

The New Enlightenment: One Year On

July 31, 2020

Executive Summary

In July 2019, a meeting of invited academics and businesspeople was held in Edinburgh, centered at Panmure House, Adam Smith's last residence. The event concluded with the signing of the Panmure House Declaration, which stated a collective commitment to shoring up the institutions of an ethically based liberal market economy. To mark the first anniversary of the conference, a webinar was organized featuring six of the speakers from the original event.

Opening remarks were made by David Teece, who had hosted the 2019 conference. He applauded the greater attention given to "stakeholder capitalism" in the intervening year, but noted the continued challenges to the global system, particularly the covid-19 pandemic and the continuing breakdown of relations between China and most of the rest of the world.

The first speaker was economist John Kay of Oxford University. He applied Smith's virtue ethics to the modern corporation and observed how companies have gone from admired pillars of society to inhumane, profit driven organizations that are no longer loved.

William Lazonick, an economist at University of Massachusetts Lowell, provided background on this transformation. The rise of the financial concept of "maximizing shareholder value" in the 1980s led to profits being "returned" to shareholders (who generally have never contributed capital to the company) through buybacks and dividends rather than being reinvested in learning and innovation. He noted that numerous changes will be needed to rehabilitate the role of corporations in the innovation economy.

Heather McGregor, executive dean of Edinburgh Business School, described how changes can be achieved through publicity and persuasion from the public and from regulators without resort to inflexible legislation. She gave the example of the "30% Club", which has been successful in its drive to increase the presence of women on corporate boards. She noted that finding appropriate metrics will be critical for pursuing the less quantifiable goals of stakeholder capitalism, and that efforts in that direction are still at a very early stage.

Sarah Keohane Williamson, CEO of FCLTGlobal, described how her organization is working toward educating asset managers and other large investors about the need for, and benefits of, long-term investing. She described a stakeholder hierarchy, noting that long-term investors earn returns after other stakeholder needs have been addressed. The identity and relative importance of specific stakeholders are culturally contingent. In some economies, for example, the government plays a far more prominent role than elsewhere.

Orville Schell, director of the Asia Society's Center on U.S.-China Relations, put governments front and center by briefly summarizing the ongoing collapse of the U.S. China relationship. The

relationship began 50 years ago as a matter of Cold War geopolitics. Following the collapse of the Soviet Union, western nations saw continued engagement as a way to bring China into the community of nations. Companies were only too happy to comply. It was the arrival of China's current leader in 2012 that caused the most noticeable shift, with China adopting a more aggressive stance aimed at securing a leading role among nations while avoiding scrutiny of its domestic behavior. A large degree of disengagement with China now seems inevitable.

The final panelist, Peter Schwartz, head of strategic planning at Salesforce, broadened the perspective, describing the rise and decline of multilateral institutions such as the IMF after World War Two ("political globalization"). He noted that, for most of that period, they helped ensure relative peace and prosperity, while, more recently, forces in both China and the United States are pulling the system apart. He sees a greater likelihood of international conflict as constraining influences fall away, leaving global corporations as the last vestiges of cross-border collaboration. He noted that this increases the stakes for implementing some form of stakeholder capitalism.

David Teece concluded by calling for scholars, businesspeople, and policymakers to bring the modern equivalent of Smith's breadth of interests to bear on the challenges of the present.

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A Summary

The following is a summary of remarks made by the webinar speakers. The full webinar can be viewed at <https://share.vidyard.com/watch/z4B4epvHUFZEwXEXPmJZ23>

Opening Remarks

Harry Broadman

Everyone on the panel participated one year ago at the first of what we hope will be an annual series of conferences honoring the opinions and insights of Adam Smith, which still apply very well today. Last year's conference was held at Panmure House, Smith's last residence. It's now a conference center and part of the business school at Heriot-Watt University.

Today we'll be talking about two broad themes: governance and globalization.

David Teece

A year ago, in Edinburgh, we signed the Panmure Declaration, reaffirming the wisdom and relevance of Adam Smith. While Adam Smith is sometimes portrayed as favoring selfishness and greed, those of us that have read either or both of his books (*The Theory of Moral Sentiments*; *The Wealth of Nations*) know that isn't the case.

