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Adam Smith's Legacy for Ethics and Economics*

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ABSTRACT

This article challenges a popular understanding of the Wealth of Nations. According to this reading of Smith, self-interested, economic actors in free competition with each other unintentionally create a self-constraining system. This system, the "invisible hand" which governs market transactions, functions both to regulate these self-interests and to produce economic growth and well-being such that no one actor or group of actors can take advantage of other actors or take advantage for very long. We suggest that this is a misreading of Smith. Smith is not a laissez-faire economist. Economic exchanges occur and markets are efficient, according to Smith, precisely because we are not merely non-tuistic, and economic growth depends on what today we call the rule of law. Smith was the Professor of Moral Philosophy at Glasgow, and argues precisely against, and may not have even imagined, a separation of ethics from economics, ethics from commerce; or ethics from his idea of a viable political economy.

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I. THE POPULAR UNDERSTANDING OF THE WEALTH OF NATIONS

I shall start by reiterating what I believe to be a widely held thesis, but one that deserves to be repeated in the context of management theory and applied ethics. Beginning with the work of the eighteenth-century philosopher Immanuel Kant (1781) it is now commonplace to argue that "our conceptual scheme mediates even our most basic perceptual experiences." (Railton (1986), 172) All experience is framed and interpreted through sets of conceptual schemes or mental models that function on the individual, institutional, societal, and cross-cultural levels. We can neither experience an event nor present a story except through mental models. Depending on which model or models is or are operative, interpretations of a situation or event by persons, groups, institutions, or societies may differ greatly from each other. Because conceptual schemes are learned and incomplete, we can also create, evaluate, and change our mental models. (Davidson (1973); Senge (1990)) Still, sometimes we become so embroiled in a particular set of mental models that shape our stories or narratives, whether or not of our own making, that we fail to compare a particular narrative with other accounts or evaluate its implications. Thus, the ways we present or re-present a story, the narrative we employ, and the conceptual framing of that story, affect its content, its moral analysis, and the subsequent evaluation. (Chambers (1996), 25)

One of the ways in which we create mental models is by selectively reading famous thinkers and creating a narrative about what they might have meant, a narrative model that then becomes reiterated and appealed to in various theories and applications. I have just done that with Peter Senge, because, when one goes back to his well-known book, "The Fifth Discipline" (1990), one will discover that I have elaborated on his slim chapter on mental models, reformulating his ideas through a neo-Kantian perspective.

One of the most egregious caricatures of this phenomenon is that of a commonly held interpretation of Adam Smith's political economy as depicted from his best-known book, "The Wealth of Nations (WN)". What I shall call the "popular view" of the *WN* is egregious, I shall argue, because it does not represent the full body of his texts, and at the same time this reading has had profound implications in economics and in applied ethics. This caricature has roots in the work of nineteenth-century German political economists, and, I am now suspecting in reading Smith through the thinking of Herbert Spencer and other British nineteenth-century liberals, and is reinforced in this century particularly by the Chicago School of economics.

Nineteenth-century German political economists such as Bruno Hildebrand, Carl Knies, and Witold von Skarzynski read the *WN* as having promulgated Thomas Hobbes' allegedly egoistic picture of human motivation, and as having solved the problem of the dichotomy between the so-called natural selfish passions and public interests. When individual human beings are granted what Smith calls the "natural liberty" to pursue their own interests, where "all systems … of restraint, therefore, being thus completely taken away" (Smith (1776); (1976), iv.ix.51) the harmony of these individual pursuits will, unintended by the actors, often produce social and economic good. This is because, according to this reading of Smith, self-interested, economic actors in free competition with each other unintentionally create a self-constraining system. This system, the "invisible hand" which governs market transactions, functions both to regulate these self-interests and to produce economic growth and well-being such that no one actor or group of actors can take advantage of other actors or take advantage for very long (Hildebrand (1948), Knies (1853), von Skarzynski (1878). See also Buckle (1861)).

