



Methods

The evolution of environmentally responsible investment: An Adam Smith perspective

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ABSTRACT

This paper demonstrates that Adam Smith has common ground with contemporary social scientists who study the management of the common pool resources from an evolutionary perspective. Contrary to the caricature of Smith, presented by neoliberals, as a promoter of self-interest, he recognized the value of other-regarding behavior. Specifically focus is given to how such behavior can contribute to constructing institutional arrangements that can help to avoid damaging market excesses. A study of the development of a process to encourage investment behavior that is environmentally responsible, establishes that Smith's work has relevance for addressing environmental issues in our contemporary complex market system.

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1. Introduction

Adam Smith writing in the late 18th century at the very start of the industrial revolution welcomed the age of commerce. This, he understood, would bring about the economic growth that was necessary to alleviate poverty and foster a more civilized society. However, the beginning of the industrial revolution was also the beginning of the Anthropocene era, the era within which human actions began to be the major driver of change in global ecological systems (Crutzen and Stoermer, 2000). This was unforeseen by Smith, and in all his lengthy writings he rarely mentions the environment.¹ Nonetheless, an objective of this paper is to illustrate that Smith's work does have relevance for addressing environmental issues in our contemporary complex market system.

This might appear contentious given that Smith's name often has been associated with those advancing a neoliberal economic agenda (Werhane, 2000) linked with ecologically careless economic growth. In particular, the neoliberal economists of the Chicago School trace their lineage back to Smith (Evensky, 2005c; Medema, 2010). However, Sen (2009) criticizes those who cite Smith 'in alleged support of their cramped and simplistic theory of human rationality' (px), a rationality that is identified with 'intelligently pursuing self-interest' (Sen, 2009, px). The commonly held view that Smith advocated that if individuals acted solely egocentrically it would result in unconditional social

benefit, is recognized by many scholars as a caricature (Darwall, 1999; Evensky, 2005b,c; Sen, 2010; Werhane, 2000). Despite being associated with *homo economicus*, Smith was a keen student of the natural condition of mankind 'the totality of impulses and instincts by which the individual members of society are animated' (Benn, 1906, quoted in Schweber, 1977) and had specific interest in how the human 'passions' could be geared towards socially and morally beneficial outcomes (Darwall, 1999; Evensky, 1993; Muller, 1995). As detailed later, his assessment of humankind aligns with that identified by evolutionary psychologists as developed during the Pleistocene era. This view of human nature forms the basis of work by Elinor Ostrom and other contemporary evolutionary social scientists, which has relevance for addressing environmental problems (Gowdy, 1994; Kallis and Norgaard, 2010; Norgaard, 1994; Ostrom, 2000). Both Ostrom and Smith recognize self-interest is part of human nature but also draw attention to the importance of other-regarding behavior, in Ostrom's case for addressing common pool resource problems, and in Smith's case for achieving a society of 'human flourishing'.

Although Smith is best known as the author of the *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) (hereafter *WoN*), it was his first book *The Theory of Moral Sentiments* (1759) (hereafter *TMS*) in which he discusses benevolence, justice and sympathy, that he considered his most important (Alvey, 2003; Raphael, 2007; Young, 1997). Initial interpretations of Smith's work struggled with the apparent contradiction between the emphasis given to self-interest in *WoN*, and the attention to other-regarding behavior in *TMS*. This became known as *The Adam Smith Problem* and was kindled by the fact that Smith did not making clear links between the two works. Some thought that Smith changed his mind, but it is widely acknowledged by contemporary scholars familiar with both books, that

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¹ Boulding (1981) has suggested that Smith cannot be blamed for being unaware of thermodynamics or the concept of entropy, for these were unidentified until the century following Smith.

Smith was consistent (Darwall, 1999; Evensky, 2005c; Griswold, 1998; Muller, 1995; Sen, 2009). His overall view on the economy appears to have been that while humans have a natural propensity to 'truck and barter' (WoN, I.1.2) leading to specialization and market pressures, humans also have a natural inclination to try to moderate market excesses and reward virtue. This point is encapsulated in the following passage: *'Thus man is by Nature directed to correct, in some measure, that distribution of things which she herself would otherwise have made. The rules which for this purpose she prompts him to follow, are different from those which she herself observes'* (TMS, III, 1, 108). Though prosperity achieved through exchange was important, at the same time Smith recognized the need for constraints in the form of social norms and other institutional arrangements to avoid a Hobbesian outcome in competitive markets (Darwall, 1999; Evensky, 2005c; Muller, 1995; Sen, 2009). Smith was also an evolutionary thinker; he had rejected the concept of the steady state, and from historical observations deduced that moral norms and economy co-evolve over time (Alvey, 2003; Evensky, 2005c; Young, 1997).

