changing motivation. Social movements such as Nazism and Communism worked hard to instil support from their citizens via socialisation. And these made particular use of movements that tried to influence younger people when perhaps they are most open to influence. In any society, the choice of educational curricula plays a key role in producing citizens with particular types of predisposition. This is playing out as liberal thinking that has dominated universities around the world is creating a new political cleavage in society. And the political backlash against educational institutions in the US is a tangible manifestation of this. Moreover, markets can produce goods that encourage or discourage particular moral sentiments. If the market encourages trades that some regard as repugnant, this may change the number of people who regard such trades as normal or acceptable.

The rise of social media, whose consequences are still being studied, has the capacity to change the sensibilities of future generations (see for example, Haidt, 2024). This is already changing the nature of social interaction and the norms for acceptable expression of ideas. As Artificial Intelligence (AI) becomes more prevalent, it may mean that interactions between humans and machines will change, affecting relationships of trust and friendship. But these things are produced using profit incentives with very little understanding of their consequences. If the process is dynamic, then hitting rewind is not an option. And a key feature of the theoretical literature on cultural evolution is that complementarities between values and actions can create hysteresis.

To fully grasp what this means requires going beyond social science and embracing debates in political and moral philosophy. For example, we need to understand whether people with stronger moral sentiments of different kinds are also more content. If we bring up children to care about climate change and yet societies do not act, then are we just compounding their misery? These are difficult issues. But once we recognise that sentiments matter for action and that organisations and institutions shape these sentiments, we need some way of navigating through this. Much is at stake, both academi-

cally but also for the hope of creating societies where reflective human reason plays a role in shaping change.

6 Concluding Comments

This chapter has argued that moral sentiments are integral to the functioning of commercial society, not constraints upon it. We have developed this argument in two stages: a static analysis showing how motivated agents enhance market efficiency and a dynamic analysis showing how values and institutions co-evolve through cultural transmission.

The static argument. When we relax the three separation assumptions that have structured much economic thinking – between markets and government, between preferences and production, and between intrinsic and extrinsic motivation – moral sentiments emerge as central to understanding economic outcomes. Motivated workers reduce agency costs, especially in organisations producing goods with social value or multidimensional outputs difficult to measure. Motivated consumers drive corporate social responsibility through product demand, making ethical production compatible with profit maximisation. Motivated investors allocate capital toward projects with positive externalities, internalising spillovers through shareholder welfare maximisation rather than pure profit maximisation. In each case, moral sentiments operate through standard market mechanisms – prices, selection, incentive compatibility – and not through departures from economic logic.

Crucially, these mechanisms are not limited to markets. The same framework explains how public service motivation makes government more effective, reducing rent-seeking and improving alignment with social objectives. It also explains the emergence of hybrid organisational forms – social enterprises, benefit corporations, and nonprofits – that allow agents to pursue profit with purpose. Moral sentiments thus enhance the performance of organisations across the economy, from pure markets to pure government provision, with myriad hybrid forms in between.

The dynamic argument. Values are not fixed. They are shaped through cultural transmission by families, schools, workplaces, and the broader institutional environment. This creates feedback loops between institutions and values. When firms adopt pro-social missions, they attract motivated

workers, who socialise colleagues into similar values, which makes pro-social missions more profitable, attracting more motivated workers. When governments implement policies that reduce the cost of pro-social behaviour – subsidizing electric vehicles, taxing carbon emissions – they make it easier for citizens to align consumption with values, increasing the proportion of citizens who develop such values. When markets make certain trades routine, they can shift what citizens view as normal or acceptable.

These dynamics generate path dependence and hysteresis. Small changes in institutions can trigger large shifts in values, which then become self-sustaining. This insight has both optimistic and concerning implications. Optimistically, it suggests that well-designed institutions can cultivate values supporting commercial society, democratic governance, and environmental sustainability. The cultural evolution framework shows how green transitions, stakeholder capitalism, or public service cultures can become self-reinforcing. But it also raises troubling questions about preference manipulation. If preferences are endogenous to institutions, what are the ethics of institutional design aimed at shaping values? When does socialization become indoctrination? These questions take us beyond economics into political philosophy and ethics.

