The Benevolent Legal Ethic of Adam Smith Merges with Nobel Laureate R.H. Coase’s Benevolent Legal Ethic
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Abstract
Adam Smith wrote a masterpiece when he wrote *The Wealth of Nations*. Clearly in it the ethic is the egocentric man who creates a business organization and all of society benefits from his maximization of profits through the “invisible hand.” However, Adam Smith in fact wrote a trilogy: 1) *The Theory of Moral Sentiments*, 2) *The Wealth of Nations*, 3) *The Lectures in Jurisprudence*. The underlying theme of the entire trilogy is benevolence interpreted and enforced by the Anglo-Saxon legal system. R.H. Coase received the Nobel Laureate because of two articles, *The Nature of the Firm* 1937 and *The Problem of Social Cost* 1960. In the 1937 article, the major concept for the entrepreneur’s success is his understanding of risk. In the 1960 article, Coase’s theorem is an economic analysis of the relationship between two “competitors” adjacent to each other. Coase suggests an economic efficiency analysis as the most desirable solution. However, there cannot be an absolute selfish right to property because to make one’s rights absolute would interfere with the whole. His suggestion is that the two parties arrive at the most efficient economic solution. Moreover, where the two parties are unable to make the decision then, in the end, the courts must. The Anglo-Saxon American court system has an exceptional ability to make both economic decisions and decisions for the whole society in the judicial process of judicial reasoning where they have a sound reasoned historical way of doing just what they do and arriving at the “best” decisions.

Both Smith and Coase suggest that the courts are uniquely able to make these best decisions based on the Adam Smith egocentric man and the invisible hand and ultimately, on the concept of benevolence.

I. Introduction

After writing “The Classical Economic Model and the Nature of Property in the Eighteenth and Nineteenth Centuries” Adam Smith’s ideas have never left my thinking. Upon reading Coase’s 1937 article, “The Nature of the Firm,” I was impressed with Coase’s knowledge of Adam Smith’s classical model and with his realistic analysis of the modern firm.

However, I was not pushed into asking the big question and jolting issue, “What is Adam Smith’s ethic?” Then I read, “The Problem of Social Cost,” Coase’s 1960 article. That article forced me to think even more what a deep and powerful thinker this Nobel Laureate is. When asked to write a paper for The Oxford Round Table, I thought, why not write on Adam Smith’s ethic compared to Coase’s ethic? However, I had never read *The Theory of Moral Sentiments* by Adam Smith because no one had ever mentioned that it was worth reading. As a matter of fact, I had never met anyone who had read the book. I decided to read it and in that way try to understand the Adam Smith ethic. After reading it, I have been able to hopefully understand the Adam Smith ethic and compare it to the Coase ethic.

This paper is divided into six parts: Part I Introduction; Part II The Ethic of *The Theory of Moral Sentiments*; Part III The Ethic of *The Wealth of Nations*; Part IV The Ethic of “The Nature of the Firm;” Part V The Ethic of “The Problem of Social Cost;” Part VI Analyses and Conclusions.

II. The Ethic of *The Theory of Moral Sentiments*

3 R.H. Coase wrote in his biography, written when he received the Nobel Laureate in Economics in 1991, that he thought he received it for the 1937 and 1960 articles analyzed in this paper.
A. The Doctrine of Sympathy

An analysis of *The Theory of Moral Sentiments* written in 1759 by Adam Smith is best begun by following the design that Adam Smith has created. For Adam Smith, the concept of ethic has to do with a moral judgment. A detailed analysis would be very informative but a more meaningful analysis is to set a limitation by dealing with the two most important doctrines of Adam Smith’s system. They are: (1) the doctrine of moral judgment which is centered on sympathy; and (2) the dualism of virtues which is based on the contrast between justice and benevolence. The reason for this is to understand the relation of his ethical theory to his economics and perhaps then see the overall implications.

For Adam Smith, sympathy is a principle of communication whereby the sentiments of an individual influence and are influenced by the sentiments of his fellow men. This does not mean that sympathy is the essential content of morality but, on the other hand, sympathy is the communicating factor between individuals from which arises or which allows the moral judgment. The doctrine of sympathy, pertaining to the moral experience, is presented in *The Theory of Moral Sentiments*.

The key to Adam Smith’s ethical theory is fundamentally an imaginary change of situation. That is, the person making the judgment places himself in the position of the individual being judged and thus he feels somewhat as if his sentiments and passions are the sentiments and passions of that judged individual. Sympathy then is the participation in the feelings of others.

Adam Smith’s own words show the nature of sympathy:

“When we see a stroke aimed and ready to fall upon the leg or arm of another person, we naturally shrink and draw back our own leg or our own arm; and when it does fall, we feel it in some measure, and are hurt by it as well as the sufferer.”

“The mob when they are gazing at the dancer on the slack rope, naturally writhe and twist and balance their own bodies as they see him do, and as they feel that they themselves must do if in his situation.”

“Persons…that in looking on the sores and ulcers which are exposed by beggars in the streets, they are apt to feel an itching or uneasy sensation in the correspondent part of their own bodies.”

A pleasure arises when the sentiments are in accord. And when this imaginary change of situation has happened and we sense that the other’s emotions are in agreement with our own in the particular situation, we approve and call them good. And obviously, in the opposite case when we sense that our own passions are not in agreement with the other, then we disapprove.

In *The Theory of Moral Sentiments*, Adam Smith says:

“We may judge of the propriety as impropriety of the sentiments of another person by their correspondence or disagreement with our own…”

Adam Smith uses this principle of an accord of sentiments in many different cases where people make judgments of moral worth. For him, there are two major differences, one, between judgments of propriety and impropriety, and two, between judgments of merit and demerit.

Sympathy is much more than pity or compassion. It is a participation in other’s feelings. A moral judgment can only be made when we look further than individual limits. The

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fundamental nature of Adam Smith’s theory is shown when he shows how judgments are made concerning our own sentiments and conduct. We look at ourselves with approval or disapproval by identifying ourselves in our imagination with the spectators of the actions we take. And we decide whether under these conditions we are able to be in sympathy with our own conduct.

If a person grew up in a solitary place where he had no communication with people, then virtue and vice would be meaningless. Moral sentiments come from a living society. We know if we are virtuous or vicious not from apriori means but from experience pertaining to approval or disapproval of our fellowmen. To Adam Smith, the social principle is central. He tries to make this idea even more understandable by adding the concept of an impartial spectator who has no limitations of knowledge or personal situation.

Thus, Adam Smith rejects the concept of utility as the foundation of morality. To Adam Smith, the moral experience is a social and not an individual concept. The centerpiece is that whatever the content of morality is, the basis of moral approval and moral disapproval is the principle of sympathy. The Adam Smith doctrine is not based on an independent individual thinker. Neither the inner intuition nor rational truth nor a divine revelation are the theories of Adam Smith. Moral judgment is based on the reflected sentiments of other individuals. And thus, the moral sentiments of his fellowmen, each support and influence the other which results in an objective order of moral standards. The entire theory is based on human experience and the different happenings in human experience.

The big question becomes, is this concept strong enough to overcome the obvious criticism, that men will not have a clear sense of responsibility to the sympathy position reached by each person. They will just ignore it because we as men are only interested in our own self satisfaction. In order to overcome this criticism, Adam Smith realized that there have to be certain general rules which arise out of experience which pertain to what are proper and improper actions. This is where Adam Smith introduces the doctrine of conscience:

“But though man has, in this manner, been rendered the immediate judge of mankind, he has been rendered so only in the first instance; and an appeal lies from his sentence to a much higher tribunal, to the tribunal of their own consciences, … to that of the man within the beast, the great judge and arbiter of their conduct.”

“…the man within can immediately humble that pride and elevation of mind which such groundless acclamations might otherwise occasion, by telling us, that as we know that we do not deserve them, we render ourselves despicable by accepting them.”

Certain general rules of morality are formed in the society through experience. When they have been so formed we often appeal to them as they are standards of judgment. Thus, when a person is confronted with a vital situation where he must make a moral choice, he does not have to go to fleeting and transient sentiments which he himself or his immediate fellow men have. He is able to find a body of rules which will give him confidence in regulating his conduct. Not only that but theological teachings may help reinforce the authority his conscience gives him and he is led to look at these rules as laws of God.

Therefore, the above shows very specifically that Adam Smith does not allow a person to act based on his own capricious sympathies. He has a moral order that is very objective very real and quite necessary.

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8 Ibid., pg. 130.
9 Ibid., pg. 130-131.
It is clear that these rules are very authoritative principles which will be looked at by a particular individual in relation to a particular incident and/or in relation to a developed experience.

It should be noted that Adam Smith’s purpose is to have two criteria:
1. Moral Sentiments originate in social experience,
2. These are rules of authority to guide an individual.

It is also important to examine the impartial spectator at this point.

The impartial spectator must be looked at in terms of Adam Smith’s total system. Very much like the concept of conscience, the concept of impartial spectator is a regulative principle which is a part of the moral order of the individual sympathies.

