

Adam Smith and the Moral Foundations of Capitalism

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What does architecture tell us about economics?



Notre Dame Cathedral,
Paris, 1160-1350



Washington Monument,
1848-84



Sears Tower, Chicago,
1971-73

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Medieval Europe
→ *Duty to God*



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Sears Tower, Chicago 1971-
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Age of Commerce
→ *Duty to Self*

Rational Choice Model

- Methodological individualism: choice operates at the level of the individual economic agent
- Individuals chose actions so as to maximize a stable set of preference functions given certain constraints.

Rational Choice Model

- Extreme version:
- *Homo economicus*—a selfish maximizer of personal welfare

- Extreme conclusion:
- *Homo economicus*, working through markets, produces the best outcomes for society through the “invisible hand”.

→ “Greed is Good!”

Walter Williams
(Former chair, Dept. of Economics,
George Mason University)

“Free markets, private property rights, voluntary exchange, and **greed** produce preferable outcomes most times and under most conditions.”

--“The Virtue of Greed in Promoting Public Good,”
Richmond Times-Dispatch, October 6, 1999, p. A15)



Ivan Boesky, leaving a federal halfway house in 1989.

“[G]reed is healthy. You can be greedy and still feel good about yourself.”

--Commencement address, May 18, 1986, School of Business Administration, University of California, Berkeley.

Shortly thereafter Boesky confessed to insider trading ...
...and received three years in prison and a \$100 million fine.

Gordon Gekko in *Wall Street* (1987)

“[G]reed is good.... Greed works. Greed clarifies, cuts through and captures the essence of the evolutionary spirit....”



Video

Big Questions

- #1 Is greed the essence of capitalism?
- #2 What is the intersection of ethics and economics?
- #3 Should we worry about ethics and morals when other countries are taking away our markets?

What Motivates People?

The Ultimatum Game

- A *Proposer* has \$10 to divide with a *Responder*.
- The Proposer suggests an amount between \$0-\$10 to give to the Responder. The balance remains with the Proposer.
- If the Responder *accepts* the offer, both players receive the payouts specified.
- If the Responder *rejects* the offer, neither player receives anything.

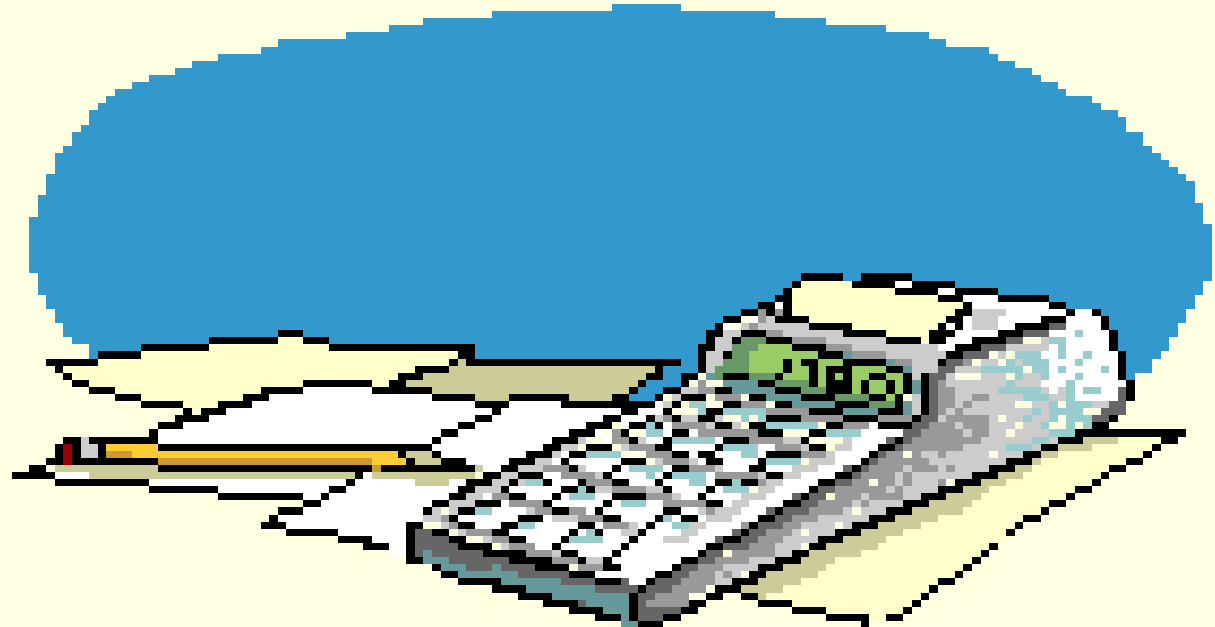
Let's Play!

