The theory of institutions and collective action in
Adam Smith’s *Theory of Moral Sentiments*

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Abstract

This paper addresses the theory of institutions and collective action in Adam Smith’s *Theory of Moral Sentiments*. It shows how Smith derives institutions from the sympathy theory and how individual selfish actions are shaped into collective action when guided by institutions. Further, it will be argued that Smith recognizes how individual actions can deviate from the standards of conduct. Smith distinguishes the act of obeying the rules of conduct from that of observing the norms of conduct, citing the differences in the probabilities between observing the rules and norms of conduct as the reason for this distinction.

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1. Introduction

The main theme of this paper is centered on Adam Smith’s *Theory of Institutions and Collective Action*. The past decades have witnessed a growing concern for the role of institutions in economics. From the viewpoint of revived institutionalism in economics, we can state that the concept of institutions also plays a great role in Smith’s *Theory of Moral Sentiments* (TMS) and *Wealth of Nations* (WN). The established consensus on the relation of WN to TMS has confirmed that self-interest-seeking behavior is conditioned by the virtue of prudence, which is one of the...
derivative virtues from the sympathy theory in TMS. Therefore, with respect to this relation, the editors of the Glasgow edition of TMS conclude that “the prudent man of TMS.VI.i. is the frugal man of WN.II.iii” (Raphael and Macfie, 1976, p. 18).

Although the above confirmation certainly appears to be absolutely correct, certain issues still remain unexplained. Needless to say, both frugality and prudence, which are considered indicative of the presupposed characteristics of an economic man’s behavior in WN, are considered among his virtues in TMS. Subsequently, a question arises as to what morality or virtues should signify. According to the views presented in this paper, Smith uses “virtues” to imply institutions. One of Smith’s major contributions is that he introduced the idea of institutions into economics, although he used it to signify morality in TMS. If virtues imply institutions, TMS may be considered an attempt to demonstrate how institutions are formed through sympathy and how they control human behavior. This concept forms the theme of this paper.

Smith’s theory of institutions and collective action consists of two parts. The first part focuses on the emergence of institutions from the sympathy theory, while the second deals with the deviation of actions from institutions. This paper is organized to deal with these two parts in the same order.

2. Institutions and collective action

It is considered necessary and helpful to provide the conceptual clarification of institutions and collective action in order to discuss the theory of institutions and collective action in TMS.

2.1. The definitions of institutions and collective action

Institutions are generally regarded as a set of formal or informal rules of conduct. Habits, customs, traditions, conventions, laws, ethical codes, and authoritative relations can be exemplified as institutions. However, this paper develops a more accurate meaning of institutions. Institutions are conceptualized as implying standards of conduct based on explicit or implicit consents between individuals. To elaborate, institutions are considered to signify consensual principles of behavior between individuals, the meanings of which are understandably shared explicitly or implicitly among them, and by which an individual’s actions are controlled or guided based on the expectations ensuing from this shared understanding.

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3 The classic definitions of institutions are those given by Veblen (1998 [1899]), which defines institutions as “prevalent habits of thought with respect to particular relations and particular functions of the individual and the community” (Veblen, 1998 [1899], p. 190) and Commons (1990 [1934]), which states that an institution is a “Collective Action in control of Individual Action” (Commons, 1990 [1934], vol. 1, p. 69). New Institutional Economics (NIE) conceptualizes institutions as the rules of a game. According to the definition, “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (North, 1990, p. 3). Ostrom defines institutions “as the sets of working rules” (Ostrom, 1990, p. 51).
Further, standards of conduct are considered to comprise rules and norms of conduct (Furubotn and Richter, 2000, pp. 140–144, pp. 156–160). Rules of conduct imply formal and explicit consents, such as legal or administrative rules, laws, and regulations, whereas norms of conduct imply informal and implicit consents, such as customs, traditions, conventions, ethics, and authoritative relations.\(^4\)

Institutions impose impartial constraints (Gauthier, 1986, p. 7)\(^5\) on an individual’s choice behavior in the form of consented standards of conduct and through these impartial constraints, they guide it in a certain direction and regularize it, so that individual actions are shaped into collective action. Hence, collective action may be defined as individual actions so long as they obey the standards of conduct.\(^6\) Thus, if two men act under a particular rule, their behaviors are considered collective.

2.2. Collective action and social order

The two notions of institutions and collective action give rise to the concept of a social order. All the individuals acting under standards of conduct are considered as forming a group, and their relationships within the group are termed social relationships. A social order is defined as a situation where social relationships, as defined above, are continuously maintained through collective action by the members of the group. This implies a situation where no member is expected to behave in negligence of the standards of conduct. This order may be considered as a kind of public good (Taylor, 1976, pp. 43–53) or more appropriately, collective good (Hardin, 1993 [1982], p. 19), partly because it is brought about by joint action (jointness of supply) and is available to every individual in the group, which ensures that his use of its unit does not preclude others’ use (impossibility of exclusion) and mainly because he takes advantage of positive externalities, pecuniary, or non-pecuniary, ensuing from this order.\(^7\)

Further, this order, as far as it is formed by collective action based on standards of conduct, will curb free-riding or opportunist behavior of the members in the group to some extent. The issue of curbing such behavior will lead to an enforcement or a commitment problem.