In order to have judgment that has ethical meaning, it would be disastrous to rely on the sympathies of spectators who surround the person. With no other standard than sympathy there would be nothing but a thin veil of egoistic ethics. For Adam Smith, sympathy is not to be regarded as a selfish principle. Adam Smith knows that when we appeal to sympathies there are going to be times when the immediate manifestations are not going to be enough. There must be a permanent authority to appeal to. Such higher authority is the impartial spectator. For the impartial spectator to be meaningful, there has to be a permanence, universality, rationality, and naturalness in the concept of sympathy. Most sympathies have a greater or lesser degree of the quality of contingency. However, when sympathies occur over periods of time they evolve into not single instances but instances that have become permanent stable elements of the phenomena of sympathy. These permanent elements become the personality of the impartial spectator.

The impartial spectator is an organic unity of individuals in society as a whole. That unity of thoughts are the moral laws of society. This objective element is the moral man. It is reason. This is, in effect, a moral consciousness which comes about by long association of many individuals in a society. This participation, this impartial spectator is the social consciousness of a community which each person strives to become a part of.

Thus, in conclusion, briefly, the concept of Smith is an ethical principle of man in society. It is a rational sympathy where a person places himself in the position of the person being judged. Moreover, it depends upon the concepts of conscience and an impartial spectator. The impartial spectator fundamentally personifies the norms of sympathy and a relationship to the general welfare of society.

B. Justice vs. Benevolence

1. Introduction

Now Adam Smith sets up a fundamental dualism. He looks at several virtues but the most important are the virtues of justice and the higher virtue of benevolence.

It must be understood at the initial juncture to this section that the two hundred years before the eighteenth century, enormous changes were taking place. The commercial and industrial thrust had been pressing on spiritual Christian ideals of the previous centuries with a new radical idea of material prosperity. After the Renaissance, material prosperity became an openly recognized element in the overall concept of values. The value of material prosperity now was looked at as something valued for its own sake and this openly non-spiritual ideal became valued and accepted. Self assertion or individuality became the central principle of a man’s being not the spiritual doctrine of self denial. Such a concept was a clear break with the old ethical standards.
Bernard Mandeville in his celebrated *Fable of the Bees* expressed very dramatically this break with the ethics of the previous two hundred years. The individual was an egocentered being who used individual initiative to foster public prosperity. There is and was much satire in Mandeville’s work and it raised basic paradoxes. The key point was, that to gain the material prosperity of England then, the medieval self denial was not the way to achieve it. It was not the medieval self denial that was the mainstay of virtue for Mandeville but self-interest which translated into different concepts of ethic known as “pride, vanity, selfishness, luxury” and ideals of that ilk.

Obviously, Adam Smith had read Mandeville’s Fable of the Bees and in *The Theory of Moral Sentiments* he attacks it. In the section called Systems of Moral Philosophy, which is in four sections, section four is devoted to attacking Mandeville. Adam Smith says:

“These, described and exaggerated by the lively and humorous, though coarse and rustic eloquence of Dr. Mandeville, have thrown upon his doctrines an air of truth and probability which is very apt to impose upon the unskillful.”

And further:

“..., exaggerated by the humorous and diverting eloquence of this lively author, has enabled him to impose upon his readers. There is an affinity between vanity and the love of true glory, as both these passions aim at acquiring esteem and approbation. But they are different in this, that the one is a just, reasonable, and equitable passion, while the other is unjust, absurd and ridiculous.”

And more:

“The ingenious sophistry and his reasoning, is here, as upon many other occasions, covered by the ambiguity of language.”

And again:

“Thus the common names (luxury and lust) of love of pleasure, and love of sex, denote a vicious and offensive degree of those passions. The words temperance and chastity, on the other hand, seem to make rather the restrain and subjection which they are kept under…”

Moreover:

“Such a system of Dr. Mandeville, which once made so much noise in the world…and to avow the corruption of its motives with a profligate audaciousness which had never been heard before.”

Of course Adam Smith knew what Mandeville was doing but was smart enough to recognize that Mandeville gained acceptance by many, saying, “had it not in some aspects bordered on the truth.” But Adam Smith does not in *The Theory of Moral Sentiments* preach a doctrine of unregulated self-interest (Mandeville will be discussed again infra). Again, there are many virtues but the two most important are justice and benevolence.

In this race for wealth and honor, man must not violate the concept of fair play. Adam Smith defines justice as fair play. And although self-interest regulated by justice is an essential element of virtue, yet there are other noble virtues. They are the benevolent ones such as

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12 Ibid., pg. 310
13 Ibid., pg. 312
14 Ibid.
15 Ibid.
16 Ibid.
generosity, charity, benevolence, pity, and others like them. The reward from mankind, as the punishment if they are not followed, is the direct aversion of our fellow-men. Moreover, in addition, an inner sense of remorse and unworthiness comes about. So, in effect, the sanctions of the higher virtue of benevolence are many works and on a higher plain. For acts of injustice the sanction is approbation and disapprobation. However, in benevolent actions, the source of the moral world is appealed to and thus there is a verdict in each individual case on its merits.

Practically how does justice differ from the virtue of benevolence?

a. In the concept of justice, force may be used to prevent injury by one man to another. But the virtues of charity and benevolence cannot be enforced by sanctions. The virtues of positive benevolence remain pertaining to the freedom of the individuals.

b. Justice is different from benevolence in that it can be treated by scientific exactness. This is so because the rules of justice are defined by the civil and criminal laws of the states. Therefore, Adam Smith says that natural jurisprudence is very scientific. This means that each society and especially the British Society had rationally developed the rules or laws which were known to all.

So what does it all mean? The notes from his students which make up the Lectures on Jurisprudence pertain to discussions on Hobbes, Pufendorf and the Baron de Cocceii. It is obvious that when Adam Smith talks about rules of justice, he is talking about the “natural law” of the seventeenth and eighteenth centuries. The natural law theorists assume the individual as ultimate and as an undervied and irreducible unit of the social order. And, as has been stated above, the doctrine of sympathy relates to an individual who arrives through social relations. Thus, the abstract individualism in the law of jurisprudence does not relate to the individual moral experience.

For Adam Smith, the moral superiority of benevolence is paramount for man. Then, the perfectly virtuous man for Adam Smith is “the man who acts according to the rules of perfect prudence, of strict justice, and of proper benevolence…”

Given the virtue of prudence, the prudent man “always studies seriously and earnestly to understand whatever he professes to understand…they are always perfectly genuine.” “The prudent man is always capable of friendship…” is “modest,” “discrete,” and “has good conduct.” He is temperate…respects all established decorums…of society.” Is under command of himself, lives within his income. He has valour, has a sacred regard for the roles of justice. He is one who has “the most perfect wisdom combined with the more perfect virtue.” (Adam Smith is very much an admirer of the stoics and uses many examples of great stoics.)

Although perfect prudence and strict justice can be determined by “scientific means,” what are the rules of benevolence? The way to do it is to appeal to the impartial spectator. They must be men who are “men of the happiest mould” which means those who look to the judgment of their social milieu and are most responsive to it, and further, those who see the organic unity of man and are most sensitive to it.

If all the above is meaningful and correct, then the highest virtue is the possession of the ability to participate in the highest degree, sympathetically in the feeling of humanity and the

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17 Adam Smith, Lectures on Jurisprudence, Edited by R.L. Meek, D.D. Raphael and P.G. Stein, Liberty Classics, Indianapolis, Indiana, 1982. (This is a book based on the notes from Adam Smith’s students).
18 Op.Cit. pg. 237
19 Ibid., pg. 213
20 Ibid., pg. 214
21 Ibid., pg. 216-234
sentiments of humanity. There is thus great sensitiveness to the social consciousness which means the individual is a better man. If the individual has a high degree of responsiveness to the human environment which is ever historical, specifically past and present and a concept of destiny in the future, such is the concept of benevolence.

It is because the individual is a member of many groups that there is a complexity in a person. The many different nations become subordinated to the great universal society of mankind. Man sacrifices himself to the superior ends of the universe all under the guidance and direction of God. Man cannot in fact reach the essence of benevolence but the very contemplation of it is the enormous achievement of mankind.

Law is for man an alien concept that coerces to force actions to be done to the benefit of the whole. One of the inferior virtues is self-interest restrained by justice. It is social because of the free play of individual interest and the welfare of society. And the higher virtues do not exclude self-interest because the perfectly virtuous man must preserve his own welfare, but he does what he does because he is conscious of the relation of his welfare to the good of the whole.

A very strong statement pulls together Smith’s concept of benevolence:

“The wise and virtuous man is at all times willing that his own private interest should be sacrificed to the public interest of his own particular order of society. He is at all times willing, too, that the interest of this order or society should be sacrificed to the greater interest of the state or sovereignty, of which it is only a subordinate part. He should, therefore, be equally willing that all those inferior interests should be sacrificed to the greater interest of the universe, to the interest of that great society of all sensible and intelligent beings, of which God himself is an immediate administrator and director.”

The lower and higher virtues are not against one another but are in accord. In the end, they are not different actions but different levels of the social consciousness.