Interestingly, a number of late twentieth-century scholars including Amatai Etzioni, Robert Frank, Milton Friedman, Albert Hirschman, and George Stigler have adapted this reading of Smith as well. (Etzioni (1988), Frank (1988), Friedman (1962) and (1976), Hirschman (1977), Stigler (1971). See also, Shack (1984) and Myers (1983)) A.O. Hirschman declared that "the main impact of *The Wealth of Nations* was to establish a powerful *economic* justification for the untrammeled pursuit of individual self-interest." (Hirschman (1977), 100) This view is nicely summarized by George Stigler, the late Nobel Prize Chicago economist who writes, *"The Wealth of Nations* is a stupendous palace erected upon the granite of self-interest." (Stigler (1971), 265)

Hildebrand, Knies, van Skarzynski and other nineteenth-century German political economists who also read Smith's earlier work on moral psychology, *The Theory of Moral Sentiments (TMS)* then argued that there was an "Adam Smith Problem." This is because, one interpreter suggests, "in the *Moral Sentiments* he [Smith] ascribes our actions to sympathy, in his *Wealth of Nations* he ascribes them to selfishness. A short view of these two works will prove the existence of this fundamental difference." (Buckle (1861) 2, 437) This same problem is cited by later writers such as Jacob Viner (1926), Glenn Morrow (1926), and Joseph Cropsey (1977). But, by and large, in this century, the problem does not always come up because seemingly economists and political theorists read the *WN* and philosophers concentrate on the *TMS*.

There are a number of influences from this reading of Smith that have trickled down into neo-classical economics and into twentieth-century thinking about markets and morality. First, there is sometimes a preoccupation with the individual economic actor both in economic theory and in business ethics. In business ethics we sometimes focus on dilemmas of individual managers as if they operated in autonomous vacuums rather than in corporations. (See for example, Donaldson and Werhane (1977)) Second, at least some neoclassical economic theory appears, now and again, to be preoccupied with the individual non-tuistic[1] or self-interested rational utility maximizer as the paradigm of economic choice and purveyor of economic value, where economic value is often linked to preferences, however qualified or defined. (Sen (1987), Hausman and McPherson (1996)) Thus the individual, as if acting on her own, without social, cultural, religious or corporate influences, is naturally and primarily motivated by self-interests; in cool rational moments, this individual is a non-tuistic utility maximizer of her preferences, or considered preferences. Third, Smith appears to separate the economic actor in the *WN* from the ordinary moral person to whom he devotes his earlier work, *The Theory of Moral Sentiments* ((1759); (1976)). So, too, one can separate ethics, politics, and economics (as we have done in academia) such that not only are these three fairly Balkanized disciplines, but more importantly, that they are different mental models and create distinct approaches. This Balkanization leads to the Separation Thesis - the view that polities, economics and ethics (or, translated, public policy, ethics and business) are three separate endeavors. Therefore one needs moral philosophers and public policy to straighten out managers and companies when they go astray. Conversely, one needs managers and management theory to tell us how it “really is” so that the practicalities of doing business (whose contributions, after all part the funding for many of the chaired professors in business ethics) are not lost in a Kantian or Aristotelian ideal world of what should be, nor are undermined by regulation. (See Freeman (1994)).

What I want to suggest in what follows is that this interpretation of the *WN* is a misreading of Smith. Smith actually tells a different story. Or, to qualify my claim, at least one careful reading of Smith's texts can paint a different picture of Smith's idea of political economy. Smith is not a laissez-faire economist. Economic exchanges occur and markets are efficient, according to Smith, precisely because we are not merely non-tuistic, and economic growth depends on what today we call the rule of law. Individual utility maximization is not the only criterion for rational choice. Indeed, Smith is not a pure utilitarian, and values are not merely individual preferences, nor even individual *considered preferences.* Moreover, Smith was the Professor of Moral Philosophy at Glasgow, and argues precisely against, and may not have even imagined, a separation of ethics from economics, ethics from commerce; or ethics from his idea of a viable political economy. So a careful reading of Smith, or, at least, one kind of careful reading, can produce some insights into how to approach ethical issues in business that avoids forms of radical individualism, a preoccupation with egoism, and the Separation Thesis. The challenge, (which I shall attempt in the second part of the paper with some examples) is to show how such an approach can be to the long-term competitive advantage of a political economy and to business and its shareholders.

