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Another Distortion of Adam Smith: The Case of the "Invisible Hand"

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A NEO-LIBERAL DISTORTION OF ADAM SMITH: THE CASE OF THE "INVISIBLE HAND"

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Abstract

This paper addresses a major omission in the way textbook writers and journalists utilize Adam Smith's concept of the "invisible hand" to make Adam Smith an intellectual precursor of modern neo-liberal economic policy. Specifically, the paper addresses the use of the concept of the "invisible hand" by Adam Smith to address two major issues in the debate over neo-liberal policy: the international flow of capital and its role in the location of investment projects and the inequality in the distribution of income that might result from certain policies.

The neo-liberal mantra about Adam Smith's invisible hand asserts that so long as there is sufficient competition and no government intervention beyond the protection of life, liberty and property, the pursuit of individual self interest will result in an improvement in the aggregate well being of society as a whole. This is true even if investments are made overseas and if economic inequality increases. Aside from some contributions to the professional literature, virtually everyone else who writes about the invisible hands ignores what Adam Smith actually said. This paper restates what Smith said when he used the term "invisible hand" in both The Wealth of Nations and in The Theory of Moral Sentiments. It places his use of the term in context to illustrate how far Smith departs from the distortions of his neo-liberal self-described admirers.

A NEO-LIBERAL DISTORTION OF ADAM SMITH: THE CASE OF THE "INVISIBLE HAND"

Michael Meeropol[*]

The head of President George W. Bush's Council of Economic Advisers, N. Gregory Mankiw, stepped into a hornets' nest when he asserted that outsourcing (the decision of American businesses to locate production facilities outside of the United States) was good for the American economy. Modern followers of Adam Smith leapt to his defense. They argued that no matter where businesses chose to make investments, if they were constrained by competition, the result would be increased efficiency (and thus economic growth) on a world scale. Even Americans who lost their jobs as a result of those business decisions would benefit. When the television commentator Lou Dobbs began the series "Exporting America," he was attacked as a "protectionist" and admonished that he should know better because he had studied Adam Smith.

Adam Smith is rightly credited with creating the first full-scale economic treatise.[1] He is also considered the father of "laissez-faire" economics because of his denunciation of the mercantilist rules and regulations that he considered inimical to the economic development of nations. Though he qualified his belief that the competitive market would maximize the growth of the "wealth of nations," he has in fact been hailed as the theoretical harbinger of modern neo-liberalism[2] (a peculiar version of laissez-faire economics to be sure[3]). The leap from Smith's work to that set of policies is unwarranted – in fact it can only be sustained by a distortion of Smith. That distortion will become apparent through an investigation of the references in The Wealth of Nations and The Theory of Moral Sentiments to the concept of the "invisible hand."

The idea of the invisible hand is quite rightly described as an essential concept for any effort to learn from human behavior, that is, to create social science.[4] However, the use of that concept both in the teaching of economics today and in the common sense understanding that is bruited about by journalists goes much further than that. Today in thousands of classrooms every year (not only in economics courses) the concept of the invisible hand is used to advance something like the following set of propositions:

1) If individuals (it may get tricky, but this concept includes both corporate entities as legal "persons" and human beings)[5] are left free to pursue their own self-interest by employing the resources they control to maximize their incomes, they will be led, as if by an invisible hand, to maximize the nation's, indeed, the

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[*] Professor and Chair, Department of Economics, Western New England College, Springfield, Massachusetts. This essay was inspired by a conversation with Noam Chomsky, whose generous comments on an earlier draft improved the final product significantly. The author also wishes to thank Carlos Liard-Muriente, Michael Enz, Schiller Casimir, Robert Pollin, Dean Baker, John McDermott and Sheldon Richman for comments and encouragement as well. Ann Meeropol read an earlier draft and her suggestions helped improve the prose. Needless to say, none of the above mentioned should be held responsible for any errors or omissions that may have remained. The title was suggested by the series of articles in the May-June (2003) Challenge headed "Distorting Adam Smith."

world's income as well as the future growth of that income through their interaction with other self-interested individuals.

2) The framework necessary for the results of proposition (1) to be achieved includes the requirement that these individuals, human and corporate, must be constrained by the process of competition – that is, individuals interacting as described in proposition (1) will achieve those positive results for society as a whole because if they do not use resources efficiently and provide the highest quality services and/or products possible, their competitors will. (This competitive process needs to occur in both factor markets and the markets for goods and services.)

3) As a corollary of proposition (2), such competition must be permitted across national boundaries. There is no justification for limiting the scope of competition in the sale of goods, services and factors of production to the national boundaries of a nation.[6]

4) In order to induce the self-interested individuals to employ their resources in the most efficient manner, government must at the very least protect people (human and corporate) in their ownership of those resources and also protect them in the enjoyment of the fruits of successful utilization of those resources. Thus, government must prohibit slavery, murder, robbery and fraud, but it also must prohibit confiscation of both privately owned capital as well as the profits from capital investments.

5) Governments must strive to minimize restrictions on the production, trading, selling and ultimate consumption of goods and services (including the services of factors of production), relying on the competition described in proposition (2) to act as the invisible hand which, history has shown, is much more efficient in identifying scarcity and preferences than any government decision-making unit.