Implications for contemporary debates. Our framework speaks directly to ongoing controversies about the purpose of business. The Friedman Doctrine – that the social responsibility of business is to increase profits – is often invoked against ESG investing, DEI initiatives, and CSR programs. Critics argue that such activities sacrifice shareholder value for managers’ pet causes or that competitive markets will punish firms that prioritise social goals over profits.

Our analysis shows these critiques are incomplete. First, when stakeholders (workers, consumers, investors) care about social objectives, responding to those preferences is profit-maximising, not a departure from it. ESG investing reflects shareholder welfare maximisation when shareholders care about externalities. CSR responds to consumer demand for ethical production. DEI initiatives can improve workforce productivity when they attract motivated workers who care about inclusive workplaces. These are not necessarily inefficient.

Second, even when social goals involve efficiency costs, pursuing them through market mechanisms can be more effective than relying solely on

government. Hybrid organisations, stakeholder governance, and private politics extend the reach of social policy. They do not replace government – redistribution, public goods provision, and certain forms of regulation remain essential state functions – but they complement it.

Third, the dynamic analysis suggests that supporting pro-social business practices today can cultivate values that make such practices more sustainable tomorrow. The cultural evolution framework implies that institutions shape preferences, creating virtuous (or vicious) cycles. This gives institutional design normative weight beyond static efficiency.

Open questions and future research. Several important questions remain building on this agenda which develops Smith’s insights about the importance of moral sentiments.

Empirically, measuring the strength of pro-social motivation across contexts is challenging. Cultural evolution operates slowly, making causal identification difficult. We need better data on how values respond to institutions and how those values affect economic outcomes. The feedback loops we identify theoretically need rigorous empirical assessment.

Theoretically, we need better models of how motivated agents interact in competitive settings. When does competition amplify or dilute the effects of moral sentiments? Under what conditions can pro-social firms survive against purely profit-maximising competitors? How do network effects and agglomeration economies affect the dynamics of value transmission?

Normatively, the most profound questions concern endogenous preferences. If institutions shape values, what guides institutional design? Are some values intrinsically better than others, or is this always contingent on further preferences? How do we balance respect for individual autonomy against recognition that autonomy is itself shaped by social context? These questions connect economics to much older debates in political philosophy about the good life, the good society and moral psychology.

The future of commercial society. Smith wrote at the dawn of industrial capitalism, before widespread suffrage, before the regulatory state and before global markets. His vision of commercial society – open, competitive, embedded in moral sentiments and legal institutions – was both descriptive and prescriptive. We have shown how this vision can be connected to modern economic tools, showing how markets embedded in moral sentiments can

function effectively.

But we have also identified a deeper lesson: commercial society is not static. The values that sustain it are produced by it, creating co-evolution between institutions and culture. This makes the future of markets and democracy partly a matter of choice – not individual choice in markets, but collective choice about institutional design. The question is not whether markets or moral sentiments will prevail, but how we can build institutions that cultivate both prosperity and virtue, both efficiency and human flourishing.⁷

We live in a moment when the liberal economic and political order faces challenges from multiple directions – rising inequality, climate change, democratic backsliding, and geopolitical fragmentation. Some critics blame markets; others blame government. Our analysis suggests the dichotomy is false. Markets, governments, and civil society all rely on motivated agents who blend self-interest with moral sentiments. By understanding how institutions shape those sentiments, we can build a commercial society that delivers not just material prosperity but also the virtue and dignity that Smith saw as essential to human flourishing. That is the promise of taking moral sentiments seriously – and the challenge for economics in the 21st century.

⁷This connects to the discussion in Censolo and Morelli (2025).

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