The below paper has been provided as an accompaniment to the Professor Sheila Dow's Econ Club webinar. Questions are provided at the end to assist with engagement with the source. Feel free to use these to assist class discussions, or as independent tasks.

Adam Smith as an inspiration for Behavioural Economics

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Adam Smith is best known for the book An Inquiry into the Nature and Causes of the Wealth of Nations, first published in 1776. This work is seen by many as the foundation of modern economics. Many readers have found a theme running through it that coordination in the market of the self-interested decisions of independent individuals tends to produce the best outcomes for society. But, as with all great books, The Wealth of Nations is subject to a wide range of interpretations, particularly when we try to draw lessons from it which we can apply to modern economies. In addition, as Kat Riach and Graeme Roy have noted in their chapter on lessons which we can take from celebrations to mark the tercentenary of his birth, Smith's political economy was just one product of his important contributions to philosophy and to the emergence of a range of new disciplines like psychology.

Specifically, before developing the arguments of The Wealth of Nations, Smith had written The Theory of Moral Sentiments. This earlier book, on which Smith relied in writing The Wealth of Nations, analysed the nature of social interactions and moral conventions. It was natural for it to have many applications from economics. However, many economists have disregarded this work, treating it as being separate from Smith's economics. Some of these scholars have even gone as far as arguing that the two books are largely incompatible.

Throughout the twentieth century neoclassical economists saw their task as formalising Smith's theory of market coordination. They relied on the concept of 'rational economic man,' an abstract notion of an isolated, fully-informed, rational individual acting to optimise personal well-being. But then behavioural economists started to conduct experiments to learn more about how people actually behave and found that behaviour was often, and quite systematically, different from what they had expected that 'rational economic man' would choose to do. Such results developed into a broad research agenda which aimed to build up theories which could better explain this behaviour. This work was initiated by the psychologists Daniel Kahneman and Amos Tversky just over fifty years ago. By the late 1970s economists, most notably Richard Thaler, had started to apply their approach to a rather wider range of problems of how we make choices.

These developments encouraged renewed attention to Smith's Theory of Moral Sentiments. Leading behavioural economists, including Vernon Smith who played a leading role in developing the use of laboratory experiments in economics, have shown how Smith had already identified key features of behaviour which are evident in experiments. Many of these features have been incorporated within modern behavioural economics under the umbrella of 'prospect theory'. This examines behaviour in the presence of risk and uncertainty in terms of the anticipation of gains and losses from possible actions. In developing prospect theory, behavioural economists have attempted to explain a tendency to be much more sensitive to the prospect of losses compared to the prospect of gains (a tendency to which Kahneman and Tversky gave the name, 'loss aversion'), and a tendency to be overconfident in our ability to predict outcomes. Other experiments have revealed a capacity for participants to act altruistically, rather than always being self-serving, and a strong tendency among many participants to value fairness in interactions. Smith discussed all these tendencies in The Theory of Moral Sentiments. They are all inconsistent with the strict form of rationality represented by 'rational economic man'.

Leading behavioural economists continue to insist that it is possible to retain the standard approach to analysing economic behaviour, which involves developing mathematical models and making deductions about behaviour from the specific assumptions of the model. Treating the 'rational economic man' assumption as a special case, they seek to broaden the scope of theory to explain what might previously have been treated as interesting 'anomalies' in behaviour. Kahneman and Tversky began their work with a model of decision making which was typically rational, apart from a few 'biases' in decision making processes. The language of 'anomalies' and 'biases' directs researchers' attention to exploring deviations from the rational standard.

This agenda is approached in two main ways. The first, associated with the work of Richard Thaler and his collaborators, is to take account of our cognitive limitations, which these researchers define as difficulties in forming fully-rational and fully-informed expectations of the future. This approach has the policy implication that governments can 'nudge' individuals into being more 'rational'. The second way, which is perhaps even more widespread, argues that what seems like irrational behaviour is in fact rational once we take into account the costs of making decisions which fully-informed 'rational economic man' does not face. In this approach, the heuristics, or short-cuts, which individuals use in decision-making can be explained as a rational response to cognitive limitations. One such short-cut is to trust others in market interactions or as experts, rather than try to acquire full information. Such behaviour is then presented as being rational in terms of serving self-interest.

Turning to The Theory of Moral Sentiments, some behavioural economists have lit on Adam Smith's notion of the 'impartial spectator'. Smith proposed that when we make decisions we take into account our anticipation of how observers of our actions, who are not affected by them, will judge them. From a behavioural economics perspective this imagined figure fits the 'dual-process' view of decision-making in which emotion drives short-term decision-making, but the impartial spectator encourages rational deliberation. There is also a tendency among economists to treat the impartial spectator as being a 'conscience', with the implication that this imaginary being is encouraging a rational application of ethical preferences.