6) The justification for the conclusion that government is less efficient than private decision-making units is because government is not subjected to the invisible hand. There are no competitive pressures on government decision-makers. There are no rewards of profit to provide incentives to be excellent and there are no punishments in the form of losses and perhaps bankruptcy to discourage inefficient, wasteful, behavior.

Since Adam Smith was specifically concerned with the various mercantilist restrictions on the behavior of economic decision-makers, it stands to reason that supporters of free markets, free trade, free flows of capital (in short, the modern neo-liberal mantra) would emphasize Smith's conclusions about the positive results of what he called the "system of natural liberty" (II, 208)[7] and suggest that his analysis forms the basis for all six of the above propositions. However, one particular element of the neo-liberal policy mix is decidedly absent from Adam Smith's discussion. In fact, when he explicitly discusses the "invisible hand" in the Wealth of Nations he emerges as totally opposed to the modern policies which support and encourage the free international flow of capital.

To demonstrate this point, it is necessary to situate the "invisible hand" reference in its appropriate context. First of all, the positive theoretical contributions of Adam Smith are developed in the first two books of the Wealth of Nations.[8] That is where we learn about the powerful dynamic created by the division of labor and the role of capital accumulation in creating wealth and economic growth. We also learn of the role of competition. Book III is a short history of agriculture in Europe up to Smith's time.[9] In book IV, Smith turns to the two "systems of political economy" that were current in his time; the one he called "system of commerce" is what we know as the doctrine of mercantilism.[10] It is in his attempt to refute mercantilism that Smith explicitly calls on the "invisible hand."

In chapter 2 of book IV, Smith argues that restraining the importation of goods from abroad so as to afford domestic producers "the monopoly of the home market" will not increase total output. The reason he gives is that output "… of the society never can exceed what the capital of the society can employ."(I: 474, 475)[11] Thus, by increasing production in the protected industry a nation merely succeeds in moving resources from other industries. The modern formulation of this analysis argues that such protectionism increases the production of goods in which the nation is relatively less efficient while decreasing the production of goods for which the nation's resources are more appropriately suited. In an effort to demonstrate that his "system of natural liberty" produces the maximum possible benefit from the point of view of increasing the wealth of a nation, Smith argues that it is totally unnecessary to force upon business owners a direction of their capital to the home market. Smith's reasoning behind this gives occasion for his use of the "invisible hand" metaphor.

Despite numerous references in the professional literature, this aspect of how Smith actually uses the "invisible hand" concept is not emphasized in the major treatises on the History of Economic Thought and is completely ignored in casual usage. In Principles textbooks and in popularizations something akin to the six propositions above is stated as the essence of the invisible hand analysis.[12] This is despite the existence of an excellent article by Joseph Persky from the 1989 Journal of Economic Perspectives.[13] Thus, an extensive quotation to revisit this issue is very much in order.

> No regulation of commerce can increase the quantity of industry in any society beyond what its capital can maintain. It can only divert a part of it into a direction into which it might not otherwise have gone: and it is by no means certain that this artificial direction is likely to be more advantageous to the society than that into which it would have gone of its own accord.
>
> Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command … the study of his own advantage naturally, or rather necessarily leads him to prefer that employment

> which is most advantageous to the society. First, every 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 …
>
> Secondly, every individual who employs his capital in the support of domestic industry, necessarily endeavours so to direct that industry, that its produce may be of the greatest possible value …
>
> 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. …
>
> 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.(I: 475-7)[14]

It is clear from this passage what Smith does NOT mean when he refers to the invisible hand. Instead of suggesting that international capital flows in search of foreign investments would be a perfectly acceptable method by which to enhance the wealth of a particular nation, Smith is making a detailed practical argument that because of the costs of supervising investments overseas, because of the time involved in turning over capital employed in foreign trade as opposed to domestic trade, the operation of the invisible hand <u>in the context of the 18th century</u> would naturally tend to favor domestic investment and therefore the economic development of the nation.

Examining Smith's discussion of the rare occurrence which will naturally draw capital to what he calls "distant" employments, we can see the main reason why he favors domestic investments over foreign. His standard for investment from the point of view of society is the amount of "productive labor" that is "maintained" by that capital.[15] Smith admits that there might be a rare occurrence where a high prospective rate of profit will be "higher than what is sufficient to balance the natural preference which is given to nearer employments."(II: 145) In this case, it is important that capital flow to these "distant employments" because the high profits being earned there are creating a situation which damages domestic business due to the high prices being paid for the products from abroad. Smith writes, "Though the same capital never will maintain the same quantity of productive labour in a distant as in a near employment, yet a distant employment may be as necessary for the welfare of the society as a near one, the goods which the distant employment deals in being necessary, perhaps, for carrying on many of the nearer employments."(Ibid.) Smith's point is that only with the outflow of capital to those foreign points of production will the increased competition reduce the prices being charged to domestic consumers of those goods. In this sentence we see both the advantage Smith believes exists from employing capital domestically as well as the limited reasons why the employment of capital in "distant" markets might be necessary. This exception is far from an endorsement of modern free capital flows.