II. SELF-INTEREST IN THE THEORY OF MORAL SENTIMENTS

Let us now turn to Smith's work and examine Smith's notion of self-interest, a notion developed in Smith's earlier work, *The Theory of Moral Sentiments (TMS).* The first thing that is striking in the *TMS* is Smith's emphasis on the social nature of human beings. Early on he proclaims,

> *[m]an, who can subsist only in society, was fitted by nature to that situation for which he was made. All the members of human society stand in need of each others assistance, and are likewise exposed to mutual injuries. (Smith (1759); (1976), II.ii.3.1)*

Thus it is hard to portray Smith as a radical individualist as some of his later readers such as Hirschman do. (Hirschman (1977)) Smith begins the *TMS* with this statement:

> *[h]ow selfish so ever 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 (1759); (1976), I.i.l.l).*

At the same time, Smith argues, "Every man is, no doubt, by nature, first and principally recommended to his own care." (Smith (1759); (1976), II.ii.2.1) Smith explains what appear to be contradictory statements through his analysis of motivation. While recognizing that all one's motivations are self-interested in a trivial sense that they originate in, and are interests *of* the self, he goes on to claim that not all the objects of our interests are interests *in* the self. That is, the self is the subject, but not the object, of all our passions and interests. Smith is highly critical both of Hobbes and Smith's infamous predecessor, Bernard de Mandeville. (Smith (1759); (1976), VII.iii.i) Indeed, it was de Mandeville, *not* Smith, who argued that private vices could be transformed into public virtues.[2] (Mandeville (1732); (1988))

According to Smith, human beings are motivated by three sets of passions or natural affections, each with its own set of objects: the selfish passions, whose object is interests, pleasures, and pains of the self; the social passions such as altruism, justice, and compassion which are directed to others; and the unsocial passions such as hate and envy which are negative reactions to others. Importantly, for Smith, none of the passions dominates others so that most of us are as naturally interested in others as we are in ourselves.

Interests are derived from, but are not identical to, the passions. Passions are akin to natural drives; interests are cognitively and emotionally developed from the passions. Like the passions, each of us has self-interests and social interests; unlike the passions, we assign virtues and vices to the operations of each of the sets of interests. Since self-interest has distinct objects (the self or others), egoism and altruism are not opposites for Smith. Egoists are individuals whose interests are all of the self as object, but egoists are not necessarily evil people. Virtuous self-love is prudence; its vice is avarice or greed. One can be a virtuous, i.e., a prudent, egoist. Even a selfish person is not necessarily evil unless she harms others or treats others unfairly in the pursuit of her interests. Social interests can be exhibited in the excellences or virtues of benevolence, altruism, and/or justice or in the vices that include harming others in the forms of malevolence or injustice.

Although Smith spends some time explaining passions and interests, values are not created merely from interests or preferences, Smith argues, because we distinguish between what we prefer, what we approve of, and what *ought to be approved of.*[3] The criteria for either of the latter do not consist merely of one's own considered preferences. One may prefer what one does not approve of, and one constantly tests one's own values against both what I and others approve of and what society deems ought to be approved of, that is; what society values. So, at a minimum, values are what a society finds admirable and praiseworthy.

Smith also grounds many of his conclusions in an appeal to warmed-over natural law theory. In the TMS Smith sometimes uses expressions such as, “men by nature …”. In both the *TMS* and the *WN* Smith uses terms such as “the natural order, “natural liberty,” and “natural jurisprudence,” he appeals to natural jurisprudence as justification for his theory of justice, and in the unpublished *Lectures on Jurisprudence* he explicitly adopts Pufendorf’s notion of natural rights. (Smith (1762)-4; (1978); [A] 1-16; [B] 1-10) So Smith appears to appeal to some non-relative basic principles, although how those relate to societal values is unclear in his writings.

