How Adam Smith's Moral Theory Explains the Rise and Fall of ESG—
and Provides a Responsible Path Forward

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Abstract: I discuss how Adam Smith's moral theory explains the rise and fall of environmental sustainability, social responsibility, and corporate governance (ESG) as the gold standard for corporate responsibility and sustainability. First, I explain the degree to which the rise of ESG challenged the traditional theory of the firm developed by the Chicago School of Economics. Although the Chicago School made Smith the poster child for their theory of the firm, he generally rejected the behavioral assumptions on which it was built. Second, I present Smith's moral theory based on shared values and social norms and explain how it formed the moral foundation for his economic theory. Third, I describe how Smith's moral theory explains both the rising popularity of ESG in the modern economy and its eventual backlash. Absent Smith's moral theory and economic sensibility, ESG went from a set of ethical guidelines promoted by the United Nations to what some critics view as an iron fist of stifling regulation and divisive public policy. I conclude by discussing how incorporating Smith's moral theory into his economic theory provides a responsible path forward for researchers, practitioners, and policymakers.

Keywords: Adam Smith; ESG; Sustainability; Corporate Governance; Theory of the Firm, Chicago School, Theory of Moral Sentiments

1. Introduction

New research regarding the historical Adam Smith has been presented at international conferences celebrating the 300-year anniversary of his birth in 1723 and the 250-year anniversary of the publication of the *Wealth of Nations* in 1776. In addition to shattering the myth that Smith attributed all human motivation to narrow self-interest, this body of research has revealed the lack of support for *das Adam Smith Problem* created by German historical economists in the 19th century and perpetuated by neoclassical economists in the 20th century. In particular, there is no evidence that Smith attributed human motivation to “altruism” in the *Theory of Moral Sentiments* (Smith, 1759/1790) and “egoism” (narrow self-interest) in the *Wealth of Nations* (Smith, 1776/1791). Instead, the latest research has recovered Smith’s consistent emphasis on shared values and social norms in both his moral theory and his economic theory. In this study, I use the latest findings on Adam Smith to develop a theoretical framework for sustainability and ESG that is useful for researchers, practitioners, and policymakers.

Given the large disparity between the historical Adam Smith emerging in the latest research and his popular caricature in mainstream economics, researchers have begun to examine the extent to which prominent economists have contributed to that caricature (Stevens, 2024a). In connection with celebrations of the 200-year anniversary of the publication of the *Wealth of Nations*, Dr. Thomas Wilson, Adam Smith Professor of Political Economy at Glasgow University, reached out to Friedrich Hayek (1899-1992) to request a new essay for a forthcoming book on Adam Smith’s influence on his contemporaries and economic theory. Hayek originally agreed to contribute an essay on “The Economics of the Moral Sentiments” for the forthcoming book at The Clarendon Press, Oxford. As time passed, however, the correspondence between Wilson and Hayek turned into a growing list of excuses regarding why the promised new essay would not be forthcoming. Wilson eventually offered to accept anything from Hayek’s pen dealing with Adam Smith, including reprints of previous articles or sections of books. Even then, Hayek was unable to contribute any insights on Smith for the bicentenary celebration of the *Wealth of Nations*.

The nearly 12-year correspondence between Hayek and Wilson from 1964-1976 is insightful on multiple levels. First, when given the opportunity to contribute an essay on some aspect of Adam Smith’s work which interested him, Hayek chose a topic that merged Smith's moral theory with his economic theory. Second, Hayek's own perception of his knowledge of Smith's work was modest at best. Initially, his excuses for not producing the agreed-upon essay included lingering health problems, his recent move back to Austria, and his efforts to complete a major work on the relation of law and morals to the economic order. In the end, Hayek admitted that his original plans for the new essay had been upset by the discovery of A. L. Macfie's book on Adam Smith, "which I had not seen before and which says most on the Moral Sentiments I would have wanted to say. This means that without a great deal of new work which I cannot undertake now I would have not enough to say on the subject."[1]

When given the opportunity to publish his perspective on Adam Smith in a major academic outlet as part of the 200-year anniversary celebration of the publication of the *Wealth of Nations*, therefore, Hayek was unable to produce even a reprint of his previous work. This stands in stark contrast to his perceived role as the resident expert on Adam Smith among the founders of the Chicago School of Economics.[2] A 1973 letter between Milton Friedman (1912-2006) and Hayek reveals this perceived role. After receiving a newspaper cover from Hayek regarding the bicentenary celebrations of Adam Smith in Kirkcaldy, Scotland, Friedman wrote to his friend "Fritz" from his summer home in Vermont:[3]

> *The newspaper accounts of the Kirkcaldy celebrations suggest that all sorts of strange bedfellows are seeking to share in his luster. I was delighted that a few real followers like yourself were there but appalled at the number of people who violated in act and word everything that he stood for who had the gall to make speeches expressing their indebtedness to him.*

The above correspondence suggests that by the 1970s, Friedman and the Chicago School had claimed the mantle of Adam Smith and believed that they were the "real followers" of his views. Of course, it would have been in the best interest of the Chicago School if Hayek could have defended the "Chicago view" of Adam Smith at the Kirkcaldy and Glasgow celebrations of *The Wealth of Nations*. As Hayek

[1] The ongoing correspondence between Hayek and Wilson is stored at the Hoover Institution Library and Archives F. A. Hayek Papers, box 9, folder 2, "Adam Smith Conference (Thomas Wilson) 1965-1976."
[2] For a discussion of the Chicago School of Economics and its relation to other schools of economic thought, including the Austrian School and the German Historical School, see Stigler (1988).
[3] Friedman to Hayek, July 16, 1973, box 9, folder 2, Adam Smith Conference, F. A. Hayek Papers, Hoover Institution Library and Archives.

himself acknowledged, however, he had very little to contribute to the celebrations. His goal of merging important insights from Smith's moral theory with his economic theory had gone unfulfilled. His stated goal of completing a major work on the relation of law and morals to the economic order also went unfulfilled during his lifetime. In contrast to his perceived role as the resident expert of Adam Smith, therefore, Hayek did little to clarify Smith's views for current and future members of the Chicago School.