The Panmure Declaration was a collective effort and marked the emergence of an intellectual community. We showed that we could find common themes. The key tenets in the Declaration were support for an ethically based liberal market economy based on the rule of law; a belief that government should consider the good of society, not just individuals; and a hope that government actions would favor market-based solutions with support for long-term investments.

Since then, the market system has continued to be attacked from the right and the left. We have a group of people that are uniquely trying to find a third way through. We're in favor of the success of corporations but we realize that short-termism and a failure to understand purpose and products lead to less profits and worse social outcomes in the longer term. We must continue to work toward improving the functioning of the market to help build a better and more just society.

Two events have clarified and amplified the importance of what we are doing. First, the pandemic has reminded us not just of the connectedness of global society, but also of differences among and within nations. The other big development over the past year is that the ambitions of the Chinese Communist Party have now become much clearer due to the events in Hong Kong and the skirmishes on the China-India border.

A year ago, the US had already decided that China was more rival than partner. Since then, a similar view of China has become more prevalent in Europe and the Indo-Pacific.

But how do the liberal democracies engage with China? The two economies are so integrated that they can't completely decouple. What economic, political, and strategic safeguards are needed? How can nation-states find the resources and garner the resolve to match China with respect to leadership in the industries of the future?

These are just some of the key issues that confront us as we think through Adam Smith's principles. It's not enough simply to recognize these as pressing issues. We must now find solutions and begin to implement them. With Panmure House we have the precious gift of the mantle of Adam Smith. We must not squander it.

First Panel: Governance

John Kay, Oxford University

The basis of Adam Smith's moral philosophy can be seen in an excerpt from *The Theory of Moral Sentiments* (Part 3, Ch. 1 & 2): "to deserve love and deserve reward are the great characters of virtue; and to be odious and punishable, of vice."

Smith believed in virtue ethics, in being deserving of love. This contradiction of the caricature of Smith as the prophet of extreme selfish individualism is the focus of my recently published book (with Paul Collier), *Greed Is Dead*. But what does it mean "to deserve love" in a business context? Business today is not loved. We have a paradox. Consider Google and Facebook, each with more than 2 billion customers. We love the products, but not the businesses that provide them.

Could it be that businesses were once more deserving of love? The pharmaceutical industry can provide an illustration. After the Second World War, companies such as Merck and Johnson & Johnson produced a series of remarkable drugs and vaccines that gave health and longer life to many people. They also gave rewarding employment to their employees and substantial profits for their shareholders. George Merck once said "Business is for the people. It is not for the profits. And the better we have remembered that, the more certainly profits have come." Johnson & Johnson expressed similar ideas in a credo first issued in the 1940s that reads like a manifesto for stakeholder capitalism.

But in the 1990s, the industry went downhill. Merck came under competitive pressure. They discovered Vioxx, an analgesic useful for a small minority of cases. But, in pursuit of profit, they marketed it for everyday aches that can be cured by aspirin. Vioxx side effects, including heart attacks, were discovered, leading to litigation and withdrawal of the drug.

In the last decade we've seen extremes in the drug industry with the promotion of opioids by Purdue and other firms in rural American communities and also the price gouging by firms like

Valeant and Turing. The industry has gone from responsible and successful to one that is no longer regarded as deserving of love.

What are the people who behave that way thinking? If they understood Adam Smith's virtue ethics, how could they have thought this was appropriate? How could car manufacturers have thought it was appropriate to cheat on emissions tests? How could companies build structures of such complexity that they appear to earn profits in no jurisdiction at all?

Nevertheless, businesses must do well to do good. Britain's pharmaceutical leader, ICI, followed a similar trajectory to Merck, and ended up being merged with a Swedish rival in the 1990s. A few years later I told the ICI story at a conference, and the next day I got an email from the vice president for corporate social responsibility at ICI. His message, roughly, was that, even though they screwed up the business, they did great on CSR. He was far from understanding what the responsibility of business actually is.

William Lazonick, U.Mass., Lowell

The United States has gone from innovation to financialization in its corporate governance over the last 40 years. It's dangerous if we worry about China too much without worrying about what we're doing in the U.S.

For a prosperous economy, we need innovative enterprises. The purpose of an innovative enterprise is a new product that has higher quality and lower cost, not profit. But when an investment in innovation is successful, enormous profit can result.