Is our modern capitalist
system one
of ...

Economics

Or ...





...Greedonomics?

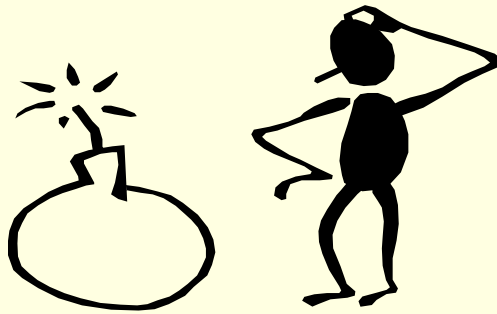


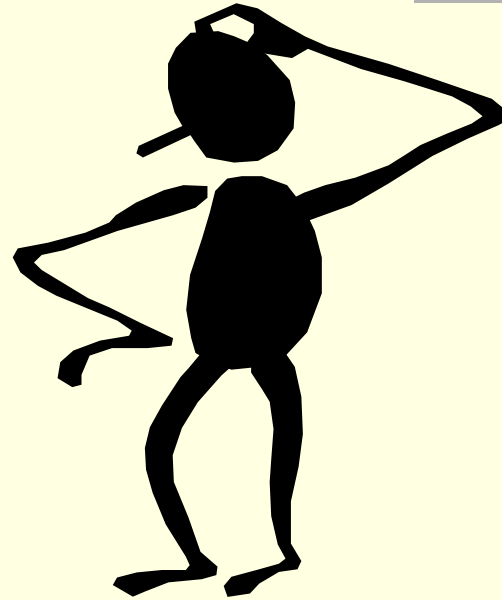


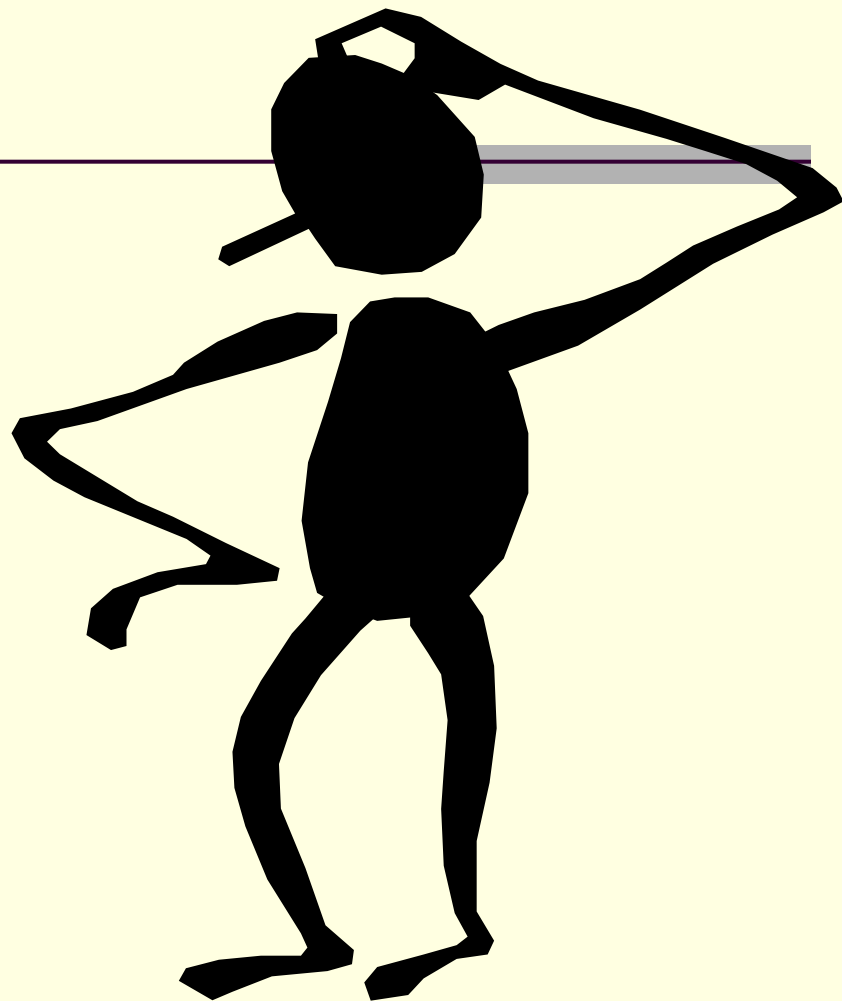
Wall Street



Wall Street







Arthur Andersen

Enron

Adelphia

WorldCom



What motivates people?

The Ultimatum Game demonstrates that people—*entrepreneurs, customers, workers, investors, and suppliers*—often care about more than making money.

** For example, people care deeply about justice.*

→ Greed is the excessive concern for self and the neglect of the legitimate rights of others. Greed is destructive of social and moral capital.

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Social and Moral Capital

Social and moral capital lubricate the exchange process by reducing transactions costs.

- a) physical capital – machinery
- b) human capital – education and experience
- c) social capital – networks of relationships
- d) moral capital – stock of trust and ethical habits

In discussing the “invisible hand” Adam Smith specifically mentions the importance of social and moral capital:

→ “He can know better the character and situation of the persons whom he trusts...” (*Wealth of Nations* 454).

THE MORAL CONTEXT

The life of Adam Smith (1723-1790)

Kirkcaldy, Scotland

Glasgow Oxford Edinburgh Glasgow

France London

Edinburgh

The Theory of Moral Sentiments (1759) made Adam Smith famous.

During the build-up to the American Revolutionary War (March 1776), Smith published *The Wealth of Nations*.

The Enlightenment: What Motivates Us?

Natural scientists in the 17th century, Newton and Galileo:

Looked *outward* to the physical world to uncover the “invisible chains of nature” that control movement (e.g., gravity) (EPS 45-46).