George Stigler (1911-1991) also played an important role in defining Adam Smith for members of the Chicago School. He associated Smith with self-interest when he famously wrote, "The Wealth of Nations is a stupendous palace erected upon the granite of self-interest" (Stigler, 1971, 265). In his preface to the 1976 edition of the *Wealth of Nations,* Stigler also associated Smith with utility-maximizing behavior by equating it with the "drive of self-interest" (Stigler, 1976, xi). As Pierre Force (2003, 101) argues, "The reason why Stigler equates self-interest with utility-maximizing behavior is because his understanding of the concept of utility is grounded in the utilitarian tradition." This utilitarian tradition, best characterized by Jeremy Benthem and John Stuart Mill, viewed egoism and utilitarianism as compatible descriptions of human behavior. When attempting to reconcile egoism (promoting one's own well-being) with utilitarianism (promoting everyone's well-being), however, leading moral philosophers of the British humanist tradition found an irreconcilable duality that violated practical reason (Andrews, 2010). According to Henry Sidgwick (1874/1907), the leading British ethicist of the latter 20th century, classical economists such as Benthem and J. S. Mill addressed this irreconcilable duality by simply exalting the principle of egoism (Stevens, 2024a).

Inconsistent with the caricature perpetuated by Stigler, however, the historical Adam Smith rejected both egoism and utilitarianism. Nobel-prize-winning economist Amartya Sen (1987, 28) discovered this upon an unbiased reading of Smith's major works as a young student at Presidency College in Calcutta:

> *The support that believers in, and advocates of, self-interested behavior have sought in Adam Smith is, in fact, hard to find on a wider and less biased reading of Smith. The professor of moral philosophy and the pioneer economist did not, in fact, lead a life of spectacular schizophrenia. Indeed, it is precisely the narrowing of the broad Smithian view of human beings, in modern economies, that can be seen as one of the major deficiencies of contemporary economic theory. This impoverishment is closely related to the distancing of economics from ethics.*

In a recent survey of 150 papers referencing Smith's work in two leading business ethics journals in the U.S. and Europe (Hühn & Dierksmeier, 2016, 119), the authors find that an overwhelming majority endorsed the view that "Adam Smith established and defended the proposition that the worlds of ethics and economics are unrelated and that, in effect, society fares best when allowing individual self-seeking to roam freely." Only 2% of the papers reflected a holistic view of Smith's body of work and the interconnectedness of his moral theory with his economic theory. The independence view reflected in these papers was the result of a flawed reading of Smith's body of work by German-speaking economists (Stevens, 2024a). Yet, Stigler (1965, 28) perpetuated this flawed reading in his "Essays in The History of Economics":

> *If one were to seek a major economic theory whose existence depended directly and essentially upon prior work in another field, he would find few likely candidates. Putting aside for a moment the methodological fields of statistics and mathematics, there is in fact no important candidate. A theory of behavior, such as our profit maximizing assumption implies, could have come from psychology, but of course it did not. In fact Smith's professional work on psychology (in the Theory of Moral Sentiments) bears scarcely any relationship to his economics…*

The independence view of Smith's two major works has had negative consequences for economic theory, public policy, and geopolitics. Most countries have translated Smith's second major work into their language first. For example, the *Wealth of Nations* (Smith, 1776/1791, hereafter *WN*) was translated into Japanese from 1884 to 1888 whereas the *Theory of Moral Sentiments* (Smith, 1759/1790, hereafter *TMS*) wasn't translated into Japanese until 1948 (Nohara, 2022, 389). Imperialist Japan studied *WN* to help it achieve its goal of controlling all of Asia—including China, Southeast Asia, Australia, and India. Postwar Japan, however, studied *TMS* to help it build "a Smithian civil society where people, based on their spontaneous maintenance of morals, protect justice and act freely." By incorporating the full corpus of Smith's writings, and merging his moral theory with his economic theory, Postwar Japan was able to escape the Marxist and totalitarian economic systems that had become popular during World War II.[4]

[4] For an insightful perspective on Japan's history and culture, including its use of Adam Smith to avoid Marxist and totalitarian economic systems in the postwar period, see Morton and Olenik (2005).

Researchers have found Smith's moral theory useful to address economic and social challenges as well as explain organizational and individual behavior. For example, Karl Polanyi and Amartya Sen found Smith's moral theory useful to address the economic and social challenges of postwar Europe and India (Stevens, 2024a), Vernon Smith and Bart Wilson found Smith's moral theory useful to explain norm-based behavior emerging in experimental economics (Smith & Wilson, 2019), and empirical researchers have found Smith's moral theory useful in business ethics (Blay et al., 2018). Little effort has been made, however, to apply insights from Smith's moral theory in discussions of sustainability and ESG. When Smith's name is invoked in such discussions, it is commonly used to support the narrow Chicago view (Owl ESG, 2023). Consistent with its rich history in advancing sustainability-related research, *Accounting, Organizations and Society* recently devoted a special section of its journal to address the complex interplays of sustainability issues, ESG reporting, and firm performance. In their introduction and review of the six papers and discussant comments contained in the special section, Christensen et al. (2024) point out the lack of a theoretical framework for sustainability and ESG research. In light of the recent backlash against ESG in the U.S., the need for a theoretical framework for this important area of research has only increased.

In this study, I discuss how Adam Smith's moral theory explains the rise and fall of ESG—and provides a responsible path forward. In the following section, I explain the degree to which the rise of ESG challenged the traditional theory of the firm developed by the Chicago School. In the third section, I present Adam Smith's moral theory based on shared values and social norms and explain how it formed the moral foundation for his economic theory. In the fourth section, I describe how Smith's moral theory explains both the rising popularity of ESG in the modern economy and its eventual backlash. I conclude by discussing how incorporating Smith's moral theory into his economic theory provides a responsible path forward for researchers, practitioners, and policymakers.