Ergo, man has justice, the lower virtue, and benevolence, the higher virtue, both of which relate to the sympathy in different degrees. This dualism of virtues is a fundamental distinction for Adam Smith between jurisprudence (justice) and ethics (benevolence). The dualism thus directly leads to the insufficiency of legal ideals and is the basis of ethical philosophy and the sufficiency and higher greatness of the universality of the sympathetic association with his kind (a stoic ideal). In the end, this concept of benevolence is the ultimate true ethic.

III. The Ethic of The Wealth of Nations

A. Historical Background

Obviously, *The Wealth of Nations* written in 1776 by Adam Smith is a great world masterpiece that develops a multifaceted model far beyond this article. The goal of this article is to understand the ethic of Adam Smith in *The Wealth of Nations.*

Specific ideas are pulled together in *The Wealth of Nations* to establish the ethic. They are: 1) the egocentric man; 2) the invisible hand, and 3) the positive functioning of government.

An interpretation of each is necessary to understand the ethic:

1) Egocentric Man

Egocentric man selfishly promotes his own selfish-interests.

One of the most famous passages of *The Wealth of Nations* presents this:

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22 Ibid., pg. 235
“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from the regard to *their own interests*. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but their advantages.”

This concept of egocentric selfish man has a long legacy. Briefly, it comes from the writings of three philosophers, Thomas Hobbes, John Locke, and Bernard Mandeville.

a) Thomas Hobbes (1588-1679) lived in very difficult times in English history with wars and revolutions happening all of the time. Because of these experiences he stressed two ideas in his political writings: 1) if there is no government, anarchy will be the result in the relations of men with each other, and; 2) in order to prevent such anarchy, the government has to have enough power to suppress disputes among citizens.

Having made those two conclusions, Hobbes proposed a government with absolute authority and believed that such was the only way for the state to stop social upheaval. The philosophy of Hobbes’ most famous book, *Leviathan*[^25], does not seem to be for the freedom of man. However, it is his theory of human nature which is important. Hobbes postulated that man is by nature a selfish egotistic creature. He is motivated by internal and private desires which, if he is to be happy, require satisfaction.

His book, *Leviathan* begins by describing life as it was before societies were in existence. He assumes a state of war. Life is a state of war with each against all.

This state of affairs is unsustainable if men are to survive. Thus men, recognizing the problem, agree among themselves to erect and abide by a set of rules which will govern their conduct. This agreement or “covenant” explains society’s origin. It comes about because of the recognized need for peace. This covenant also creates a government to secure tranquility and to enforce the rules that bring about this condition. It is thus implied that an agent who is outside the workings of society is vested with the power of enforcement. That agent becomes a sovereign. And his power becomes absolute, assuming that such is what is necessary to maintain social order.

The point that is central to all of Hobbes is that man is by his very nature an egotistic, self-centered person.[^26] Hobbes’ observation had a great effect on the ideas and thoughts of the seventeenth and eighteenth centuries.

b) John Locke (1632-1704)

John Locke’s theory which pertains to the individual’s relation to the state and the state to him is presented in *Two Treatises of Government*.[^27] Following Hobbes, Locke assumes men are in a natural state which is essentially a state of war. Because this state is totally unsatisfactory the individuals agree to give up their natural rights to a central government through a social contract. It will be sufficient to state briefly Locke’s conclusion:

First, the foundation of the theory is that individuals have a natural right to life, liberty, and estate. Second, men are members of a community. Locke explains that the society depends on the consent of the majority and he makes it clear that his belief is that the community is a specific unit and is the trustee of individual rights. Third, government exists within the society. This government is also a trustee for the community in the same way as the community is for the

[^26]: See also F. McNeilly, *The Anatomy of Leviathan*, 1968.
individual. Fourth, the legislature is the most important part of government while the executive is important but has a lesser role than the legislature.

The major theme of Locke’s theory is centered on the natural rights of each individual. The great differences between Hobbes and Locke, as it applies to the individual, is that Hobbes looks at man as selfish and warlike, and Locke looks at man as good and loving. Locke understands that strife does exist in the natural state but it is this very unsatisfactory condition that leads to men coming together to establish the social contract.  

c) Bernard Mandeville (1670-1733)

Mandeville was a contemporary of Locke. He was a Dutch physician who had, in his youth, settled in England. He “scandalized” the world with his grand satire entitled The Grumbling Hive or Knaves Turn’d Honest published in 1705 and later republished in 1714 as The Fable of the Bees: or Private Vices, Public Benefits.

The work was written as an allegorical poem. Mandeville carefully declares that it is the vices of society, such as ambition, greed, and pride which advance society in power and wealth. There is a description of a hive of bees which were wicked but prosperous, but afterwards reforming their morals and becoming very poor. When honesty triumphs over the common vices of pride and envy, there is a diminishing of one’s palate and passions. Therefore, industry and trade decline and what was a very flourishing society, which was founded on a healthy and natural human selfishness, in very little time becomes vulnerable to its enemies. In the end, decimated in battle, the bees have no choice but to retreat to a hollow tree to lead temperate and frugal lives “Blest with content and honesty.” The progressive civilization was given up because the bees gave up their vices.

The moral of the story is: Do not indulge the utopian longing for a society which is free of vice, for, “Fools only strive to make a Great and Honest Hive.

Mandeville is clearly saying that we indulge our passions or we carefully disguise them. However, our behavior is fundamentally based on our overt or latent egoism. A society which is allowed to seek its own ends, will become vigorous and very successful in a worldly sense.

Hobbes, Locke, and Mandeville obviously espoused the egoist position. They believe that human action is based on a pattern to which people conform. The end result is that a person acts to promote his own advantage even if it is to the detriment of others.

2) Francis Hutcheson (1694-1746)

Francis Hutcheson was Adam Smith’s professor at Glasgow College. Hutcheson was a follower of the Third Early of Shaftesbury (1617-1713) and, like Shaftesbury, who identified private virtues with public benefits, he looked at the idea of beauty as emanating from nature’s order and harmony existing within its infinite variety. It was from Hutcheson that Adam Smith gained the concept “a providential order of the universe in which man is but an instrument of the Author of Nature, promoting ends that are not of his intention.”

The fundamental idea of the eighteenth century was that natural law combined with the principle of reason which ordered the world and controlled men who acted in the world and seeking through that rationality a knowledge of God’s will, generally called the “invisible hand.”

3) Physiocrats – Laissez-Faire

30 Ibid. pg. 36.
31 For a discussion of Hutcheson’s philosophy and influence on Adam Smith see, J. Rae, Life of Adam Smith, (1895).
The physiocrats were a group of philosophers who arrived at the early creation of the concept laissez-faire. The physiocrats pulled together Hobbesianism, Cartesian realism and some of their own ideas of how to coordinate free competition. Their conclusion was that there “was a providential harmonious and self-operating physical order of nature, which could be matched in its providential character, in its automism, and in its beneficence in the social order of nature.” 33 The physiocrats believed that through education this idea would be evident to all men. Thus rationality, through education, would point these men in the direction of equating social interest with their own proper behavior because it would be necessary if the “good life” was to be achieved. 34 And self-interest would be gained through enlightened despotism. 35

B. Synthesis of the Three Ideas

Adam Smith, in The Wealth of Nations, made a synthesis of the three above ideas:
1. The egocentric man
2. The invisible hand
3. Government removes hindrances to man acting egocentrically

Quite obviously, the physiocrats had already done this. However, Adam Smith made a clearer analysis of the theory and changed the physiocrats’ ideas in two ways:

a) the government should be a free government
b) some economic actions could not be done by individuals but had to be done by government alone.

The doctrine of laissez-faire became one of the major themes of classical economic theory but Adam Smith does not use the term in his book. It is later used by John Stuart Mill in his Principles of Political Theory.

Thus, for purposes of the ethic of Adam Smith, Adam Smith propagates:
1) Egoistic man – Man was an egoistic being. And his major psychological drive was self-interest. (derived from Hobbes, Locke, and Mandeville, discussed above).

The famous passage from The Wealth of Nations expresses this very well:

“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 interests. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages…”36

2) Invisible Hand – An invisible hand leads men to promote benefits which are social without his conscious intent to advance.

Another famous passage from The Wealth of Nations says:

“He (the individual) generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such manner as its produce may be of greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worst for the society that is no part of it. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.”37

34 Ibid. pg. 59.
37 Ibid., pg. 423.
3) Limited Role of Government

Adam Smith wanted a fundamentally free government to have little interference with a person’s freedom of action.

The physiocrats wanted an enlightened despot to rule and thus determine men’s actions. Adam Smith looked at a free government having three duties:

“First, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain…”\textsuperscript{38}

Ergo, in The Wealth of Nations, Adam Smith created an ethical model which proposed a government that supported a society which propagated the egocentric man who was “led” by an invisible hand. It allowed for a limited but careful government that intervened where the individuals were unable by themselves to effectively operate.

IV. The Ethic of “The Nature of the Firm”

A. Introduction

In the article, “The Nature of the Firm”\textsuperscript{39} written in 1937 by R.H. Coase, an attempt is made to define the firm. And the definition is pertaining to the real world. The definition is based on the two instruments developed by the economist, Marshall – margin and substitution.

