1 Introduction: The New Enlightenment

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In July 2019, an international array of leading policymakers, academics, and business leaders came together for *the New Enlightenment*, a conference devoted to understanding the opportunities for reshaping capitalism. The conference took place in Edinburgh at Panmure House, where Adam Smith lived and worked over two centuries ago.[1] Speakers included former UK prime minister Gordon Brown, the historian Niall Ferguson, the economist John Kay, and Weijian Shan, head of the Hong Kong–based private equity firm PAG Group.[2]

The conference was conceived by one of us (Teece), who was in turn stimulated by exchanges with his friend and Edinburgh Business School (EBS) colleague, Neil Kay. Kay was, at the time, helping to provide a vision for the renovated historic home of Adam Smith that former academic director Keith Lumsden had purchased on behalf of the EBS. Teece and like-minded colleagues had serious forebodings about the stresses disrupting Western economies, about the way China has begun to reposition itself technologically and militarily, and about the mounting opprobrium directed toward large corporations. An awareness has emerged that the liberal democracies and the rule of law–governed global economy – which had seemed quite robust just thirty years earlier with the collapse of the Soviet Union – were facing a deep and still evolving existential challenge. It was clear that wide-ranging conversations needed to take place to delve into and explore the antecedents and implications of the growing disenchantment with globalization and the conduct of large banks and corporations. The simultaneous intersections of multiple, massive global challenges seemed to require new models and novel mindsets.

In Edinburgh, over the course of three days, the effort to explore the interconnected issues holistically and work toward potential solutions got underway in plenary and breakout sessions and at two memorable dinners. The general focus was on two tracks: what companies can and should do to better align their interests with those of their stakeholders; and how major external events are likely to reshape the business environment. In particular, the informal

[1] Academic cosponsors included Edinburgh's Heriot-Watt University, the Edinburgh Business School, the Haas Business School of University of California – Berkeley, and the David Eccles School of Business of the University of Utah. Corporate cosponsors included German insurer FWU AG, American Discovery Capital, and the Berkeley Research Group. The conference would not have been possible without the generous support of all the sponsors.

[2] Full details of the conference are available at www.panmure2019.com, including links to videos of the sessions.

discussions during breaks, meals, and walks between locations surfaced an array of issues including the undercurrents driving short-termism, the need to better incentivize long-term investing and innovation, the insularity of corporate governance, the undesirable side effects of shareholder value maximization, the challenge of the unfolding digital industrial revolution, the changing nature of work, the emergence of new powerful tech giants, and the forces driving deglobalization and the gradual decoupling of the world's two largest economies.

Underlying the discussions was a collective aspiration to revisit and renew Adam Smith's holistic perspective, not just as an economist but as a moral philosopher, by openly engaging why capitalism, which has generated so much wealth and progress, is increasingly deemed to be failing so many. The sources of concern are everywhere: the depth and breadth of unequal opportunities, social injustice, widening of income and wealth gaps, disparities in life expectancy, housing shortages, uneven access to medical care, perceived inequality in primary and secondary education, and the disjuncture between education and the labor market.

Clearly, the range of potential topics is vast, hence the opportunity for this new Cambridge University Press Element Series on Reinventing Capitalism, the brainchild of Professor Arie Lewin of Duke University and coedited with Professor Till Talaulicar of Germany's University of Erfurt. How firms operate and how they are perceived are profoundly affected by the major global problems of the age: systemic and growing inequality, the fragmentation of the global datasphere, the rise of illiberalism, and the existential challenge of global warming. By the same token, firms can opt to be part of the solution, and some are beginning to undertake their own initiatives (e.g., Mars' Economics of Mutuality, see Badger 2020).

In his 2021 annual letter to CEOs, Larry Fink, the founder and CEO of the BlackRock investment fund, observed that the COVID-19 pandemic revealed and highlighted challenges associated with deeper trends, including a growing retirement crisis, systemic inequalities, historic protests for racial justice, and deep political alienation powered by social networks and political opportunism (Fink 2021). But the letter also takes note of companies that were motivated to focus on their stakeholders and innovate to keep food and goods flowing during lockdowns and that have stepped up to support nonprofits serving those in need. The same letter concludes by noting that, amid all the disruption in 2020, many corporations adopted policies and strategies to address climate risk.