Enlightenment philosophers in the 18th century:

Looked *inward* to uncover the invisible principles which explain the movements and progress of human society.

“The science which pretends to investigate and explain those connecting principles is what is properly called moral philosophy.” (WN 769).

→ Moral Philosophy is what we today call *psychology, economics, sociology, political science, philosophy, and law*.

Smith's Invisible Chains: Instincts

In evolutionary psychology, “instincts” are the short-cut reasoning or preference circuits that address adaptive problems of natural selection (Cosmides and Tooby 1994, 330).

→ “Thus self-preservation, and the propagation of the species, are the great ends which Nature seems to have proposed in the formation of all animals.” (TMS 76).

Instincts over rationality

“[Survival and propagation] has not been intrusted to the slow and uncertain determinations of our reason... Nature has directed us to the greater part of these by **original and immediate instincts**. (TMS 77-78).

→ *Instincts are the “invisible hand” directing our activities.*

Smith: Three Main Instincts

1. The selfish passions

It is appropriate (and even virtuous) to be self-interested.

“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 82-3).

“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. We address ourselves, not to their humanity but to their self-love....”

--*The Wealth of Nations* (1776, pp. 26-27)

Smith: Three Main Instincts (con't)

2. The social passions

Man can subsist “only in society” and man is “fitted by nature” for that situation (TMS 85).

“How selfish soever 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” (TMS 9).