This approach seems very different from Smith's view of the impartial spectator. His account of behaviour follows from his theory of human nature, as set out in The Theory of Moral Sentiments, an early instance of psychological theory. There are good reasons to expect behavioural economists to look back at Smith's work and give it a fresh interpretation. In doing so they need to remember that this theory of human nature was at the heart of Smith's system of social science. Comparing Smith's system with the rational optimising system of mainstream economics, we can understand why behavioural economists tend to approach individual behaviour so differently from Smith, despite the common elements in their thinking.

Smith sought an explanation in human nature for the urge to build knowledge in the first place. He identified a range of human faculties: the capacity for sentiments (among which he studied both the moral, and the aesthetic), the power of imagination, and the capacity to reason. He proposed that the sentiments of awe and wonder at new unexplained events, as well as moral sentiments with respect to promoting the good, motivated the search for explanations. Proposing that imagination suggested patterns in reality, experienced through introspection or through detailed study of history, he argued that the imagination, together with reason, would then suggest theoretical formulations based on these patterns. Persuading others to accept these theories in turn required an exercise in rhetoric, appealing to these others' experience, sentiments and reason. (In his Lectures on Rhetoric and Belles Lettres, Smith also made a notable contribution to our understanding of these arts of persuasion.)

Smith presented this philosophy of science in his essay on The History of Astronomy, in which he set out as an alternative to Descartes's rationalist system whereby all knowledge was derived by reason alone. For Smith, as for his friend and fellow-philosopher David Hume, the nature of the physical and social worlds meant that reason was insufficient for determining the true causal forces at work. These worlds were complex and evolving – we would now call them 'open systems' – with the result that the past was an inadequate guide to the future. We try our best to theorise about underlying causal mechanisms, but we can never be sure that we have truly identified them. This impediment to certain knowledge could ultimately be said to be caused by cognitive limitations. But for Smith these limitations were a feature of the human condition, so that they could not be overcome. The context for decision-making was thus one of inescapable, intractable uncertainty. In contrast, according to prospect theory, uncertainty is ultimately resolvable through careful observation and calculation.

In the same way, where modern behavioural economics emphasises the nearly perfectly rational individual decision maker, interpreting social interactions in terms of self-interest, Smith set the pursuit of self-interest in specifically social terms. For Smith, self interest could exist only with reference to others. That is why the individual, motivated to achieve a level of propriety within society, would make decisions with an eye to how they would be judged by others. Propriety in turn required the pursuit of a range of virtues with respect to rights and duties: the virtues of prudence, justice and beneficence. In other words, behaviour was governed by moral sentiments and efforts at self-command. The impartial spectator was thus a socialising agent, promoting and establishing constructive moral sentiments, rather than correcting them. For Smith our imaginative faculty facilitated self-command by dampening the passions while simultaneously enhancing engagement with others by heightening passions.

The individual therefore exercised the imagination in relation to sympathy with others. Formally, Smith's sympathy was an ability to enter into the feelings which our actions might cause – quite literally to feel with others. It was not just a matter of compassion but an imaginative capacity to understand others' point of view, with respect to one's actions as well as their own actions. Sympathy thus involved a sense of awareness of the approval or disapproval of others. The impartial spectator was a product of the imagination, an embodiment of individuals' social sense in general, and their moral sentiments in particular.

While behavioural economics treats sentiment as separate from, and distorting, cognition, Smith saw the two as intimately interrelated. Cognition originated in sentiment since sentiment provided the motivation for seeking knowledge. Cognition was also facilitated by sentiment since building knowledge drew on the imagination and conventional beliefs in the absence of demonstrable truth. Cognition was also shared by means of the exercise of rhetoric. Sentiment thus performed an invaluable social role. But Smith also identified damaging effects of sentiment, distinguishing between the social and unsocial passions. He was also wary of passions (social or unsocial) being overly strongly held since they would not attract the sympathy of others. He also knew that the exercise of imagination could lead to a false sympathy in which we feel emotions which the person whom we observe does not.

We can now see that there are fundamental differences between Adam Smith's system and the system of mainstream economics of which modern behavioural economics is a part. There is nevertheless scope for behavioural economics to develop, not just by incorporating more of Smith's ideas, but more importantly by embracing his approach.

First, Smith's system was more comprehensive. It included a theory of mind as part of its account of the origins of behaviour. This contrasts with the behavioural economics practice of assuming the norm of rationality without further explanation, and then identifying behaviours as being biased with respect to the strict rationality model. The emphasis is thus put on discovering and categorising many biases rather than developing a general theory explaining all behaviour. There is much more which could be incorporated from the fields of psychology and philosophy to produce a more complete theory.