To further illustrate this point, we should note Smith's discussion of the negative impact on Britain of the Navigation Acts, which monopolized the trade with North America for British industry and merchants. He noted that such a monopoly artificially diverts capital from activities that are more important, those that "maintain … the greatest quantity of productive labor."(II: 114) The Navigation Acts diverted capital to long distance trade with the North American colonies rather than domestic manufacturing, the home (coastal) trade, or trade with closer markets as in Europe.[16] The idea that such far flung investments would almost never be preferred by domestic investors absent the artificial acts of government led Smith to conclude that colonies, themselves were a burden from which Britain "derives nothing but loss."(II: 131)[17]

Thus, the idea that large corporate enterprises would become the most important form of business organization and that they would become multinational and voluntarily invest capital all over the world without national preference would have been inconceivable to Adam Smith. The one example of such internationally oriented enterprises in Smith's day were the various trading companies set up by European nations and granted a monopoly of trade between the home country and various colonial acquisitions particularly in east Asia but elsewhere as well. Here he is unsparing in his condemnation both of the value of such companies to the home country and of the behavior of such companies in the regions they control. On the first point, Smith argues that for some countries, the existence of such companies creates trade where no trade would exist whereas for other countries such companies restrict trade to less than would exist. He concludes, "Every derangement of the natural distribution of stock is necessarily hurtful to the society in which it takes place; whether it be by repelling from a particular trade the stock which would otherwise go to it, or by attracting towards a particular trade that which would not otherwise come to it."(II: 148)

On the second point, Smith waxes eloquently indignant, noting that the Dutch are stripping their east Asian colonies of clove and nutmeg trees, causing the population to fall.[18] In India, the British East India Company's servants were known

> …to order a peasant to plough up a rich field of poppies, and sow it with rice or some other grain. The pretence was, to prevent a scarcity of provisions; but the real reasons, to give the chief an opportunity of selling at a better price a large quantity of opium, which he happened then to have upon hand. Upon other occasions the order has been reversed; and a rich field of rice or other grain has been ploughed up, in order to make room for a plantation of poppies; when the chief foresaw that extraordinary profit was likely to be made by opium. (II: 153)[19]

The modern giant, multinational, corporation was prefigured in the institution of the joint-stock company. Smith criticized such companies because "owners" cared little about the company since they risked only their investment and members of the Board of Directors did little for the company because they knew virtually nothing about the business. Meanwhile, the actual managers of the company because they were dealing with "other people's money" were likely to practice "[n]eligience and profusions… It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers. They have, accordingly, very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one"(II: 265)

Smith went further and argued that giving such a corporation political control over a colony (he used India and the East India Company as his prime example) would produce perverse economic incentives for individuals associated with it. The directors actually would have little interest in the actual prosperity of India (and even of the company itself) but would, instead, desire to buy their way onto the board in order to arrange for "friends" to be appointed to jobs in India where they could engage in the kind of individualized plunder that the supposed "owners" back home in Britain were powerless to prevent.[20] Once such an individual had succeeded in placing friends in such potentially lucrative jobs,

> … he frequently cares little about the dividend; or even upon the value of the stock … About the prosperity of the great empire, in the government of which that vote gives him a share, he seldom cares at all. No other sovereigns ever were, or, from the nature of things, ever could be, so perfectly indifferent upon the happiness or misery of their subjects …(II: 276)

It is clear from these passages, that Smith saw the kind of world embraced by the neo-liberal analysis as not at all conducive to the "wealth of nations." He argued that absent the monopolies provided by government, investors would first look close to home for investments. Meanwhile, people in other countries would presumably do the same. When trade would occur, it would occur in ways that were mutually beneficial. These other countries would not and should not, according to Smith, be subject to the misconduct of the servants of companies like the Dutch and British East India Companies.

The world that Smith described is no more. The 19th century saw the transformation of how American society conceptualized corporations. Early in that century the grant of corporate charters was considered "a special privilege conferred by the state for the pursuit of public purposes"[21] just as in Smith's day. This changed by the 1870s as states replaced the practice of issuing specific acts of incorporation with more general incorporation laws making organizing businesses in that form more routine. Still, in 1873 in the *Slaughterhouse Cases,* the Supreme Court held that the 14th Amendment to the Constitution did not include corporations within the group of "persons" receiving "equal protection."[22] The view about the "personhood" of corporations began to change. In 1882, the Court agreed with the oral argument by a lawyer appearing before it that when Congress wrote the 14th Amendment they were explicitly interested in applying the concept of persons not just to human beings but also to corporations.[23] By the early 20th century, corporations had achieved much of the rights bestowed upon individuals by the 14th Amendment while retaining the privilege of being a "supra-individualistic entity."[24]

The Supreme Court did hold in 1904 that there were certain advantages that accrued to businesses utilizing the corporate form of organization, and it was that rationale that led the Court to permit the imposition of a corporate income tax (and this was before the Constitutional Amendment that permitted income taxation of individuals). However the principles of limited liability and legal personhood created a new concentration of power in the market economies of the world that would have dismayed Adam Smith. He had vigorously opposed such concentrations of power and privilege in the 18th century. He would have recognized that the spread of the corporate form of business organization had universalized the government granted privileges, which he had strongly criticized. In such a context, he might have been led to conclude that his "system of natural liberty" was being seriously eroded by the rise of these powerful entities.