Smith: Three Main Instincts (con't)

3. The unsocial passions

Hatred, jealousy, and revenge

The unsocial passions are *defensive* for “the safeguard of justice” (TMS 79).

→ **Justice is the “main pillar” without which social organization would “crumble into atoms” (TMS 86).**

Moral Conscience

The instincts—*for self, for others, and against others*—are moderated and harmonized by **moral conscience**.

Moral conscience arises from the natural human ability to empathize with others: the faculty of “fellow-feeling”:

- Humans seek the approval of those around us.
- Through such socialization we acquire perspective.
- Perspective is personified by the “impartial spectator.”
- Ultimately, we seek to be worthy of approval.

Happiness and meaning come from developing and living by a **moral conscience**.

“[B]y acting according to the dictates of our moral faculties, we necessarily pursue the most effectual means for promoting the happiness of mankind, and may therefore be said, in some sense, to co-operate with the Deity....”

Self-interest is virtuous, but *self-control* is more virtuous:

“When the happiness or misery of others depends in any respect upon our conduct, we dare not, as self-love might suggest to us, prefer the interest of one to that of many.” TMS (pp. 137-38).

- Is there a conflict between *Moral Sentiments* and *Wealth of Nations*?
- *Das Adam Smith Problem*?

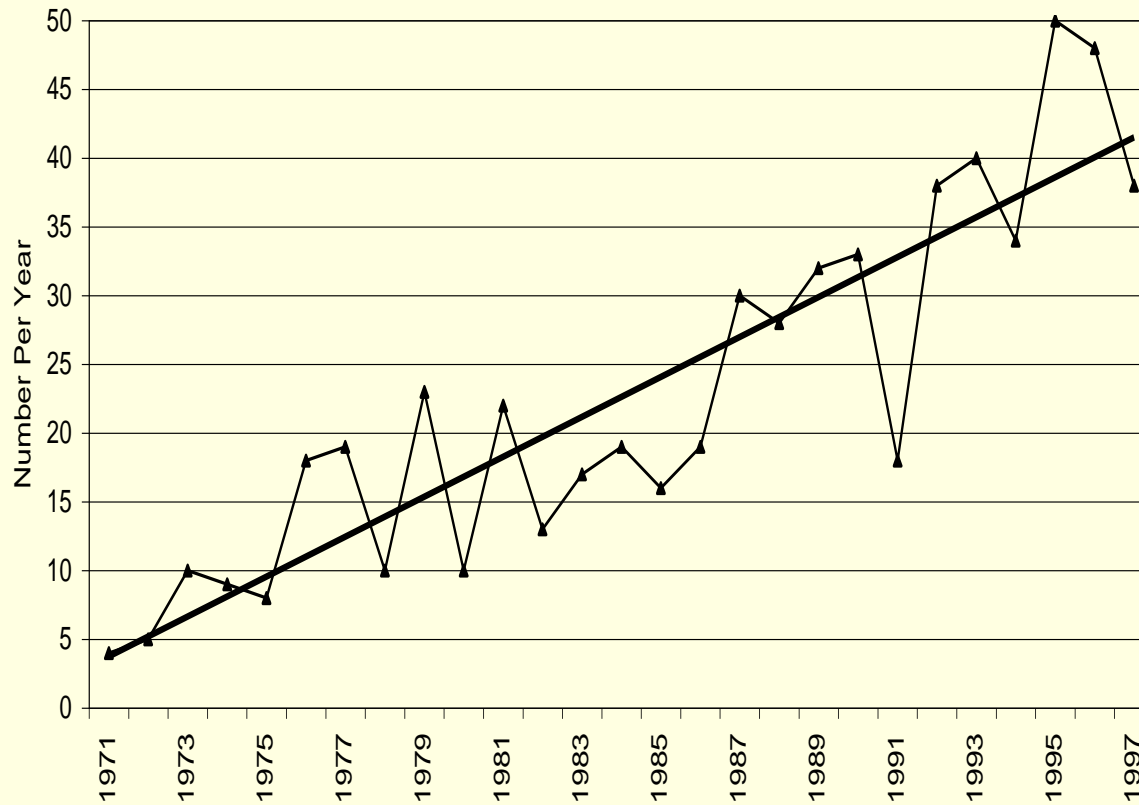
Summary

1. Properly socialized adults do not respond to instincts in a knee-jerk fashion.
2. The moral faculties oversee the passions and judge “how far each of them was either to be indulged or restrained” (TMS 165).
3. The raw passions are “brought down to a pitch much lower than that to which undisciplined nature would raise them” (TMS 34).