2. How ESG Challenged the Traditional Theory of the Firm

Eric Schliesser (2016) discusses the philosophical commitments that drove Alfred Marshall (1842-1924) and neoclassical economists after him to view their discipline narrowly as having no room for social or moral concerns. Schliesser traces the drive to remove moral science from economic science back to the

British ethicist Henry Sidgwick (1838-1900). While at Cambridge in 1883, Sidgwick published the first edition of his textbook, *The Principles of Political Economy*, which was designed for a course in political economics as distinct from moral philosophy (Sidgwick, 1883/1887). Prior to Sidgwick's textbook, political economics and moral philosophy were generally viewed as inseparable. Further, "moral science" was viewed as synonymous with "social science." Thus, while Sidgwick criticized the tendency for classical economists to address the irreconcilable duality between egoism and utilitarianism by simply exalting egoism, his textbook helped advance that same egoistic view. While developing a theoretical framework for economic science separate from social and moral science, however, Sidgwick emphasized the need for *better data* and *consensus over values*. Absent insights from the social and moral sciences, however, the possibility of consensus over values has remained illusive in economic science.

Marshall completed the separation of economic science from moral science at Cambridge University. He dropped political economy from the moral sciences in 1903 and expunged the label "political" to make the field of economics an objective science (Stevens, 2024a). Based on Marshall's price theory (Marshall, 1890/1920), economists initially modeled the firm as a set of cost and demand curves categorized by market structure (i.e., perfect competition, pure monopoly, monopolistic competition, imperfect competition, etc.). The first task of the theory of the firm, therefore, was to explain why firm coordination was superior to market coordination. In his seminal paper entitled, "The Nature of the Firm," Ronald Coase (1910-2013) argued that firms emerge as a least-cost means of economic coordination (Coase, 1937). Coase eventually added transaction costs to his theory of the firm, which left room for the possibility of social and moral norms reducing transaction costs. Stigler and the Chicago School, however, largely ignored or distorted his theoretical arguments (Coase, 1988).

In contrast to early neoclassical theories that modeled the firm as a set of cost and demand curves, Michael Jensen (1939-2024) and William Meckling (1921-1998) modeled the firm as a nexus of contracts (Jensen & Meckling, 1976). Their theory of the firm, called *agency theory*, focused on the agency relationship that arises when a principal hires an agent to perform some task that involves the delegation of decision-making authority. Jensen argued that agency relationships exist in all organizations and across all levels of management, including the relationship between shareholders and managers of a corporation (Jensen 2000). Given traditional assumptions of the theory, the principal's problem is to induce a self-interested agent to maximize the welfare of the firm through financial incentives and formal contracting. Similar to previous neoclassical theories of the firm, agency theory assumed a well-defined set of preferences including narrow self-interest with preferences only for wealth and leisure. While this made the theory useful for formal modeling and powerful theorizing, it reduced agents of the firm to mere calculators (Khurana, 2007).

The economic theory of the firm that emerged out of the Chicago School is described in Jensen's book, *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* (Jensen, 2000). His description of the theory included a frontal attack on stakeholder theory, which extended the responsibilities of the firm to the interests of all stakeholders including customers, employees, suppliers, and communities (Freeman, 1984). Jensen (2000, 9) argued that the purpose of corporate governance was to assure that "the owners' interests would prevail." Jensen did not alter his views in response to the dot-com market crash in 2000 and the widespread corruption it uncovered at major corporations such as Enron, Adelphia, Tyco, and Worldcom. In fact, he continued to criticize common management controls found in practice that appeared inconsistent with the traditional theory of the firm. For example, Jensen criticized the use of participative budgeting because it only encouraged managers to lie (Jensen, 2001) and the use of the balanced scorecard because of its focus on other objectives besides financial returns for shareholders (Jensen, 2002).

Over time, however, Jensen moderated his views regarding the behavioral assumptions of his theory of the firm. The first sign of a change in Jensen's views appeared in 2004 when he partnered with Werner Erhard to develop a leadership course that emphasized *integrity* and *authenticity* as key conditions for individual thriving and institutional effectiveness (Dierksmeier, 2020). As part of this effort, Jensen and his colleagues developed a positive economic model of integrity and circulated it for discussion (Erhard, Jensen, & Zaffron, 2008). In the wake of the worldwide market crash of 2007-08 and the dramatic failures of corporate governance it uncovered (FCIC, 2011), Jensen went public with his moderated views in a foreword written for a collection of articles on the role of values in the economy (Jensen, 2008, ix-x):

> *Economics, having traditionally focused on the positive analysis of alternative institutional structures, has far too long ignored the normative world. By the term "positive analysis," I mean, of course, the analysis of the way the world is, however it behaves, independent of any normative value judgments about its desirability or undesirability…By "normative," I mean establishing, relating to, or deriving from a standard or norm that specifies desirable or undesirable conduct or behavior, that is, what ought to be…I look forward to seeing the creation of an entirely new field of inquiry in economics, and in its sister social sciences, focused deeply on the positive analysis of the role of values in elevating the possible outcomes of human interaction.*

Jensen's focus on positive analysis throughout his career was consistent with Friedman's (1953) *Essays in Positive Economics*. Friedman emphasized the importance of positive theory in economics and discounted the importance of unrealistic behavioral assumptions. Friedman's essay helps explain why the Chicago School resisted important and natural extensions of the theory of the firm meant to increase the realism of its underlying assumptions (Coase, 1988; Williamson, 2009). In their drive to mimic the methods of the natural sciences, neoclassical economists promoted mechanistic models of the firm based on Marshall's price theory. These models, however, eliminated "precisely those aspects of the human condition that enable individuals and institutions to advance the course of an ethical economy…(including) any and all interests in the social, moral, and ecological sustainability of business" (Dierksmeier, 2016, 11). Friedman and Stigler's efforts to resist useful extensions of their theory of the firm, however, did not stop them from encouraging researchers to apply their neoclassical price theory to government regulation and a host of other social issues such as discrimination, education, crime, the family, and politics (Becker, 1993).

In the later years of his life, Jensen continued to emphasis integrity and incorporate stakeholder perspectives into his theory of the firm (Madden & Stevens, 2024). In particular, Jensen aspired to empower managers "to give authentic expression to their personal values in their professional lives, and he (saw) the main function of management studies as assisting them in this effort" (Dierksmeier, 2020, 73). Thus, Jensen moved away from promoting a "mechanistic" approach to management based on narrow self-interest to a "humanistic" approach based on integrity and personal values. Jensen's continuing commitment to positive economic theory, however, impeded the kind of progress he envisioned for management education. To avoid normative issues, for example, he ignored common definitions of integrity related to being honest and having strong moral principles. Instead, Jensen used a definition of integrity from engineering, "the state of being whole, complete, unbroken, unimpaired, sound, perfect condition," which he argued was a "purely positive phenomenon, not a normative virtue concept" (Jensen & Erhard, 2011, 26).