In terms of finance, the collective learning that underlies innovation requires funds that are committed ("patient capital") from the time investments are made until a competitive product—if one is developed—is sold. In the innovative enterprise, the foundation of financial commitment is profit that a firm retains, not the stock market, as is commonly assumed.

When successful, the innovative enterprise tends to provide its employees with greater employment stability, higher wages, superior benefits, and more creative employment opportunities. Its higher labor costs are actually a source of competitive advantage if workers' productive capabilities contribute to the generation of innovative products.

That's basically how, in the post-World War Two decades, the United States became the world's leading economic power with a growing and thriving middle class. But then, from the 1970s, the ideology emerged that companies should be run not for product but for profit. And by the late 1980s, the ideology took the form of maximizing shareholder value (MSV), promulgated by business schools and dominating the thinking of corporate board rooms.

The MSV argument, with its mantra to "disgorge the free cash flow", is that the profits belong to shareholders. MSV ignored the need for ongoing investments in innovation in its definition of "free cash flow". This is analyzed in a book I wrote recently called "Predatory Value Extraction: How the Looting of the Business Corporation Became the US Norm and How Sustainable Prosperity Can Be Restored".

From 1983, in addition to dividends, U.S. companies began distributing huge sums of corporate cash to shareholders in the form of stock buybacks done as open-market purchases. The main purpose is to manipulate the company's stock price. The Securities and Exchange Commission made this possible with its Rule 10b-18, adopted in November 1982, and which I call "a "license to loot". At the beginning of the 1980s, buybacks were minimal. For all companies in the S&P500 for 2010-2019, buybacks totaled \$5.3 trillion (54% of net income) and dividends were \$3.8 trillion (39% of net income).

Over the last decade, my research team has contributed to a growing body of knowledge which shows that buybacks have been a prime means of concentrating income among the richest households while destroying middle-class employment opportunities. In the name of MSV, leading companies will press down wages whenever they can, lay off employees even when profitable, price gouge customers, avoid taxes, and take on debt.

In pharmaceuticals, 18 companies in the S&P 500 in the period 2009-2018 distributed \$335 billion in buybacks and \$287 billion in dividends, the sum of which equals 106% of their profits. Yet these companies contend that they need to charge U.S. patients at least twice as much as elsewhere in the world because they use the higher profits to accelerate innovation. But that's clearly not the case. Financialized pharmaceutical companies have been losing out in innovation to their less-financialized European rivals such as Roche and AstraZeneca.

Now the CEO of Pfizer was one 181 executives who signed the Business Roundtable's Statement of Purpose of the Corporation in August 2019. The Roundtable was rejecting its shareholder primacy position from 1997 in favor of a stakeholder purpose. Another signer of the Roundtable statement was Tim Cook, CEO of Apple. But in the 9 months after signing, Apple did \$55 billion in buybacks in addition to \$11 billion in dividends. Apple does these record-breaking distributions to shareholders under its "Capital Return Program". But the only funds that Apple ever raised from the stock market was \$97 million in its IPO in 1980. How can Apple "return" cash to shareholders who never gave Apple anything?

My Predatory Value Extraction book discusses the transformation needed for the sake of investment in productive capabilities. Changes are needed in board membership, executive pay, and government regulation and taxation. We also need new policies to enhance the opportunities for American workers to engage in lifelong learning through collective and cumulative careers.

Heather McGregor, Edinburgh Business School

I'm going to start by reading from a letter Adam Smith wrote at Panmure House to a French duke in 1785: "In a country where Clamour always intimidates and faction often oppresses the Government, the regulations of Commerce are commonly dictated by those who are most interested to deceive and impose upon the Public."

From this quote, I want to look forward – to a world where the Panmure House Declaration was something that everybody looked to. I would suggest, in line with what you just heard Bill talk

about, that we need a purpose-led world. The world of the Panmure House Declaration is purpose-led rather than populist-led—what Adam Smith referred to as Clamour.

As we move from shareholder- to stakeholder-led governance, I've got two questions for the people listening and for my fellow panelists. First of all, how should we do this? And secondly, how should we measure it?

