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#### **Virtues and institutions in Smith: a reconstruction**

by

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# Virtues and institutions in Smith: a reconstruction

Emmanuel S. de Dios\*

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## Abstract

I provide a formal explanation of the relationship between the virtues of prudence, justice, and benevolence described by Adam Smith in the *Theory of moral sentiments* and connect these with the themes Smith subsequently discusses in the *Wealth of nations*. I contend that the other-regarding concerns Smith discusses as internally held virtues in TMS are presumed addressed instead by formal mechanisms in the WN — particularly the third-party institutions of law and anonymous market exchange.

**Keywords:** Adam Smith Problem, virtues, institutions, self-interest, altruism

**JEL codes:** B12, B15

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In his *Theory of moral sentiments* (TMS), particularly the expanded final edition<sup>1</sup> of 1789, Adam Smith discusses the origins and operation of “virtues” that he thought rendered society possible. As McCloskey [2010] has shown, Smith’s work was in the established tradition of “virtue ethics” flowing from Plato and Aristotle, to the Stoics, to the Schoolmen, and finally Smith’s own teacher Hutcheson. What distinguished Smith’s approach, however, was his naturalistic, from the ground-up approach to explaining the natural appeal of virtues. This allowed him to develop “a coherent and plausible account of the processes by which we learn the principles of morality from the experience of common life” [Phillipson 2010:148].

In what follows we explain the relationship between the “virtues” described by Smith in the TMS and relate these to the important themes Smith subsequently discussed in the *Wealth of nations* (WN), particularly the institutions of law and the market. Through a formal statement, we construct a bridge between the two works, the search for which has pre-occupied many writers—the so-called Adam Smith Problem—but which thus far seems to have eluded them.<sup>2</sup> Wilson and Dixon [2006: 251] note that “there is still no widely agreed version of what it is that links these two texts, aside from their common author; no widely agreed version of how, if at all, Smith’s postulation of self-interest as the organising principle of economic activity fits in with his wider moral-ethical concerns.”

## 1. Sympathy

Sympathy is Adam Smith’s starting point in TMS: “In every passion of which the mind is susceptible, the emotions of the by-stander always correspond to what, by bringing the case

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<sup>1</sup> Unless otherwise stated, all references pertain to the part, section, chapter, and paragraph (e.g., TMS VI.ii.3.6) of the TMS as edited by Raphael and McFie, i.e., Smith [1976 (1789)]. Similarly, references to the *Wealth of nations* refer to the book, chapter, and paragraph (e.g., WN I.i.5) of the Glasgow edition [1976(1776)] edited by Skinner and Campbell.

<sup>2</sup> A survey of various interpretations and attempts at “solutions” to the problem is provided by Montes [2003] who concludes the issue “continues to be a source of debate”.

home to himself, he imagines should be the sentiments of the sufferer” [TMS I.i.1.3]. When they originally raised what later came to be known as the Adam Smith Problem, writers of the German Historical School<sup>3</sup> mistook the capacity for sympathy to mean altruism or benevolence itself, an error that has since been clearly pointed out (e.g., Raphael and McFie [1976: 20ff]). Smith’s use of the term shows he was clearly referring to a general capacity for understanding the circumstances and action of others—a “fellow-feeling with any passion whatever” [TMS I.i.1.5]—and not a predisposition or urge to actual benevolence itself. More contemporary language would denote this ability by empathy, “the capacity to understand others people’s feelings by sharing their affective states”<sup>4</sup> [Singer 2014: 517].

Sympathy in TMS is what allows a person to imagine the possible consequences of his own actions on the state and opportunities of another. Because of this, a person is able to judge the effect of his action on the condition and interests of other persons. Because of this, Smith sees no great wall that separates people from understanding others’ conditions; he appeals instead to introspection and a common human experience:

As we have no immediate experience of what other men feel, we can form no idea of the manner in which they are affected, but by conceiving what we ourselves should feel in the like situation [TMS I.i.2].