And what about the alleged natural preference for domestic investments? Today, instantaneous communication permits investors to keep track of their capital all over the world. Thus, there is no advantage of supervision that would lead an investor in New York, to prefer a Boston location to a location in Singapore for either a factory or a customer service bank of telephones. International enforcement of the rights to private property make, for example, oil investments safe in Venezuela and Indonesia as well as in Texas (assuming the "wrong" government does not come to power in either of the foreign countries). Convertibility of currencies makes it possible for Chileans, Kuwaitis and Poles to send their capital to American, Swiss or German banks with no disadvantage whatsoever. These developments change the facts that led Smith to the conclusion that the invisible hand leads investors to the best possible employ of their personal capital so as to maximize the productive employment of their fellow citizens in domestic industry. The internationalization of capital markets, as Joseph Stiglitz made clear in <u>Globalization and Its Discontents</u> has had a profoundly destabilizing impact on the pursuit of wealth for many nations. "Western banks benefited from the loosening of capital market controls in Latin America and Asia, but those regions suffered when inflows of speculative hot money … that had poured into countries suddenly reversed. The abrupt outflow of money left behind collapsed currencies and weakened banking systems."[25] This is hardly the process Adam Smith was talking about when he touted the role of the invisible hand.

Lest we believe that the complaints about multinational enterprises raised by Smith were really complaints about government-granted monopolies in the strict sense of a one-firm industry, we should recall the important political roles of major international corporations throughout the 20th century and continuing to this day. Firestone Rubber was not granted a monopoly by the United States government for developing the rubber plantations of Liberia during the 20th century, nor did it enjoy a monopoly in the sale of rubber to American markets. However, within Liberia it did get concessions – from that government. Though the United States government did not grant a monopoly to the United Fruit company in Central America, it did come to its defense on Cold War pretexts to help overthrow the elected government of Guatemala in 1954 when that government proposed to nationalize some underutilized land owned by that company. The overthrow of the nationalist Mossadeq in Iran in 1953 is too well documented to deserve more than a passing mention, but the entire interaction between governments and international oil companies has been a central feature of the history of the Middle East with all its military and political conflicts since World War I.

That interaction continues today. The United States government has awarded a no-bid monopoly contract to the Halliburton Corporation for overseeing the reconstruction efforts of the Iraqi oil fields, and, as Adam Smith, himself would have predicted, the first evidence of overcharging and kickbacks has already hit the newspapers.[26] The complaints of Adam Smith about the actions of the Dutch and British East India Companies can find echoes throughout the 20th century as well as in the few short years of the current one if we are careful enough to look for them in their more modern forms.

SMITH ON THE DISTRIBUTION OF INCOME: MORE DEPARTURE FROM NEO-LIBERALISM

Smith referred to the invisible hand once in his earlier work The Theory of Moral Sentiments. Here he argued that despite the desire to accumulate vast riches, individuals who were in a position to do so were forced to

> … divide with the poor the produce of all their improvements. They [owners] are led by an invisible hand to make nearly the same distribution of the necessaries of life which would have been made had the earth been divided into equal portions among all its inhabitants; and thus, without intending it, … advance the interest of the interest of the society, and afford means to the multiplication of the species.[27]

Here again, we see Adam Smith's disagreement with the neo-liberal paradigm. Modern economics is predicated in part on the principle that issues of efficiency can, at least theoretically, be separated from those of equity. In other words, one can judge the efficiency of an economic situation without inquiring as to the distribution of income and well being among the population. The concept of Pareto efficiency is achieved when it is impossible to make any person better off without making at least one other person worse off.[28] This laissez faire approach to economics has often been supplemented with the view that if the nation decides (as a matter of morality) that the distribution of income in a particular Pareto efficient situation is unacceptable, then such a nation can engage in whatever redistribution of income it wishes to in order to achieve a more equitable result. However, those who make this argument usually urge that such a program of re-distribution not interfere with the way the competitive market place allocates resources. Following Henry Simons, who argued that the only correct form of taxation was an income tax which was totally neutral in terms of its effect on the allocation of resources, this argument attempts to clearly separate efforts to make the economy as efficient as possible from efforts to achieve some standard of equity in the distribution of income.[29]

Modern neo-liberalism takes the stronger position that it is virtually impossible to redistribute income without negatively impacting efficiency. This trend of thought emphasizes the incentive problems created by government redistribution activity. First of all, in opposition to Simons, it is argued that the very act of taxation based on income, especially if rates are graduated, is harmful to the incentives of workers, savers and investors. The result is a reduced supply of labor, less savings and less risk-taking than would exist absent that taxation. Second, subsidizing non-work through governmental mandated charity to the poor, especially to able-bodied adults capable of working, has a negative impact on the willingness of individuals to offer their labor in the marketplace. The availability of such subsidies might also reduce the pressure on those currently employed to apply intense diligence to the carrying out of tasks for which they were hired. Nevertheless, even according to modern neo-liberals, some minimal re-distribution of income by government is required, as the Council of Economic Advisors in the first Reagan administration concluded.[30] Because of the dangerous incentive effects, however, it was explicitly asserted during Reagan's first term that such redistribution should be limited to the "truly needy."[31] In 1994, the Republicans captured control of Congress under the banner of the "Contract with America" which had promised to re-invigorate the efforts begun by President Reagan to escape from the "failed policies of the past." The man destined to become Speaker of the House, Newt Gingrich, described those failed policies as the "redistributionist model of how wealth is created"[32] – an approach he identified as the cause of all the problems facing the US economy – and in fact the society at large.