How do we move to a stakeholder-led governance system? I'd like to focus a bit on how do we not move. One way I don't want to see it done is by legislation. There are many other things that government can do to encourage and prompt a world in which governance is stakeholder-led.

Adam Smith was not, of course, a fan of huge government. He actually said that government needed to provide peace, easy taxes (not *no* taxes), and a tolerable administration of justice. As John said, it beggars belief that some large companies pay no taxes, and I think Smith would be appalled at that.

I was a founding member in 2010 of something called the 30% Club (<https://30percentclub.org>), which is a group of women – there were twelve of us at first. We set up a campaign group to have more women in senior management, particularly on the boards of the FTSE 100. There are now 30% Club chapters all over the world, and there are now more than 30% women on boards in both the FTSE 100 and the FTSE350.

When we started that work ten years ago, there were only 12.5%, and it hadn't changed for ten years. What we did with the 30% Club was to shine a light on the statistics; it wasn't about getting the government to legislate. On the contrary, we felt that if there was legislation it would make for a difficult position. Legislation is not the way to stakeholder-led governance.

I would highlight that here in the UK we have a system of “comply or explain”. So companies are asked why there aren't more women on boards, or why they have a gender pay gap, or why they're creating environmental concerns. They then have to explain that in their annual report. This has helped to drive more women on boards, a greater rotation of directors, employee engagement, and a reduction in gender pay disparity.

In the United States, you only have 20% of women on boards in the S&P 500. I don't think any progress will be made there until the government encourages the rotation of directors. In the S&P 500, there are only 30 companies that have term limits in their articles.

Finally, environmental changes can be encouraged by government without legislation. The interest and encouragement of regulators is something that I'd rather see. Sam Woods, who is the president of the Prudential Regulation Authority, our regulating authority for banks in the UK, wrote on the first of July to the CEOs of all of the banks in the UK setting out how he and the organization wanted to see banks providing for climate change risks. He wrote “Climate change represents a material financial risk to ... the financial system. Whilst the Covid-19 pandemic is a present risk and an understandable priority for firms, minimizing the future risks from climate change also requires action now.”

My second question was how do we measure our progress toward the world of the Panmure House Declaration. We've all been charged with thinking about how to design some kind of index or annual statement about how far the world is moving either towards or away from the world of the Panmure House Declaration.

You have to measure what you value, or you'll end up only valuing what you measure. One way is through initiatives like the Global Reporting Initiative (<https://www.globalreporting.org/>) but not much is published about how companies comply or not.

And any measurement needs the oxygen of publicity and debate. That's how we got more women on boards. Not through legislation but through measurement and publicity.

Governance is important. Too much of it, and it will stifle; too little, and we all drift back from stakeholder to shareholder, from purpose to profit.

Adam Smith was a purpose-led philosopher. And we should be a purpose-led society.

Second Panel: Globalization

Sarah Keohane Williamson, FCLTGlobal

For those of you who don't know us, FCLTGlobal is an independent non-profit organization supported by global companies, asset owners, and asset managers who are deeply committed to creating long-term value for society. Our mission is to rewire the global capital markets to support long-term sustainable growth. We've been focusing on practical tools around the five levers for long-term investing that creates value: governance, incentives, engagement between companies and investors, strategies for future competitiveness, and public policy. We're also developing measures of long-term value creation, including non-traditional or ESG metrics.

As companies are deciding how to manage themselves through this tumultuous time, we have turned to psychologist Abraham Maslow for guidance. Maslow's "Hierarchy of Needs" argues that humans must fulfill basic needs, such as the need for food, before moving up the pyramid to higher-level needs, such as safety, love, or self-actualization. Importantly, Maslow viewed each of these as building on the prior level, rather than being trade-offs between them.

Similarly, we've been thinking about how companies really consider stakeholder capitalism. Are there trade-offs among stakeholders? Or are they integrated in the midst of this crisis? There is more detail available in our paper "A Hierarchy of Stakeholder Needs" on our website, but in a nutshell, the idea is that companies, like Maslow's humans, have a hierarchy of stakeholders.

The baseline need is likely to be company survival. We recognize that many companies are not going to survive this downturn and will not have stakeholders in the future as they will fail and cease to exist. If survival is secured, the company can look to its employees, customers, and supply chain. Finally, we get to the long-term shareholders, whose needs can't be met without making good choices about the other stakeholders in the hierarchy.