→ *Key role for self-control.*

A modern re-awakening:

Annual Citations to *The Theory of Moral Sentiments*, 1971-97



Source: Wight (2002).

**“the individual is a part of a social organism
and thrives only within the attachments to
family, community and nation that precede
choice.”**

**–David Brooks, *New York Times*
(October 5, 2007)**

Role of Institutions in the Social Organism

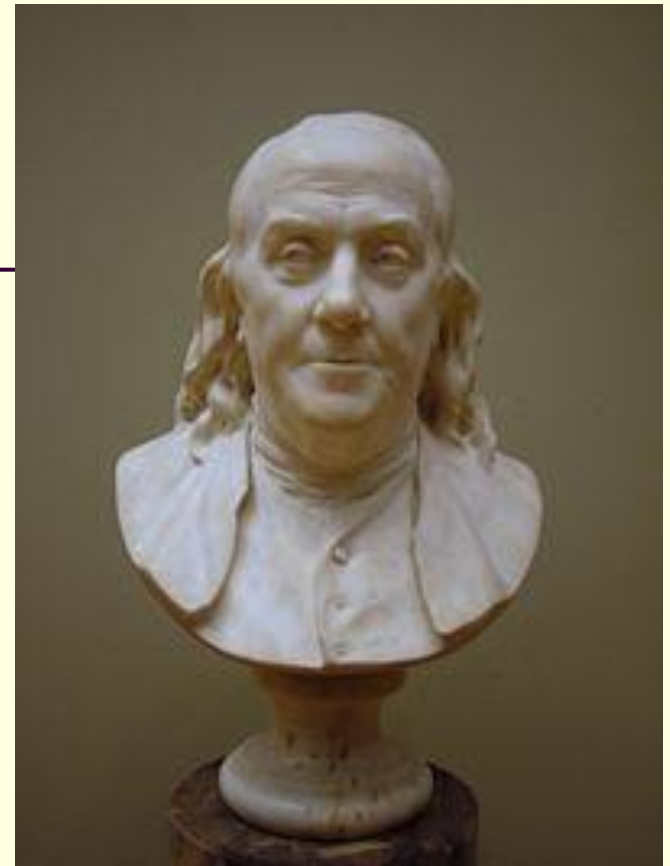
Family, church, school, government and moral culture help individuals acquire self control.

A competitive marketplace is an important institution for improving morals because of its incentive structure that ties personal diligence to personal reward and external accountability.

→ See: Deirdre N. McCloskey. *The Bourgeois Virtues: Ethics for an Age of Commerce* (2006).

Benjamin Franklin (1706-1790)

- Entrepreneur
- Scientist and inventor
- Revolutionary
- Diplomat



Franklin emphasized the role of civic and personal virtues.

- A virtuous life takes effort, discipline, and discovery.
- Like Aristotle and Smith: Virtue = Moderation and Self-Control

The Invisible Hand

In the right institutional setting, acting on instincts—moderated by moral conscience—produces beneficial outcomes for individuals and also for society.

- * Positive external benefits
- * Providential outcomes

Justice

It is within the context of 600 years of developing British common law that Smith supposed that

- * property rights
- * individual liberty
- * moral and social capital
- * competitive markets

created advantageous conditions for economic justice (fair rules). **Markets do not operate in isolation of ethical standards and ethical institutions.**

Institutions are not perfect

“Do not let the best be the enemy of the good.”