2.3. Enforcement of standards of conduct

The manner in which standards of conduct should be enforced is an important issue. Standards of conduct can be enforced by the use of sanctions that restrict possible opportunist behavior. The sanctions themselves are established “by law or by custom (including the social enforcement of ethical and moral codes of conduct)” (Furubotn and Richter, 2000, p. 6). Therefore, the enforcement mechanisms can be divided into two types by distinguishing between the rules and norms of

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\(^4\) However, Binmore (2000) is against this kind of distinction. According to him, “Legal rules are nothing more than particularly well-coordinated conventions” (Binmore, 2000, p. 32).

\(^5\) Vanberg, who insists that morality is an element of “an extended preference function” (Vanberg, 1988, p. 9), is against this view of morality as an institution.

\(^6\) This definition of collective action implies its connotation, and not its logic. It merely implies that collective action is a rule-following behavior. For the theory of collective action, see the classical theory by Olson (2003 [1971], pp. 22–36), which shows that “certain small groups can provide themselves with collective goods without relying on coercion or any positive inducements apart from the collective good itself” (Olson, 2003 [1971], p. 33). For n-persons iterated Prisoner’s Dilemma and collective action, see Hardin (1993 [1982], pp. 25–28).

\(^7\) Smith’s treatment of the duties of the sovereign may be understood as discussing the problem of providing public goods. Ostrom (1984) discusses the duties of the sovereign in WN from the viewpoint of supplying public goods. However, as Hechter (1990) suggests, providing public goods can be distinguished from cooperative institutions.
conduct. Rules of conduct can be externally enforced and are guaranteed by the probability that physical or psychological coercion, such as legal or pecuniary sanctions by a private or public coercive power, will ensue in case of their violation within a given social group, thus making them strongly binding. On the other hand, norms of conduct, being implicit and informal agreements, are internally enforced and guaranteed by the probability that deviation from them may result in disapproval or censure, or by the probability that conforming to them may cause approbation, thereby making them weakly binding.  

2.4. Emergence of institutions from market failures

Several authors have enumerated the following reasons for institutions to emerge from the actions of numerous individuals: the existence of negative externalities, the provision of common goods, economizing transaction costs, the way out of Prisoner’s Dilemma, or, a solution to a coordination game.

Irrespective of the reasoning that the abovementioned authors have adopted, they have conclusively attributed the genesis of institutions to market failures and regarded institutions as complementing a market in terms of economic efficiency.

The theories on the emergence of institutions are premised on the methodological individualism of neoclassical economics (NCE), which assumes individuals to be sole entities who are independent of each other, or, to be more precise, lacking any social relation and that collective entities, such as “society,” “firm,” “state,” and “organizations” are derived from and explained by an individual’s utility-maximizing behavior and his rational choices. Due to their individualism, the neoclassical economists come to consider society not as a collective of social relations but as an aggregate of individuals.

In applying the methodology, although some of the traditional assumptions of the NCE are relaxed, the abovementioned theories insist that individuals’ utility-maximizing behaviors are responsible for the genesis of institutions even when a market fails. Institutions will form direct interactions among individuals instead of transactions in a market if, and only if the market fails (Koslowski, 1994).

The shared assumption between the NCE and the theories on institutions simply implies that there exist no relationships between individuals other than that of contracts, which is broadly defined as a partial or total transfer of property rights between independent individuals. This

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8 This distinction between the two types of enforcement is based on Weber’s conceptualization. Refer to Weber (1978, p. 34). Weber divided social order into conventions and law. There exist some types of methods to make agreements binding. The first type involves coercive enforcement by an external third party. The second type involves broadly defined conventions, and implies endogenous enforcement of cooperative behavior (cf. Taylor, 1976; Axelrod, 1984), conventions (Lewis, 2002 [1969]), and moral codes (cf. Gauthier, 1986; Raub and Voss, 1990). Frank (1990) attempted to distinguish between the “commitment model” and “self- interest” model.

9 Williamson (1975) exemplifies the theory of transaction costs. Williamson explains that institutions will emerge from economizing transaction costs. See also Eggertsson (1990), Koford and Miller (1991), Miller (1992), Koslowski (1994), and Wieland (2000). Game theory has contributed to showing how cooperation between selfish agents is formed. As an example, Schelling (2002 [1980]) regards tradition as the solution to a coordination game. See also Ullman-Margalit (1977), Axelrod (1984), and Taylor (1976). For the relation between externalities and institutions, see Papandreou (1998, chapter 3). For theories utilizing rational choice theory, refer to Gauthier (1986), who, basing his argument on the rational choice theory, views morality as rational principles that constrain the actors pursuing their private interests.