Jensen and his coauthors claimed that their positive model of integrity contained testable implications that should be useful to researchers (Erhard, Jensen, & Zaffron, 2008). Their model of integrity, however, has not received serious consideration by researchers attempting to extend the theory of the firm (Steven, 2019). This is likely because it ignores all normative standards that come from shared values and social norms. In contrast to the Chicago School's attempt to ignore all "normative talk," German economist Max Weber argued that it was "not only possible, but obligatory to engage in controversy about normative standards" (Löwith, 1993, 124). Adam Smith provides ample guidance for the kind of normative standards that business leaders and educators should promote in *TMS*. For example, Smith argued that middle class values such as honesty were preferred for success in market economies (*TMS* I.iii.3.5). He also maintained the importance of the regard to "general rules of conduct," or "what is properly called a sense of duty" (TMS III.5.1). In fact, additions made in subsequent editions of *TMS* demonstrate that Smith became more normative and virtue-based in his thinking over his lifetime (Hanley, 2009).

In addition to causing the main architect of the theory of the firm to moderate his behavioral assumptions, the worldwide market crash of 2007-08 led to an increased interest in ESG investment practices (Ferraro, 2013). ESG gained in popularity during this time because it supported the new emphasis on aligning business interests with societal goals and strengthening corporate governance. The origins of ESG, however, can be traced back to the United Nation's 1948 Universal Declaration of Human Rights (Gramm & Keeley, 2024). While European and Asian countries were still reeling in the aftermath of World War II, progressives at the UN were busy defining a political, social, and economic agenda that was aspirational if not utopian. The UN's Universal Declaration stipulated that every human being on the planet was entitled to free education, gainful employment, a living wage, medical care, and a comfortable retirement among other entitlements.

In a recent book published by the American Enterprise Institute for Public Policy Research, *Ending ESG and Restoring the Economic Enlightenment*, Phil Gramm and Terrence Keeley summarize criticisms leveled against ESG by economists in the Chicago School tradition. Gramm and Keeley (2024, 2) argue that ESG would not have been possible without the "unimaginable economic progress fueled by the expansion of market-based economies and the explosion of world trade, which made it possible for the United Nations to attempt to channel that cornucopia of progress to achieve its social goals." They point out that by the turn of the century, market-based capitalism and a vast expansion of global trade had already lifted humanity out of the abject poverty that had been the experience of about half of the world's population at the time of the Universal Declaration in 1948. Yet, in early September 2000 the United Nations gathered the largest assembly of national leaders in history to adopt a new collection of Millennium Development Goals that reaffirmed the Universal Declaration's aspirational goals.

In April 2006, the UN launched the Principles for Responsible Investment at the New York Stock Exchange, which included a non-exhaustive list of objectives related to Material ESG risks: Environmental (including climate change, resource depletion, waste, and pollution), Social (including human rights, modern slavery, child labor, and working condition), and Governance (including bribery and corruption, executive pay, board diversity and structure, and political lobbying). Since then, ESG goals have been promoted increasingly in corporate shareholder and board meetings and governments have expanded their regulatory powers to promote ESG. Further, fund managers have promoted ESG goals by exercising the voting power of shares that belong to their clients. Finally, large private equity firms such as Vanguard and Blackrock have encouraged ESG goals and investing by withholding funds from offending firms. In the past few years, market and societal forces have led to the formation of the International Sustainability Standards Board (ISSB), the passage of the European Union's Corporate Sustainability Reporting Directive (CSRD), and the issuance of climate disclosure rules at the SEC (Christensen et al., 2024).

In summary, the emergence of ESG goals and reporting in the 21st century challenged the traditional theory of the firm developed by the Chicago School. In his famous article on the purpose of the corporation, Friedman (1970, 1) asserted that the claim that business is responsible for promoting desirable social ends such as "providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers… (is) preaching pure and unadulterated socialism." Thus, Friedman viewed attempts to expand the purpose of the corporation beyond increasing profits for shareholders as a threat to capitalism itself. It is not surprising, therefore, that economists in the Chicago School tradition have heavily criticized the development and influence of ESG in the world economy.

3. Adam Smith's Moral Theory Based on Shared Values and Social Norms

Schliesser (2016, 143) concludes that "professional economics may be changing so that the question of virtue's role in economics can be asked anew." I concur with Schliesser that the best place to begin addressing this neglected question is with the father of modern economics. The historical Adam Smith was heavily influenced by the Scottish Enlightenment emphasis on the Stoic philosophy of the ancient Greeks and Romans. In contrast to the Augustinians and Epicureans, who viewed pleasure as the ultimate good, the Stoics viewed the practice of virtue as the ultimate good. The influence of Stoicism on Adam Smith's moral philosophy, as well as his true perspective on self-interest, can be seen in the following passage from *The Theory of Moral Sentiments* (*TMS*, VII.ii.I.20):

> *The wise and virtuous man is at all times willing that his own private interest should be sacrificed to the public interest of his own particular order or society. He is at all times willing, too, that the interest of this order or society should be sacrificed to the greater interest of the state or sovereignty, of which it is only a subordinate part. He should, therefore, be equally willing that all those inferior interests should be sacrificed to the greater interest of the universe, to the interest of that great society of all sensible and intelligent beings, of which God himself is the immediate administrator and director.*

Recent scholarship confirms that Scottish Enlightenment philosophers "were generally sincere Christians who found it virtually unthinkable that there might be no God requiring duties of us" (Emerson, 2003, 24). Even David Hume, despite his skepticism, joined Francis Hutcheson and Adam Smith in including religion in the British debate on the foundations of morals. Although they had rival moral theories, their source of the ability to judge right from wrong had many similarities. For example, all three Scottish philosophers attributed moral judgment to the ability of humans to "sympathize" with other humans and those common social experiences "which enable us to establish general rules and to create a stable, common language of moral praise and blame" (Turco, 2003, 145). All three philosophers argued that these socially-derived rules become operationalized in the "impartial spectator," which explains the formation of the moral conscience. While the impartial spectator is assumed to be disinterested, it incorporates commitments to "self-love" as well as various virtues and religious commitments (Griswold, 1999).