This contrasts with the solipsism of neoclassical welfare economics, which prevents not only the welfare-observer but also the subject himself from making interpersonal welfare comparisons. It is sympathy that instinctively orients a person to the condition of others and rules out a retreat into solipsism, leading to Smith’s well-known beginning line: “How selfish soever a man may be, there are evidently *some principles in his nature*, which interest him in the fortune of others...” [TMS I.i.1.1]. (Emphasis supplied.)

In the tradition of virtue-ethics, Smith then proceeds to list the standards he believes prescribes ideal human behaviour, which he depicts as being more or less already emergent or potential in human nature. He cites three in particular:

The man who acts according to the rules of perfect prudence, of strict justice, and of proper benevolence, may be said to be perfectly virtuous [TMS VI.iii.1].

Smith also includes “self-command” as a virtue and also writes that real virtue consists in the “keen and earnest attention to the propriety of our own conduct” [TMS VI.iii.17]. But this should be interpreted as saying that self-command is the ability to recognise the respective relevance of the substantive virtues of prudence, justice, and benevolence and the skill to apply them in the proper measure in given situations.

Further on, Smith explains the content of these virtues in relation to the priorities and actions they entail:

Concern for our own happiness recommends to us the virtue of prudence; concern for that of other people, the virtues of justice and beneficence; of which, the one restrains

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<sup>3</sup> Hence, for example, Knies [1853:182] noted how Hutcheson’s views on the incompatibility between moral behaviour and self-love and self-interest were shared by many philosophers, “nicht minder in dem moralphilosophischen Werke von Adam Smith selbst, *der das Wohlwollen gegen Andere als Sympathie auffaßte* und die praktische Formel aufstellte, daß sittliche Handlungen nur diejenigen seien, welche allgemeine Billigung finden können”[Emphasis supplied]. Here, Knies explicitly equates sympathy in Smith with benevolence (*Wohlwollen*) towards others.

<sup>4</sup> On the other hand, empathy is to be distinguished from “theory of mind”, which refers only to the cognitive understanding of another person’s mental state, without affecting one’s own affective state. Even a sociopath would have theory of mind. Players in a strategic game would find it indispensable to have a theory of mind of their adversaries.

us from hurting, the other prompts us to promote that happiness. *Independent of any regard either in what are, or to what ought to be, or what upon a certain condition would be, the sentiment of other people*, the first of those three virtues is originally recommended to us by our selfish, the other two by our benevolent affections [TMS VI. Concl. 1]. (Emphasis supplied.)

The italicised parts of the above passage point to an important part of Smith's discussion of virtues that is overlooked: virtues are to be regarded *ex ante* or as first principles to be upheld and acted on regardless of their expected consequences in terms of other people's opinions or reactions. As will be seen further below, recognising this fact saves avoids a good deal of confusion in interpreting the role Smith assigns to self-interest-seeking versus benevolence.

## 2. Prudence

Among the virtues, Smith assigned a basic role to prudence or "self-love" as the most reliable motivation<sup>5</sup>: "Every man is, no doubt, by nature, first and principally recommended to his own care; and as he is fitter to take care of himself than of any other person, it is fit and right that it should be so" [TMS II.ii.2.1]. In a later passage, Smith states what prudence consists in:

The care of the health, of the fortune, of the rank and reputation of the individual, the objects upon which his comfort and happiness in this life are supposed principally to depend, is considered as the proper business of that virtue which is commonly called Prudence [TMS VI.i.4].

In the WN, of course, Smith's entire argument draws upon the necessity and sufficiency of self-love in economic organisation (e.g., WN I.ii.2, ("benevolence of the butcher, etc.") and WN IV.ii.9 ("invisible hand")).

This human motivation is represented in the more familiar utilitarian literature as the maximisation of individual utility or welfare. Thus, if  $X$  denotes the set of an individual's feasible actions in a given state of nature, and the individual's welfare, as he perceives, is described by the function  $u$ , then behaviour according to prudence or self-love may be described simply by the familiar problem:

$$\max u(x), x \in X, \tag{1}$$

where  $u$  is the individualistic utility function. In the familiar market context, of course, the elaboration of (2) specifies  $X$  as the budget constraint with  $x$  being the choice of market goods consistent with prices and endowment. It is advisable at this point, however, to maintain the more general form that allows  $X$  to include "the care of the health, of the fortune, of the rank and reputation of the individual" [TMS VI.i.5].