10 Arrow (1994 [1974]) drew our attention to institutions and collective action as means for “the allocation of resources through non-market methods” in situations when a market mechanism did not work efficiently (Arrow, 1994 [1974], p. 26).
fundamental assumption alone can justify the reason for the authors to resort to the idea of market failures to explain the emergence of institutions. In contrast, Smith’s basic assumption regarding the genesis of institutions is that there exists a relationship between individuals. In Smith’s view, institutions emerge from this relationship between individuals.\textsuperscript{11}

3. Sympathy and institutions in TMS

Following the elaboration on some preliminary remarks on key notions, we now proceed to address the theme of the paper.

Smith does not state that only if a price mechanism works efficiently will the aggregate of individual private-interests-seeking behavior naturally attain the social order that is generally considered as market equilibrium in mainstream economics. One of the mechanisms that can channel the pursuit of private interests into a social order is the institution of a market; however, this is only one of Smith’s answers.

Smith begins his argument on TMS by discussing individual actions in the same manner as the NCE. However, unlike neoclassical economists, Smith strongly believes that there exist direct and mutual relationships between acting individuals. It is for this reason that each individual can and should adjust his behavior to comply with rules and norms of conduct \textit{before} he engages in economic activities in a market.

The significance of TMS lies in Smith’s conviction that human behavior in general, and selfish behavior in particular, should be subject to rules and norms of conduct so that some kind of social order may be established. Behavior being bound by rules and norms will ensure that the entire body of each man’s actions constitutes a social order where collective action is in control of private actions.

It is common knowledge that Smith attempted to derive “the rules of morality,” which are usually considered synonymous with “virtues,” from the sympathy theory. The following argument will show how Smith develops the idea of institutions in identifying the rules of morality with “the general rules of conduct.”

3.1. Sympathy and approbation

Smith begins his analysis in TMS with two principles of human nature. The first principle is that a man has the following three types of passions: the first is selfish passions, whereby an individual is motivated to pursue his private interests; the second is social passions, which include generosity, humanity, friendship, kindness, and compassion; and finally, unsocial passions such as anger, resentment, and hatred. The second principle of human nature is that a man has fellow feelings. These two principles are used to define sympathy as “our fellow feeling with any passion whatever” (TMS.I.i.1.5).

Sympathy works as a mental faculty through which we can approve or disapprove of others’ as well as our own actions and sentiments, thereby determining moral sentiments, i.e., the sense of propriety (TMS.I) and the sense of merit (TMS.II) of actions.

It is the sympathy of “an impartial spectator” that judges whether or not an action motivated by passions can be morally approved. Smith enumerates three sets of passions; however, at the

\textsuperscript{11} Coleman (1990) also explains the genesis of a norm by introducing the idea of externalities of an action. Refer to Coleman (1990, pp. 249–255).
same time, he emphasizes that an individual action in itself, excited by passions, is not the object of approbation. In order to explicate how actions arising from passions can be virtuous ones, Smith divides an action into three parts. The first part is the cause of an action, which refers to the motive or sentiment from which an action originates. The second is the action itself. The third part concerns the effect of the action. The first part of action is ascribed a sense of propriety, whereas the third is ascribed a sense of merit. Actions approved in terms of their motive gain a sense of propriety, while those approved in terms of their effect acquire a sense of merit. Finally, actions approved in terms of both their motives and effects qualify as being morally approved.

The set of three virtues of beneficence, justice, and prudence, despite having originated from social, unsocial, and selfish passions, respectively, can now be characterized as virtuous acts through the sympathy of an impartial spectator. Sympathy, thus, implies the principle of moral approbation. In this manner, Smith accounts for “the origin of our moral sentiments from sympathy” (TMS.iii.3.17).

3.2. Smith’s basic assumption

Smith’s assumption regarding the genesis of institutions is that individual’s actions and emotions that excite them never fail to have social externality, which implies non-pecuniary and intangible effects on others, ensuing from mutual and direct relationships between individuals. Smith’s argument in TMS commences with the following famous passage:

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.I.i.1)

One of these “principles” is sympathy and if we derive pleasure from seeing the fortune of others, social externality is bound to exist. Smith takes it for granted that human beings are sympathetic in nature. Yet, how can we sympathize with others’ actions and emotions at all? According to Smith, this is because a man’s moral sentiments have “an immediate reference” to others’ sentiments.