Smith published the first edition of *TMS* in 1759 during his tenure as Chair of Moral Philosophy at the University of Glasgow. He published a second edition in 1761 in response to comments received after his first edition. This was followed by three more editions which differed little from edition two: edition three in 1767, edition four in 1774, and edition five in 1781. Edition six, however, which he published in the final year of his life in 1790, contained extensive additions including a new section devoted to the topic of moral virtue (Part VI). Coming as it did at the end of his life, this new material reflects Smith's lifelong reflections on commerce and society (Raphael & Macfie, 1982). Rather than reflect a view that he would abandon in his later years, therefore, the sixth edition of *TMS* reflects Smith's final and most developed view of human motivation (Stevens, 2024a).[5]

Smith attributes human motivation in *TMS* to "bettering our condition." In particular, he attributes "all the toil and bustle of this world," including "the pursuit of wealth, of power, and preeminence," to this motivation (*TMS*, I.iii.2.1):

> *From whence, then, arises that emulation which runs through all the different ranks of men, and what are the advantages which we propose by that great purpose of human life which we call bettering our condition? To be observed, to be attended to, to be taken notice of with sympathy, complacency, and approbation, are all the advantages which we can propose to derive from it. It is the vanity, not the ease, or the pleasure, which interests us.*

Smith repeats and magnifies this argument in *WN*, where he argues that "the desire of bettering our condition" is one that "comes with us from the womb, and never leaves us till we go into the grave." Smith argues that this motivation is the source from which both national and private wealth are derived, and even inefficient public policy is not able to stop it (*WN*, II.iii.31):

> *The uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things towards improvement, in spite both of the extravagance of government and of the greatest errors of administration.*

[5] A seventh edition of *TMS* was published posthumously but Smith had no hand in its publication so it is not relied upon (Long, 2022).

Here we see the consistent influence of Smith's moral theory on his economic theory. The motivation of every person to "better their condition" causes them to work hard and adopt behavioral patterns and norms that are highly esteemed by society. This generates the shared values and social norms of the merchant culture which gave birth to capitalism—including creativity, initiative, hard work, and industry as well as responsibility, honesty, reciprocity, and fairness (Soll, 2014; Stevens, 2019). The generation of shared values and social norms within capitalist society reveals a providential design that the Scottish Enlightenment philosophers attributed to the wisdom of the Creator. By the means of commerce and the perfect system of liberty, society operates as if it were a republic of saints.[6]

Consistent with other 18th-century Scottish Enlightenment philosophers, Smith viewed the topic of political economy as a branch of ethics. Student notes and correspondence regarding his days at Glasgow University confirm that political economy was included from the start in Smith's lectures on moral philosophy. Although Smith attributes the great wealth created by commerce to the division of labor in *WN*, it remains a product of the motivation of every person to better their condition and achieve high esteem from their peers. Further, the desire to achieve high esteem is ultimately grounded in the Stoic virtues and the desire to be praiseworthy. When 19th-century classical economists adopted Hobbes's and Mandeville's "selfish hypothesis" as the first principle of their discipline, therefore, they adopted a principle that Smith, Hume, Hutcheson, and the other Scottish Enlightenment philosophers had adamantly rejected (Force 2003).

Stigler's (1971, 265) description of *WN* as "a stupendous palace erected upon the granite of self-interest" does not hold up under closer scrutiny. As Force (2003) points out, the term "self-interest" appears only once in *WN*. Even then, the term is used in the context of Smith's speculation that the tradition of paying Catholic priests based on voluntary gifts keeps their industry and zeal alive by "the powerful motive of self-interest" (*WN*, V.i.g.2). The commonly quoted passage linking Smith to narrow self-interest doesn't

[6] Adam Smith himself invokes the "invisible hand" three times in his corpus of writings, once in the *History of Astronomy*, once in *The Theory of Moral Sentiments*, and once in *The Wealth of Nations*. In the first occurrence, Smith refers to the invisible hand of Jupiter as contrasted with the visible hand of thunder and lightning. In the other two occurrences, Smith follows the common practice among English and French philosophers of referring to the invisible hand of divine providence (Force 2003). This contrasts dramatically with the Chicago School view of the invisible hand analogy, which is meant to emphasize the efficiency and effectiveness of unregulated markets.

even contain the term. In analyzing the motives we should address when negotiating with "the butcher, the brewer, or the baker" for our supper (*WN*, I.ii.2), Smith does not refer to *self-interest* but *self-love*: "We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." Griswold (1999, 260) highlights the difficulty of Stigler's interpretation of *WN* and his perpetuation of the *das Adam Smith Problem* created by German historical economists:

> *(T)he "Adam Smith problem" depended on a misunderstanding of the terms "sympathy" and "self-interest," according to which the first was taken to mean "benevolence" and the other "selfishness." The "problem" then seemed to be that the book on ethics praised virtue whereas the book on political economy built a large edifice on vice. Smith's famous remark to the effect that in procuring our dinner we address ourselves not to the humanity or benevolence of the butcher, brewer, or baker but to their self-love (WN I.ii.2) seemed to underline the point and to encapsulate everything that is both necessary to and morally repulsive about market economies.*

Griswold (1999) proposes an interpretation of this passage within its full context that is consistent with both Smith's moral theory and his economic theory. Just before the passage in question, Smith argues that the division of labor and its resulting national wealth are "not originally the effect of any human wisdom," but are the unintended consequence of "the propensity to truck, barter, and exchange one thing for another" (*WN*, I.ii.1). He then argues that this propensity, which "is common to all men, and to be found in no other race of animals," is "the necessary consequence of the faculties of reason and speech" (*WN*, I.ii.2-3). Thus, the necessity of developing rhetorical skills is especially great in a commercial society. In this society, according to Smith, the division of labor makes each person highly dependent on exchange for their basic needs and yet, one's "whole life is scarce sufficient to gain the friendship of a few persons" (*WN*, I.ii.2). Rather than supporting a first principle of narrow self-interest in economics, therefore, the often-quoted passage in *WN* is part of a larger argument considering the "civilizing" role of persuasion and the ability of commerce and trade to support moral virtue.

