Honoring Adam Smith
EconomicsPennsylvania

Remarks by John C. Bogle
Founder and Former CEO, The Vanguard Group
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Adam Smith left an indelible imprint on economic thought all over the globe. But, make of it what you will, he was not an economist. Indeed, the study of what we now call Economics did not even exist when Adam Smith attended Glasgow University, where he studied mathematics, the natural sciences, philosophy, and classical writings, becoming professor of moral philosophy at the age of 27. His early eminence was as a professor who drew legions of students to his lectures, not, is the case today, as a researcher and writer of papers for the academic journals where "publish or perish" has become the name of the game. And a good thing too, for in Scotland in the eighteenth century, professors were paid . . . *by the student*. No students, no pay. So he not only talked the economics talk, he walked the economics walk. He had to!

It was only late in his career, at the age of 53, when Adam Smith published *The Wealth of Nations.* It is in that masterpiece where we find his most famous words:

> "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest . . . Every individual intends only his own security; . . . by directing that industry in such a manner as it produce what may be of the greatest value, he intends only his own gain, and is led by an invisible hand to promote an end which was no part of his intention . . . promoting the interests of the society more effectively then when he really intends to promote it."

We now know, of course, that his perception of the invisible hand of competition was right on the mark. Indeed, it *defines* today's notion of democratic capitalism.

More than that, we have come to take many of his other tenets as Holy Writ as well. Adam Smith believed that it was part of human nature to strive for economic growth. "Every man makes a uniform, constant, and uninterrupted effort to better his condition," he said. And he didn't favor government intervention beyond guarding society from violence and invasion (I'm sure he would have included terrorism), protecting its members from injustice and oppression, and providing necessary public works. Nonetheless, he believed that, "it is the highest impertinence in kings and ministers to pretend to watch over the economy of private people, and to restrict their expense by law."

But the Scottish philosopher was far from a no-holds-barred right-winger. He warned that, "no society can surely be flourishing and happy of which the far greater part of the members are poor and miserable." And he favored, not the flat tax we now hear so much about, but the gradual tax structure that characterized the United States system today: "The subjects of every state," he cautioned, "ought to contribute towards the support of government, as nearly as possible in proportion to their respective abilities."

If Adam Smith Came Down from Heaven

One can only wonder what Adam Smith would have thought if he could return from his well-earned spot in Heaven and see our world today. But from his writings we can make some pretty good guesses.

He would have applauded the modern world. His thoughts on entrepreneurship—he called it "the search for the pleasures of wealth and greatness"—seem to anticipate just *how* our world would grow. This search, he said, "keeps in continual motion the industry of mankind . . . to found cities and commonwealths, to invent and improve all the sciences and arts which embellish and enable human life; which have entirely changed the whole face of the globe . . . and make the trackless and barren ocean the great high road of communication to the different nations of the earth." Marvelously contemporary, isn't it? He was also a free trader, and would have applauded the global markets we enjoy today, even as he would have viewed with skepticism the tariffs and trade subsidies that to this day restrain trade and cause our commerce and markets to fall well short of his freely-competitive model.

Given Adam Smith's unrelenting opposition to monopolies and their practices, he would be appalled by the powerful trend—not just in America, but all over the globe—of mergers and consolidations, often between already giant enterprises, for these staggering aggregations of capital in a single firm set severe limits on competition. Consider today's auto, airline, petroleum, pharmaceutical, and media industries, and the long list hardly ends there. As for monopoly: It naturally charges "the highest price that can be got, but is the great enemy of good managers." But the great Scot well knew the value of competition: "Where competition is free, the rivalship of competitors renders excellency an object of ambition, and frequently occasions the very greatest exertions."

This gargantuanism is more than a restraint on free competition and a constraint on effective management. In the long run it reduces economic efficiency. Senior management gets disconnected from day-to-day operations, and the decent treatment of human beings takes a back seat to managing by the numbers. Innovation may ultimately be stifled. Conglomeration, in short, is the antithesis of Adam Smith's ideals. An op-ed piece in today's *New York Times*, incidentally, said the very same thing: "Rather than having to demonstrate skill in creating new products, providing better services, or motivating employees, these executives are usually judged by investors and analysts only by the swelling size of their empires."[1]

As he looked over today's Corporate America, with its huge and often ill-acquired aggregations of individual wealth, Adam Smith also would not be amused. "Power and riches appear to be what they are: enormous machines contrived to produce a few trifling conveniences to the body, consisting of springs the most nice and delicate, which must be kept in order with the most anxious attention, ready at any moment to burst into pieces and crush in their ruins their unfortunate possessor. . . . They keep off the summer shower, not the winter storm, but leave him . . . more exposed than before to anxiety, to fear, and to sorrow." And he would be appalled by the selfishness that many American business leaders have demonstrated. "When we prefer ourselves so shamefully and so blindly to others, we become the problem objects of resentment, abhorrence, and execration."