Clearly, there is some evidence that companies can play a positive role in the quest for solutions to the many national and global challenges in which they are directly or indirectly implicated. Corporate leaders, separately and through industry-spanning organizations such as Inclusive Capitalism (under the leadership of Lady Lynn Forester de Rothschild), have the opportunity to engage their workforces with a broader purpose that encompasses the search for solutions to big problems of unequal opportunities writ large, and also to advance national discourse directly and through advocacy with policymakers. Today's complex challenges demand the active participation and cooperation of every sector of society.

Before concluding the Edinburgh conference, a majority of attendees voted in support of a Panmure declaration that called on government leaders to recommit to ethically based democracy and to protect the freedom and well-being of the communities in their care.[3] But it was clear that this was a beginning, not a conclusion.

On July 31, 2020, during the COVID-19 pandemic restrictions, there was a follow-up online event called "One Year On" that updated the major conference themes: the need to reform corporate governance and the changing structure of globalization. There was much to update and process, including the Business Roundtable's support for stakeholder capitalism (Business Roundtable 2019), the increasing assertiveness of China, and the disruption of global trade due to the pandemic, which accelerated the trend toward deglobalization and decoupling of sources of production and global supply chains.

The present Element, which includes contributions from several of the speakers at the Edinburgh conference as well as other distinguished academics, seeks to extend and expand the conversation still further. Our goal in this volume – and in the new Cambridge Elements series that it inaugurates – is to advance the work that began in the home of Adam Smith by juxtaposing multiple perspectives so as to generate new insights into the nature of purposeful stakeholder capitalism.

The Reinventing Capitalism series will feature explorations of various aspects of the crisis of legitimacy facing capitalism today. The series is intended to be a collection of authoritative literature reviews of foundational topics on the revitalization of the capitalist system. Contributions to the series aim to be forward-looking as well as descriptive of recent developments. While grounded in a business and management perspective, the series incorporates insights from multiple disciplines that provide insights into the causes

[3] "This First Declaration of Panmure House urges international leaders to base their policies and decision-making on a set of common principles, as espoused and formulated by Adam Smith, which cherish the required values of an ethically-based liberal democratic system, a moral commitment to the well-being of our communities and affirm responsibility to protect economic, political and social freedoms, use resources wisely, avoid unintentional consequences, follow the rule of law, favour markets and prices as guides to resource allocation and take a long term view of private and public investments, to support inclusive economic growth and prosperity for all."

of the current crisis and potential solutions. Subjects cover the history and development of various forms of capitalism; the relationship between capitalism, socialism, and democracy; the role of "moral sentiments" in the modern economy; capitalism and the future of corporate governance; globalization in a disaggregating world; and entrepreneurship and innovation in the modern economy.

This Element consists of eight sections in addition to this Introduction:

1. Craig Smith (University of Glasgow): Capitalism and the Legacy of Adam Smith
2. Ted Ryan (Duke University): The Failure of Shareholder Value Ideology and the Contours of a Humane Capitalism
3. William Lazonick (University of Massachusetts–Lowell): Innovation and Financialization in the Corporate Economy
4. Arie Y. Lewin (Duke University) and Till Talaulicar (University of Erfurt): Corporate Governance, CEO Compensation, and the Income Gap
5. Sarah Koehane Williamson (FCLTGlobal): Reviving Productive Capitalism: How CEOs and Boards Can Drive Sustained Value Creation
6. Gerald F. Davis (University of Michigan): Market Power and the New Antitrust: Where the Antimonopoly Narrative Goes Wrong
7. Maryann Feldman (University of North Carolina–Chapel Hill), Frederick Guy (University of London), Simona Iammarino (London School of Economics and Political Science), and Carolin Ioramashvili (London School of Economics and Political Science): The Emerging Technological Revolutions and Social Change
8. Orville Schell (Center on U.S.–China Relations at the Asia Society): How and Why Globalization Is Disaggregating: The Impact of China

Each author presents a short, insightful essay about specific problems faced by capitalism and liberal democracies as well as potential paths forward. It will be clear to even the casual reader that the authors are not always in agreement. This Element, like the series as a whole, aims to provide a sampling of some of the diverse perspectives that must be reconciled to find workable solutions; these will be developed in subsequent Elements.