B. The Economic Model – Assumptions and Realities

The assumptions in 1937 were that the classical model was in fact reality. Coase gives the assumptions of the classical model, which are briefly: a) supply adjusted by demand; b) production determined by consumption; c) the process is automatic, elastic and responsive; d) their economic system is an organism (not an organization) which is coordinated by a price mechanism.

Thus, price is the key mechanism that coordinates the entire organism. There are people who as individuals do make plans and look to the future and choose between alternatives. However, the key to the economic model is that whatever planning there is by individuals the system works because of the price system and is not really influenced or determined by separate individual decision making.

Obviously the above is the description of the classical economic model which also includes the concept that no responsibility is necessary since the mechanism works automatically and no responsibility is necessary since the benefits to society are automatic and ipso facto entirely beneficial to society and to the business organization. And all is right with the world because the model works to the benefit of all.

C. The Realities of the Economic Model

In fact, asserts Coase, inside the firm the classical model assumes, that if the price of a good goes up, the firm will move a worker from one department to another in order to lower the cost of the good and thus the price. However, in the real world, this does not happen. Often a person does not move from one department to another because he is told to move. The point is that there are all kinds of decisions made in a business organization that relate to the conscious power by the manager that have little to do with the price mechanism.

\textsuperscript{38} Ibid., pg. 651.
This last point leads to a further point that if the price mechanism were the determining factor then no organization would be needed. However, organizations are needed and exist in the real world and entrepreneurs make decisions based on planning not on the price mechanism. Coase argues that outside the firm price movements are what cause the amount of the production of goods which are coordinated by a, b, c, and d of the classical model presented above.

However, inside the firm the outside market transactions are eliminated and in the place of the complex market structure with exchange transactions, the entrepreneur/coordinator is substituted who directs the production. The point of this analysis is to establish that if production could be directed by the market exchange mechanism then no organization would be needed. But, that is not the case and an organization is in fact needed. It should be clearly understood, that the amount that the price mechanism is suspended varies enormously from industry to industry.

Coase’s conclusion, up to this point of the analysis is that the single most important feature of the modern firm is that it “suppresses” the price mechanism. Further, Coase’s purpose in writing the paper is to bridge the gap between the assumption that resources are allocated by the price mechanism and that the allocation is dependent upon the entrepreneur/coordinator.

D. Reasons for Establishing a Firm

Coase maintains that contracts are not eliminated but when a firm is created they are reduced. The reasons are:

1. The worker will work for a wage, which is fixed or fluctuating and he agrees to do what the entrepreneur will direct the other factors of production.

2. It may be desirable to make a long term contract for the supply of a particular article or service. The reason for this is, if the contract is for a longer period, rather than a shorter period, then specific costs of making the contract are avoided.

3. Since the firm does not know what their needs are, it is not often desirable to specify what the contracting party is expected to do. It may not matter to the worker but it does matter to the entrepreneur. Thus the service provided is in general terms. All the contract will state are the limits to what a person will do.

Coase’s conclusion is that it is costly to operate in a market. By forming a corporation, the entrepreneur directs the resources and certain marketing costs are saved. The key is that the entrepreneur gets the factors of production at a lower price than on the open market.

E. A Definition of a Firm

The above leads to the definition of a firm which is:

“A firm consists of a system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.”

F. Size of the Firm

Coase’s answer to size is that the firm becomes larger as additional transactions are organized by the entrepreneur. Is it possible to understand why some firms are larger than others? His answer, in agreement with Professor Knight’s answer, is that size depends on “the personality and historical accident rather than of intelligent general principles.” Thus Coase assumes, with Knight, that it is impossible to treat scientifically what are the determinants of size of a firm.

G. Analysis of the Size of a Firm

40 Professor Frank H. Knight one of the major economic theorists from the University of Chicago, who wrote the book Risk, Uncertainty, and Profit, Hart, Schaffner, and Marx Publishers, 1921.
1. The first issue is the aspects of marketing.
2. The second issue is if certain costs are reduced like production costs, then are there any marketing costs?
3. Why is not all production carried on by one firm?
4. Answers:
   i. As a firm gets larger the costs of organizing additional transactions within the firm may rise. If such is the case, the costs of carrying on an extra transaction within the firm are equal to the costs involved in carrying out the transaction in the open market. Then often a corporation will not create the extra transaction. Or another entrepreneur may be able to do it cheaper in another organization.
   ii. As transactions increase the entrepreneur may fail to make the best use of the factors of production, thus this is not efficient and the result is waste. If this is the case, then the open market can do it better or another entrepreneur can do it better.
   iii. The supply of one or more factors of production may rise. In such a case, a small firm may be able to do the job better than a large firm.
   iv. The actual ceasing of the expansion of a firm may be a combination of the above.
   Generally, the other things being equal, a firm is large if:
   1. There are less costs of organizing and the slower these costs arise then there is an increase in the transactions organized.
   2. Less mistakes are made by the entrepreneur and the smaller the increased mistakes lead to an increase in transactions organized.
   3. There is a greater lowering in the supply factors of production to firms of larger size.
   There are other problems which will ensure higher prices:
   a) Distributing supplies over a distance.
   b) Distributing supplies to different kinds of operation.
   c) Where chance of prices changing is expected and happens frequently.
   Several other things enter into the mix. Inventions are very important because they generally bring factors of production closer together lessening the distances distributed, for example, telephone and telegraph. Any changes which improve managerial technique. Finally, merger and integration.
   H. Price Mechanism and Entrepreneurs
   Some theorists argue that the division of labor is the reason for the existence of a firm. Coase insists that the price mechanism is the answer. The price system is the integrating force in a differentiated economy. The problem is why the entrepreneur, who is an integrating force, is substituted by another integrating force. The answer says Coase, is from Professor Knight’s book, *Risk, Uncertainty and Profits*. In the classical model, Professor Knight asserts every individual has perfect knowledge of the situation. There is thus no need for responsible management or control of any productive activity. Even marketing activities are not found because there is perfect knowledge by everyone. Therefore, under the classical economic model, the flow of raw materials and productive services to the consumer would be automatic.
   Now, the key to the modern economic system is uncertainty. Knight asserts that as soon as uncertainty is introduced, then ignorance not certainty becomes the real key and opinion, rather than knowledge, is central. The actual execution becomes secondary with uncertainty in the mix. The primary problem becomes *what to do* and how to do it. Uncertainty brings in the two central characteristics of the firm:
1. Goods are produced for a market, which is based entirely on impersonal prediction of the wants of consumers and not for the satisfaction of the producer’s wants. The producer then takes the responsibility of forecasting the consumer’s wants.

2. The entrepreneur becomes the new economic functionary because he becomes the concentration point of forecasting and technological direction and control of production.

3. Professor Knight concludes in *Risk, Uncertainty and Profits*, pp. 268-269:
   “When uncertainty is present and the task of deciding what to do and how to do it takes the ascendency over that of execution the internal organization of the productive groups is no longer a matter of indifference or a mechanical detail. Centralization of this deciding and controlling function is imperative, and a process of cephalisation is inevitable.”

4. Ultimate Conclusion About the Firm
   i. The basic change according to Knight, is a system where the confident and venturesome assume the risk.
   ii. And they guarantee to the doubtful and timid a specified income in return for an assignment of actual results.
   iii. Thus, this manifold specialization of function results in an enterprise and wage system of industry.
   iv. The entire system comes about because of uncertainty.
   v. In different words – the fact of uncertainty leads to people forecasting future wants.
   iv. Plus, a class springs ups who directs others’ activities to whom they reward with guaranteed wages.
   vii. The whole concept works because good judgment is directly related to confidence in one’s judgment.

I. Coase’s Conclusion About the Firm
   The question becomes, does it pay to bring in an extra change transaction under the organizing authority?
   Answer: Coase says, “At the margin, the costs of organizing within the firm will be equal either to the costs of organizing in another firm or to the costs involved in leaving the transaction to be organized by the price mechanism.”
   Thus, businessmen will always be experimenting and controlling and therefore equilibrium will be maintained. But equilibrium is not necessarily a reality. Dynamic forces are central to any thesis of a given in society. Firms get larger and smaller based directly on changes which affect:
   a. cost of organization within the firm,
   b. marketing costs

J. The Ethic
   What does all of the above mean? Is there a responsibility by the entrepreneur to the society as a whole? The answer is that nothing in this analysis of the nature of a firm relates to the ethic.
   What ethic is there for the businessman to follow? The assumption of risk leads to those entrepreneurs who make judgments. Good judgments equal excellent margins and thus excellent profits. In 1937 the ethic was being discussed by a few theorists, but it was hardly a major theme. And Coase does not discuss it except, perhaps, as an underlying assumed theme.

V. The Ethics of “The Problem of Social Cost”

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41 Ibid., pp. 268-269.
“The Problem of Social Cost”\textsuperscript{42} was written by Coase in 1960. In this article, Coase is interested in understanding what the results are when business firms’ actions have harmful effects on others.