Adam Smith on the other hand, as the above quote makes clear, believed that a relatively equal distribution of "the necessaries of life" would be in the best interest of society as a whole. In the Wealth of Nations, Smith strongly supported the need to achieve a decent standard of living for the lower ranks,[33] even going so far as to recommend that schools be set up at public expense that even the children of "the common people" could afford to attend them.(II: 306)[34] In his belief that such an equal distribution of the "necessaries of life" is essential for the well-being of society as a whole, Smith is clearly more closely aligned with the US Catholic Bishops who in 1985 issued their Pastoral on the US Economy, Economic Justice for All,[35] than with his neo-liberal admirers. In that report, the Bishops recommended a national commitment to providing all people with food, shelter, education, employment and medical care, in effect, fleshing out what Smith's "necessaries of life" actually meant in concrete terms for the late 20th century.[36] Many economists who subscribe to neo-liberalism reacted in horror to the Bishops' report. They argued that the Bishops were creating a blueprint for a "statist" solution to economic problems and that such solutions would be a prescription for more not less poverty. In short, they made the same claim Gingrich made a decade later – that the "redistributionist" approach to economic problems would only make matters worse.[37]

Instead of guaranteeing people jobs, food, medical care, etc. the neo-liberal approach is based on the idea that people should instead be guaranteed the opportunity to develop their individual skills and then be guaranteed the opportunity to offer themselves in the marketplace so they could earn the wherewithal to purchase housing, food, medical care, etc. In other words, the neo-liberal approach requires opportunity to participate fully in the market place but cannot require that government be responsible for insuring any particular result of that participation. Of course, most neo-liberals are not heartless, uncharitable ogres. As individuals they may be quite generous. However, they do not believe it is the function of government to guarantee results. At the end of the day, those individuals who are truly needy do deserve official help from the government, but it must be carefully calibrated so as not to do more harm than good, as the old AFDC system allegedly did before it was "reformed" in 1997.

Because neo-liberalism starts with a strong disapproval of official government redistribution of income, the increased inequality of income in many third world countries as a result of policies adopted over the past 20 years has not given neo-liberal intellectuals or policy-makers much pause. As Joseph Stiglitz so clearly shows in Globalization and its Discontents,[38] officials of the IMF and elsewhere continued to recommend policies that they knew would increase inequality and the suffering of lower income people in many of the countries they were advising. They believed that such "medicine" was necessary to cure what ailed those economies. By recommending reduced government subsidies, the end to government deficit spending, the reining in of inflation and turning balance of payments deficits into surpluses, the were attempting to force these countries to adopt policies that would let the invisible hand (as described above in the six propositions) work its will.

It is clear that Adam Smith, at least the Smith of The Theory of Moral Sentiments, believed that the invisible hand was already at work guaranteeing the necessities of life for the poor. How quaint Smith's idea appears today.[39] He was, of course, describing a landlord with a landed estate who could only eat so much of the food grown on it. However, his own discussion of the misconduct of the officials of the British and Dutch East India Companies showed what would be possible under certain circumstances (he believed these to be unnatural circumstances in his day and age). He noted that the Dutch seemed to have no trouble artificially reducing the production of the necessities of life so that, in fact, the population itself was declining. Similarly, the British had no problem reducing the production of food so as to increase the opium crop (destined for export). In the Wealth of Nations, Smith had come to believe that "… the silent and insensible operation of foreign commerce and manufactures gradually brought about…" a situation which permitted well off individuals an opportunity to

> … exchange the whole surplus produce of their lands, … without sharing it either with tenants or retainers. All for ourselves and nothing for other people, seems, in every age of the world, to have been the vile maxim of the masters of mankind. As soon, therefore, as they could find a method of consuming the whole value of their rents themselves, they had no disposition to share them with any other persons." (I: 437)

Thus, what appeared as the work of the invisible hand in the Theory of Moral Sentiments (written 18 years before the Wealth of Nations) was no longer operative.

Based on the totality of Smith's analysis – especially his specific examples of the role of the invisible hand and his criticisms of the international corporations of his day, one can make a very strong case that some kind of restrictions, even the "mercantilist" ones that Smith attacked in Book IV of the Wealth of Nations, may be just the kind of government actions necessary to protect national economies (even advanced economies like the US) from the depredations of the "servants" of giant corporations (recall the Enron debacle) and the destabilizing impact of "free flowing capital." Smith would also have recoiled in horror from the gross inequalities that the world has experienced in the previous two centuries, as some nations have grown extremely wealthy. Based on his belief in the importance of some semblance of equality at least in the distribution of the "necessaries of life," he would have looked at the world today and condemned it asserting, "This is not what I expected from the invisible hand." Rereading his condemnations of the inefficiencies created by joint-stock companies and the oppressions visited upon British India and the Netherlands East Indies, we do not believe it too much of a stretch to imagine that Dr. Smith, himself, were he writing today, would be supporting the efforts of the various groups and individuals who regularly gather in protest against the negative impacts of globalization, neo-liberal style.

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[1] Mark Blaug, Economic Theory in Retrospect (Cambridge: Cambridge University Press, 1985): 60.

[2] Supporters of the neo-liberal order have claimed Smith for their own: "… Smith's modern-day acolytes … [wear] ties sporting his profile. President Ronald Reagan, … Milton Friedman, Fed Chairman Alan Greenspan have felt the need for their necks and vests to demonstrate this fealty to free enterprise principles." Gerald Houseman "The Use and Abuse of Adam Smith" Challenge (May-June 2003): 109. In London, the Adam Smith Institute is hard at work promoting privatization of government services. It "… persuaded the Conservative government to sell off the railways, deregulate the buses, … outsource local government services and start to part-privatize the National Health Service and the education system." George Monbiot "On the Edge of Lunacy" The Guardian Jan. 6, 2004. For Friedman's own distortion of Adam Smith, see below, note xv.