Craig Smith's section on Adam Smith provides a link to the original Enlightenment. Smith's *Wealth of Nations* (1976a [1776]) has been widely lauded as the philosophical foundation of modern capitalism. For Smith, however, the workings of the economy were just one aspect of his field of endeavor, known as moral philosophy. Before the *Wealth*, he wrote *The Theory of Moral Sentiments* (1976b [1759]). In it, Smith posited that economic agents operate under shared moral constraints of right and wrong because they are part of society. He also saw a role for government in promoting desirable behavior in the marketplace.

Craig Smith argues that if Adam Smith were able to observe the economy of the twenty-first century, he would be impressed with the high standard of living but dismayed by the obsession with wealth as the basis of social status. He would recognize the balancing act required by society to enable companies to create value while restraining their anticompetitive tendencies. Rediscovering all of Adam Smith's thinking would help modern corporations, steeped in the logic of neoclassical economics, to develop new models for balancing their mission of wealth creation with the maintenance of a just society.

We shift the focus more squarely to the heart of contemporary capitalism with Ted Ryan's section, "The Failure of Shareholder Value Ideology." The dogma that the sole purpose of a firm is to make money for its shareholders is typically traced to a 1970 essay by Milton Friedman in the *New York Times*. Ryan forcefully develops the argument that maximizing shareholder value (MSV) can be self-defeating, emphasizing short-term payouts over long-term investments, and generates negative social externalities, including environmental degradation.

Ryan notes that many firms have already begun to move away from strict MSV, and he proposes grouping these efforts under the term "Purposeful All-Stakeholder" (PAS) capitalism. This builds on the idea that employees and managers will be more motivated if they see their work as serving a larger purpose for society as well as the profits of shareholders. The section concludes by pointing to companies that have already moved toward the new PAS model, including Costco, Electrolux, and Best Buy.

William Lazonick's section on "Innovation and Financialization" provides insight into one of the mechanisms favored by shareholder value maximizers, namely, the diversion of funds from long-term reinvestment in new and better products and services to short-term payouts to shareholders through dividends and share buybacks. He calls this shift the "financialization" of the firm and draws a direct line from this process to the worsening of employment opportunities, growing income inequality, and weak productivity growth. He concludes by calling for regulatory and governance reforms.

The section by Arie Lewin and Till Talaulicar on "Corporate Governance, CEO Compensation, and the Income Gap" looks at the inner workings of firms to explore why CEO compensation has grown consistently faster than the stock market for over forty years. There are numerous forces pushing in this direction. One is that the board of directors that sets the compensation package is populated in part by other CEOs who seem to favor more generous pay packages. Another problem is that the typical budgeting process allows executives to underpromise and overdeliver, setting the bar low for contingent bonuses. Executives are able to keep investors happy by shortchanging long-term strategy to meet and smooth quarterly earnings per share targets. Executives also have incentives to build "empires" through mergers and acquisitions because they can expect to be more highly compensated as the head of larger firms.

The generosity of CEO compensation interacts with the stock buybacks discussed by Lazonick. Boards of directors increasingly relied on compensating CEOs in the form of stock and options on the theory that this would better align the CEO's interests with those of shareholders. But managers are also effectively incentivized to conduct stock buybacks to raise the value of the shares they hold. Lewin and Talaulicar discuss several ways that board composition and CEO compensation plans could be designed to redirect efforts in support of the the needs of employees and other stakeholders, rather than just shareholders.

Sarah Keohane Williamson's section on "Sustained Value Creation" addresses the complementary issue of short-termism. Evidence suggests that long-term thinking is consistent with better corporate results, yet surveys show that short-term thinking is becoming more prevalent. Williamson calls for executives and directors to embrace a long-term, stakeholder perspective, to pursue riskier strategies (appropriately analyzed) that offer the possibility of opening new lines of business, and to adjust capital allocation more frequently so as to favor promising initiatives, instead of throwing good money after bad. Companies that only follow their current business model indefinitely will ultimately disappoint their stakeholders by failing to thrive in the future.