Adam Smith's *The Theory of Moral Sentiments* talked about the balance between self-interest and sympathy. Even those with a heavy emphasis on self-interest, at least long-term self-interest, recognize the importance of the many stakeholders in a company's context.

Stakeholder capitalism has different meanings in different economies. The American version of stakeholder capitalism is very much about thinking through the needs of all stakeholders in order to maximize long-term shareholder return, whereas, in Europe, there is more of a balancing among various constituencies. Companies in other countries may put government needs much higher up the list.

Around the world, the influence of governments on companies varies widely from little role at all to literally having a seat at the table. One of the impacts of both the rise of China and the pandemic is a reconsideration of the role that governments play in business and investment decisions.

The way forward builds on Adam Smith's understanding of the balance between self-interest and empathy. Self-interest is the foundation of today's capitalist, market-based system, but it's sympathy for the long-term needs of a healthy society that will allow companies and policymakers to address where the market fails.

Orville Schell, Asia Society

What lies behind the train wreck that we now find ourselves confronting with China?

We had this rather amazing conceit that lasted almost four decades that came to be known as Engagement. It started in 1972. When Nixon and Kissinger went to China, they were just wanting to gang up on the Soviet Union. But when the Soviet Union collapsed, this idea of collaborating with China somehow—which almost took a stake through the heart in 1989 with the Beijing Massacre—lost its operating system. And it was here we got a very artful dodge, begun by Bush the elder and getting its consummate expression by Bill Clinton, namely, that open markets equal open societies. If you just trade, and exchange, and interact, then slowly, and in a kind of Hegelian way, the metal will bend in China.

There was a notion that history was somehow going in one direction. We had divined its pulse, and sooner or later China would have to change. Maybe not become like us exactly, but at least more convergent. It was that principle of convergence which lay at the heart of our ability to continue to collaborate and for the global market system to continue to develop.

We got to where we are now because Xi Jinping came to power in 2012, and he was a leader of a very different kind. He wanted to see China restored to greatness. It wanted to be wealthy, it wanted to be powerful. This was its long dream. It was no longer “peaceful rise”. It was no longer to integrate into the existing system in the world outside China's once-autarkic borders, but to begin to change that system—to make the world system safe for Chinese authoritarianism. The world didn't have to become authoritarian; it just had to be accepting, compliant, and it had to be subservient.

And it is this new propensity in China that I think has been responsible for highlighting the fact that we have different values, different systems. It isn't just a question of trade, balance of payments, currency exchange and things like that any longer. We are really in, I'm sad to say, a world that Adam Smith would recognize where China goes about its trade, its relations, its affairs very differently from the pretensions of the liberal democratic world outside.

This is a real problem, and it lands us in a contradiction. We find that the effects from this are rebounding throughout all of our once rather recklessly optimistic forms of interaction. We find people all over having to scramble to one side or the other. In this new world, the global compact is beginning to break apart. Oil and water are beginning to separate.

Look around the world. In the last six to eight months, what's happened in India? It's a startling about-face in terms of the understanding of China's intentions. Look at Australia, where there's now an amazing state of resistance to many of China's policies. There are five Australian naval ships patrolling with the U.S. Seventh Fleet in the South China Sea. And the British aircraft carrier Queen Elizabeth—as soon as it finishes its sea trials—is going to be steaming out to the South China Sea. Look at Sweden, the archetypical neutral nation, now in a state of real antagonism—almost an abusive relationship—with China. And this is replicated elsewhere in the world.

We're at a state where the values proposition that divides the liberal democrat world and the authoritarian world of China is more and more coming into play whether we like it or not. Pompeo's speech the other day at the Nixon Library was a fulsome cry about the Free World versus this other world represented by China (<https://www.state.gov/communist-china-and-the-free-worlds-future/>).

This is going to fray every aspect of the global market system: the idea of global multinationals being able to operate freely in the world, of Chinese companies being able to launch IPOs on American stock exchanges, or how we cross-pollinate the boards of companies in China.