Significantly, however, Smith begins his discussion of virtues in TMS not with prudence but with an explicitly social concept, the "impartial spectator". The mechanism for considering the welfare of others and for restricting one's prudential actions must be initially based, according to Smith, on the impartial spectator's regard for the individual's action. One can therefore posit that an action  $x \in X$  will be considered eligible by A only if it is *unobjectionable* from the viewpoint of an impartial spectator. Even prudence in the sense of (1) must be encased in a larger social but internalised judgement. What Smith variously calls "reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct" [TMS III.3.4] really consists of a higher level of self-observation

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<sup>5</sup> Indeed Smith observes that the principle exists even among animals [TMS VII.ii.1.15], implicitly evoking an evolutionary argument.

that evaluates the subject's action as if from the viewpoint of an external observer. Indeed, Smith is explicit about the need to subsume prudence under a higher-order judgement:

If he would act so that the impartial spectator may enter into the principles of his conduct, which is what of all things he has the greatest desire to do, he must, upon this, as upon all other occasions, *humble the arrogance of his self-love*, and bring it down to something which other men can go along with [TMS II.ii.2.2]. (Emphasis supplied.)

Smith, therefore, clearly recognises a distinction between a valuation of action according to self-love, as summarised by (1), and a valuation by the impartial spectator. If we denote this aspect of higher moral judgement by some function  $S$  that evaluates  $x \in X$  according to criteria distinct from  $u$ , this leads to the possibility that:

$$\operatorname{argmax} u(x) \neq \operatorname{argmax} S(x), x \in X. \quad (2)$$

Whether and how such a conflict is to be resolved in a manner that preserves the integrity of Smith's work is the essence of the Adam Smith Problem.

### 3. Digression: Ronald Coase and Vernon Smith

An incidental but illuminating issue is how Vernon Smith (henceforth V. Smith) [1998] and Ronald Coase [1976]—two Nobel Prize-winning economists who have written influentially on the Adam Smith Problem—essentially propose an interpretation where  $S = u$ , therefore obviating the problem in (2). In earlier work, V. Smith proposed that a “single behavioural axiom” runs through Smith's work, namely the “propensity to truck, barter, and exchange” cited by Adam Smith in Chapter II of WN. V. Smith then refers to the wide-ranging coverage of what constitutes an individual's well-being—e.g., encompassing social stature and reputation—to include “not only goods, but also gifts, assistance, and favors out of sympathy” in the ambit of prudence. From this, it is not hard to show that reciprocity can call forth behaviour that is observably other-regarding and at times arguably even altruistic. A simple example is the Folk Theorem (also as experimentally observed) that repeat transactions and a sufficiently low discount rate are sufficient to resolve many Prisoner's Dilemma situations. V. Smith then contends<sup>6</sup> that reciprocity “explains why human nature appears to be simultaneously self-regarding and other-regarding” [Smith 1998:3].

Against a derivation of all other-regarding behaviour from reciprocity, however, are simply Smith's own words in TMS. Smith explicitly distinguishes mutual exchange based on reciprocity, for example, when he describes how a second-best society without benevolence is able to “subsist among different men, as among different merchants, from a sense of its utility”, and “upheld by a mercenary exchange of good offices” [TMS II.ii.3.2]. Moreover, Smith explicitly rejects the idea that all natural sentiment is derived from self-love when he criticises “[t]hose who are fond of deducing all our sentiments from certain refinements of self-love” [TMS I.i.2.1]. Such people, he says, assert that rejoicing in others' joys and lamenting their pains occurs only in self-interested anticipation of assistance is possibly or ultimately forthcoming in return. On the contrary, Smith argues, the automaticity or instantaneousness of sympathy is evidence that self-regarding considerations, presumably calculated, cannot be the motivation. As for fame, rank, and reputation as “goods”, A. Smith also takes a dim view of those who “have imputed to the love of praise, or to what they call vanity, every action which ought to be ascribed to that of praise-worthiness” [TMS III.2.27]. Finally, of course, there is already the earlier-quoted passage [TMS VI. Concl. 1], which explicitly removes from virtuous behaviour any prior anticipation of others' feelings and

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<sup>6</sup> To be fair, however, V. Smith in subsequent work seems to have modified this earlier view to say that intent is important. See, e.g., Smith [2012].

strategems. For Smith, other-regarding behaviour, as a manifestation of true virtue, is not game-strategic. All else—no matter how outwardly altruistic in form, but motivated by ultimate self-gain or profit—must be classified as self-love.