--Attributed to Smith's friend, *Voltaire*

Adam Smith was a Scottish reformer. He was not doctrinaire or dogmatic. He was *pragmatic*.

→ Smith did *not* advocate pure laissez-faire capitalism.

Examples:

- * Interest rate ceilings
- * Public investments
- * Education for the poor

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Globalization in the Early Industrial Age

In the 18th and 19th centuries, global markets were rigged, created behind the barrel of a gun:

→ **Mercantilism, colonialism and imperialism.**

Both Adam Smith and Karl Marx argued against coercive forms of globalization.

Smith's Keys to Wealth:

- The key to better living standards is higher *labor productivity*.
 - The key to higher labor productivity is *specialization*.
 - The key to specialization is voluntary *trade*, because it widens the market.
- Voluntary trade breaks down the monopolies of the rich and powerful.

The *Wealth of Nations* is about the human rights of the poor.

- Trade barriers are chiefly carried out “for the benefit of the rich and the powerful” while policies supporting the poor and the indigent are “too often, either neglected, or oppressed” (WN 416).
- “To prohibit a great people ...from making all that they can of every part of their own produce, or from employing their stock and industry in the way that they judge most advantageous to themselves, is a manifest violation of the most sacred rights of mankind” (WN 372).

Smith's scathing critique of coercive, monopoly capitalism:

- “The rulers of Great Britain have, for more than a century past, amused the people with the imagination that they possessed a great empire on the west side of the Atlantic. This empire, however, has hitherto existed in imagination only....
- “It has hitherto been, not an empire, but the project of an empire; not a gold mine, but the project of a gold mine; a project which has cost, which continues to cost, and which, if pursued in the same way as it has been hitherto, is likely to cost immense expense....
- “[T]he effects of the monopoly... [have been] to the great body of the people, mere loss instead of profit (WN 619)

Adam Smith (1723 – 1790)

Karl Marx (1818-1883)

Decentralized Markets
(Competitive Capitalism)

PRAGMATIC solution
The Wealth of Nations
(March 1776)

Central Planning
(Communism)

UTOPIAN solution
Das Kapital (1867)
The Communist Manifesto (1848)

**Virginia
Planters and
Revolutionaries**

American Revolution
(July 1776)

French Revolution (1789)

V.I. Lenin

*Imperialism: The Highest
Stage of Capitalism* (1916)

Russian Revolution (1917)
Chinese Revolution (1949)



Seeking Freedom from Economic Oppression

**"Give me Liberty, or
give me Death!"**

--Patrick Henry
St. John's Church, 1775
Richmond, Virginia

→ The *Wealth of Nations* was read avidly by American revolutionaries.

Seeking Freedom from Economic Oppression



**"Give me Liberty, or
give me Death!"**

--Nat Turner

Rebellion, 1831

Southampton County, Virginia

The humbling (and hypocritical) paradox of
America's revolution → *Slavery*

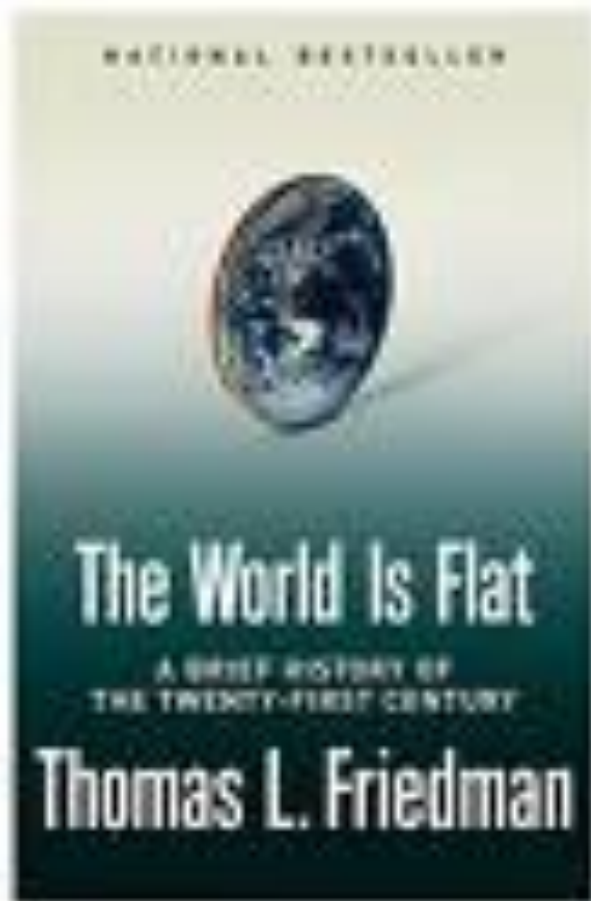
Markets operate within the moral norms of society.