I think we're heading into a period where there will be greater and greater separation—the word is decoupling—and, whether we like it or not, that is in process. I don't think it will be complete; it should not be complete. But the winds that are blowing, are ill winds when it comes to advancing the old global agenda.

I think the problem that is fundamentally behind the distinctions between the two worlds as they're developing is very much the world which Adam Smith described in his *Theory of Moral Sentiments*. And it would be very interesting if one could have a seminar or conference in China on that book and see the reaction. But, alas, I would not hold your breath.

Peter Schwartz, Salesforce

I want to talk about the role of the system of international institutions that came into being mostly after World War Two—things like the IMF, the World Bank, the United Nations, the GATT (now the WTO), and NATO that appear to have produced nearly 50 years of relative peace and prosperity. In the first half of the 20th century, we killed about 160 million people in

war, and in the second half it was more like 20 million. So one can see this as meaningful progress.

What happened after World War Two was what you could think of as a kind of political globalization. We had economic globalization prior to World War One, and the first wave of globalization driven by the British Empire. But there were no international institutions like the IMF as part of that fabric.

We now see a debate over the meaning of the past 50 years. Was that global system just a tool, for example, of American and British foreign policy to fight a Cold War by aligning a number of nations behind them to fight the Soviet Union and then Communist China? That it was essentially a political objective in a global competition between what amounts to two imperial groups.

Or, was it, alternatively, a step forward in human progress because the leading countries saw their own interests and the collaborative interests as aligned?

I'm inherently an optimist, and I tended to see it in optimistic terms, that there were altruistic motives along with the narrower sense of self-interest. That this was a measure of human progress. I find it disappointing to see the system now beginning to break down and an increasing likelihood of conflict.

China constrained by an international system is one thing; China unconstrained, with no need to play by the rules of institutions and laws is another. The United States constrained by a system of institutions and laws is one thing. A United States under Donald Trump *unconstrained* by those is quite another thing.

I think the role of governments will be diminishing in that international system. They will meddle and conflict and not produce peace and prosperity.

So, if there is to be any progress, then it falls back to the corporate world. And this takes us then to the question of governance and the role of stakeholder capitalism. If the governments of the world are failing to maintain that system of peace and prosperity, then the only other institutional framework that I can imagine that can actually take up that mantle is, in fact, stakeholder capitalism. Capitalism that regards not only the objective of producing profits and product but also a larger sense of social purpose.

In this world of increasing anarchy, I think it becomes incumbent upon companies to start thinking of themselves in global terms, and thinking far more widely in terms of who it is that they are working for, the much wider range of stakeholders that need to be considered in the face of this increasing anarchy.

So we need measures of how it is that companies are actually behaving with respect to stakeholder capitalism, Stock prices don't really qualify. One might have said 50 years ago, that the stock market was a good reflection of corporate values and value, and if a company did well this meant that many people admired the company or at least thought it generated value. Today,

75% of trading on the stock market is electronic trading without any meaningful connection to the value of the company, simply exploiting the small movements of the price driven by other traders. And so the stock market is no longer a particularly good measure of corporate value and values in terms of stakeholder capitalism or, frankly, even shareholder capitalism.

So we need other measures of a company's ability to play a role in the world, and help build a more effective fabric of connection than the anarchy that we now seem to be headed toward.

Closing Remarks

David Teece

Peter Schwartz did a wonderful job of actually linking the global issues to the governance issues. As global institutions decline in importance, it's all the more important that the private sector and multinational enterprises really adopt some acceptable code of governance because to some extent they're going to become proxies for nation-states. If that perspective is right, that global institutions are going to be weakened and not replaced, then it underscores more than one could conceivably imagine the importance of getting governance right.

We are already confronted by a whole set of moral and ethical questions. And of the great economists of the world, Adam Smith is one of the few who explicitly took both sides of human nature into account. Our recent Nobel Laureates are narrow, and their wisdom, while great, is nowhere near as eclectic and as wide as Adam Smith.

The decline of global institutions puts enormous burdens on management and on boards of directors to ask deep questions. From what I can tell, very few of them are. There is a particular role here that I think we have with the Panmure House Society, if you will, to really get our managerial classes focused on this in all of its complex dimensions, to really bring these together in a way that's meaningful and that shapes not just attitudes but shapes behaviors.