Coase's attempted reconciliation is more subtle but falls short nonetheless. He writes that Adam Smith's account of the development of our moral sentiments is "essentially self-centered" [Coase 1976: 8]. A more generous regard for others according to acceptable codes of behaviour is observed "because conformity with them brings approval and admiration".<sup>7</sup> The nuance in Coase's explanation is that he does not ascribe or utility solely to the transacted objects themselves (e.g., goods, rank, and reputation) but also to the *act of conforming* with acceptable behaviour, which brings admiration and is therefore pleasurable in itself. Both authors, however, essentially argue either that the approbation of others is rewarding owing to expected reciprocity, or is simply and directly pleasurable in itself.

Once more, the problem with this attempt at reconciliation is that Smith himself speaks against it. This is explicitly seen in his critique of the Epicurean view which, like the Coasean proposal, held that "The whole virtue of justice, therefore, the most important of all the virtues, is no more than discreet and prudent conduct with regard to our neighbours" [TMS VII.ii.2.11]. Smith states that such a view is "altogether inconsistent with [the system] which I have been endeavouring to establish" [TMS vii.2.13]. He argued that virtues were distinct ends in themselves, rather than means to other goods or goals such as material wealth, rank, and esteem of others. Without denying the pragmatic value of gaining the approval of others, Smith instead distinguishes this from the value of virtues "under their proper characters" that "deserved to be pursued for their own sake" [TMS VII.ii.2.13 and VII.ii.2.17].

Smith warns against a too-assiduous resort to Occam's Razor that results in removing the distinctions among the virtues and reducing them to the single one—prudence. He explicitly criticises "running up all the different virtues" and warns against "the propensity to account for all appearances from as few principles as possible" [TMS VII.ii.2.14]. Finally, in his criticism of Mandeville [TMS VII.ii.4] he returns to the theme: "That system, again, which makes virtue consist in prudence only, while it gives the highest encouragement to the habits of caution, vigilance, sobriety, and judicious moderation, seems to degrade equally both the amiable and respectable virtues, and to strip the former of all their beauty, and the latter of all their grandeur."

#### 4. Justice

In numerous parts of TMS Smith underscores the crucial role of justice, "the most important of all the virtues" [TMS VII.ii.2.11]. More than benevolence ("the ornament that embellishes" the building that is society), justice is the foundation for society itself, "the main pillar that upholds the whole edifice", without which "the immense fabric of human society...must in a moment crumble into atoms" [TMS II.2.3.4]. Justice is what Smith primarily means when he asserts that individual action in pursuit of self-interest should be circumscribed by a prior social criterion. This is an assertion that remains evident in the *Wealth of nations*, pointing to the consistency between the two:

Every man, *as long as he does not violate the laws of justice*, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men [WN IV.9.51] (Emphasis supplied.)

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<sup>7</sup> Coase proceeds from Smith's observation that "Man naturally desires, not only to be loved, but to be lovely; or to be that thing which is the natural and proper object of love" [TMS III.ii.1].

In TMS, sympathy allows an agent A to posit  $Y(x)$  as the opportunity set of another person, B, as affected by A's action  $x \in X$ . A's problem is then to decide what criteria to apply in choosing his action, being mindful of the possible consequences.