Second, Smith's account of social conventions would enhance the modern discussion of heuristics as short-cuts to rationality in the case of cognitive limitations. Smith analysed conventional beliefs more generally as a way for society to deal with the inaccessibility of demonstrably-true knowledge. He saw conventional belief as a general feature of knowledge which was necessary for society to function. His friend David Hume, who was famously sceptical about how we acquire knowledge, pointed out that while the existence of reality could not be proved, the conventional belief in existence had over centuries provided an invaluable workable assumption.

Of course, both Smith and Hume knew that conventional beliefs could be, or could become, misguided, and they saw it as being the role of the philosopher or scientist to challenge them with reason and evidence, employing sentiment to be persuasive. The scope of modern behavioural economics could expand were it to develop an analysis of behaviour under uncertainty which went beyond the current treatment of heuristics as being short-cuts to rationality.

Third, while modern behavioural economics sometimes notes the possibility of moral sentiments, they tend to be assigned a peripheral role. For example, trust is treated as an exercise in rational self-interest, while other-regarding behaviour is analysed as altruism and is typically understood as being the opposite of self-interest. But for Smith moral principles were wrapped up in the concept of self-interest of individuals as social beings. All decision-making involved moral sentiments in some form and degree or another. There may be scope for modern behavioural economics to consider incorporating more complex sets of goals for human behaviour than the pursuit of self-interest. This possibility has been developed in the literature on hierarchies of goals. Nutrition, shelter and security (the most basic self-interest) might be given first priority at subsistence levels of income, while transcendence might come last after intermediate goals. This does not capture Smith's notion of goals as being complex in themselves. But it could provide a framework for operationalising that complexity.

In all three examples, the scope for building on Smith's psychological framing is limited by insistence on retaining the mainstream rationality framework. Behavioural economics aims to provide a realist account of behaviour rather than the abstract account of neo-classical economics, which is based on rational economic man. But there are so many difficulties in explaining how strict rationality with full information could work in practice that its usefulness even as a benchmark is in considerable doubt. It has never been meant to be understood as a realist account.

Perhaps the most challenging feature of Smith's theory of behaviour is the integral role of moral sentiments as determining goals for behaviour and means of achieving them. The mainstream economic modelling framework requires goals to be fully-specified such that behaviour can be presented as optimisation with respect to one goal. Multiple (possibly hierarchical) goals could in principle provide a basis for formalising moral sentiments within a mathematical model. But incorporating moral goals would also require us to abandon the practice of building theory on the individual as an isolated unit.

A final feature of Smith’s approach from which mainstream economics diverges is his historical method. Smith’s theories were developed based on patterns found in historical experience, but are treated as provisional; they might need to be amended for application to other contexts. Smith did seek commonalities where possible. Thus he identified what he regarded as universal features of humanity, but was at pains to explain that these features manifested themselves differently in different contexts. This contrasts with the mainstream economics goal of generating theories for universal application.

The conclusion therefore is that modern behavioural economics could build more fruitfully on Smith’s Theory of Moral Sentiments if efforts to fit into the mainstream framework were abandoned. In fact, there is a tradition in behavioural economics dating back to the 1950s, which is sometimes referred to as ‘old behavioural economics’ when compared to the ‘new behavioural economics’ which emerged about twenty years later. This older tradition, which is especially associated with Herbert Simon’s work on decision theory which spanned political science, economics, psychology, and computer science, developed separately from mainstream economics and has built theory along the lines suggested above, often with explicit reference to Smith. One possible fruitful direction for research would be to blend the old and new behavioural economics traditions, in the process setting aside the strictures of the mainstream approach to economics with its very narrow, individualist definition of rationality.

Questions

1. How can Smith's concept of the 'impartial spectator' be applied to modern corporate governance and ethical business practices?
2. In light of Smith’s analysis, how might a government use the principles of behavioural economics to design effective economic policies?
3. Apply the idea of 'loss aversion' to a recent economic decision made by a major corporation or government.
4. Analyse how Smith’s work on moral sentiments could challenge the assumptions of 'rational economic man' in the context of a market failure.
5. Compare and contrast Smith’s theory of human nature with the assumptions underpinning the neoclassical model of economics.
6. Discuss the potential impact of behavioural biases on market outcomes, drawing parallels to Smith’s insights on human behaviour.
7. Evaluate the relevance of Smith's 'Theory of Moral Sentiments' in understanding consumer behaviour in the digital age.
8. Critically assess the effectiveness of 'nudging' as a policy tool in light of Smith’s views on human nature and decision-making.
9. Evaluate the assertion that Smith’s economic theories and his moral philosophy are incompatible, using examples from current economic practices.