Whatever judgment we can form concerning [our own sentiments and motives], accordingly, must always bear some secret reference, either to what are, or to what, upon a certain condition, would be, or to what, we imagine, ought to be the judgment of others. We endeavour to examine our own conduct as we imagine any other fair and impartial spectator would examine it. (TMS.III.1.2)

... all these [virtuous or vicious] characters have an immediate reference to the sentiments of others. (TMS.III.1.7)

This “immediate reference to the sentiments of others” is another expression of the existence of direct relationships between individuals. Sympathy is founded on social externality because, due to the “immediate reference,” an individual’s actions and emotions will directly affect others and in turn, others will affect his actions and feelings.12

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3.3. Sympathy regulating behavior

The existence of direct relationships between individuals, however, does not necessarily guarantee that they interact with each other based on mutual consent. An individual’s action, which has externalities, will definitely affect others, and those affected will, on their part, react to his action. Regardless of this kind of interaction, their actions are not necessarily performed out of mutual consent. Orientated to others’ actions and emotions, an individual should always consider other people so that he can regulate his behavior based on this expectation of others’ behavior. In Smith’s view, “the love of praise-worthiness” (TMS.III.2.2), or, “the desire of rendering ourselves the proper objects of those sentiments” (TMS.III.2.24) gives rise to the necessity for regulation, which testifies that social externality provides a basis for sympathy.

It is also worthwhile for us to pay more attention to the manner in which sympathy regulates actions and emotions. As is widely known, this regulation is founded on an “imaginary change of situation” (TMS.I.i.4.8). In this imaginary change, a person principally concerned makes efforts to “bring down his emotions to what the spectator can go along with” and in turn, the spectator makes efforts to “enter into the sentiments of the person principally concerned” (TMS.I.i.5.1), until they reach “perfect concord” of “the original passions of the person principally concerned” with “the sympathetic emotions of the spectator” (TMS.I.i.3.1).

Here, the sympathy of the spectator acts as a mechanism for rewarding (approbation) or imposing sanctions (disapprobation) at an emotional level, so that it necessitates individuals to take each others’ reactions into consideration and induces them to act on this consideration. Sympathy, thus, regulates individuals’ actions and emotions in relation to each other until they arrive at mutual consent regarding their behaviors. It is for this reason, that “concord” can be considered an institution, which implies an implicit consent among individuals regarding their behaviors. Eventually, regulation of conduct results in the formation of a social relation based on mutual consent between individuals, which Smith refers to as the approbation of conduct through sympathy.

3.4. The rules of morality as institutions

The rules of morality, which are our primary concern, are dealt with in TMS III, where Smith delves into “the origin and foundation of our judgments” concerning our own [sentiments and conduct] (TMS.III.1.1) and then derives “the general rules of morality,” which consist, as mentioned earlier, of beneficence, justice, and prudence.

It is noteworthy that Smith equates “the general rules of morality” with “the general rules of conduct.” Smith wrote:

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13 Frank (1990) is of the opinion that this mechanism is “the reward mechanism,” where “rational calculations play only an indirect role” (Frank, 1990, p. 75) and that “certain of the emotions—anger, contempt, disgust, envy, greed, shame, and guilt—were described by Adam Smith as moral sentiments. The reward theory of behaviour tells us that these sentiments, like feelings of hunger, can and do compete with the feelings that spring from rational calculations about material pay-offs.” (Frank, 1990).

14 The most significant work that deals with the issue of implicit agreements among individuals is by Macneil (1980), wherein “relational contract” is used to indicate this consent.

15 Strictly speaking, “the rules of morality” comprise only two virtues—beneficence and justice. The virtue of prudence is not included in these rules because it is considered an inferior virtue. However, we may state that “the general rules of morality” do include the virtue of prudence because it is “admired” and “approved.” See the citation on p. 12.
It is thus the general rules of morality are founded. They are ultimately founded upon experience of what, in particular instances, our moral faculties, our natural sense of merit and propriety, approve, or disapprove of. (TMS.III.4.7)

The regard to those general rules of conduct, is what is properly called a sense of duty, a principle of the greatest consequence in human life, and the only principle by which the bulk of mankind are capable of directing their actions. (TMS.III.5.1)

We can regard the general rules of morality as institutions because they imply interpersonal relations regarding how to behave. Since “the bulk of mankind are capable of directing” their behavior by observing “the general rules of conduct,” we can regard “the general rules of morality” as institutions and “their actions” can now be viewed as collective action. To elaborate, individuals can understand the connotations of the rules (justice) and norms (beneficence and prudence) of conduct, and their behavior is controlled or guided by them. Therefore, virtues such as justice, beneficence, and prudence are institutions and constituents of standards of conduct. This leads to the emergence of a social order taking the form of “the general rules of conduct” (Skinner, 1990, p. 69).

Smith’s TMS, thus, shows that morality is an institution and that institutions shape individuals’ rules of choice behavior. The development of “the general rules of morality” from the sympathy theory in TMS can be understood as a process of deducing one of the simplest forms of institutions, namely, the standards of conduct.

4. Institutions and private interests in TMS

This paper have argued that the three sets of virtues in TMS may be considered as institutions that emerge from the direct interactions among acting individuals, which result in individual actions being fashioned into collective action. This section addresses institutions in detail, particularly from the point of view that they may also be utilized as means of guiding or controlling the pursuit of private interests.

