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Adam Smith, Collusion and “Right” at the Supreme Court

David M. Levy* and Sandra J. Peart**

*Adam Smith’s views on collusion were injected into the Supreme Court’s ruling in *Bell Atlantic v. Twombly* as Justice Stevens puzzled over why a collusive action might be viewed as “right.” Motivation by a desire for approbation provides Smith’s explanation for the existence of well-functioning groups. “Right” action is approved by the group. The question is what happens when the groups are in conflict. For Smith, collusion is one instance of the larger problem of faction in which a small group organizes to exploit the larger society.*

I. INTRODUCTION

Adam Smith acquired yet another fifteen minutes of fame when his views on collusion were injected into the Supreme Court’s ruling in *Bell Atlantic v. Twombly*.¹ Writing for the Court, Justice Souter footnotes the use of Smith’s argument by the dissent. Souter suggests that Smith’s remark about the collusion of masters was “tongue-in-cheek:”

the dissent playfully suggests that they conspired to restrain trade, an inference said to be ‘buttressed by the common sense of Adam Smith.’ If Adam Smith is peering down today, he may

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¹ *Bell Atlantic v Twombly*, 127 S Ct 1955 (2007).

be surprised to learn that his tongue-in-cheek remark would be authority to force his famous pinmaker to devote financial and human capital to hire lawyers, prepare for depositions, and otherwise fend off allegations of conspiracy; all this just because he belonged to the same trade guild as one of his competitors when their pins carried the same price tag.²

Writing in dissent, Justice Stevens quotes the famous passage from Smith, and suggests that in fact Smith’s judgment concerning collusion may, in this instance, be on target:

Many years ago a truly great economist perceptively observed that ‘[p]eople of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.’ I am not so cynical as to accept that sentiment at face value, but I need not do so here. Respondents’ complaint points not only to petitioners’ numerous opportunities to meet with each other,³

Justice Stevens then notes the famous puzzle: when a company agrees to collude with its rivals, it faces the immediate incentive to cheat. So the puzzle is, what’s the right thing to do:

also to Notebaert’s curious statement that encroaching on a fellow incumbent’s territory ‘might be a good way to turn a quick dollar but that doesn’t make it right.’ What did he mean by that? One possible (indeed plausible) inference is that he meant that while it would be in his company’s economic self-interest to compete with its brethren, he had agreed with his competitors not to do so.⁴

Two questions follow immediately. First, did Smith’s remark reflect a serious statement about the prevalence of collusion, i.e. is Justice Stevens interpreting Smith correctly? Second, supposing Smith did in fact see cooperative behavior as some sort of norm, how was cooperation (or collusion) enforced in his system? Today, economists might answer the latter question by presuming a punishment system is in force with repeated interactions. Expected payoffs to cheating alter with repetition, making it no longer profitable to renege on cooperative agreements. All is handled in terms of expected monetary

²Id at 1971, n 12 (internal citations omitted).

³Id at 1985 (citing Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, in R. Hutchins and M. Adler, eds, *Great Books of the Western World* 55 (1952)).

⁴Id at 1986 (internal citations omitted).

rewards. "Right" actions are determined by the highest expected payoff. We suggest that Smith thought otherwise.

Consider first cooperative behavior among the masters. Cooperation can of course be good for society. But when small groups cooperate at the expense of large groups, a problem that greatly troubled Smith, the outcome is a less happy one. That Smith believed the masters were "always and everywhere" in a combination is readily apparent in the *Wealth of Nations*.⁵ There, he considered the problem of wage determination in various societies, supposing a group bargaining situation with masters pitted against workmen. The combination of masters is, he wrote, "the natural state of things:"

We rarely hear, it has been said, of the combinations of masters, though frequently of those of workmen. But whoever imagines, upon this account, that masters rarely combine, is as ignorant of the world as of the subject. Masters are always and everywhere in a sort of tacit, but constant and uniform combination, not to raise the wages of labour above their actual rate. *To violate this combination is everywhere a most unpopular action, and a sort of reproach to a master among his neighbours and equals.* We seldom, indeed, hear of this combination, because it is the usual, and one may say, the natural state of things which nobody ever hears of.⁶

The problem of small groups exploiting large ones is known as the problem of factions. The faction of immediate concern in the chapters on wages and growth in the first book of the *Wealth of Nations* are the masters.