[3] Strict laissez-faire economics would have no place for limitations on the international movement of all factors of production, including labor, yet modern neo-liberalism at least implicitly is totally supportive of migration limitations. Similarly, the extension of patent protection across international boundaries and the lengthening of copyright protection would have no place in a regime of strict laissez faire, yet modern neo-liberalism has supported increasing the scope of government granted monopolies on forms of intellectual property as evidenced by the various trade agreements proposed and negotiated during the last 15 years.

[4]The entry in the New Palgrave Dictionary of Economics argues that "The only alternative to describing social processes as the unintended by-products of purposeful human actions would be to view all social institutions and practices either as the predicted unfolding of conscious human plans or as the results of natural or supernatural phenomena beyond human experience." (Karen J. Vaughn, "invisible hand" in John Eatwell, Murray Milgate and Peter Newman, Ed. The New Palgrave Dictionary of Economics, II: 998.) It may be a bit more complicated than this. Noam Chomsky has argued that "social processes and social institutions and practices do not fall in any of the three designated exclusive categories, but in all of them and more: in part attributable to all of the following: (1) unintended by-products; (2) intended products of conscious human plans that unfold as predicted; (3) products of conscious human plans that unfolded differently from what was predicted; (4) results of natural phenomena, which may sometimes be beyond human experience but are in any event beyond human control." Private Communication with the author.

[5] See below, p. 6.

[6] This actually needs to be qualified because the principle of free movement of goods and services extends to the capital market but does not, routinely, include a proposal for free human migration. Departing from a strictly libertarian interpretation of the role of the invisible hand, (see note iii above), free market economics as taught in the United States does not support the removal of restrictions on immigration. Opponents of this departure are to be found in the Austrian school of economists as exemplified by the

work of Ludwig von Mises. See Liberalism: The Classical Tradition (Irvington, N.Y.: Foundation for Economic Education, 1995 [1962]): 136-142.

[7] All direct quotes from Smith, Adam An inquiry into the Nature and Causes of the Wealth of Nations (Chicago, U. of Chicago Press, 1976) will be referenced parenthetically in the text by volume (I or II) and page(s).

[8] See Smith, I, 1-397.

[9] See Blaug: 37-60 for a "reader's guide" to the Wealth of Nations.

[10] The other doctrine he called the "agricultural systems" by which he meant the various analyses of the physiocrats. See Smith II: 182-209.

[11] Note here that Smith is implicitly assuming full employment of resources. This is in keeping with his adherence to a rudimentary version of Say's Law (that "saving is spending"). See Blaug: 54-56.

[12] For Principles texts and History of Thought treatises, see note xiv below. For a representative example of how non-specialists utilize the concept, consider the reference to Smith's invisible hand in the Introduction to Alfred Chandler's comprehensive business history, The Visible Hand: The Managerial Revolution in American Business, (Cambridge, MA: The Belknap Press of Harvard University Press, 1977). "The theme propounded here is that modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating its resources. In many sectors of the economy the visible hand of management replaced what Adam Smith referred to as the invisible hand of market forces." (1). However, there is extensive discussion of just the point made in this essay in the professional literature. For just a few examples, see Pier Francesco Asso, "The 'Home Bias' Approach in the History of Economic Thought: Issues on Financial Globalization from Adam Smith to John Maynard Keynes," in Markets and Authorities: Global Finance and Human Choice, ed. Jochen Lorentzen and Marcellos de Cecco (Northmapton, MA: Edward Elgar, 2002): 20-47, J. Grampp, "What Did Smith Mean by the Invisible Hand?" Journal of Political Economy, Vol. 108 (2000): 441-65, E.L. Khalil, "Making Sense of Adam Smith's Invisible Hand: Beyond Pareto Optimality and Unintended Consequences," Journal of the History of Economic Thought, Vol. 22 (2000): 49-63, Samuel Hollander, "Some Implications of Adam Smith's Analysis of Investment Priorities," History of Political Economy, Vol 3 (1971): 238-64.

[13] Joseph Persky, "Retrospectives: Adam Smith's Invisible Hands" Journal of Economics Perspectives (1989): 195-201.

[14]The author consulted 10 Principles textbooks and every one of them mentioned the invisible hand as illustrating the role of competition in guiding private interests to serve public ends without revealing what Smith actually said. Some utilize the well-known quote by Smith; "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard for their own interest."(I: 18) This quote is specifically identified as illustrating the invisible hand principle even though Smith's reference to the invisible hand is hundreds of pages later in a different context. The reference to the businessman's preference for domestic investment is excised from all direct quotes from Smith and in some instances the earlier quote is run together with the truncated "invisible hand" quote. See for example, N. Gregory Mankiw, Principles of Microeconomics (NY: The Dryden Press, 1998, 145), Joseph E. Stiglitz and Carl E. Walsh Economics (3rd Edition) (NY: W.W. Norton and Company, 2002): 204 and Arthur O'Sullivan and Steven M. Sheffrin Microeconomics: Principles and Tools (3rd Edition) (Upper Saddle River, NJ: Prentice-Hall, 2003): 6. Sometimes there is just a simple statement that "… the invisible hand of the marketplace leads the economy to produce an efficient variety of goods and services, with efficient production methods as well." Ronald M. Ayers and Robert A Collinge Microeconomics: Explore and Apply (Upper Saddle River, NJ: Prentice-Hall, 2004): 7. See also Karl E. Case and Ray C. Fair Principles of Microeconomics (7th Edition) (Upper Saddle River, NJ: Prentice-Hall, 2004): 67, William A. McEachern Microeconomics (6th Edition) (Mason, Ohio: Thomson Southwestern, 2003): 39, William J.