1. Common Legal Causes
   A factory is usually emitting smoke that affects neighboring property owners. These are called nuisance cases in the law. These cases look at the factory versus the private property owners. Generally the results are based on an economic analysis following the book \textit{The Economics of Welfare} by Pigou (discussed and cited infra). There are usually one of three conclusions reached: 1) have the factory pay for damages to the property owners; 2) put a tax on the factory based on the damages caused; or 3) disallow the factory from residential areas where the factory smoke causes harm to property owners.
   Coase states that such conclusions are not desirable because they do not deal with the real and basically important issue and thus they do not give sound answers.

2. The Problem is Reciprocal in Nature
   The problem can be solved much better and in effect be much more meaningful in a free economic society. Generally the question seems to be looked at as if A is harming B, and thus the answer pertains to how to stop A from harming B. \textit{But the answer may be that each has certain rights that need and should be addressed.}

   Coase gives an economic example that shows the nature of the problem and the more fair or the more meaningful final disposition. The example follows: Cattle are straying which destroy crops on land that is neighboring. That the cattle will stray is an inevitable consequence, given the facts. Given that the cattle will stray then, economically speaking, an increase in the supply of meat can be obtained only at the expense of a decrease in the supply of crops. The choice is clear: meat or crops. The answer cannot be gained unless we know what the value of that which will be obtained, and at the same time, the value of that which is sacrificed to gain it. Coase also gives another similar example which Professor George J. Stigler gives pertaining to the contamination of a stream.\textsuperscript{43} The example relates to pollution of a stream and the fish that die because of the pollution. The question that needs answering is: is the product that contaminates the stream more valuable than the fish that are lost? Obviously the problem needs to be looked at overall and also relative to margin.

3. Liability for Damage and Pricing System
   Generally most economists are willing to accept analytically the answer to the problem where damages are paid by those who cause the damage and the pricing system is without cost (meaning that the pricing system works very well.)

   A second example in relation to cattle and crops. Let there be, a first given, that the farmer and the cattleman are operating on adjacent properties with no fencing between them. A second given, is that an increase in the cattleman’s herd increases the total damage to the farmer’s crops. There are numerous happenings as to margin depending on if the cows are side by side or the cows are more restless as the herd increases, etc. To keep things simple, an arithmetic example will be used and any marginal damage by the herd will be ignored.

   The assumption is that the annual costs of the farmer’s fencing of the property is $9.00 and that the crop price is $1.00/ton. Further, the assumption is that the relation between the number of cattle in the herd and the annual crop loss is the following:

   \begin{tabular}{|c|c|c|}
   \hline
   Number in Herd & Annual Crop Loss & Crop Loss Per \\
   \hline
   \end{tabular}

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\textsuperscript{43} G.J. Stigler, \textit{The Theory of Price} (1952), pg. 105.
If it is assumed that the cattleman is liable for damages that are caused, and if the cattleman increased his herd from 2 to 3 steers and $3.00 are the damages for each cow, then obviously he will not increase the size of the herd unless the value of the additional meat produced is greater than the additional costs that such will cause plus the value of any additional crops destroyed.

Given that the annual costs of fencing is $9.00, the cattleman who wants a herd of 4 steers or more would pay to put in fencing and maintenance of the fencing. By erecting the fence the marginal costs will be zero. But it may be cheaper for the cattleman not to fence and pay for the damaged crops, with 3 or fewer steers.

Coase gives several other examples to show different problems which will occur with the increase of the cattleman’s steers and the cattleman’s fence. Whatever, for purposes of this paper the concept is clear:

If the cattleman is liable for the damage caused and if the pricing system works well, the reduction in the value of production elsewhere will be taken into account when one is computing the additional costs which now are involved in increasing the size of the herd.

This particular cost will be weighed against the value of more meat production, and if there is perfect competition in the cattle industry, the allocation of resources will be optimal in cattle raising.

An emphasis, perhaps also worth noting is, if there is a fall in the value of production elsewhere, that problem the cattle raiser must take into account, pertaining to the damage the cattle would cause to the crops.

Because of the above, it is possible, given market transactions, to discontinue cultivation of the land. This may happen when the damage the cattle would cause, and for which the cattleman is perfectly willing to pay, however, is not enough to cover the amount which the farmer would pay for the use of the land.

Where there are conditions of perfect competition, the amount the farmer pays for the use of the land and the value of the product yielded, after the cattleman’s steers do damage to the crops may be very efficient. However, if the money received by the farmer for decrease in crops is not enough to pay for the overall factors of production then, the farmer will have to go out of business and leave the land uncultivated.

Coase presents this latter possibility to show that a pricing system with liability for damages has many different effects. But the key is always market forces which may affect either party. The overall results are always that circumstances can change to cause the party paying for the damages to go out of business. In this case, the market forces are causing both parties to abandon their previous agreement and the land is left ungrazed for cattle and uncultivated for the farmer. And the market forces are causing ultimately more efficient use of the land.

4. A New Way of Looking at the Problem

The problem of straying cattle and the damaging of crops which was discussed above is the same problem that arises in many different ways.
Coase shows how four cases in English law are decided. All of these cases are in the late 19th century. Two cases will be analyzed for this presentation.

The facts of the case are that the confectioner (on Wigmore Street) used two mortars and pestles in connection with his business. One of the businesses had been in operation in the same place for more than 60 years and the other for 26 years. Then a medical doctor bought and occupied the neighboring premises (on Wimpole Street). The confectionary was used for 8 years and caused no harm to the doctor. Then the doctor built a consulting room at the end of the garden right next to the confectioner’s kitchen. It was found that noise and vibration caused by the confectioner’s machinery made it rather difficult for the doctor to use the new consulting room.

The complaint stated:
“In particular…the noise prevented him from examining his patients by auscultation (using the stethoscope) for diseases of the chest. He also found it impossible to engage with effect in any occupation which required thought and attention.”

The doctor brought a legal action to force the confectioner to stop using his machinery. The courts granted the injunction. The court’s decision established that the doctor had the right to prevent the confectioner from using his machinery.

Coase suggests that a better decision would have been to have the parties bargain for a reasonable arrangement. For example, the doctor could have waived his right and allowed the machinery to continue to operate if the confectioner would have paid a sum of money which was greater than his loss of income. His losses were to come from (1) moving to a more costly place; or, (2) a less convenient location; or, (3) from having to curtail his activities at that location; or, (4) from having to build a separate wall which would deaden the noise and vibration.

Such an arrangement would have been good for the confectioner if it was less than his fall in income which would happen because (1) he had to change his mode of operation; or, (2) abandon his operation; or, (3) move his business to another location.

Suppose the confectioner had won the case. Then the confectioner could have continued using the machinery and not paying the doctor. Now the doctor would have a problem. So if the doctor would lose money because of the machinery then it would be in the doctor’s interest to make a payment to the confectioner which would get him to not use the machinery.

The essential conditions are the same as the case of the cattle which destroyed the crops.

The judge’s view was that they were settling how the land was to be used and this says Coase, “would be correct only if the costs of carrying out the market transactions exceeded the gain which might be achieved by any rearrangement of rights.” And, of course, if it was good to maintain the residential or professional use of the area. However, the judges should have looked at the values of the rights of both parties which could have been compromised by paying for the rights that the other had which a reasonable economic bargain would have solved.

b. Case two: Bryant v. Lefever, C.P.D. 172 (1878-1879)

The facts of the case were that the parties were occupiers of adjoining houses, which were roughly the same height. Before 1876, the plaintiff was able to light a fire in any room of his house without the chimney smoking. The two houses had been in the same condition for 35 years. In 1876, the defendants tore down their house and proceeded to rebuild it. They built their house so that the wall by the side of the plaintiff’s chimneys was much higher than before and also they stacked timber on the roof of their house. The result was that the plaintiff’s chimneys smoked whenever he lighted his fireplaces.
The reason that the fireplaces smoked was because the erection of the wall and stacking of timber prevented free circulation of air.

In the jury trial, the plaintiff was awarded damages of £40.
In the Court of Appeals, the judgment was reversed.
Bramwell, L.J. argued:
“…it is said, and the jury have found, that the defendants have done that which caused nuisance to the plaintiff’s house. We think there is no evidence of this. No doubt there is a nuisance, but it is not the defendant’s causing. They have done nothing in causing the nuisance. Their house and their timber are harmless enough. It is the plaintiff who causes the nuisance by lighting the coal fire in a place the chimney of which is placed so near the defendant’s wall that the smoke does not escape, but comes into the house. Let the plaintiff cease to light his fire, let him move his chimney, let him carry it higher, and there would be no nuisance. Who then causes it? It would be very clear that the plaintiff did, if he had built his house or chimney after the defendants had put up the timber on theirs, and it is really the same though he did so before the timber was there. But (what is in truth the same answer), if the defendants cause the nuisance, they have a right to do so. If the plaintiff has not the right to the passage of air, except subject to the defendants’ right to build or put timber on their house, then his right is subject to their right, and though a nuisance follows from the exercise of their right, they are not liable.”