In WoN, Adam Smith describes how society had evolved through four stages, from hunter-gathering, to pasturage (shepherding), onto agriculture, and then onto commerce. He demonstrated how development from one stage to another was dependent on suitable governance mechanisms emerging (Evensky, 2005c). While he was largely positive about the age of commerce, viewing material progress not only as an opportunity for many to escape poverty, but also to create a surplus to establish courts of justice, and thus fashion a more civilized society, Smith held some caution because he was aware of the biased interests that accompany commerce (Alvey, 2003). Two hundred years on, anxiety does exist that markets and commercial values have become excessively dominant and that collective resource management has become more difficult. Ostrom et al. (1999) note that globalization has brought new challenges for managing common pool resources. While historically trade and technology brought temporary relief from local ecological constraints (van den Bergh, 2007), specialization has resulted in the production of goods becoming highly disaggregated not only across geographical space but also between organizations within complex global supply chains. Increased specialization has made the human race more intricately interdependent but at the same time more distant from each other and the natural resource base on which it depends (Ostrom et al., 1999). Zygmunt Bauman (2001) has argued that the way individual interests now are satisfied no longer promotes the collectivization of interests, with the expansion of markets leading to a *'dissipation of responsibility for the distant stranger – be it contemporary poor or future generations'* (p25).

This paper seeks to show that despite the apparent dominance of markets, and the disaggregation of production within the global economy, co-operative Pleistocene man can still be observed as working away within the market system to address environmental issues. Furthermore, this is revealed to be the case within the financial sector, a sector considered to be particularly lacking in social context (Knorr Cetina, 2006) and where theories associated with rational actors have been particularly dominant (Schliefer, 2000). Specific focus is given to the evolution of environmentally responsible investment in company stock, the development of investment practices that take account of the environmental consequences of company actions. Co-operative behavior to address environmental concerns in this context does have to tussle with market arrangements; therefore an Adam Smith perspective is apposite, because of his combined insights on both markets and the motivations that drive human endeavor to contain the effects of markets.

It is not supposed that precise recommendations for action today can be derived from Smith's work. Indeed he understood that different circumstances necessitated different arrangements. However, importantly his work provides *'a way of looking at the social world that balances moral concern with a realistic appraisal of human nature and human*

institutions.' (Muller, 1995, p5). In so far as cognitive frameworks can be influential in the way economic activity is conducted (Beckert, 2010), and that some of Smith's ideas from WoN have been (mis)used by neoliberals, there is pertinence in asserting Smith's wider perspective. In this paper his work is shown to have parallels with Ostrom and others with regard to how collective action is prompted, but differs with attention given to adjusting market arrangements, rather than direct management of common pool resources. Such market adjustments can be an important complement (rather than alternative) to attempts to set more direct constraints on the use of specific environmental resources. Environmentally responsible investment offers the opportunity to promote compliance with direct constraints, and to encourage more proactive and precautionary action.

The rest of the paper is structured as follows. The next section explores the evolutionary nature of Smith's work, and demonstrates that his assumptions about human nature align with Ostrom's. Section 3 establishes the argument for environmentally responsible investment while Section 4 looks at the progress being made to bring responsible investment into practice. Section 5 provides a summary and conclusion.

2. Adam Smith, Evolution, and Collective Action

Smith's credentials as an evolutionary thinker could be taken as established by the fact that his work influenced Charles Darwin (Gould, 2002; Schweber, 1977). However, there are various forms of evolutionary thought applied to economics (see Hodgson (1993) for a full discussion), and the evolutionary dimensions of Smith's work have been classified in two different ways. Hodgson has categorized Smith's ideas as ontogenetic, whereas Darwin's theory involving natural selection is phylogenetic.² In this section it is argued that Hodgson's judgment is based solely on Smith's analysis of the market mechanism, whereas taking the whole body of Smith's work, it can be described as phylogenetic, and comparable with contemporary evolutionary social science work on co-operative behavior and co-evolution. Nevertheless, with regard to the evolution of responsible investment, the observations from the ontogenetic approach are seen to have relevance, and are a component of phylogenetic socio-economic evolution.

It is considered that Darwin was persuaded by Smith's work to focus on individuals as the unit of his theory of natural selection (Schweber, 1977). But it is this focus that leads Hodgson to consider Smith's work as ontogenetic because it *'starts from the idea of a set of individuals with given predispositions, motives or sentiments'* (p42) and these individuals, in Hodgson's view, are analogous to a given set of genes. With the economic system as the organism, economic change in Smith's model according to Hodgson, is not a result of natural selection or genetic drift (as the individuals do not alter). Instead change in the 'organism' results from the division of labor into separate tasks, determined by the extent of the market rather than differences in individual attributes.³ This line of reasoning appears to draw solely on one of the central themes in WoN. Similarly, Boulding (1981) in his book *Evolutionary Economics*, when contemplating Smith focuses only on WoN, identifying the positive feedback effects of both the price mechanism and the new niches opened up from the expansion of trade.

In contrast to Hodgson (1993), Gould (2002) argues that Darwin's theory of natural selection is in effect Smithian economics (as derived from WoN) transferred to nature. Even so, Gould considers it ironic that while relevant to nature, Smith's WoN economics is not strictly

² Ontogeny relates to individual development, and phylogeny to the evolution of species and lineages (Gould, 1977).

³ This is the view of Hodgson (1993), and while Smith does emphasize that extending the market raises productivity, Smith also does acknowledge that labor is not homogenous (See WoN I.6.3.).

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