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Article *in* Journal of Economic Perspectives · February 1989

Source: RePEc

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Journal of Economic Perspectives—Volume 3, Number 4—Fall 1989—Pages 195–201

Retrospectives
Adam Smith's Invisible Hands

Joseph Persky

Economists of today possess an undervalued inheritance bequeathed to them by social scientists of the past. While economists frequently refer to "the invisible hand" or "dependency theory" or "Henry George's theory of taxation," they are often only dimly aware of the history and context behind these expressions. This feature will discuss various topics in the history of economic thought. At a minimum, such discussions should enrich and deepen the workaday dialogue of economists. But in addition, they should often cast a new light on ongoing issues.

"Retrospectives" seems a particularly fit name since it underscores the historical nature of the economic perspectives to be considered. Of course it also echoes the title of Mark Blaug's famous book, *Economic Theory in Retrospect*. This feature will appear irregularly, perhaps in every other issue or so. If you have comments or criticisms about this column or suggestions for future topics (or authors?), please write to: Joseph Persky, c/o *Journal of Economic Perspectives*, Department of Economics (M/C 144), The University of Illinois at Chicago, Box 4348, Chicago, Illinois, 60680.

Introduction

After more than two centuries, Adam Smith's famous simile comparing the market system to an invisible hand continues to convey the essential message of Anglo-American political economy. In fact, Smith's buoyant optimism in the efficacy of his system of "natural liberty" has a quite modern ring in this age of deregulation, free trade and perestroika. Despite the fact that much economic work in recent

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decades has focused on specifying the multitude of conditions necessary to squeeze Pareto optimality out of general equilibrium, economists continue to invoke the invisible hand with considerable abandon.[1] For many the seductive idea of the invisible hand has mutated from analysis to mythology. One historian of thought has gone so far as to see in the invisible hand traces of Faustian mysticism. Like Goethe's Mephisto, the invisible hand conjures up "part of that power, not understood,/ Which always wills the bad, and always works the good."[2]

Given this almost transubstantial view of the invisible hand, it may come as something of a shock to discover that Adam Smith required a few awkward and historically specific assumptions to make his argument. Apparently, invisible hand stories have never been all that easy to describe, as a perusal of Smith's original text demonstrates.

A Fortunate Coincidence

Smith explicitly considered the invisible hand only once in *The Wealth of Nations* (although he also used the phrase in his *Theory of Moral Sentiments* in a somewhat different context.)[3] The famous passage occurs in Chapter II of Book IV, page 423. Although the main purpose of the chapter is to make an argument against import duties, the critical paragraph is concerned with the social benefits to be derived from the free movement of capital. In case you don't keep your *Wealth of Nations* by the bed, here is the passage:

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He 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 a manner as its produce may be of the 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 worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the 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. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

[1]Hahn (1982) provides a readable review of this list. Greenwald and Stiglitz (1986) demonstrate the pervasiveness of market failures associated with incomplete markets and imperfect information.

[2]Henry W. Spiegel makes this comparison and presents the quote from Faust in "Adam Smith's Heavenly City," in O'Driscoll (1979), p. 112.

[3]For a succinct and sophisticated introduction to the history of the invisible hand see the article by Karen I. Vaughn in *The New Palgrave Dictionary of Economics* (1987), pp. 997–998.

For those of us who identify the invisible hand with Pareto efficiency (as in Samuelson's "invisible hand theorem"), there is something a bit off the point in Smith's discussion. In particular, the references to "security" seem too specific and too (historically) contingent to a modern economist. But Smith has a hidden agenda here: He is trying to anticipate a potential criticism of his broader argument for economic freedom. The criticism was that the capital of British merchants, once drawn into international commerce, would prove a drain on the domestic economy. Whatever economists of today may think about the matter, Smith found this proposition plausible, plausible enough to unglove the invisible hand.

Smith wished to demonstrate that owners of capital, when left to themselves, would inadvertently promote the public interest by pursuing their own private interests. But what exactly was "the public interest"? Smith was not especially clear on this point. In his most explicit statements the public interest is identified with maximizing the "annual revenue of society." But at other points in *The Wealth of Nations*, the public interest is presented as synonymous with the "general industry of the society" or even "employment." It is this latter definition that dominates Smith's discussion of the invisible hand. Thus, he wanted to show that privately motivated decisions as to the use of private capital will maximize the general industry or employment of a country.

Smith (p. 421) begins the discussion leading up to the invisible hand with his explanation of how the capital of a society is related to overall employment and "general industry."

> The general industry of the society never can exceed what the capital of the society can employ. As the number of workmen that can be kept in employment by any particular person must bear a certain proportion to his capital, so the number of those that can be continually employed by all the members of a great society must bear a certain proportion to the whole capital of that society, and never can exceed that proportion.