Cotton, L.J. said:
“Here it is found that the erection of the defendant’s wall was sensible and materially interfered with the comfort of human existence in the plaintiff’s house, and it is said this is a nuisance for which the defendants are liable. Ordinarily this is so, but the defendants have done so, not by sending on the plaintiff’s property any smoke or noxious vapor, but by interrupting the egress of smoke from the plaintiff’s house in a way to which…the plaintiff has no legal right. The plaintiff creates the smoke, which interferes with his comfort. Unless he has…a right to get rid of this in a particular way which has been interfered with by the defendants, he cannot sue the defendants, because the smoke made by himself, for which he has not provided any effectual means of escape, cause him annoyance. It is as if a man tried to get rid of liquid filth arising on his own land by drain into his neighbor’s land. Until a right had been acquired by user, the neighbor might stop the drain without incurring liability by so doing. No doubt great inconvenience would be caused to the owner of the property in which the liquid filth arises. But the act of his neighbor would be a lawful act, and he would not be liable for the consequences attainable to the fact that the man had accumulated filth without providing any effectual means of getting rid of it.”

Coase is not interested in showing how the situation should be modified by bargains between the parties. Since the cattle example should suffice to show how it’s done.

But Coase does want to talk about the issue of who causes the smoke damage. The case is novel because the smoke is suffered by the man who lights the fires.
Issue, who caused the smoke nuisance? The answer, it was caused by both, the man who built the wall and the one who lit the fire. If the fire is given, no smoke nuisance would have occurred without the fires. If the wall is given, there would be no smoke without the fires. If the wall or the fires are eliminated there would be no smoke.

Given the marginal principle, they are both at fault. And thus both should be held liable. And given market transactions they should solve the problem by bargaining. Although the wall
builder was not legally liable for the nuisance, the plaintiff would accept from the wall builder the cost of continuing to have the high wall and timber stacked on the roof.

Judges must decide legal liability. However, there is an economic problem. In the case of the cattle and the crops, the truth is, there is no crop damage without cattle. Also there would be no crop damage without the crops. The doctor’s work would not have been disturbed if the confectioner had not worked the machinery. However, the machinery did not disturb anyone if the doctor hadn’t placed his office near the machinery.

Causation is the key and both parties cause the damage.

Thus Coase is saying, that an optimum allocation of resources is the economist’s critique. And to do this both parties should look at the nuisance and see what is caused by each before deciding what to do. The pricing system works and “the fall in the value of production due to the harmful effect would be a cost to both parties.”

5. Understanding the Cost of Market Transactions

Coase says that in the above materials the discussion centers around the assumption that there are not costs involved in carrying out the market transactions. He says quite clearly that such is a “very unrealistic assumption.” Whenever there is a transaction one must find out who you will deal with. Then one must determine what terms to deal. Then, to determine conduct negotiations which lead up to the bargain. Further, to draw up a contract, and inspect the terms of the contract to see if the terms are being abided by, etc. These operations are costly and often prevent transactions from being carried out where the world is in a pricing system which works without cost.

Previously it was said that when rearranging legal rights the argument was that rearrangement would be made through the market if it led to an increase in the value of production. Coase says, “Once the costs of carrying this out market transactions are taken into account it is clear that such a rearrangement of rights will only be undertaken when the increase in the value of production consequent upon the rearrangement is greater than the costs which would be involved in bringing it about.” It is a given in this section, that there is an initial delimitation of rights and costs of carrying out market transactions.

Of course, for Coase, this was discussed in his 1937 article (discussed above) which describes the acquiring of legal rights of all parties and arrangement of activities not by rights of contract but by administrative decisions within the corporation. And this method will be adopted whenever the administrative costs of the firm are less than the costs of market transactions. All of it is explained in the analysis of the 1937 article above.

Where the firm cannot do it, sometimes the government can do it cheaper because the government can avoid the market altogether which a firm cannot. Sometimes government costs are too high and government can’t do the job efficiently and it will have to be left to the market.

However, given all of the above, sometimes government can act efficiently and it is superior to the market and a firm acting. An example would be smoke nuisance where government can do it more efficiently because such a large number of people are involved.

The point of this section is to try to understand the most efficient and effective way to choose the appropriate social arrangement for dealing with harmful effects. It’s best to see by study which are the effective ways of doing the job most effectively and then doing it. Most large scale real estate development companies, government zoning and other regulating activities usually do not work and Coase believes government activities should be curtailed.

The aim of this article is to indicate what economic approach should be used.

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44 Ibid., pp. 15-16.
6. The Economic Problem Pertaining Specifically to the Legal Delimitation of Rights

The previous section considered English cases but American cases in this area are very similar. When the market transactions are very costly it becomes difficult to change the arrangement of rights established by law. In these cases the courts then directly influence the economic activity. Therefore, it behooves the courts to try to understand the economic consequences of their decisions and thus take them into account when making the legal decisions.

The American writers refer to these decisions more specifically than the British. A quote from the American Prosser on Torts:

“A person may make use of his own property or...conduct his own affairs at the expense of some harm to his neighbors. He may operate a factory whose noise and smoke cause some discomfort to others, so long as he keeps within reasonable bounds. It is only when conduct is unreasonable, in light of its utility and the harm which results, that it becomes a nuisance...”

Prosser gives a similar view that the world must have factories, smelters, oil refineries, noisy machines and blasting, even where it is inconvenient to neighbors and a plaintiff may have to accept some not too unreasonable comfort for the general good.

In one of the cases discussed above by the judges in Sturges v Bridgman obviously the judges were looking at the economic consequences of alternative decisions. They argued that to follow the principle being followed to its logical conclusion would lead practically to quite serious consequences, for to say that a person could build a residence on a vacant piece of land then force a manufacturer to cease manufacturing is quite reprehensible. The judges said, “whether anything is a nuisance or not is a question to be determined, not merely by an abstract consideration of the thing in itself, but in reference to its circumstances.”

The point that is being made is that there is an established position that the character of the neighborhood is directly related to a decision pertaining to whether or not something is a nuisance.

Salmond on Torts says basically that if one dislikes traffic noise, one should not build a house in the city. One who is devoted to peace and quiet should not live where businesses make boilers and steamships.

Coase makes it quite clear that often judges do not specifically refer to the economic problem that arises in cases but words like “reasonable” and “common or ordinary use” are usually their way of recognizing the economic aspects of a problem being adjudicated. This is found in a Court of Appeals case Andreea v Sefridge and Company, Ltd. This case pertains to a hotel on Wigmore Street which was situated on part of an island site. The rest of the site was bought by Sefridges which razed the existing buildings so that new buildings could be built in their place. The hotel lost customers because of the noise and dust due to the demolition work.

In the lower court the plaintiff received a judgment for £5,000. Sir Wilfred Green, M.R. speaking for the Court of Appeals states first, that in dealing with operations that are temporary, such as demolition and rebuilding all parties have to realize a reasonable amount of discomfort,

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45 Restatement, Torts, SS826, 827, 828.
46 Ibid.
47 11 Ch.D. 865 (1879).
49 I Ch I (1935).
since the operations cannot be carried on without noise and dust. Thus a rule of interference has to be qualified.

Then he spoke to the lower court’s decision saying that in referring to common or ordinary use of land does not mean using land and buildings in such a way that they are to be stabilized forever. As time passes, new inventions and new methods enable land to be used more profitably by digging down or mounting up into the skies. But these are part of the normal use of land. Guests at hotels are easily upset especially if the particular view they were coming for was no longer available. In this particular case the work was not carried on in a reasonable time frame but unnecessarily and unreasonably prolonged. Thus there were substantial damages and the damages awarded by the lower court were reduced from £4,500 to £1,000.

Coase continues saying that the legal position in the United States is essentially the same as England except the legislatures do authorize what would be nuisances under common law, especially without giving compensation to the person harmed, which is a little more limited, being usually subject to constituted restrictions.\(^{50}\)

That concept notwithstanding, there are cases where the power is available and American cases follow the more liberal English cases. Airports and the operation of airplanes are good examples in point. The case of *Delta Air Corporation v. Kersey* and *Kersey v. City of Atlanta*\(^{51}\) is a sound example. In that case the plaintiff maintained that his property was “a quiet, peaceful, and proper location for a home before the airport was built, but dust, noises, and low flying of airplanes caused by the operation of the airport have rendered his property unsuitable as a home.”\(^{52}\)

The judge first referred to a previous case, *Thrasher v. City of Atlanta*\(^{53}\) in which he observed that the City of Atlanta had been expressly authorized to operate an airport. Thus the franchise authorized the aviation and it was recognized as an enterprise affected with a public interest. Therefore all persons using the airport in the manner contemplated by law were within the protection and immunity of the franchise granted by the municipality. And further, that an airport is not a nuisance per se, although it could become one from the manner of its construction or operation.