Jerry Davis' section "Market Power and the New Antitrust" turns our attention back to how firms behave, particularly how large technology-based firms exert power over individuals and regulators, as well as how their relentless drive to increase profits often stretches the rules. Davis calls into question the conventional wisdom that we are coming to an antitrust "moment," because industries are more concentrated and consumers are being harmed, by noting that the evidence is unclear or even points in the opposite direction. Antitrust is indeed a blunt instrument to address the subtle but damaging impacts of "big tech." His main recommendation is to have a new, tech-savvy agency regulate the ability of the big platform owners (Amazon, Facebook, etc.) to control the capacity of potential rivals to grow or even get started.

Davis argues for the need to devise a new regulatory framework that sets guidelines and strict enforcing mechanisms and appropriate fines, as the European Union (EU) has done with the establishment of the General Data Protection Regulation (GDPR) – a legal framework that sets guidelines for the collection and processing of personal information from individuals who live in the EU.

Maryann Feldman, Frederick Guy, Simona Iammarino, and Carolin Ioramashvili broaden this perspective in their section on "Technological Revolutions," which considers some of the ways that platforms and artificial intelligence are driving societal changes – particularly in the workplace. In some ways, they note, workers are becoming subservient to technology that monitors or even paces their work. While noting that the impact of a tech revolution can only be properly judged in retrospect, they lean toward the hypothesis that workers will lose more ground relative to employers who use new technologies to deskill or displace current jobs.

In contrast to Davis, Feldman et al. accept the mounting evidence that market power is becoming concentrated among a smaller number of large firms, not least the owners of tech platforms. They note that the ownership of these firms is also becoming more concentrated among a few large finance companies, such as BlackRock, that manage funds for investors. Even the locations where technology is developed and wealth accumulated, such as Silicon Valley, are now more concentrated than they were in the past. They call not only for more robust regulation, including antitrust enforcement, but also for new, decentralized technologies such as blockchain that can potentially democratize the economy. Noting that more job destruction is likely in the near term, they suggest that measures such as universal basic income may be necessary to make society more resilient.

We finish by widening the lens still further to look at the major geopolitical challenge of our time in Orville Schell's section on "The Impact of China." Even as liberal democracies struggle with the internal forces described in the earlier sections, a tide of authoritarianism is rising in many parts of the world that challenges and attempts to undermine democratic arrangements such as the EU. The apotheosis of this development is Xi Jinping's China, which is in the process of reimposing Maoist principles on a country that for decades appeared to be opening outward as it modernized. Instead, China is increasingly isolating its citizens from outside influences and broadcasting its preferred forms of governance outward through its "Belt and Road" initiative of investment in key infrastructure projects around the world. And, like Russia, its neighbor and fellow authoritarian state, China is beginning to project itself militarily. This state of affairs is leading to a partial decoupling of the global economy, with some manufacturing and services spanning the divide while others, especially if they involve personal data, becoming rigorously divided. The trust and openness that underlaid the historic wealth creation of late twentieth-century capitalism has been damaged, perhaps irrevocably.

The existential challenge posed by China has immeasurably raised the stakes for renewing capitalism in liberal democracies. Our authors span a range of opinion as to whether Western capitalism – riven by the effects of poor governance, technological upheaval, and uncontrolled finance – is in the process of destroying itself and whether minor adjustments or major overhauls are needed to regain the (then unnamed) stakeholder capitalism that predominated when firms were smaller, more embedded in their communities, and less subject to the forces of globalization and financial engineering. It is through the rational exchange of ideas among multiple perspectives that a New Enlightenment conversation will produce fresh insights and workable solutions.

Our goal was not to be comprehensive but to stake out the complex terrain that needs to be mapped and managed. It's as wide as global challenges (how to integrate a rising China) and as narrow as what goes on inside individual firms (reforming CEO pay and corporate boards, integrating new technologies). It's about how firms interact with investors (stock buybacks) and with each other (increased concentration among big firms). And it's also about the philosophy behind these efforts (questioning shareholder primacy, rediscovering the moral philosophy of Adam Smith). This is the territory we'll be exploring in this new Cambridge Elements series.