Now Smith had no doubt that if individuals employed their capital in the domestic economy, it would be invested in a way that would create value for the economy. As he put it (pp. 422–23), "[E]very individual who employs his capital in the support of domestic industry, necessarily endeavors so to direct that industry, that its produce may be of the greatest possible value." But this argument is limited to domestic industry, because if capital was employed outside the nation, it wasn't obvious that this would do much good for the domestic economy. Because of this concern, Smith needed to argue either that foreign investment would help the domestic economy in some way, or that capital would stay close to home and thus support domestic industry.

Smith was not seriously concerned that capital would flee into direct investments abroad. Indeed, he doesn't even consider the possibility. However, he was very worried about capital used in international commerce. In particular, he had previously argued (Book II, Chapter V, p. 351), in his discussion of the "employment of capitals" that capital invested in the foreign carrying trade "is altogether withdrawn from supporting the productive labour of that particular country, to support that of some foreign countries." His basic idea was that the capital of merchants freed up other capital to finance direct production. The merchant in buying his inventory allowed the producer to reinitiate production. At the same time the merchant allowed buyers to hold off their purchases to the most convenient time thus allowing them to also make productive use of their capital (p. 342). However, when either buyer or seller was from abroad, the gain made possible by merchant capital accrued outside the nation. Given his belief that merchant capital employed in foreign trade did not benefit the domestic economy, Smith felt it was necessary to show that the pursuit of private gain would not drain off inordinate amounts of capital into foreign trade. Smith (p. 421) argued this point by asserting a basic proposition concerning investor behavior: "[E]very individual endeavours to employ his capital as near home as he can, and consequently as much as he can in the support of domestic industry; provided always that he can thereby obtain the ordinary, or not a great deal less than the ordinary profits of stocks."

The first thing to note here is that Smith conditions his conclusions on the rough equality of profits at home and abroad. Smith doesn't tell us whether capital drawn abroad by higher than domestic profits is to be regretted. He seems just to assume that rough equality is the more likely situation. However, he does offer a rationale (p. 422) for why under these conditions capital will favor domestic trade. At home a merchant "can know better the character and situation of the persons whom he trusts, and if he should happen to be deceived, he knows better the laws of the country from which he must seek redress." For this reason, "Home is in this manner the center, if I may say so, round which the capitals of the inhabitants of every country are continually circulating, and towards which they are tending, though by particular causes they may sometimes be driven off and repelled from it towards more distant employments."

All of this might seem a bit academic, if it didn't represent the context of one of the most quoted passages in economics. Smith's hypothesis of a strong private concern with achieving "security" and a consequent aversion to foreign investment is as much a part of the invisible hand mechanism as the basic desire for profit.

Say and Ricardo

These wrinkles in Smith's original invisible hand receive little attention today. However, among the second generation of classical economists they stirred considerable discussion. Smith's able French disciple, Jean-Baptiste Say, took up the argument and expressed it with a characteristic bluntness. If economists of today read Say as well as Smith, we might not have lost sight of the role of domestic security.

In his *Treatise on Political Economy*, Say devoted a short chapter to a discussion "Of the Employments of Capital Most Beneficial to Society." Expanding on Smith, Say makes the broad social question quite explicit: "To the capitalist himself, the most advantageous employment of capital is that, which with equal risk yields the largest profit; but what is to him most beneficial, may perhaps not be so to the community at large." The reason for concern is clear: "[C]apital has this peculiar faculty, that, besides being productive of a revenue peculiar to itself, it is, moreover, a means, whereby land and industry may generate a revenue likewise." At least potentially, Say (1832, pp. 357–359) argues, the placement of capital "is an exception to the general principle, that what is the most productive to the individual, is so to the community at large."[4] In particular, capital employed abroad may well pay the highest return, but for the time used elsewhere be unable to mobilize domestic resources.

Does this mean we are to give up our confidence in the invisible hand? Not in the least. According to Say (1832, p. 358), nature requires no help from governmental regulators to keep capital in its most socially useful activities:

> It is very fortunate, that the natural course of things impels capital rather into those channels, which are the most beneficial to the community, than into those which afford the largest ratio of profit. The investments generally preferred are those that are nearest home.... The owner of a capital, especially of a moderate one, will embark it rather under his own superintendence, than in distant and remote concerns.

For Say the security motive gets virtually equal billing with the profit motive in guaranteeing the wealth of nations. For him, as for Smith, both forces were "natural."