III. SELF-INTEREST AND SOCIAL INTEREST IN THE WEALTH OF NATIONS

In the *WN,* self-interest is usually equated with the natural desire to better one’s condition and look after one’s own welfare. So at least one commentator contends that “[in the *WN*] Smith gave new dignity to greed and a new sanctification to the predatory impulses.” (Lerner (1937), ix) Part of the difficulty in reading Smith is that he is both descriptive and normative, and despite the fact that he was a student of David Hume, famous for instigating the fact/value distinction, Smith is notoriously slipshod in making that distinction. So Lerner may have confused Smith’ s description of self-interest in commerce with his admonitions concerning greed and avarice. Smith repeatedly argues that avarice interferes with competition, hoarding capital slows down economic growth, and greed is antithetical to the ideal of a free political economy as Smith envisions it. (e.g., Smith (1776); (1976), II.iii.25-26, II.ii.36) So even as we strive to “better our condition,” the demands of morality and the ideal of a free exchange political economy require prudence and parsimony of one’s economic desires.

But what is the role of the social passions and interests in the *WN*? One of the most famous quotations in the *WN,* of course, is:

> *[i]t 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. 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. (Smith (1776); (1976); I.ii.2)*

Indeed, he says further, "[n]obody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens." (Smith (1776); (1976); I.ii.2) Has Smith divided "economic man" from ordinary mortals who have a variety of passions, interests, and virtues? Dealing with these quotations out of context, one might be led to that conclusion. However, such a conclusion ignores two important notions that play central roles in commerce and in any political economy: cooperation and justice.

Economic exchanges, even between the most selfish parties, are not merely competitive nor purely adversarial, according to Smith. We have a natural "propensity to … truck, barter, and exchange" and indeed, "[t]he division of labour … is a necessary, though very slow and gradual consequence of [this] certain propensity in human nature." (Smith (1776); (1976), I.ii.l, I, ii.5) Our natural desire to cooperate motivates us to work together by dividing and specializing our labor. It also motivates us to barter, where the appeal to self interest of others as well as to their good win in honoring the exchange results in "mutual and reciprocal" gains. (Smith (1776); (1976), II.i.l) Do we participate in cooperative ventures because it is our self-interest to do so, or does cooperation arise out of our social passions? For Smith, these two cannot be separated. It is both natural and an advantage to cooperate in economic affairs. Our friends, the butcher, brewer, and baker, do not give away meat, beer, or bread, but they depend on mutual respect, fair play in business, the honoring of contracts, and indeed, even cooperation to stay in business together in the same town.

But what about benevolence, and the poor beggar? One will remember that there are two virtues of the social interests: benevolence and justice. It will turn out that justice is the most essential virtue both in the *TMS* and in the *WN,* and it will also turn out that justice, as natural jurisprudence, will play a critical role in Smith' s ideal of a political economy as well.

According to the *TMS,* the notion of justice arises from the social passions and is the virtue of what Smith calls impartial social interests. Justice is the "consciousness of ill-desert." (Smith (1759); (1976), II.ii.3.4) It is what an impartial spectator would classify as unfair in social relationships even among strangers. It is both a negative principle that proscribes deliberately banning another and includes the positive notion of fair play.[4] (Smith (1759); (1976), II.ii.i.9 and I.ii.l) In the *TMS* justice is both a personal virtue and, as natural jurisprudence, "the main pillar that upholds the whole edifice [of human society].” (Smith (1759); (1976), II.ii.3.4) “Society may subsist, though not in the most comfortable state, without beneficence; but the prevalence of injustice must utterly destroy it.” (Smith (1759); (1976), II.ii.3.3)

In his unpublished *Lectures on Jurisprudence* Smith is careful to clarify his notion of justice. By justice he means commutative, not distributive justice. According to Smith, it is always wrong to deliberately harm others, to violate their personal rights to liberty, property (however societally defined), and reputation, not to honor promises and contracts, or to act unfairly. Thus one has perfect duties, always to be just; that is, it is always wrong to violate the principles of commutative justice. While other virtues such as benevolence are desirable, they are not enforceable since one need not be benevolent to be moral. Justice, Smith argues, is the only virtue for which one my use force to ensure. (Smith (1762)-4: (1978), [A] i. 14-16; v. 142). Thus while the beggar has no claim on our benevolence, he does have a claim on equal opportunity and fair treatment. Principles of distributive justice like benevolence, are not enforceable, since there is conceptual disagreement about the extent and fairness of such principles.