2 Capitalism and the Legacy of Adam Smith

Craig Smith

Adam Smith is known to the public as the founding father of capitalism, as the man who invented economics, the defender of self-interest, and apostle of free markets. These observations, like so many other widely held popular beliefs, are only partly true. If we are to look at Adam Smith's legacy in a volume devoted to reinventing capitalism, then we ought to start by noting that Smith was not an economist, but a moral philosopher who worked on a subject he understood as political economy.

Smith's contribution to the study of the economy is to be found in the clarity of his development of the basic concepts of economic analysis. How we understand the economy today has largely been shaped by the *Wealth of Nations* (Smith 1976a [1776]), but that book was part of a wider system of thought that Smith developed throughout his life and it is complemented by his great work of moral philosophy, *The Theory of Moral Sentiments* (Smith 1976b [1759]). Smith's views on political economy exist within a moral framework, and the same agents who compete in the marketplace cooperate and associate in other social settings. Our beliefs about how we ought to behave in our economic life are constrained by our moral beliefs about right and wrong.

Smith could not be clearer about this. Indeed, he starts the *Moral Sentiments* by denying that human beings are dominated by self-interest. As he puts it: "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" (Smith 1976b [1759]: 9). Smith had no truck with crude abstractions such as *homo economicus*. The idea that humans are best understood as abstract agents, much less rational utility maximizers whose behavior can be predicted with accuracy, cuts against the spirit of Smith's project. Smith took human beings as they are and sought to explain all the complexities of their behavior.[4]

While academic specialization has caused the discipline of economics to become separated from those of moral philosophy and political science, it is important to note that this was not the case for Smith. His subject was political economy, a discipline that saw politics and economics as intimately related and which Smith taught as part of his moral philosophy lectures. What this means is

[4] Indeed, the best of the latest scholarship on Adam Smith focuses on *The Theory of Moral Sentiments* and Smith's writing on jurisprudence (Smith 1980b) and philosophy of science (Smith 1980a).

that it is not enough to try to understand the operation of the economic life of a nation in a manner detached from its political life or its moral beliefs. Political actors respond to economic incentives and economic actors are aware that political institutions have a profound impact on the conditions in which economic activity takes place. Both political actors and economic actors are raised in a society that has shared moral beliefs about right and wrong conduct. Smith knew this and understood that moral and political constraints would be placed on what we could expect from economic policy.

Also, on any proper reading, Smith is not a capitalist. The term "capitalism," meaning a system under which labor is alienated from ownership of the means of production, was actually popularized in the mid-nineteenth century – long after Smith had died – by early critics such as Proudhon and Marx. As with most terms invented by people who are hostile to what they are naming, it is of limited use in understanding any lessons that Smith might have to teach us. Smith did not talk of capitalism but of commercial society, a form of society which was new and very different from the types of society that had gone before it. Commercial societies, Smith saw, were based on exchange. They were also wealthy societies, and wealth was a good thing because it reduced poverty and, more particularly for Smith, it reduced infant mortality. This may seem crude to us today, but for Smith it was a simple and effective measure of what he called improvement. If, in a commercial society, you did not need to watch your children die from want, then your life was qualitatively better than those in earlier societies.

This argument is complemented by his analysis in the *Moral Sentiments*. There, Smith argued that human beings are moral creatures possessed of a deep capacity to sympathize with one another. He noted that poverty and suffering limited our opportunities to sympathize with others. If we are desperately trying to stay alive, then our attention is focused on our own needs. If our lives are characterized by suffering and misery, then we learn to suppress our emotions and concern for others as a survival mechanism (Smith 1976b [1759]: 205). But once subsistence becomes secure we are able to give greater play to our emotions and devote time to expressing our concern for others. Smith believed that "A humane and polished people, who have more sensibility to the passions of others, can more readily enter into an animated and passionate behaviour" (Smith 1976b [1759]: 207). He talks about the natural circles of sympathy where we feel most for those closest to us, our emotional connection becoming more shallow as the people concerned become more distant from us. He realized that this was a natural feature of human behavior, but he also realized that growing wealth and security allowed those circles to widen and our sympathy to deepen.