A assumes B to be prudent (like himself) and therefore to maximise some individual utility or welfare  $v(y)$ ,  $y \in Y(x)$ . Let  $v^0$  be the status-quo welfare level of B as observed or introspected<sup>8</sup> by A; then at a minimum the principle of *justice* according to Smith requires A to at least preserve the status quo ("restraining us from hurting"). This is a common thread: in his *Lectures*, Smith puts it succinctly: "The end of justice is to secure from injury" [Smith 1763: Part I, Introduction]. The ethical limits of self-interested actions vis-à-vis the interest of others is categorically expressed in the following quote, which gives special mention to the current state of the other person:

...[T]hough the ruin of our neighbour may affect us much less than a very small misfortune of our own, we must not ruin him to prevent that small misfortune, nor even to prevent our own ruin. We must, here, as in all other cases, view ourselves not so much according to that light in which we may naturally appear to ourselves, as according to that in which we naturally appear to others .... If he would act so as that the impartial spectator may enter into the principles of his conduct, which is what of all things he has the greatest desire to do, he must, upon this, as upon all other occasions, humble the arrogance of his self-love, and bring it down to something which other men can go along with. They will indulge it so far as to allow him to be more anxious about, and to pursue with more earnest assiduity, his own happiness than that of any other person. ... In the race for wealth, and honours, and preferments, he may run as hard as he can, and strain every nerve and muscle, in order to outstrip all his competitors. But if he should jostle, or thrown 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. This man is to them, in every respect, as good as he; they do not enter into that self-love by which he prefers himself so much to this other, and cannot go along with the motive from which he hurt him [TMS II.ii.2.1].

Further on, Smith gives enumerates what he regards as the requirements of justice: "laws which guard the life and person of our neighbour; the next are those which guard his property and possessions; and last of all come those which guard what are called his personal rights, or what is due to him from the promises of others"<sup>9</sup> [TMS II.ii.2.2].

More formally, this allows us to define the following subset of  $X$ :

$$X^S(v^0) = \{x \mid \exists y \in Y(x), \text{ s.t. } v(y) \geq v^0\}. \quad (3)$$

That is,  $X^S(v^0)$  is the set of all possible actions by A that in his estimation allows B to attain *at least* a minimum level of well-being,  $v^0$ . Smith asserts that the impartial spectator in A ("the man in the breast") ought to value all of his potential actions according to the principle of justice, without obviating the need for prudence, though this may require "humbling the arrogance of his self-love". The social valuation that implements Smith's stricture of "doing no harm" and "preventing another man's ruin" may then be represented as follows:

$$S(x; v^0) = \begin{cases} 1 & \text{if } x \in X^S(v^0) \\ 0 & \text{otherwise} \end{cases} \quad (4)$$

<sup>8</sup> It is not important for this argument that  $v$  should *actually* represent B's welfare, only that it is as imagined by A, whose ability and willingness to do are ensured by the axiom of sympathy.

<sup>9</sup> In his *Lectures* [1763] Smith enumerates three kinds of personal rights, namely those arising from "contract, quasi-contract, or delinquency" [LJ, Part I, Introduction].

Virtuous action by A in conformity with then be represented by the maximal element of a lexicographic ordering<sup>10</sup> of the vector denoted by

$$g(x) = [S(x; v^0), u(x)], \quad (5)$$

where  $u$  is as already defined in (1). As between two alternatives  $w$  and  $z$  both in  $X$ , the agent will prefer  $w$  to  $z$  if and only if the first non-vanishing component of  $g(w) - g(z)$  is positive. This effectively implies maximising one's own utility subject to what is conjectured as the other person's reservation level<sup>11</sup> of well-being  $v^0$ .

As an example, let  $Y(x)$  be the unit-interval and consider two alternatives  $w$  and  $z$ , with  $w > 1 - y^0$  and  $z < 1 - y^0$ . Then obviously, since  $w > z$ ,  $u(w) > u(z)$ , and the prudential component of utility would prefer  $w$  to  $z$ . On the other hand,  $0 = S(w) < S(z) = 1$ , so that

$$\begin{aligned} g(w) &= [0, u(w)] \\ g(z) &= [1, u(z)]. \end{aligned}$$

In short, the situation described in (2) prevails. Nonetheless, lexicographic ordering implies that  $z$  will be preferred over  $x$  based on the first component, notwithstanding that  $u(w) > u(z)$ . In this manner, as Smith describes, A effectively "humble[s] the arrogance of his self love". This effectively provides an answer to the Adam Smith Problem.