II. "RIGHT" AS A SUPPORT FOR COLLUSION

The question that follows, is how the faction is maintained when there may be monetary rewards to cheating? Smith's answer was that rewards accrue in two incommensurate dimensions, money and approbation, and people like both money and approbation. People interact using language. These interactions yield two sets of rewards, money and approbation, which is carried by language. Approbation results from following a norm of reciprocity (from not cheating on agreed-upon actions); disapprobation results from violating it (from cheating). Thus, the rewards to co-operation are augmented by the approbation that results when a person follows the group norm. For

⁵ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Methuen 1904).

⁶Id at i 8, §13 (emphasis added).

individuals who desire both approbation and income, co-operation satisfies what we have called "katallactic rationality."⁷

This provides the solution to Justice Stevens' puzzle. While a master might earn a bit more if he were to deviate from his agreement with the masters, he would suffer their disapproval and be shunned by the group to which he belongs. So, the masters who co-operate are rewarded by the approval of their equals; their conduct would be approved, that is, said to be "right." Of course, when we take the larger group into account, this "right" conduct might well be bad for society as a whole. The problem of factions is that the cooperation of the small group occurs at the expense of a larger group.

In Smith's account, it is unclear whether the combination will succeed or not. What we do know is that the masters have a considerable advantage in his view because they are fewer and richer than the workmen.⁸ At the same time, combinations might not survive growth in the demand for labor. In America, Smith finds that the continual increase in the demand for labor makes employer collusion impossible so that the condition of the working class improves dramatically.

This raises the obvious question. If the workers' condition improves but that of the masters deteriorates, is society better or worse off? One way to decide is to count those helped and those harmed and to appeal to the reader as impartial spectator:

Is this improvement in the circumstances of the lower ranks of the people to be regarded as an advantage or as an inconveniency to the society? The answer seems at first sight abundantly plain. Servants, labourers and workmen of different kinds, make up the far greater part of every great political society. But what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that, they who feed, cloath and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, cloathed and lodged.⁹

Smith goes on to emphasize the importance of economic growth for the well-being of the children of the poor¹⁰ and the influence of children on judgment.

⁷ Sandra J. Peart and David M. Levy, *A Discipline without Sympathy: From Median Well-Being to Mean Well-Being*, 38 *Can J Econ* 937, 937-54 (2005).

⁸ Smith, *Wealth of Nations* at i 8, §12 (cited in note 5).

⁹ *Id* at i 8, § 35.

¹⁰ *Id* at i 8, § 36.

III. CONCLUSION

A staple result of experimental economics is that talk supports co-operation in social dilemma games.¹¹ Why this is so is less clear to modern economists. The impact of language on choice, which Smith developed at great length, is now receiving a modicum of professional attention.¹² People, unlike dogs, trade because they have language and a concept of “fairness.” When they select an occupation, people are willing to trade material income for the approbation of others.

Explaining co-operation is not the end of the story for Smith, since cooperation can produce bad results. Consequently, we need to consider to what end people are co-operating. What concerns Smith is the possibility that people co-operate to exploit others. The approbation which supports co-operation also supports collusion.

Motivation by a desire for approbation provides Smith’s explanation for the existence of well-functioning groups. The question, however, is what happens when the groups are in conflict? Smith’s answer, supposing that groups constrain themselves by considerations of justice, was to side with the larger group. In this supposition and conclusion, Smith was followed by utilitarians in the classical period.¹³

¹¹ R. Mark Isaac and James M. Walker, *Communication and Free-Riding Behavior*, 26 *Econ Inquiry* 585-608 (1988).

¹² See David M. Levy, *The Economic Ideas of Ordinary People* (Routledge 1992); Ariel Rubinstein, *Economics and Language* (Cambridge 2000); David M. Levy and Sandra J. Peart, *Sympathy and Approbation in Hume and Smith: A Solution to the Other Rational Species Problem*, 20 *Econ & Phil* 331, 331-49 (2004); Sandra J. Peart and David M. Levy, *The “Vanity of the Philosopher”: From Hierarchy to Equality in Post-Classical Economics* (Mich 2005).

¹³ See Peart and Levy, *The “Vanity of the Philosopher”* (cited in note 12); Peart and Levy, 38 *Can J Econ* at 937-54 (cited in note 7).