Inconsistent with the independence view promoted by Stigler and the Chicago School, historical economists have come to view Smith's moral theory as the moral foundation for his economic theory. His moral theory is best summarized using the sixth edition of *TMS*: (1) As with every edition, Smith begins by refuting narrow self-interest as the main motivation for human behavior. He does this by condemning

Mandeville's view of virtue and by distinguishing between good self-interest (prudence) and bad self-interest (selfishness). (2) Smith grants mankind the ability to empathize with others, which he calls *sympathy*, and makes it the major force behind moral judgment and behavior. (3) Smith uses the concept of the *impartial spectator* to explain moral judgment and the moral conscience. Individuals observe what constitutes praiseworthy behavior over time and internalize these behavioral norms. (4) Smith adds a new section on moral virtue to emphasize that individuals are motivated by both the desire for *praise* and the desire to be *praiseworthy*.

Ryan Hanley (2009, 4-5) argues that the new material added in his sixth edition of *TMS*, which added almost a third to its length, reflected Smith's attempts to "set forth a sustained and developed remedy for the ills he diagnosed" regarding commercial society. In particular, Hanley argues that "the sixth edition's entirely new Part VI, 'Of the Character of Virtue," was intended by Smith as a remedy for the challenges that he identified with the advent and progress of commercial society…Smith's study of virtue in Part VI thus represents at once his mature answer to what he considered the primary question in moral philosophy – 'wherein does virtue consist?' (TMS, VII.i.2) – as well as his considered response to the ills of commercial corruption that he himself so powerfully articulated." While Smith focused on the nature and source of moral judgment in previous editions of *TMS*, the new material focused on the nature of virtue. Rather than abandoning his moral foundation for his economic theory later in life, therefore, Smith enriched that foundation by embracing character virtues and adding portraits of virtuous characters such as "the prudent man," "the wise and virtuous man," and the "magnanimous man" (Hanley, 2009, 66).

In summary, the historical Adam Smith does not match the popular caricature perpetuated by the Chicago School. Smith was a moral philosopher of the Scottish Enlightenment who developed a detailed and pragmatic moral theory based on shared values and social norms. Further, that moral theory formed the moral foundation for his economic theory. Rather than egoism and utilitarianism, Smith based his political economy on shared values and social norms. Finally, rather than abandoning his moral theory later in life, Smith become increasingly concerned about both the corruption of commercial society and the corruption of the soul. "(T)he old Adam Smith Problem has been replaced by a much more interesting reconciliatory question: namely the question of how Smith was able to synthesize the normative and descriptive aspects of his social science" (Hanley, 2009, 58). This synthesis has the potential to provide a theoretical framework for sustainability and ESG that is useful for researchers, practitioners, and policymakers. To demonstrate this potential, I use Adam Smith's moral theory to explain the rise and fall of ESG.

4. How Adam Smith's Moral Theory Explains the Rise and Fall of ESG

Both the 1948 Universal Declaration of Human Rights and the 2006 Principles for Responsible Investment represent a list of ethical guidelines for firms to follow (ESG Access, 2024). However, progressives at the UN have provided little moral justification for their ESG agenda. To fill this hole, FTX and other high-tech firms have used a new moral philosophy called "Effective Altruism" (EA) as a moral justification for ESG. Based on utilitarian ideas developed by Australian philosopher Peter Singer in the 1970s, and promoted at Oxford by a one-time lecturer in philosophy named William MacAskill, EA uses mathematical calculations to determine how individuals could do the most good with their time and money. EA encourages its followers to pursue high-paying jobs in order to maximize charitable giving to progressive causes. While EA continues to have a following among wealthy investors in Silicon Valley, it has been heavily criticized on the grounds that it perpetuates wealth inequality and paints the rich as heroes while failing to address the root causes of poverty and social injustice.[7]

ESG goals and investments continue to be promoted on moral grounds. In a speech at the UN on March 29, 2023, for example, Secretary-General António Guterres stated, "Climate justice is both a moral imperative and a prerequisite for effective global climate action. The climate crisis can only be overcome through cooperation between peoples, cultures, nations, and generations." Similarly, ESG initiatives are commonly opposed on moral grounds using arguments related to fiduciary responsibility similar to Friedman's (1970) classic article on the purpose of the corporation (Greene, 2024). Some opponents in the U.S. have even argued that ESG mandates are unconstitutional (Hagan, 2022). Progressives and

[7] At FTX, Sam Bankman-Fried used EA to justify high-risk cryptocurrency investments and improper use of investor funds that cost investors over $10 billion (Wallerstein 2023).

conservatives alike, however, lack a viable moral framework for their opposing positions. The lack of a viable moral framework perpetuates the growing polarization that has occurred around the topic of ESG.

The global market crash of 2007-08, and the failings of the traditional theory of the firm it revealed, motivated a corporate finance researcher from Oxford to write a book entitled, *Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in It*. Colin Mayer (2013, 144) argues that by focusing on the agency problem between management and owners, the traditional theory of the firm has undermined the position of other stakeholders who have significant interests in the corporation. Further, the assumption of narrow self-interest has encouraged solutions to the agency problem that are detrimental to trust and commitment such as hostile takeovers, shareholder activism, and powerful economic incentives that drain the resources of the firm. In particular, the theory of the firm "does not recognize the fundamental role of commitment in all aspects of our commercial as well as social lives and the way in which institutions contribute to the creation and preservation of commitment."

In contrast to Friedman's (1970) narrow view of corporate responsibility, Mayer (2013, 2) argues that the corporation "offers the opportunity to provide a means of extracting ourselves out of poverty, inequality, and environmental destruction." He turns the theory of the firm on its head by arguing that the separation of ownership from control is the very vehicle by which the public corporation can uphold obligations to other stakeholders of the firm. In particular, he argues that the traditional emphasis on agency costs due to the separation of ownership from control is misplaced. To Mayer (2013, 6), the miracle of the public corporation "derives from its ability to combine and balance the traditional perspective on incentives, ownership, and control with the alterative view… of obligations, responsibilities, and commitment." Based on over three decades of research and consulting in corporate governance and organizational control, Mayer provides practical ways to create the "moral" firm based on trust and commitment.