Because economic exchanges are often between strangers, justice plays a central role in a viable political economy. Laws of justice are essential not only to restrain overindulgent self-interests, but also because we often unfairly cooperate or collude with each other. Thus, Smith writes,

> *[e]very man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest in his own way (Smith (1776); (1976), IV.ix, 51, my italics)*

But there remains the *invisible hand* question. Smith wrote,

> *[The man of commerce] generally, indeed, neither intends to promote “the public interest, nor knows how much he is promoting it …. By directing industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. (Smith (1776); (1976); IV.ii.9)*

Smith is obviously arguing that people in commerce tend to act in their own self-interest (i.e., seek personal economic gain). But this neither means that people of commerce are, or should be, necessarily selfish or greedy, nor is Smith proposing purely laissez-faire markets.

Putting this quotation in the context of the rest of the *WN,* Smith is arguing that markets (the famous invisible hand) work best under conditions of economic liberty grounded in commutative justice, (the "rule of law") when people are parsimonious and prudent, and cooperative as well as competitive. Markets work best when embedded in a political economy that enforces human rights, contractual agreements, and fair play. Smith goes so far as to claim that the ideal is a level playing field'—-a climate where "[t]he whole of the advantages and disadvantages of the different employments of labour and stock … be either perfectly equal or continually tending to equality."(Smith (1776); (1976), I.x.a.l) This is neither to conclude that economic actors consciously or intentionally are always prudent, fair, cooperative, nor that markets act independently. Rather, the market works most efficiently and competitively when prudent parsimonious actors act fairly in competitive and cooperative ventures, whether or not they deliberately intend to do so.

But still, could we not conclude that we are prudent, fair, and cooperative because it is in our self-interest, at least long-term self-interest, to be so? Smith's answer wou1d be "yes" and "no". Of course it is in my interest, thus rational, to act accordingly. On the other hand, according to Smith each of us is naturally interested in others, thus it is also rational to be cooperative. "Consciousness of ill-desert" is part of human nature, even though some of us do not play fairly all the time. Prudence and parsimony are virtues many of us try to emulate, sloth and greed, and are not admired. So for Smith, a rational person is prudent, cooperative, and fair "by nature," because this is admirable, and because it is to her advantage to be so.

Smith was not a purist, nor was he naive about agency problems. He was highly critical of 'joint –stock companies,' writing:

> *[t]he trade of a joint stock company is always managed by a court of directors … The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private company frequently watch over their own … Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. (Smith (1776); (1976), V.i.e.18)*

Yet at least part of this criticism is leveled because there were few corporations in Smith' s time, the most notorious being the East India Company which, despite mercantile regulations, exemplified managerial greed to perfection.

On a macro level, Smith argues that the ideal political economy is one that protects its citizens, creates conditions for well-being, including economic growth, and provides public services in the context of personal liberty, protections of rights, and enforcement of laws of justice. (Smith (1776); (1976), Introduction, IV.vii.c.44 and IV.ix.51 and (1762-64), (1978), [A] i.9) This is hardly a "night watchman" theory of the political economy, a position sometimes traced to Smith. A viable political economy cannot exist for long without justice, and it cannot prosper without economic development in the form of free commerce. Thus, in the Smithian well-functioning political economy, ethics (as prudence and personal fairness), economics (the enhancement of economic well-being of each citizen) and politics (in the form of protection of rights and commutative justice through the laws and guardians of the system) are all interrelated, inseparable, and necessary for a well-functioning, just, political economy.