Baumol and Alan S. Blinder Economics (8th Edition) (NY: Harcourt College Publishers, 2001): 67-68, Roger A. Arnold, Economics (4th Edition) (Cincinnati, Ohio: South-Western College Publishing, 1998): 436, Paul A. Samuelson and William Nordhaus, Economics (16th Edition) (NY: Irwin, McGraw-Hill, 1998): 30-31 and especially 201, and Campbell R. McConnell and Stanley L. Brue Economics, Principles Problems and Policies (14th Edition) (NY: Irwin, McGraw-Hill, 1999): 73. . The failure of any Principles text to pick up on Persky's article, despite the fact that it appeared in the most accessible of the American Economic Association journals represents something akin to pedagogical malpractice. It would be much more accurate, and much more revealing of the true nature of Adam Smith's analysis if textbook writers would say something like: "Even though Adam Smith used the term 'invisible hand' to specifically explain the preference of businessmen for domestic over foreign investment, common usage within the economics profession has transformed that concept into a generalized argument in favor of the idea that pursuit of private advantage when constrained by competition will lead to public benefits." Perhaps it is not too much to hope that textbook writers might be willing to make such a change once the error of their present presentation is pointed out to them. Turning to History of Thought analyses, Blaug's discussion of the "invisible hand" asserts it is "nothing more than the automatic equilibrating mechanism of the competitive market." He does allow that Smith's admitted defects in the "simple system of natural liberty" provide "sufficient ammunition … for several socialist orations," [p. 58] but he does not specifically identify the focus of the invisible hand on promoting domestic investment. Similarly, J. A. Schumpeter's History of Economic Analysis (NY: Oxford University Press, 1954: see particularly 185-94) fails to mention this specific focus. No reference to the invisible hand is to be found in the index. Robert L. Heilbroner's The Worldly Philosophers (NY: Touchstone, Simon and Schuster, 1980) identifies the invisible hand as the process whereby the " 'private interests and passions of men' are led in the direction 'which is most agreeable to the interest of the whole society'." (52). Emma Rothschild's Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment (Cambridge: Harvard University Press, 2001) devotes an entire chapter to Smith's use of the idea of an invisible hand (116-156). Though she carefully quotes both of Smith's references addressed in this article, she does not explicitly develop the points made here and in Persky's article (but see below, note 39). The entry in the New Palgrave Dictionary of Economics does includes the entire quote with its emphasis on domestic investments but then fails to remark upon it (Palgrave: 997). For popularizations, consider Milton and Rose Friedman's best-selling Free to Choose (NY: Harcourt Brace Jovanovich, 1979). Right in the beginning of the book they identify the Wealth of Nations as a statement of how "a market system could combine the freedom of individuals to pursue their own objectives with the extensive cooperation and collaboration needed in the economic field to produce our food, our clothing, our housing. … *so long as cooperation is strictly voluntary* … an individual who 'intends only his own gain' is 'led by an invisible hand to promote an end which was not part of his intentions … By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it…' " (1-2)

[15] For Smith's distinction between productive and unproductive labor, see Book II, Chapter 3. "There is one sort of labour which adds to the value of the subject upon which it is bestowed: there is another which has no such effect. The former, as it produces a value, may be called productive; the latter, unproductive labour." (Smith I, 351).

[16] See Smith, II, 111-121 for the detailed discussion.

[17] With 250 years of experience with colonialism and imperialism since Smith wrote these words, we can suggest a significant modification of Smith's assertion: Colonies (and neo-colonial relations as well) often act as massive redistributions of income within the colonial power (or the neo-colonial center). Income flows from the average taxpayer and average citizen to the specific beneficiaries of colonial and imperial activities. The on balance benefits or costs to colonial nations as a whole have been the subject of endless debate but it is hard to imagine that there would be any dispute about the role of colonialism and imperialism as an internal mechanism for redistributing income to favored sectors.

[18] "Even in the islands where they [the Dutch] have settlements they have very much reduced, it is said, the number of those trees. If the produce even of their own islands was much greater than what suited their market, the natives, they suspect, might find means to convey some part of it to other nations; and the best

way, they imagine, to secure their own monopoly, is to take care that no more shall grow than what they themselves carry to market. By different arts of oppression they have reduced the population of several of the Moluccas nearly to the number which is sufficient to supply with fresh provisions and other necessaries of life their own insignificant garrisons, and such of their ships as occasionally come there for a cargo of spices." (Smith: II: 152).

[19]Smith concluded, "In the course of a century or two, the policy of the English company would in this manner have probably proved as completely destructive as that of the Dutch."(Ibid. II: 153).