Institutions and collective action are particularly required in the case of selfish passions motivating actions, since actions excited by such passions sometimes harm or neglect others’ interests. Among the three passions, selfish passions will require special control since they are “easy to restrain for single moment, or even for a short period of time; but [are], by their continual and almost incessant solicitations, are, in the course of a life, very apt to mislead into great deviations” (TMS.VI.iii.2). In this situation, we encounter the familiar problem of how private-interests-seeking behavior is controlled by morality, or, in our terms, standards of conduct.

Following the derivation of “the general rules of conduct,” Smith proceeds to substantiate the institutions of habits, morality, rules of justice, and status order.

These four have their own enforcement mechanisms and control actions driven by selfish passions. Smith will use the term regard for describing the situation of a man’s actions being controlled by such institutions.

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16 Smith is consistent in framing the rules of morality by consent. “But if you’ll attend to it all the Rules of Criticism and Morality when traced to their foundation, turn out to be some Principles of Common Sence, which every one assents to.” (LRBL.i.133) For the view of “virtue by consent,” refer to Hope (1989, chapters 4 and 5).
4.1. Habits as actual of regularities of conduct

According to Smith, habits are instrumental in controlling the pursuit of private interests. Smith wrote the following on habits:

The objects with which men in the different professions and states of life are conversant, being very different, and habituating them to very different passions, naturally form in them very different characters and manners. (TMS.V.2.4)

Smith terms the regard for such habituating as “habitual reflection,” which denotes a kind of enforcement by habituation, and then relates this to habits.

Those general rules of conduct, when they have been fixed in our minds by habitual reflection, are of great use in correcting the misrepresentations of self-love concerning what is fit and proper to be done in our particular situation. (TMS.III.4.12)

So far, few authors have paid any attention to habits as collective action and as a way of “correcting the misrepresentations of self-love.” However, habits can be considered as institutions since they imply actual regularities of conduct and can serve as conventional means for directing selfish actions by imposing disapprobation in case they are breached.

4.2. Sense of duty as self-enforcement of norms of conduct

After deriving “the general rules of morality” in TMS III, as shown above, Smith describes “a sense of duty” as “the regard to those general rules of conduct” (TMS.III.5.1). Here, the idea of an “impartial spectator” bears the character of the conscience (Raphael and Macfie, 1976, pp. 15–16). Thus, we may understand “a sense of duty” as being a self-enforcement of norms of conduct.

This self-enforcement of norms is an implicit agreement and, as such, is binding for an individual. In this case, “the sentiment of self-approbation” (TMS.III.6.13) or the “regard to the sentiments of the supposed impartial spectator” (TMS.VI.concl.2) plays the role of an enforcement mechanism that induces each individual to obey the norms of conduct. Even an individual’s action, when it comes from a sense of duty, can be seen as collective action.

4.3. Laws of justice as conduct-forcing rules

Among the rules of morality, only the laws of justice are considered conduct-forcing rules, since they constitute law and order, which is enforceable by the coercive power of the state.

Smith points out that the laws of justice are “the most sacred” (TMS.II.ii.2.2) because they determine with the greatest exactness every external action (cf. TMS.III.6.10) and also because they are enforceable by a civil government. It is for these reasons that justice enjoys a privileged position among the three virtues. According to Smith, the laws of justice comprise “the laws which

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17 Sen (1987, p. 87) is considered the first author to draw our attention to the significance of habits in TMS. Leibenstein (1987) states that conventions may serve as “solutions” to a “latent Prisoner’s Dilemma.” Lewis (2002 [1969]) argues that in a situation where some coordination equilibria exist, conventions are instrumental in choosing one among them. See also Schotter (1981).

18 From the standpoint of the NIE, self-enforcement agreements include norms of behavior. For example, a worker’s effort is determined by the norms of behavior. See Furubotn and Richter (2000, pp. 156–160).
guard the life and person of our neighbor,” “those which guard his property and possessions,” and “those which guard what are called his personal rights, or what is due to him from the promises of others” (TMS.II.ii.2.2). These laws are, in Hume’s sense, institutions of laws, which are intended to enforce individuals’ abstinence from seizing the possessions of others. The possibility of external sanctions being imposed in case these laws are broken forces individuals to abide by them.