It should be noted that this formulation leads to the bare minimum being conceded to the other person. In a typical dictator game, for example, it would lead to A offering the minimum to B. The point Smith makes is that while such an outcome might seem mean-spirited, it is not unjust, since the rules allow A to make such an inequitable offer to begin with. It is well to remember that Smith's idea of justice is commutative, not distributive. What (5) would rule out—which is possible in a world of real dictators—is a taking of what B already possesses, thus worsening the latter's position. The minimal requirement of justice as a virtue is seen in the following:

The man who barely abstains from violating either the person, or the estate, or the reputation of his neighbours, has surely very little positive merit. *He fulfils, however, all the rules of what is peculiarly called justice*, and does every thing which his equals can with propriety force him to do, or which they can punish him for not doing. We may often fulfil all the rules of justice by sitting still and doing nothing [TMS II.ii.1.9]. (Emphasis supplied.)

In a multi-person context, the agent A must make personal distinctions as between different counterparties that in principle require levels of  $v_j^0, j = 1, 2, \dots$  that are not necessarily identical. The same action by A, for example, could affect a disabled person differently from how it would affect a normally abled person. This means (3) must be specified according to the distinct current situation of each  $j$ .

$$X_j^S(v_j^0) = \{x \mid \exists y \in Y_j(x), \text{ s.t. } v_j(y) \geq v_j^0\} \quad (5)$$

For that reason in a multi-person setting, one must redefine (3) as

$$X^S = \bigcap_j X_j^S \quad (6)$$

<sup>10</sup> On lexicographic ordering, see Georgescu-Roegen [1959], Chipman [1960], and Encarnación [1964].

<sup>11</sup> It may be argued that there may be a degree of uncertainty in A's introspection regarding B's reservation utility. To incorporate this, one may instead redefine  $X^S$  as  $\{x \mid \exists y \in Y(x), \Pr(v(y) \geq v^0) \geq \pi^*\}$ .

while the ordering defined in (4) still applies. While the consideration of other persons' individual circumstances may be practical in smaller societies which permit of personal relationships, a set such as (6) obviously becomes intensive in information requirements once in the context of impersonal societies with anonymous exchange.

## 5. Benevolence

Smith's discussion of benevolence is similarly represented as in the foregoing. In terms of implied action, following a previously quoted passage from Smith, benevolence entails "promoting the happiness of others". In most of TMS VI.ii-iii, Smith discusses the ever-widening social ambit towards which a person naturally shows beneficence, which he summarises as follows:

After the persons who are recommended to our beneficence, either by their connection with ourselves, by their personal qualities, or by their past services, come those who are pointed out, not indeed to, what is called, our friendship, but to our benevolent attention and good offices, those who are distinguished by their extraordinary situation; the greatly fortunate and the greatly unfortunate; the rich and the powerful, the poor and the wretched [TMS VI.ii.i.20].

Beyond this, he also discusses the extent to which benevolence is extended to one's own compatriots, to other nations, and to all of humanity. Of these, however, beyond kinship relations, Smith lays particular stress on the beneficence owed those who have shown past beneficence to the agent ("Nature...renders every man the peculiar object of kindness, to the persons to whom he himself has been kind" [TMS VI.ii.i.19].), although Smith would caution that for a truly benevolent person, the original act of kindness will have had nothing to do with a prior expectation of reciprocal kindness in the future.

To incorporate this in our scheme, the same structure can be posited, except that different criteria will apply to specific persons, say, a relative, close friend, someone who has shown kindness in the past, and so on. This suggests that  $X^S$  may further differ for different people, roughly between acquaintances and strangers. For such objects of beneficence, one can define

$$X^B_j = \{x \mid \exists y \in Y_j(x), \text{ s.t. } v_j(y) \geq v^*_j > v^0_j\}. \quad (7)$$

It will be evident that, since  $v^* > v^0$ ,  $X^B_j(v^*_j) \supset X^S_j(v^0_j)$  for any  $j$ .