- Adam Smith opposed slavery on both economic and ethical grounds. Slavery is “the vilest of all states....”
- Smith deplored the selling of human beings “man, woman, and child, like so many herds of cattle, to the highest bidder in the market.”
- Moral: Markets without justice do not produce good outcomes for society. Be careful!

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Is the World Really Flat?



Implications of a “Flat” World

- Technology allows the global flow of capital and services, in addition to merchandise;
- Capital flows south where labor is cheap;
- Great “sucking sound” of American jobs outsourced to India and China;
- Gradual convergence of world incomes.

Implication: **Location no longer matters**, and U.S. workers—*accountants, managers, and radiologists*—will compete with the lowest cost world labor.

A “Flat” World implies Commodities, Not Innovative Products

- The U.S. currently has a comparative advantage in *creative* products and services

Hollywood (entertainment)

Silicon Valley (software)

Boston (biotechnology)

New York (finance)

Agriculture (Green Revolution)

Process efficiency (Wal-Mart)

The Future is About Innovation

- Where do new *product, process, and service* innovations come from?

Accidents

Design: Creative thinking encouraged and rewarded

Critical mass: Clustering of creative resources

- What institutions support technological innovation?

Rule of law (contracts enforced)

Property rights (no undue seizure)

R&D in pure science (public goods—positive spillovers)

Access to capital (venture capital)

Human capital (critical thinking—not rote learning)

The Role of Relationships

- Institutions and organizations that encourage creativity build upon *relationships*.
- Good relationships rely on moral capital (e.g., trust) which lowers transactions costs and supports creative thinking.
- Entrepreneurs are creative problem solvers—how do we create new enterprises based on exciting and motivating others?

Economic Implication (con't)

Business is a vehicle for transforming the world, using voluntary exchange and free choices.

Companies can attract the best workers and improve productivity by creating social and moral capital.

Examples: Ukrops, Performance Food Group, Owens and Minor, McCormack Spices, and many others.

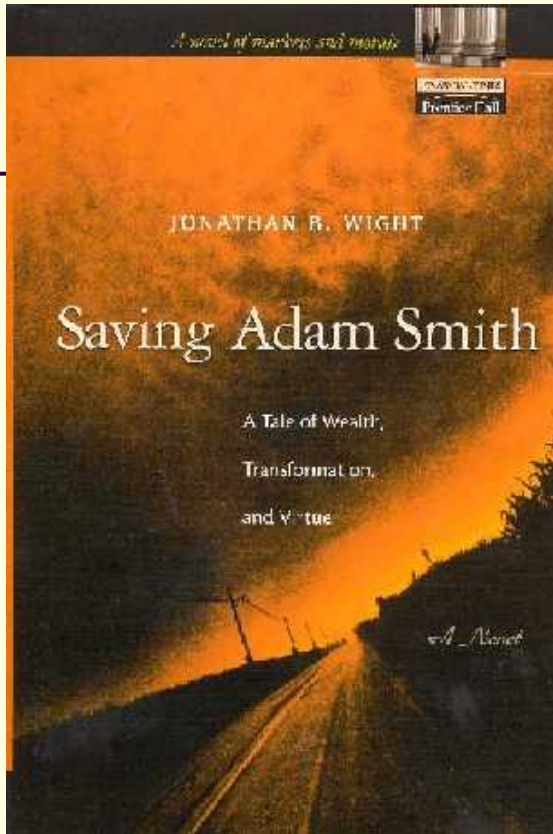
→ Moral imagination can drive business innovations.