Ergo, it was made clear that aviation was a lawful business affected by a public interest. Moreover, the construction of the airport was authorized by statute. The judge cited *Georgia Railroad and Banking Co. v Maddox*\(^{54}\) where it had stated that where a terminal yard is located and its “construction authorized, under statutory powers,” if it was constructed and operated in a proper manner then it cannot be adjudged a nuisance. Consequently, injuries and inconveniences to persons residing near the yard, from noises of locomotives, rumbling of cars, vibrations produced thereby, and smoke cinders, soot and the like, which result from the “ordinary and necessary,” therefore, proper use and operation of the yard, are not nuisances, but are the necessary concomitants of the franchise granted.\(^{55}\)

Given all of the above, the judge decided that the noise and dust complained of “may be deemed incidental to the proper operation of an airport and thus cannot constitute a nuisance.”\(^{56}\)

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\(^{51}\) Supreme Court of Georgia, 193 Ga. 862, 20 WS.E. 2nd 245 (1942).

\(^{52}\) Ibid.

\(^{53}\) 178 Ga. 514, 173 S.E. 817 (1934).

\(^{54}\) 116 Ga. 64, 42 S.E. 315 (1902).

\(^{55}\) Ibid.

\(^{56}\) Ibid.
However, the low flying complaint was not in the same category. The judge said that flights as low as 25-50 feet above Mr. Kersey’s house were imminently dangerous to life and health and cannot be concomitant of an airport. The city should be able to get enough land sufficiently large to operate the airport without that danger.

The judge did add, however, that if the city could not get the land, and it appeared that it was indispensible to the public interest that the airport operate in its present conditions then, petitioner would be denied help.

Thus, says Coase, the problem is to determine whether “gain from preventing harm is greater than the loss which would be suffered elsewhere as a result of stopping the action which produces the harm.”

The point related directly to a world where there are “costs of rearranging rights established by the legal system.” And where the courts are making decisions based on nuisance, they are looking at the problems of the parties as economic problems and thus making determinations of how resources should be employed. Coase believes that the courts are very conscious of this and they are making comparisons between what would be gained and what would be lost and then preventing actions that will be harmful. Sometimes the Government will get involved with statutory actions. This kind of action is not always unwise, but extensive Government intervention in an economic system is not desirable and often leads to protecting those who are causing the harmful effects. And this can be carried way too far.

7. Pigou’s *Economics of Welfare*

Coase writes at length on the answer of many economists to the problem but most of it based on Pigou’s book *Economics of Welfare.*

He now discusses the conclusions Pigou comes to which are basically three conclusions reached: 1) have the factory pay for damages to property owners; 2) put a tax on the factory based on the damages caused; or 3) disallow the factory from residential areas where the factory smoke causes harm to property owners.

Coase’s main arguments against Pigou are longer than the time available. However, they are economic arguments that are analogous to the original cattle trespassing on the land. Only this time it’s the smoke that is trespassing.

8. The Change of Approach

The first point that Coase makes is that the economists who are arguing in terms of welfare economics are incorrect. What needs to be looked at is to comparisons of the value of production as measured by the market as has been discussed above. But pushed further, Coase suggests, we must even look at broader terms and that “the total effects of these arrangements in all spheres of life should be taken into account.” And Coase mentions that Frank H. Knight suggests that problems of welfare economics must ultimately be defined in terms of aesthetics and morals.

The second point is to make a determination between – the state of laissez-faire and the ideal world. It’s difficult because unless the ideal world is the same as the laissez-faire world, it’s hard to know what the ideal world is. So, Coase suggests looking at things as they are and then looking at new ideas and see if they are better or worse. Thus new ideas have relevance to what we have.

The third point is to recognize that the reason there are problems is because we start from the faulty concept of the factor of production. Meaning the physical entity that man acquires like land or fertilizer rather than a right to perform certain physical actions. We may look at a person

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owning land and using that as a factor of production but what he actually has is a right to carry on a circumscribed list of actions. The key here is that the landowner does not have unlimited rights. Certain buildings may or may not be allowed to be built. Or certain crops can or cannot be grown. The main reasons are not because of government regulation but, also, because common law may not allow it.

The central concept is: *if the rights of individuals were unlimited, in fact there would be no rights.* When we have the cost of exercising a right (that is, using a factor of production) there is always a right lost somewhere else as a consequence of that right. That right could be to park a car, build a house, enjoy a view, breath clean air, etc.

Anytime there is a change in one thing which is an improvement, it will lead to lessening of others.

Conclusion by Coase: “In devising and choosing between social arrangements we should have regard for the total effect.”

VI. Analyses and Conclusions

A. Analysis – Adam Smith

*The Theory of Moral Sentiments*\(^{58}\) was first published in 1759. A second revised edition appeared in 1761. The third edition was published in 1767, the fourth in 1774, the fifth in 1781. And these editions are basically the same. However, edition six has numerous changes. The editors of the 1976 edition, Raphael and Macfie, say that the sixth edition was, “…the fruit of long reflection by Smith on his wide knowledge of public affairs and his equally wide reading of history.”\(^{59}\) Given that Adam Smith was born in 1723 and died in 1790, he thus finished his sixth revision of *The Theory of Moral Sentiments* in his last year of life.

*The Wealth of Nations*\(^{60}\) was published on the 9\(^{th}\) of March, 1776. The second edition appeared in 1778. There are very few differences between the first two editions. The third edition was published in 1784 and there were many differences from the 2\(^{nd}\). The fourth edition was published in 1786 and few alterations were made. The fifth edition was published in 1789. It is almost the same as the fourth.\(^{61}\) Again, given that Adam Smith was born in 1723 and died in 1790, he thus finished his 5\(^{th}\) and last edition of *The Wealth of Nations* one year before he died.

THE MAJOR POINT being made is that Adam Smith wrote *The Theory of Moral Sentiments* first and subsequently wrote *The Wealth of Nations*, however, since he continued to revise both books up to one year before his death, the clear conclusion seems to be that the ideas in both books are part of a system or model.

Therefore, in a nutshell, Smith is saying, pertaining to *The Theory of Moral Sentiments*, that a moral ethic is based on sympathy which pertains to others and also the conscience of the individual and a theoretical impartial spectator who adds a standard of the community beliefs to any ethical decision. Plus, the virtues of justice and benevolence are important. In addition the concept of selfishness in *The Wealth of Nations* is quite important as a source of the drive for man to achieve and the invisible hand to affect the entire economy. In addition, the government is needed to support the necessary rudiments of commerce and society: (1) military protection

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\(^{58}\) Introduction to Adam Smith, *The Theory of Moral Sentiments*, Edited by D.D. Raphael and A.L. Macfie, Liberty Fund, Indianapolis, (1976), pg. 1

\(^{59}\) Ibid.


\(^{61}\) Ibid.
from foreign invasion; (2) protecting individuals from each other, and; (3) erecting public education.

*The Theory of Moral Sentiments* logically has to be the underlying thesis of *The Wealth of Nations* or *The Wealth of Nations* would have no meaning in that the selfish egocentric man has to be grounded on benevolent ethic or the society would not be the society Smith envisioned.

To verify this very significant statement, in the *last page of each of the editions of The Theory of Moral Sentiments*, Adam Smith says:

“I shall *in another discourse* endeavor to give an account of the general principles of law and government, and of the different revolutions they have undergone in the different ages and periods of society, not only in what concerns justice, but in what concerns police, revenue and arms, and whatever else is the object of law. I shall not, therefore, at present enter into any further detail concerning the history of jurisprudence.”  

In addition, in his Advertisement which was added *only* in the sixth edition of *The Theory of Moral Sentiments* Adam Smith says:

“In the last paragraph of the First Edition of the present work, I said that I should in *another discourse endeavor* to give an account of the general principles of law and government, and of the different revolutions which they have undergone in the different ages and periods of society; not only in what concerns justice, but in what concerns police, revenue, and arms, and whatever else is the object of law. In the *Enquiry Concerning the Nature and Causes of The Wealth of Nations*, I have long projected, I have hitherto been hindered in executing, by the same occupations which had till now prevented me from revising the present work. Though my very advanced age leaves me, I acknowledge, very little expectation of ever being able to execute this great work to my own satisfaction; yet as I have not altogether abandoned the design, and as I wish to continue under the obligation of doing what I can, I have allowed the paragraph to remain as it was published more than thirty years ago, when I entertained no doubt of being able to execute everything which it announced.”  

The point that is being made, by including at length what Adam Smith said, is to verify to the reader that Adam Smith intended to write a trilogy (1) *The Theory of Moral Sentiments*, (2) *The Wealth of Nations*, and (3) *Jurisprudence*. If this is so and this author thinks that Adam Smith has clearly made that statement, then a sound conclusion seems to be that *The Theory of Moral Sentiments* is the fundamental foundation to *The Wealth of Nations* and in the end the ethic and benevolence are both dependent on law.

If that is the case, then what is the problem that Smith has with Mandeville? It is assumed that Smith depends on Mandeville among others to develop the egocentric man. And this author is convinced that is so. Then what is Smith’s problem with Mandeville and why is it important? Smith does not disagree with the egocentric man that Mandeville propagates but disagrees with the extreme words used by Mandeville to make his point. They both love the egocentric man but Mandeville is so unhappy with the utopian writers and other writers who preach that the best state is a society where government will provide for all, that he exaggerates in his *Allegory of the Bees* to prove his point. For Mandeville, it is important to use these terms to jolt the reader into seeing how weak and inappropriate a utopian society is. And, Adam Smith is actually acknowledging Mandeville’s powerful allegory but is afraid the ordinary person will get confused by the language and subtlety of the underlying theme.