4.4. A status order and principle of authority

Lastly, a status order can also contribute toward constraining the pursuit of private interests, in that it restrains the selfish passions in the poor. Smith explains how this order is established by introducing the concept of “sympathy with joy” (TMS.I.iii.1.1), that is, “our sympathy with our superiors being greater” (LJ(B).12), which performs the function of founding “the distinction of ranks and the order of society” (TMS.I.iii.3.1). Smith wrote:

Upon this disposition of mankind, to go along with all the passions of the rich and the powerful, is founded the distinction of ranks, and the order of society. (TMS.I.iii.2.3)

Further, Smith refers to authority and utility (LJ(B).12) as being the two principles that induce men to enter into a civil society. Authoritative relationships, such as status or rank, are established by the principle of authority. Smith observed:

... yet tho’ [the poor] expect no benefit from [the rich] they have a strong propensity to pay them respect. This principle is fully explained in the Theory of Moral Sentiments. (LJ(B).12)

The principle fully explained in TMS is nothing but “sympathy with joy.” The manner in which this sympathy with joy controls actions is peculiar; through this sympathy, the poor are tempted to willingly, in other word, with joy, curb the envy for the rich with no expectations of benefit, and practice the behavior of the rich. Therefore, it is very appropriate to state that sympathy with joy founds a principle of authority and that it is one of the norms of conduct.

To summarize, habits, morality, laws of justice, and status order correspond to the actual regularities of conduct, the self-enforcement of norms of conduct, the conduct-forcing rules, and authoritative relationships, respectively. These four institutions through their own enforcement mechanisms control the pursuit of private interests motivated by selfish passions. As long as these institutions direct such actions, the collective pursuit of self-interest will result in a situation where negative externalities are solved.

19 Hume’s solution to this problem was “a convention enter’d into by all the members of the society” (Hume, 1985 [1739–1740], p. 489), “a general sense of common interest” (Hume, 1985 [1739–1740], p. 490), in other words, the mutual guarantee of property rights by justice. This “convention” is intended to be the “abstinence from the possessions of others” (Hume, 1985 [1739–1740]). Hume also considered “convention” as an “artifice” (Hume, 1985 [1739–1740], p. 489), or, “rules” (Hume, 1985 [1739–1740], p. 490).

20 The poor, driven by such selfish passions as envy, are sometimes prompted to steal from the rich. Smith wrote, “the affluence of the rich excites the indignation of the poor, who are often both driven by want, and prompted by envy, to invade his possessions.” (WN.V.i.b.2).
5. The theory of institutions and collective action

The theory of WN is premised on the behavioral assumption of economic actors—the capitalists’ frugality and the workers’ industry. In this section, it will be argued that the behavior of capitalists and workers represent collective action, which is controlled by both the rules and norms of conduct.

On the other hand, Smith’s argument will show that institutions cannot fully control an individual’s behavior. Thus, there will be always the possibility of an individual’s action deviating from the standards of conduct. This section proceeds to address the problem of how likely institutions are to guide the behavior of economic actors. However, it is necessary and helpful to clarify the theme of WN before addressing these topics.

5.1. The theme of WN and prudence

Smith, after defining the nature of wealth as consumer goods, concludes that the causes of wealth can be attributed to the increase in productivity resulting from the division of labor and investment by capitalists, which correspond to workers’ industry and capitalists’ frugality, respectively. Yet, Smith simultaneously insists that among the two, the investment by capitalists should be considered the main cause for wealth since the extent of the division of labor is determined by the extent of a market, which depends on the capitalists’ investment.

Parsimony, and not industry, is the immediate cause of the increase of capital. Industry, indeed, provides the subject which parsimony accumulates. But whatever industry might acquire, if parsimony did not save and store up, the capital would never be the greater.

Smith’s theory of natural order of investment ("natural progress of opulence") explains in more specific terms why investment by capitalists should be considered the main cause of wealth. According to this theory, which Smith developed in WN.II., the extent of a market depends on the amount of labor employed due to the investment made by capitalists in agriculture, manufacturing, and commerce. In addition, the number of laborers employed sets out the following investment order: first, agriculture; second, manufacturing; and last, commerce (cf. WN.III.i.8). Smith asserts that if capitalists invest their money in this order, it will maximize employment, and if the employed laborers are industrious, then the wealth of a nation will be maximized.21

We encounter the following questions: why should capitalists invest their money? Moreover, why should the employed laborers increase their productivity or work industriously? Is it not possible that the capitalists would waste their money on luxuries and the laborers would be lazy and idle?22

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21 The denial of the significance of natural order of investment was necessary for those authors who were inclined to interpret WN as the germ of the general equilibrium theory. See Stigler (1993 [1976]) and West (1990). On the other hand, Myint (1965), Eltis (1975), Lowe (1975), Thweatt (1993 [1957]), Spengler (1993 [1959]), and Gee (1994 [1981]) insisted that the theme of WN was founded in the logic of capital accumulation presented in WN.II.

22 Smith always viewed capitalists’ extravagance and avarice and workers’ laziness as major vices. “But avarice and ambition in the rich, in the poor the hatred of labour and the love of present ease and enjoyment, are the passions which prompt to invade property, passions much more steady in their operation, and much more universal in their influence.” (WN.V.i.b.2).
Here is a possibility that this might be true. However, capitalists are assumed to always be frugal and strongly inclined to invest their saved money, and workers are assumed to always be diligent and to work as hard as possible in the world of WN.