[20] The inability of the owners of the company to control the behavior of their "servants" in India is a clear early example of what has come to be known as the "principal-agent" problem. See Ibid. II, 155-157.

[21] Morton J. Horwitz, The Transformation of American Law, 1870-1960 (NY: Oxford University Press, 1992): 72.

[22] See 83 US (16 Wall.) 36 (1973): 100-105 for both the majority and a dissenting view from Mr. Justice Stephen Field. See also Horwitz: 69.

[23] The lawyer was former Congressman Roscoe Conkling. See Howard J. Graham, "The 'Conspiracy Theory' of the Fourteenth Amendment, 47 Yale Law Journal 371 (1938). In 1886, the Chief Justice explicitly stated in Santa Clara County v. Southern Pacific Railroad Company 118 U.S. 394 (1886), that "the Court does not wish to hear arguments on the question whether the provision of the 14th Amendment to the Constitution which forbids a State to deny to any person within its jurisdiction the equal protection of the laws, applies to corporations. We are all of the opinion that it does." Nevertheless, the issue was not settled by the Supreme Court until well into the next century. See Horwitz: 69-79.

[24] Horwitz: 74. Since then, there has been a rather strong tradition of dissent from this view. See for example the dissent of Justice Hugo Black in Connecticut General Life Insurance Co .v. Johnson 303 U.S. 77, 85-90 (1938) "Neither the history nor the language of the Fourteenth Amendment justifies the belief that corporations are included within its protection"; In Wheeling Steel Corp. v. Glander 337 U.S. 562, 576-581 (1949) Black was joined by Justice Douglas in a dissent arguing "I can only conclude that the Santa Clara case was wrong and should be overruled." For more examples and details see the "Model Legal Brief to Eliminate Corporate Rights" made available by The Program on Corporations, Law & Democracy (POCLAD) at http://www.poclad.org/ModelLegalBrief.cfm.

[25] Joseph E. Stiglitz, Globalization and its Discontents (NY: W. W. Norton and Co., 2003). 7. See also 64-67.

[26] See for example the Associated Press story by Larry Margasak, "Ex-Halliburton worker testifies" Springfield [Mass] Republican 14 February 2004: A5. See also "Halliburton Likely to Be a Campaign Issue" New York Times 14 February 2004: A11.

[27] Adam Smith, The Theory of Moral Sentiments ed. D.D. Raphael and A. L. Macfie (Oxford: Clarendon Press, 1976): 184-5.

[28] See Vilfredo Pareto Manual of Political Economy (London: Macmillan, 1971). Pareto's term was "optimality" but it is more appropriately described as "Pareto efficiency" because many efficient solutions are clearly sub-optimal on other grounds.

[29] See Henry C. Simons, Personal Income Taxation (Chicago: University of Chicago Press, 1987).

[30] See Economic Report of the President, 1982: 34-5 for an analysis of the relatively narrow limit of permissible income redistribution by government.

[31] Defined by two Reagan Administration aides as "unfortunate persons who, through no fault of their own, have nothing but public funds to turn to…" Robert B. Carlson and Kevin R. Hopkins, "Whose Responsibility Is Social Responsibility?" Public Welfare 39 (Fall, 1981): 10 qtd. in W. Lee Bawden and John L. Palmer, "Social Policy: Challenging the Welfare State," in John Palmer and Isabel Sawhill, Eds. "The Reagan Record (Cambridge, MA: Ballinger, 1984): 192n. This incredibly restrictive definition (no one with ANY income of their own would qualify if this quote were taken literally) actually was not applied by the Reagan Administration. In general, the "truly needy" came to be defined as those either mentally or physically incapable of working.

[32] Qtd. in Gillespie, Ed and Bob Schellhas, ed. Contract With America (NY: Times Book, 1994): 189. The full quotation from speaker-designate Gingrich reads: "It is impossible to take the Great Society structure of bureaucracy, the redistributionist model of how wealth is acquired, lll and have any hope of fixing them. They are a disaster. They … have to be replaced thoroughly from the ground up."

[33] "No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable." (Smith, The Wealth of Nations, I: 88)

[34]Smith even proposed forcing all people to attend such school by requiring "every man to undergo an examination or probation in [the more essential parts of education] before he can obtain the freedom in any corporation, or be allowed to set up any trade either in a village or town corporate."

[35] Catholic Church, National Conference of Catholic Bishops, Economic Justice for All: Pastoral Letter on Catholic Social Teaching on the US Economy, (Washington, DC: US Catholic Conference, 1986).

[36]Similarly, the United Nations Universal Declaration of Human Rights adopted over 30 years before had included the right to a job and to an education.

[37] See, for example Milton Friedman, "Good Means, Bad Ends," in Thomas M. Gannon, S.J., ed. The Catholic Challenge to the American Economy (NY: Macmillan Publishing Company, 1987): 99-106.

[38]See, for example, 12-22, 76-84.

[39] Emma Rothschild connects Smith's analysis to modern neo-liberalism at the conclusion of her chapter-long treatment of the invisible hand concept. "Adam Smith was in a secular sense a man of faith. … faith … in the mildness and thoughtfulness of most men and women. He is induced, thereby, to believe they will usually not pursue their interests in grossly oppressive ways, and that they will usually wish to live in a society in which other people are not grossly oppressed and deprived. ... This, and little more, is the foundation of the system of economic freedom. It is a pious hope as well as a shortcoming of liberal economic thought." (156)