As the Academic Lead for The British Academy "Future of the Corporation" program, Mayer has been instrumental in advancing his expanded vision for the corporation. The Future of the Corporation program was formed as a cross-disciplinary research program into how the corporation will need to adapt over the coming decades to address the economic, political, social, and technological challenges and opportunities it confronts. Its landmark reports in 2018, 2019, and 2021 set out a framework of principles, practices and policies that support a new way of defining the purpose of business: “to profitably solve the problems of people and planet, and not to profit from creating problems” (British Academy 2023). The Future of the Corporation program has confirmed that it has only been since the influence of the Chicago School in the 1970s that corporate purpose has come to be equated solely with earning profits for shareholders. In a follow-up book, *Prosperity: Better Business Makes the Greater Good*, Mayer (2018, 2) directly confronts the “Friedman doctrine”:

> *The message of this book is that the Friedman doctrine is not a law of nature. On the contrary, it is unnatural; nature abhors it, if only because it has been the seed of nature’s destruction. If it ever deserved to have its time, the Friedman doctrine has had it. It is not the business paradigm of the twenty-first century, and as long as we continue to believe it to be so, the greater will be the damage it inflicts on our societies, the natural environment, and ourselves. Few social science theories are both so significant and misconceived as to threaten our existence but that is precisely what the Friedman doctrine is doing in the twenty-first century.*

In contrast to Mayer’s critical view, mainstream economists in the U.S. remain generally faithful to the Friedman doctrine. Phil Gramm, a former Republican senator and economics professor, and Terrence Keeley, a former managing director at BlackRock, argue that ESG investing poses a grave threat to the historic economic growth that began in the first industrial revolution and lifted billions out of poverty (Gramm & Keeley, 2024). Gramm and Keeley identify three factors that have plagued the ESG movement: *data*, *definitions*, and *process*. In a recent study, ESG ratings among the top six rating agencies (KLD, Systainalytics, Moody’s, S&P, Refinitiv, and MSCI) correlate only 0.31-0.71 percent of the time (Berg, Kolbel & Rigobon 2022). “We are now 15 years into the ESG movement, yet there is no output conformity among ESG rating agencies…As with data divergence, there is no single standard defining what an ESG or sustainable investment product actually is.” (Gramm & Keeley, 2024, 22-23). As ESG indexes underweight oil and gas companies, they are doomed to underperform broad indexes over time. For example, oil and gas stocks were the best-performing sectors of the market in 2022 (Bousso, 2023).

Recent trends suggest that enthusiasm for ESG has significantly waned since the peak of 2022. In 2023, for example, Vanguard CEO Tim Buckley shocked the investment community by withdrawing his firm from the Net Zero Asset Managers initiative. BlackRock CEO Larry Fink also conceded to this waning enthusiasm in June of 2023, admitting that he no longer used the term "ESG" because it has become so highly politicized (Binnie, 2023). Based on their analysis of these trends, Gramm and Keeley (2024, 33) conclude:

> *However noble its intents may have been, (ESG) has been wrongly designed and executed. ESG does less well and good than a combination of investing for profit and using the profits for philanthropy and impact investing. The sooner investors, regulators, the asset-management industry, and other financial intermediaries realize this, the better off the world will be… The basic appeal of ESG is and has always been its proponents' ability to promote their vision of how to do good with someone else's money. However noble their intents may have been, those proponents are in fact doing more harm than good.*

The fall of ESG has been noted by both progressive and conservative economists. In August of 2023, Alex Edmans published an article presenting "A Progressive's Case for Getting Rid of ESG." Edmans (2023) agrees that the term ESG has become heavily politicized, leading to ideological reactions rather than logical evaluations. He notes that ESG advocates wrongly assume that more ESG investment is always better whereas ESG opponents wrongly assume that considering ESG risks violates fiduciary duty. Edmans asserts that "(m)ore investment isn't always better, due to diminishing returns, and taking risks into account is consistent with fiduciary duty—in fact, an essential part of fiduciary duty." Instead of debating ESG, Edmans argues, we should discuss "intangible assets" and "long-term value." He concludes, "Let's scrap the politicized, simplistic, and restrictive term of ESG and free companies to create long-term value."

While efforts to promote ESG challenge the traditional theory of the firm, they can be explained by applying insights from Adam Smith's moral theory. Karl Polanyi (1944/2001, 3-4) applied Smith's moral theory to explain historical attempts by Britain to address the vulnerabilities and excesses of free-market capitalism in the first half of the twentieth century. Polanyi argued that the idea of a self-adjusting market was the unique innovation behind the global economy that had evolved in the West. "Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surrounding into a wilderness. Inevitably, society took measures to protect itself…" Polanyi labeled the tendency to protect society from the perils of a self-regulating market *the double movement*. According to his double movement theory, capitalist society oscillates between cutting regulation to encourage economic growth and promoting regulation to protect society from the vulnerabilities and excesses of unregulated markets.

Given the state of the global economy after World War II and the severe market crash of 2007-08, it is reasonable that the UN would seek to protect capitalist societies from the vulnerabilities and excesses of unregulated markets by promoting environmental sustainability, social responsibility, and corporate governance. According to Polanyi's double movement theory, however, ESG regulation may have imposed too heavy of a burden on economic growth in the West. This explains why market and societal forces appear to have turned against the emphasis on ESG and Net Zero investments to fight global warming. To reignite economic growth and address unforeseen externalities arising from the Net Zero agenda, critics argue for reducing the burden of ESG regulation. Because Polanyi's double movement theory is based on Adam Smith's moral theory, it demonstrates the usefulness of applying Smith's moral theory to his economic theory to address sustainability and ESG issues.

The rise and fall of ESG can also be explained by Smith's emphasis on "the pleasure of mutual sympathy." In *TMS*, Smith argues that "whatever may be the cause of sympathy, or however it may be excited, nothing pleases us more than to observe in other men a fellow-feeling with all the emotions of our own breast; nor are we ever so much shocked as by the appearance of the contrary." (*TMS*, I.i.2.1). To Smith, the pleasure of mutual sympathy applies to a person's actions, passions, and opinions (*TMS*, I.i.3.2). Thus, Smith's moral theory is able to explain the initial enthusiasm for ESG as well as the strong ideological backlash that followed (Edmans, 2023). It turns out that simply adding ESG goals to the purpose of the corporation was the easy part. The hard part was choosing ESG goals that stakeholders of the firm could approve of. Progressives at the UN appear to have underestimated how ESG standards could violate the moral sensibility of some stakeholders of the firm. This seems to be true of certain DEI initiatives promoted by progressives over the objections of conservatives.