Financial Markets in the Recent Era

I have no doubt that Adam Smith would have been disgusted at this recent era in the financial markets, an era in which the *economics* of investment—the search to innovate, to improve production, to gain efficiency, all in a competitive marketplace, with the objective of building cash flow—became

[1] By Jeffrey Sonnenfeld of Yale School of Management

dominated by the *emotions* of speculation, a mania in which greed was the watchword, and which resulted in an historic bubble. It was an era in which the analogy of the casino to our financial markets is hardly far-fetched.

Our market system has experienced a failure of character. *Investors have focused on short-term speculation based on the hope that the price of a stock will rise, rather than long-term investment based on the faith that value of a corporation will increase*. Wall Street's conflicted sell-side analysts have lost their objectivity; the buy-side analysts of our large financial institutions have put aside their skepticism; too many of our corporations have forced the fulfillment of their aggressive earnings guidance by fair means or foul; off-balance-sheet special purpose enterprises have been created solely to conceal debt; corporate directors have, knowingly or inadvertently, let down their guard as a check on management; and too many chief executives have used their unchecked power to build personal fiefdoms, often losing sight of the difference between the corporation's property and their own.

And that's hardly the end of the list: Enormous compensation from stock options has enriched corporate executives who have succeeded in hyping the *price* of their *stocks* without increasing the *value* of their *corporations*; and auditors have important business incentives to be partners of management rather than independent professional evaluators of management's financial reporting. As all of these forces accumulated, investors came to realize that they had assumed risks that were far larger than those for which they bargained. They are demanding a higher risk premium, which in turn has raised the cost of capital. Unless we resolve these nettlesome issues in favor of the stockholder, that higher cost will ultimately drag down our economy.

A Failure of Character

But there's more at stake than that. This nation's founding fathers believed in high principles, in a moral society, and in the virtuous conduct of our affairs. Those beliefs shaped the very character of our nation. If *character counts*—and I have absolutely no doubt that character *does* count—the failings of today's business and financial model, the willingness of those of us in the field of wealth management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets greed overwhelm reason, all erode the character we'll require in the years ahead, especially in the post-September 11 era. The motivations of those who seek the rewards earned by engaging in commerce and finance struck the imagination of no less a man than Adam Smith—the man we honor this evening—as "something grand and beautiful and noble, well worth the toil and anxiety." I can't imagine that anyone in this room today would use those words to describe our corporate governance system at the outset of the 21st century.

By focusing on short-term speculation at the expense of long-term investing, we institutional managers have, I fear, gotten the corporate governance that we deserve—*bad* governance. Yet, despite the eye-opening and alarming events of the past year, most giant institutional investors—who, by holding fully one-half of all of the stocks in America, have a huge stake in the outcome—have been conspicuous only by their silence. But if we at last speak up and simply act as good corporate citizens, recognizing that ownership entails not only rights but responsibilities, we will again get the governance we deserve—*good* governance. If institutional investors take the initiative to stand up and be counted, we will at long last return to an era in which the great creative energy of American business and finance will once again drive our economy, and our corporate leaders will return to the task of building the businesses they manage on a sound footing. There is so much good in our economic system that is up to *all* of us to preserve it, to protect it, to defend it, and, above all, to *fix* it. We must return our economic system to its historic character.

The mission of EconomicsPennsylvania surely both echoes and reinforces that goal. I salute you for your accomplishments in increasing and improving the understanding of the American economic system. This process must begin in our schools, for it is never to early to teach our citizens about the management of financial resources, the role of entrepreneurship, and the advantages of being more productive workforce members, more knowledgeable consumers, more competent decision makers, more prudent savers, and more intelligent investors.

Character Counts

Permit me to close by moving briefly to a higher plane that transcends economics, a message to all of you, especially the young men and women who are gaining so much valuable economic education through the efforts of the EconomicsPennsylvania. Even before venturing into economics in *The Wealth of Nations*, Adam Smith unveiled his not inconsiderable credentials as a philosopher. In *The Theory of Moral Sentiments,* he expressed this thought, which I hope will ring out loud and clear to each of you. For it drives home the message that, invisible hand or not, engaging the whole person goes far beyond the mere promotion of one's own interests:

> "What is it which prompts the generous among us, upon all occasions, and the meanest, upon many, to sacrifice their own interests to the greater interests of others? It is not the soft power of humanity. It is a stronger power, a more forcible motive. It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct . . . who shows us the propriety of generosity, of reining in the greatest interests of our own for yet the greater interests of others, the love of what is honorable and noble, of the grandeur, and dignity of our own character."

Yes, it's all about character. And as that final piece of wisdom from Adam Smith confirms, *character counts*.

Thank you all for supporting EconomicsPennsylvania and joining us this evening.