The virtue of prudence has been considered to be the reason for this. Sure enough, Smith emphasizes the virtue of prudence as being the driving force of the economic man. On prudence, Smith wrote:

In the steadiness of his industry and frugality, in his steadily sacrificing the ease and enjoyment of the present moment for the probable expectation of the still greater ease and enjoyment of a more distant but more lasting period of time, the prudent man is always both supported and rewarded by the entire approbation of the impartial spectator, and of the representative of the impartial spectator, the man within the breast. (TMS.VI.i.11)

In addition, the pursuit of self-interest implies following the rules of morality. Smith wrote:

The pursuit of the objects of private interest, in all common, little and ordinary cases, ought to flow rather from a regard to the general rules which prescribe such conduct [italics added], than from any passion for the objects themselves. (TMS.III.6.6)

Therefore, the economic men of WN are assumed to have internalized “the general rules,” and their self-interest-seeking behavior should arise from a regard for these rules.

From our standpoint that morality belongs to institutions, behaviors such as those mentioned above are considered to represent two kinds of behavioral patterns. Although seeking profits and high wages could be an individual behavior driven by the desire for private interests, the capitalists’ frugality and the workers’ industry cannot be thought of as mere individual actions. Their behaviors bear collectivity because they have been institutionalized by being guided by prudence as a norm of conduct, with the result that capitalists are always frugal and workers are always diligent. Those institutionalized actions or the collective action of capitalists and workers, fashioned into the two classes of the capitalists and the laborers, respectively, justify their frugality and industry and therefore, account for the capital accumulation. The behavioral assumption on economic actors–capitalists’ frugality and workers’ industry—in WN are thus based on institutions and collective action in TMS.

5.2. Rules and norms of conduct

However, confirming that the collective characteristics of capitalists’ frugality and workers’ industry arise from the rules of morality and determining rules that control their behavior are two distinct issues.

The most important aspect to be realized regarding the behavior of economic men is that not only are their actions under the control of the rules of morality, but also both the rules and norms of conduct are obeyed by them. Some authors, who are neoclassic-economics-orientated, have based their interpretation of WN on the following passage:

All systems either of preference or of restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. 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.ix.51)
In the above passage, the laws of justice, as shown earlier, mean “the laws which guard the life and person of our neighbor,” “those which guard his property and possessions,” and “those which guard what are called his personal rights or what is due to him from the promises of others.” Neoclassical economists state that individuals are free in the pursuit of their own private interests as long as they do not violate “the laws of justice” and that this will enable a “system of natural liberty” to be established. However, they fail to address the central issue.

Although the actions observing these laws may cause a capitalist to desire higher profits and a laborer to demand higher wages, it is impossible that the capitalists’ frugality and the laborers’ industriousness result from private-interests-seeking behavior subject to the laws of justice.  

Observing the laws of justice is an action that merely conforms to the rules of conduct. However, capitalists’ parsimony and laborers’ industry are actions in accordance with the norms of conduct, which are accountable to the theme of WN. Therefore, it follows that by observing both the rules (the laws of justice) and norms (prudence) of conduct, actions of capitalists and laborers evolve into collective action—capitalists’ parsimony and laborers’ industry within the laws of justice.

Because the pursuit of private interests, excited by selfish passions is more robust (“very apt to mislead into great deviations”) than that of self-interest following the rules of morality, it is postulated that the behavior of the economic men of WN must be based on both the rules and norms of conduct lest such passions should cause individuals to deviate from the standards of conduct. If their activities rely on the rules of conduct alone, the resulting social order through obeying the laws of justice will be the mere aggregate of individual private-interests-seeking behavior.

5.3. The deviation of individual actions from standards of conduct

After having shown that the capitalists’ frugality and workers’ industry are collective actions guided by both the rules and norms of conduct, this section proceeds to a discussion on the likelihood of the standards of conduct controlling the behavior of capitalists and workers. Smith seems to suggest that there exists the possibility of two types of collective actions in TMS. The first type is the pursuit of self-interest while observing the rules of morality. The second involves the pursuit of private interests driven by selfish passions such as avarice and ambition, within the rules of conduct.

The second point to be noted is, therefore, regarding Smith’s recognition that there exist possibilities that individual conduct cannot be completely guided by the standards of conduct and may deviate from them. Smith’s mentions of the corruption of morality will present a good basis for further discussion.

Smith repeatedly drew our attention to how individual conduct might divert from the norms of conduct. Further, Smith termed the deviation of individual actions from the rules of morality

23 The interpretation that the only institution besides that of a market that Smith stressed upon was justice can be termed the interpretation centered on justice. Hont and Ignatieff (1990) represents this interpretation. “Our argument is that the Wealth of Nations was centrally concerned with the issue of justice, with finding a market mechanism capable of reconciling inequality of property with adequate provisions for the excluded.” (Hont and Ignatieff, 1990, p. 2).