It is entirely possible that complications and conflicts may arise between applying justice with respect to some persons and showing benevolence to others. Suppose, for example, that A may act to favour C in terms of beneficence owing to past favours, but that this has the effect of positively harming B, i.e., reducing B's welfare to below what justice requires. That is to say, for some pair  $j$  and  $k$ ,

$$X^S_j(v^*_j) \cap X^B_k(v^*_j) = \emptyset \quad (8)$$

It would seem that in such cases, Smith would put priority on fulfilling the demands of justice.

It is different however in the case of voluntary beneficial actions. There may, for example, be conflicting favours due to different individuals, e.g., a child may have needs that conflict with those of a friend. That is to say,

$$X^S_j(v^*_j) \cap X^B_k(v^*_j) = \emptyset. \quad (9)$$

On how such potential conflicts are to be resolved, Smith himself seems ambivalent or undecided:

When those different beneficent affections happen to draw different ways, to determine by any precise rules in what cases we ought to comply with the one, and in what with the other, is, perhaps, altogether impossible. In what cases friendship ought to yield to gratitude, or gratitude to friendship; in what cases the strongest of all natural affections ought to yield to a regard for the safety of those superiors upon whose safety often depends that of the whole society; and in what cases natural affection may, without impropriety, prevail over that regard; must be left altogether to the decision of the man within the breast, the supposed impartial spectator, the great judge and arbiter of our conduct. [TMS VI.ii.i.22]

## 6. The law and markets

Smith was well aware that law supersedes relational contacts in impersonal societies, when he makes a distinction between “pastoral” and “commercial societies” [TMS VI.ii.1.12-17]. In the context of an impersonal society, the law can be viewed as an externalisation of the constraints in (3). The law essentially restricts allowable actions to a set  $L \subseteq X$ , with the characteristic that if every agent selects an action from  $L$ , there is a subjective assurance that  $v_j(y) \geq v_j^0$ .

$$L = \{(y_1, \dots, y_N) \mid v_i(y_i) \geq v_j^0, y_j \in Y_j, \forall j\} \quad (10)$$

The set  $L$  contains all the actions that guarantee each agent at least the private status quo, where it is assumed that  $L \neq \emptyset$ . The latter may in principle be a problem, although it is always possible to find a nonempty set for low-enough levels of  $v_j^0$ . This also

Given the law and its enforcement, therefore, an ethic in accord with justice simply entails:

$$\max u(x), \quad x \in X \cap L \quad (11)$$

The advantage of (11) over (5) is evident where there are large numbers of other agents. Where  $N$  is large, it is an obvious informational burden on a subject to verify that his fellow-individual attains at least the minimum utility. The existence of  $L$  instead provides that minimum assurance, with the advantage that it also allows even those with a diminished moral sense to function in society. A society with external restraints on human behavior manifests a higher degree of cooperation and success than those who rely entirely on prudence tempered with benevolence. Hence  $L$  can be understood as the objectification of the impartial spectator, as the state.

The novel claim by Adam Smith in WN, however—one not found in TMS—is that in the context of a market, prudent reciprocity need not take up scarce decision-making power. In WN, the virtue of justice is already presumed embodied in  $L$ , an external restraint enforced through the state. But the social optimality for society of the choices within  $L$  is not being asserted.

The invisible hand of WN adds a further mechanism, namely, the price-mechanism, which reorders  $X$  to incorporate budgets and total endowments and defines actions as supplies and demands.

$$M(p) = \{(y_1, \dots, y_N) \mid py_j \leq pw_j^0, y_j \in Y_j, \forall j\}. \quad (12)$$

Market actions are in the sphere of lawful actions, so that  $M(p) \subseteq L$ . Moreover, with  $v_j(w_j^0) = v_j^0$  as a starting point, the market purports to guarantee in principle that  $v_j(y_j) \geq v_j^0$ , or the result is no worse than the original situation. With this assurance, the agent's actions in an economy with complete markets and a lawful society are further narrowed to

$$\max u(x), \quad x \in X \cap M(p) \subseteq L \quad (13)$$

This is the point where one leaves the world of TMS and enters that of WN. There is no Adam-Smith Problem in the sense that the restrictions on self-love that are in TMS remain unchanged in WN. There are, however, simply other institutions than the subjective impartial spectator that ensures them—namely the law as implemented by the state, and the market.

END

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