The Earth is *Not* Very Flat

Societies that have the **institutions** and **incentives** to solve problems creatively will continue to advance rapidly.

The **market** is an important institution: in many cases it provides the incentives for voluntary action that produce positive outcomes for society.

Shared ethical frameworks (norms) can make markets more efficient because of moral capital (trust), which lowers transactions costs and supports risk-taking and innovation.



The role of social and moral capital in creative businesses

An economic novel

Saving Adam Smith: A Tale of Wealth, Transformation, and Virtue
(Financial Times/Prentice Hall, 2002).

The Role of Social Entrepreneurs

- Social entrepreneurs are creative thinkers who address a range of problems in society using their moral imaginations.
- While many social entrepreneurs have used NGO's (non-profits) to organize their activities, increasingly a *business* model is being adopted:
 - incentives for change
 - external accountability, and
 - long run sustainability.

Mohammed Yunus – Grameen Bank

- Problem: poor people can't get credit through traditional bank loans because they lack material or financial collateral
- Solution: use **social and moral capital** as a form of collateral – the invention of “micro-lending.”



Global Warming

President Bush: "The moment is now" to find a broad consensus on how to confront the challenge of climate change. "I want to get the job done....We have identified a problem; let's go solve it together."

(September 28, 2007)



Solutions to Global Warming

a) **Treaties and Laws**

- * Necessary when property rights are absent.

b) **Markets**

- * Wal-Mart: hydrogen fuel cells
- * Wal-Mart: energy audits of its supply chain

The unfolding **moral imagination** plays an important role in directing creative ideas in American and world markets.

We began by looking at architecture...



Notre Dame Cathedral,
Paris, 1160-1350

Medieval Europe
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Dawning of a New Era?

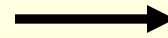


Age of Aquarius? → Duty to the cosmos - -the universe, the whole of creation ?

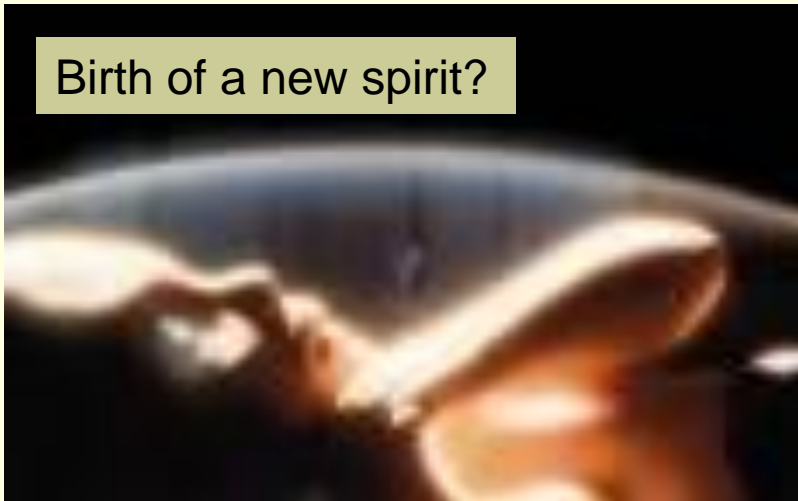
2001: A Space Odyssey

Stanley Kubrick, director

Arthur C. Clarke, writer



Birth of a new spirit?



Adam Smith's Final Words

“We direct a narrow prudence toward our own affairs...”

A superior prudence is directed toward “greater and nobler purposes than to the needs of the individual.”

“**Superior**” prudence requires the utmost perfection of intellectual and moral virtues.

“It is the best head joined to the best heart.”

(TMS, p. 216)

Pip Productions