24 On the view of the possibility of the corruption of moral sentiments inherent in sympathy, see Griswold (1999, p. 128) and Brown (1994, pp. 91–92).

25 The first part is referred to in TMS.I.iii.2–3; the second, TMS.II.iii.; the third, TMS.IV.2.; and the final, TMS.V.2. All of these parts discuss the corruption of moral sentiments or deviation from the norms of conduct.
as “the corruption of moral sentiments,” and attributed the cause of corruption of morality to sympathy with joy. In the chapter titled “On the corruption of our moral sentiments,” Smith observed:

This disposition to admire, almost to worship, the rich and the powerful, and to despise, or, at least, to neglect persons of poor and mean conditions, though necessary both to establish and to maintain the distinction of ranks and the order of the society, is, at the same time, the great and most universal cause of the corruption of our moral sentiments. (TMS.I.iii.3.2)

We wish to determine the causes of this corruption and the reasons for Smith using the term “corruption.” The existence of corruption can be attributed to the difference between the probabilities of individuals pursuing their private interests by simply obeying the rules of conduct and their pursuing their self-interests while following the norms of conduct.

The difference arises from the differences in enforcement mechanisms of the rules and norms of conduct. As explained earlier, the rules of conduct can be externally enforced by the probability that physical or legal punishments and sanctions will ensue in case of their violation, making them strongly binding, whereas the norms of conduct are internally enforced by the probability that deviation from them may cause disapproval, thus making them weakly binding. According to Smith, adherence to the norms of conduct is guaranteed only by a sense of duty or self-approbation; therefore, it follows that the rules of conduct have a higher probability of being adhered to by individuals than the norms of conduct. Hence, differences in the extent of enforcement bring about two types of behavioral patterns of behavior, one being the pursuit of self-interest while observing the rules of morality and the other being the pursuit of private interests motivated by selfish passions within the rules of conduct.

Given these differences, sympathy with joy in place of prudence will seduce certain members of a given social group to pursue their private interests, abiding by the rules but in negligence of the norms of conduct. Therefore, the pursuit of private interests motivated by selfish passions within the rules of conduct is furthered by sympathy with joy.

Smith recognizes this, and for this reason, calls “the corruption of moral sentiments” a situation where, among the standards of conduct, an individual action has regard for the laws of justice because of the highest probability of obeying them, whereas the norms of conduct are neglected. A breach of laws is not corruption, but only an illegal act, whereas deviating from norms may well be termed corruption.

If an increasingly large number of members of the group follow this path that some members have taken, a different collective action will emerge with the result of the emergence of a new social order, which differs from the social order that is formed with the pursuit of self-interest complying with the rules of morality. However, this new behavioral pattern will be identical to the pursuit of selfish passions within the rules of laws. In this case, selfish passions such as avarice for money and ambition for power, will become the new norms of conduct, and as such, will induce individuals to pursue their private interests while obeying the laws of conduct.

When it is affirmed that market equilibrium would be the result of its own accord, provided individuals were left free in the pursuit of their private interests, the NCE would interpret the pursuit of private interests driven by passions such as ambition and avarice within laws as implying self-interest-seeking behavior.

However, it is noteworthy that the social order ensuing from the individual pursuit of private interests, in accordance with the rules of conduct, is not one that results from the collective action of the pursuit of self-interest in compliance with the rules of morality. Therefore, different collective actions will result in different social orders.
Smith recognizes the difference between actions that merely obey the rules of conduct and those that are in accordance with the norms of conduct and that these differences cause the social order to change.

We recognize from the two cases of possible collective actions the likelihood of standards of conduct controlling an individual’s actions. From this recognition, therefore, we can conclude that the essence of Smith’s institutionalism consists of the recognition of how likely institutions are to guide an individual’s actions rather than control them. This shows that if the rules that individuals follow differ, different collective action will emerge and that if the presupposed patterns of behavior differ, different types of social orders will result. This sums up the theory of institutions and collective action in TMS. Smith, thus, introduced institutions in economics.

From the viewpoint of this theory, it would be appropriate to state that the collective action of the economic men in WN can deviate from the norms of conduct although they are rigidly controlled by the rules of conduct.

6. Conclusion

This paper argues on how Smith developed the theory of institutions and collective action in TMS. The virtues in TMS can be viewed as institutions through which individual actions are shaped into collective action. By demonstrating that Smith recognized how an individual action deviates from the standards of conduct, this paper concludes that the essence of Smith’s institutionalism lies in the recognition of how likely institutions are to control an individual’s actions.

Smith’s basic assumption is that humans cannot feel, live, and act independently of each other. The simplest unit of economic analysis are the *relations* among individuals, in Smith’s words, reference to others. Smith’s methodology may be termed as “institutional individualism” since it provides a theoretical explanation on how institutions emerge from mutually related individuals.

References