Unlike Say, David Ricardo was quite hostile to Smith's analysis of merchant capital. More sympathetic to commercial activities, Ricardo (1821, p. 339) went out of his way to deny Smith's claims about the impotence of capital employed in foreign trade. Nevertheless, Ricardo was not immune to the broader logic of Smith's concern. In the midst of his famous discussion of comparative advantage, Ricardo tells us that if Portugal can make both wine and cloth significantly cheaper than England, then it would be in the interest of English capitalists and consumers in both countries if the capital and labor of England could be moved to Portugal. But of course it might not be in the interest of the nation. Thus Ricardo reassures us, "Experience, however, shows, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connections, and entrust himself, with all his habits fixed, to a strange government and new laws, check the emigration of capital." Here is the basic Smithian argument and again it is all for the better. Although hardly as enthusiastic as Smith and Say, Ricardo (p. 117) owns that "these feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations." Even Ricardo perceived a higher good in the natural inclinations that keep capital at home.

It is interesting that Ricardo explicitly contrasts the situation pertaining between England and Portugal to that between London and Yorkshire. In the latter case,

[4]It is of some interest that Say's American editor, Clement C. Biddle, took strong objection to Say's argument. Biddle contended (Say, 1832, p. 359) that "there is *no* exception to the general principle that what is most productive for the individual is also so to the community at large."

capital flows freely whenever a difference in profits obtains. While a few sentimental Yorkshiremen might regret the exodus of the region's resources, such a development earns no pity from Ricardo. Again it seems that the national boundaries endorsed by the invisible hand are just right; not too big, not too small.

Of States and Markets

The beneficence of Smith's invisible hand is couched in terms very specific to the historical circumstances of the late 18th and early 19th centuries. In particular, as distance becomes more manageable, as transport charges fall, as conducting business abroad becomes more secure, the incentive to keep capital at home must weaken. And then given Smith's concern with employment and the general industry of the nation, some constraint on capital movements might seem quite logical. Smith himself was an avowed nationalist. It is not clear at all what Smith's attitude toward the modern multinational corporation would be. And one suspects he would have been sympathetic to Margaret Thatcher's reluctance to merge Britain into Europe. On the other hand, it is easy to imagine a time not many centuries before Smith wrote, when a desire for security restricted Yorkshire merchants to the immediate countryside, a much smaller geographic area than Smith would have thought optimal. In this case the invisible hand might work too well, leaving the national economy unintegrated and inefficient. For a nationalist like Smith, invisible hands can be a very delicate business.

If economists choose to reject Smith's nationalism, we may approach the entire question from a more evolutionary perspective. We know that the technologies of transportation and communications change over time. These changing technologies help to shape the behavior of investors. Moreover, these technologies strongly influence political loyalties and political boundaries. It seems reasonable to suggest that the relation between national boundaries and investor behavior is something more than accidental.

Such observations bring to mind the geopolitical theories of Gustav Schmoller and his German historical school. Where Smith took investors' greater confidence in their national markets to be an act of providence, Schmoller saw this psychology as part of a political and economic evolution. At each stage of technological development, potential economic gains from integrating broader markets were a spur to political action. In this historical context, Schmoller (1884, p. 2) argued, "mass sentiments and mass conceptions" would "gravitate" around first the town, then the region and then the nation.

While Schmoller's approach is suggestive as positive economics, it is not clear what normative meaning can be read into such an evolutionary process. Schmoller makes a few references to the "life of the race or nation." He seemed to think that the succession of governmental forms was an efficient means of encouraging economic development, but the argument is rather vague. More explicit in this respect is Mancur Olson's recent work on *The Rise and Decline of Nations* (1982). Olson sees territorial expansion as useful in breaking down the entrenched special interests that grow up in any stable political system. Geographic growth serves to shake things up and thus fosters efficiency. But Olson sees no compelling forces that guarantee an optimal pace to this process.

The wealth of nations is still a central concern of economics. Smith's insight that a system of broad economic freedom might facilitate the development of national economies, through no intention of the participants, is still a plausible proposition. However, it is clear that economic freedom alone is not sufficient to guarantee the desired outcome. The relation between self-interest and social welfare is mediated by a host of economic, political and social institutions. This point was well expressed a long time ago by Edwin Cannan, who suggested: "[T]he working of self-interest is generally beneficent, not because of some natural coincidence between the self-interest of each and the good of all, but because human institutions are arranged so as to compel self-interest to work in directions in which it will be beneficent."[5] In this context, economists would be naive to assume that those political and social institutions are always optimum optimorum. The invisible hand is of great importance, not because it is the last word in social policy, but because it suggests such a rich range of economic issues. Not the least of these is the still only little understood influence of political boundaries on economic behavior.

■ *Thanks for helpful comments from Gib Basset, Bill Gramp and Will White. Timothy Taylor, Carl Shapiro, Joe Stiglitz and Gavin Wright all added perspective to the argument.*

[5]This passage is quoted by Pigou (1932), p. 128. Pigou cites Cannan's *The History of Local Rates*, p. 176.

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