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63 Ibid., Advertisement (placed before the table of contents in the book).
Given all of the above, this author is saying that Adam Smith’s theory of a society is one with the ethical model from *The Theory of Moral Sentiments* which is the underlying theme of the classical economic model and the egocentric man of *The Wealth of Nations*. Moreover, *The Wealth of Nations* leads to a natural law theory of jurisprudence which depends upon justice and ends with the underlying theme of *The Theory of Moral Sentiments*, the highest ideal of benevolence.

B. Analysis—Coase

It seems unnecessary to repeat the arguments given supra by Coase. However, this analysis is presented to show Coase’s major points pertaining to the ethic. In the “Theory of the Firm” written in 1937 the breakthrough in the article is that Coase defines the modern firm in an economic society very practically and much differently from the firm in the classical economic model. To him the analysis of the entrepreneur in the classical economic model doesn’t work as it was theorized. Adam Smith assumed that the large corporation would not be created because a large corporation could not possibly be created and maintained in a perfectly competitive society.

Coase presents a new definition of the firm in the 1937 article which most business theorists of today have accepted. However, the ethic is not discussed. But, the ethical problems of the large monopolistic corporations have become quite clear and were being discussed in the 1930’s by Berle and Means in the 1933 book *The Modern Corporation and Private Property*, and, of course, Keynes in 1935 with *The General Theory* raises many other issues.

Now in “The Problem of Social Cost,” the 1960 article, Coase does discuss the ethic head on. And his answer is an economic one to be decided by the courts. Thus, he follows the critique of Adam Smith that the courts will have to decide since they follow the Greek ideal of law. Moreover, Coase agrees with Smith that in the end what is the most beneficial to the whole must be the answer that the courts will give. _Thus their thinking merges._

Smith did not write his jurisprudence book, therefore his details of how the law should handle the problems are not discussed. But Coase is quite careful in the analysis. He introduces it with the economic principle of the cattle and the crops. This becomes in Coase’s words:

> “the analysis has been confined, as is usual in this part of economics, to comparisons of the value of production, as measured by the market. But it is, of course, desirable that the choice between different social arrangements for solution of economic problems should be carried out in broader terms than this and that the total effect of these arrangements in all spheres of life should be taken in account.” And then Coase says that Professor Knight constantly asserts that problems of welfare economics generally dissolve into a study of aesthetics and morals.

The point to all of this, is to question whether we will follow a state of laissez-faire or some kind of ideal world. And Coase says that the ideal world looks better than the laissez-faire world but it’s not as easy as it looks and sounds because, we have never figured out how to get to the ideal world from where we are.

_Coase’s solution is to look at what we have._ We often talk in terms as if a person who owns land therefore possesses the right to do certain things. But the rights of a landowner are not unlimited and never can be. And, moreover, government regulation is not necessarily the way to accomplish it. The common law already has ways of doing it. _If under any legal society a person had unlimited rights the result would be no rights at all._ Any cost of exercising a right

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(that is, using a factor of production) is always a loss that is lost somewhere else as a consequence of the exercise of that right. Any change in the system that exists will lead to limited improvements for some and a lessening of improvements for others. Always there are costs which are the consequence of particular social arrangements no matter if it’s in the market or in a government agency. Always costs arise even if there was a change to some new system, whatever it is.

A few important comments and consequences about the concepts are in order at this point. Carved over the entrance to the Yale Law School quadrangle is the sentence: “The Law is a Living Growth, Not a Changeless Code.” That is the ideal that Judge Benjamin Cardozo presented in his lectures at the Law School of Yale University on December 1923 called The Growth of the Law.\(^\text{66}\) Although the English legal system had been developing for hundreds of years, especially since 1066 A.D., no one really had made an analysis of the way it developed. Always, before 1900, no professor of law or theorist of law had presented to law students anything but positive law. That meant that law was rules and principles, the true doctrines, the correct definitions.

Cardozo had been a judge in the Court of Appeals of New York for years without realizing how judges were caught in a web of making decisions which actually slowly evolved. It was a process of change that developed as the society and the ideas and ideals of society changed. No one decided to make this happen. It happened because of the nature of the way judges made decisions, which were based on previous decisions which literally came from particular ideals that kept changing imperceptibly as the years progressed. It was a unique judicial process. When one looked back on the decisions made, the laws could be seen in retrospect actually changing as each case was decided.

A superb example of the judicial process is well illustrated when Justice Cardozo wrote the decision in the famous McPherson v. Buick Motor Co.\(^\text{67}\). In that case McPherson sued Buick Motor because a defective wheel collapsed and McPherson was injured. Buick maintained, since it did not sell the auto to McPherson but a dealer did, that Buick was not liable because there was no privity between the parties. This meant that there was no direct contract between Buick and McPherson. A group of five cases originating in 1852 had been decided on this issue. No one had seen or planned the trend. It happened as a process of judicial reasoning that could be traced over the years from the original notion to the present notion developed from 1852 to the present Buick case in 1916. In his decision, Judge Cardozo analyzed it beautifully:

“The principle that the danger must be imminent does not change, but the things subject to the principle do change (in this case from stage coaches to automobiles). They are whatever the needs of life in a developing civilization require them to be.”\(^\text{68}\)

It is this same judicial process that is happening in the field of property law and economics that Coase has traced. Moreover, he has suggested that it should continue because of the present needs of the society. Obviously, the point is that the ethic is changing.

In 1935 E. Merrick Dodd (corporate law professor at Harvard Law School) was asked to speak at the dedication of the new law school at the University of Chicago. At the time, he was in a debate with Adolph Berle (the corporate law professor at Columbia Law School) in the Harvard Law Reviews of 1931-1932. His speech at the University of Chicago was published in the Chicago Law Review as an article continuing the debate. It was entitled “Enforcement of

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\(^{68}\) Ibid.
Duties of Corporate Managers.” He argued that we dare not abandon the notion that we must have some kind of legal principle to enforce social responsibility. And then in a famous footnote he said that the notion of corporate social responsibility must be looked on favorably by the judges in our legal system and the judges will have to begin to decide in favor of social responsibility so that a common law may develop as decisions are rendered case by case. And this is what Coase is proposing in his position on the cases that need to be decided with an economic basis and a benevolent flavor.

It is also interesting to note that the writings of the modern F.A. Hayek, the Nobel Laureate in economics for 1974, have become equivalent to Mandeville and his Fable of the Bees. Like Mandeville, Hayek is a master of hyperbole. And hyperbole is used by both Mandeville and Hayek to seriously show the beauty of economic theory. Hayek, in his book The Fatal Conceit, marvelously gives the economic thesis:

“The market is the only known method of providing information enabling individuals to judge comparative advantages of different uses of resources...whether they so intended or not, they serve the needs of distant unknown individuals...”

Further, Hayek continues:

“These issues are highly abstract, and are particularly hard to grasp...it took me a long time...to state my theories...”

Of course these are clearly Adam Smith’s egocentric individual and invisible hand concepts, from The Wealth of Nations.

Finally, the Nobel Laureate in Economics for 1972, Kenneth Arrow, in The Limits of Organization, has this to say about an economic analysis of the law cases. The cases must be analyzed as an ethic which is a group ethic that is made for the benefit of all (clearly what Adam Smith asserts in The Theory of Moral Sentiments and Coase asserts in “The Problem of Social Coast”). And when one looks at these decisions there may be compromises which are necessary for the benefit of all.

Arrow is careful to show a problem that always arises from group decisions. They often become ingrained in the consciousness of society and it becomes difficult to be perceived as wrong. Arrow’s example is in the Iliad where Agamemnon raises the question of whether the Greeks should abandon the siege of Troy. Odysseus makes them realize that such a question is irrelevant because they would be breaking their commitment. However, Arrow says that the great tragedies of history are those where “this sense of commitment to a past purpose which reinforces the original agreement precisely at a time when experience has shown it must be reversed.”

Arrow’s main point is that the doctrine which Coase presents, that the concept should be economic and taken legal case by legal case is very important to the beneficial nature of the argument. And we should carefully take this action as long as we understand, like all actions, the consequences may not be expressly clear:

70 Ibid.
72 Ibid., pg. 85.
73 Ibid., pg. 88.
75 Ibid., pg. 29.
“...but to retain our full rationality we must sustain the burden of action without certitude, and we must always keep open the possibility of recognizing past errors and changing course.”

Thus, the second part of Arrow’s point is not to deny the main point of the economic and beneficial analysis of these actions but to warn of dangers once there is such an understanding and it is rationally accepted.

C. Final Conclusion

After slicing through everything and recognizing that the laissez-faire ethic is fundamental, the Adam Smith ethic allows a touch of benevolence to bleed through for the benefit of all.

After slicing through everything and recognizing that the laissez-faire ethic is fundamental, the R.H. Coase ethic allows a touch of benevolence to bleed through for the benefit of all.

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