IV. CONCLUSION

What should be concluded from this reading of Smith is that the popular view creates a questionable paradigm and is not the only way to think about politics, economics, and ethics. Just as one set of political economists, in particular, neo-classical economic theory, appealed to Smith for some ground for their conclusions, so too, we can appeal to Smith to tell another story about commerce and free enterprise. This story might include: questioning the range and scope of rational choice theory and agency theory, pointing to the normative aspects of positive and welfare economics, raising questions about the alleged autonomy of markets (e.g., the 'market for corporate control'), and exploring what kinds of stories one can tell about free enterprise if ethics, economics and politics cannot be neatly compartmentalized.

Much of this project is already under way. We have seen examples of "cowboy capitalism" where new capitalist economies flounder without a well-defined rule of law. Agency theory and rational choice theory are objects of a number of targets. Both Amartya Sen, in his book, On *Ethics and Economics* (1987) and in a more recent book by David Hausman and Michael McPherson, *Economic Analysis and Moral Philosophy* (1996), focus on the normative aspects of positive economics and, in the case of Sen, of welfare economics. Criticizing the Chicago School reading of Smith, Sen points out the limitations of rational choice theory, and Hausman and McPherson argue that the modeling criteria one uses in economics function normatively to frame the kinds of theories outcomes a particular model will produce.

What I want to highlight is the intersection of politics, economics and ethics. If ethics and economics are not easily compartmentalized, that is both good news and bad news. The good news is that the "Business Ethics is an oxymoron" jokes themselves are oxymorons. As Oliver Williamson noticed, if managers behave ethically, transaction costs go down. (Williamson (1985), 170) The bad news is that management cannot use the excuse, "We did it for business reasons, even though, on moral grounds, the behavior raised some questions."[5] If ethics and economics are mutually dependent constructs, then a morally 'good' company that fails in the market (e.g., IBM in the late 1980s) is really no better than the unethical behavior of a manager (e.g., Ivan Boesky), a morally questionable company (e.g., Bre-X), or a questionable activity of a company that is economically successful. Both eventually will fail. The former will fail for obvious reasons; the latter will fail because it will either self-destruct or be caught.

But something more is at stake. On a practical level, the challenge is to tell a new story about business, to create a new mental model wherein the interrelationships between commerce, ethics, and public policy are formulated as a positive construct that makes sense to management as part of their competitive advantage.

NOTES

1. "Non-tuists" are persons unconcerned with the interests of others except as they relate to, or are the object of, that person's interests.
2. Mandeville writes:

   So Vice is beneficial found,
   When it' s by Justice lopt and bound; …
   Bare Virtue can't make Nations live
   In Splendor; they, that would revive
   A Golden Age, must be as free,
   For Acorns, as for Honesty.
   (Mandeville (1732), (1988), § 23-24)
3. We ought to refer here to Smith's principle of sympathy, or rather empathy as it refers to the capacity of men to feel what others feel. This is according to Smith as fundamental as self-interest. People are socialized around this principle of sympathy (Smith (1759); (1976), I.i.1-3) and it also allows us to determine what constitutes an appropriate or an inappropriate action, feeling or passion. It is therefore also connected to how we judge right and wrong.
4. 3 "Fair play" is not clearly defined. In the TMS Smith writes,[If one is just] he would act so as that the impartial spectator may enter into the principles of his conduct …

In the race for wealth, and honours, and preferments, he may run as hard as he can, and strain every nerve and every muscle, in order to outstrip all his competitors. But if he should justle, or throw down any of them, the indulgence of the spectators is entirely at an end. It is a violation of fair play, which they cannot admit of. ((1759); (1976), II.ii.2.1)

5. That is almost a direct quotation from the former CEO of Lockheed when, in 1977, he paid $12 million in extortion to Japanese government agents in order to get the Lockheed 1011 contract he wrote, "From a purely ethical and moral standpoint I would have declined such a request. However, in this case I would most certainly have sacrificed commercial success." (Kotchian (1977), 11.)

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