5. Conclusion: How Adam Smith's Moral Theory Provides a Responsible Path Forward

Critics have argued that Friedman's (1970) classic article on the responsibility of the corporation reflects an outdated perspective that has outlived its usefulness (Mayer, 2018). For example, there is little support for Friedman's claim that the exercise of social and environmental responsibility in business is by nature an unfair and socialist practice (Mulligan, 1986). Some have argued that Friedman was simply responding to what he saw as a deteriorating competitive environment in the U.S. (Ramanna, 2020). The deregulatory environment encouraged by the Friedman doctrine and the Chicago School unleashed the power of the market and reawakened economic growth after nearly a decade of "stagflation." Consistent with Polanyi's (1944/2001) double movement, however, the deregulatory environment also unleashed a new age of opportunism that appears to have contributed to the global market crash of 2007-08, which ushered in a counter movement of increased regulation. That counter movement generated strong market and societal support for ESG. So what is the path forward now that such support is lagging?

I conclude that Adam Smith's moral theory provides a responsible path forward to protect society and the environment while avoiding the crushing burden of excessive regulation. As reflected in the new Business Roundtable statement on the purpose of the corporation (Business Roundtable, 2019), business leaders are not just passive recipients of laws and social norms. Russell Greene (2024) asserts that business leaders can be norm-makers:

> *The most successful business leaders are able to cast a compelling long-term vision, one that includes but goes beyond making money, and to persuade their investors to remain focused on the long-term. That is, business leaders lead their investors, they don't merely respond to investor preferences. Further, policymakers depend on the counsel of industry to respond to technological innovations, as we are now seeing with artificial intelligence. And business leaders seek to influence both the law and public opinion, such as through lobbying, public relations, media, and publishing their thoughts.*

Returning to the traditional theory of the firm based on narrow self-interest, utilitarianism, and shareholder primacy is not a realistic option in the modern economy. However, it is incumbent upon both supporters and critics of ESG to provide an alternative vision for the public corporation. Smith's moral theory not only incorporates shared values and social norms, it also contains "a surprisingly robust conception of human flourishing and liberty" (Schliesser, 2020, 22). Thus, incorporating Smith's moral theory with his economic theory supports a rational approach to sustainability and ESG that protects individual liberty. As such, his moral framework would support a more decentralized, local approach to ESG. Smith was also a systematic and pragmatic thinker who focused on uplifting the poor and needy.

Nevertheless, he joined David Hume and other Scottish Enlightenment philosophers in viewing differences in wealth and rank as necessary for a prosperous and well-ordered society (Force, 2003). Thus, Smith's theoretical framework would avoid social justice and Marxist theories that have caused much of the political division and backlash associated with ESG. As such, Smith's emphasis on shared values and social norms provides a viable path to achieving sustainability and ESG goals in the firm.

Bart Madden (2022) describes the current globalist approach to ESG as overly-simplistic "linear cause-and-effect thinking," and calls for the incorporation of "systems thinking" in addressing ESG concerns. In particular, he argues that overly simplistic thinking regarding greenhouse gas emissions and the drive for Net Zero has resulted in public policies with few direct benefits and many secondary effects. These secondary effects include new geopolitical risks due to the growing dependency of many European countries on Russia for their oil, gas, and coal supply and China for their rare earth minerals supply. Instead, Madden calls for bottom-up innovation by firms to solve the needs of customers while minimizing waste and harmful emissions, which he argues is a powerful driver of economic prosperity with minimal harm to the environment. This is consistent with Mayer's (2018, 39) argument that the purpose of the corporation should be to produce profitable solutions for the problems of people and planet without profiting from producing problems for either. Mayer's enlightened view of corporate purpose is based on commitment that engenders "mutual relations of trust" across all stakeholders of the firm.

Consistent with Madden's (2022) call for bottom-up innovation and Mayer's (2018) enlightened view of corporate purpose, accounting researchers have begun to develop new accounting systems to track the cost of greenhouse gas emissions. For example, Robert Kaplan and Karthik Ramanna (2021) have proposed an accounting and control system that records Greenhouse Gas (GHG) units emitted during operations as an *E-liability*. This new accounting system harkens back to the Balanced Scorecard (Kaplan & Norton, 1996) with its focus on intangible assets and non-financial results that are leading indicators of financial performance. While Jensen (2002) criticized the Balanced Scorecard because of its focus on other goals besides firm profit, it remains a valuable tool for responsible firms wanting to track long-term value creation due to ESG factors as well as non-ESG factors (Edmans, 2024). To encourage long-term value creation in the firm, and provide intuition on how to measure that value creation, Madden (2020) has developed "The Pragmatic Theory of the Firm."

Based on Stigler's (1988) own review of the rise and fall of economic schools of thought, Stevens (2024b) argues that the Chicago School lasted from the first Mont Pélerin Society meeting in 1947 to the global market crash in 2007-08.[8] The Chicago School continued efforts by Sidgwick and Marshall at Cambridge to reduce uncertainty and increase political consensus by separating economic science from the social and moral sciences. While attempting to develop a theoretical framework for economic science, however, Sidgwick emphasized the need for *better data* and *consensus over values*. Given the inability of economic science to provide that consensus, or explain organizational and market behavior in the modern economy, researchers are turning again to the social and moral sciences for valuable insights. Theorists have already demonstrated the usefulness of incorporating Smith's moral theory into the theory of the firm (Stevens & Thevaranjan, 2010), and his moral theory has been used to explain norm-based behavior arising in experimental tests of economic theory (Abdel-Rahim & Stevens, 2018; Smith & Wilson, 2019). Smith's moral theory has also been used by empirical researchers to generate new insights in business ethics (Blay et al., 2018). I conclude that incorporating Smith's moral theory into his economic theory provides a valid theoretical framework for sustainability and ESG research and, as such, provides a responsible path forward for researchers, practitioners, and policymakers.

[8] See Mayer (2024) for a detailed and insightful comment on Stevens' roadmap for revising the theory of the firm developed by the Chicago School.

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