

“The Invisible Hand.” In *The Business System: A Bicentennial View*, pp. 2-13. Hanover, New Hampshire: Amos Tuck School of Business Administration, 1977.

I hear talk of the progress of the business system in the past two hundred years, as if there had been continuous progress. There has not been. There has been progress and there has been retrogress. There have been areas in which the progress has been met, so that we stand today in a very much better position than we did two hundred years ago. But in other respects we have returned to the state of affairs as it was in Great Britain at the time when Adam Smith wrote his first great work, *The Wealth of Nations*.

There is a great misunderstanding about Adam Smith, a serious misconception of his role. Because he is known as the father of laissez-faire, because of his emphasis on the “invisible hand,” and because he explained the virtues of the price system, Smith is ordinarily regarded as if he were a defender of the status quo, a representative of the existing institutions, part of the establishment. He was anything but that. Smith was a revolutionary, one of a small minority who attacked the existing order of things. At the time he wrote in the late eighteenth century, Britain was a mercantilist state, in which the government was exercising almost as great a control over economic affairs as the United States government does now. It was a state of affairs in which there were restrictions on imports and exports, there were remnants of the guild system of the middle ages, and so on down the line. Adam Smith attacked this system. His book was a tract for reform, calling for a revolution in the way in which economic affairs were conducted. Smith, who was not a naive man, did not expect to succeed. “To expect indeed,” he said, “that the freedom of trade should ever be entirely restored in Great Britain, is as absurd as to expect that an Oceania or a Utopia should ever be established in it. Not only the prejudices of the public, but what is much more unconquerable, the private interests of many individuals, irresistibly oppose it.” Those are precisely my sentiments today.

Business enterprises are, in fact, a main obstacle to a restoration of freedom of trade. Every business enterprise claims a belief in Adam Smith’s principles for everybody else, but not for itself. The steel industry, or the U.S. Steel Corporation, takes out full-page ads to tell you how great a system free enterprise

is. It also sends its lobbyists to Washington to foster tariffs and import quotas on steel. The oil companies sing hymns of praise to the free enterprise system, but only a few years back they were in the forefront of those supporting import quotas on oil and in favor of the prorationing of oil in Texas and Oklahoma. Business enterprises do not promote and foster freedom of trade today any more than they did in Adam Smith's day. It was precisely that which Smith was referring to when he said that not only the prejudices of the public, but the private interests of many irresistibly oppose it.

The interesting thing is that Smith was wrong. He said that it was absurd to expect free trade to be established, yet free trade *was* established, though not for some seventy years after his great book appeared. It came out in 1776, and the basic step that dismantled the trade barriers and brought back free trade in Britain—namely, the repeal of the corn laws—took place in 1846. That was when free trade was established in Great Britain. In the United States a reasonable approximation to freedom of enterprise prevailed through most of the nineteenth century but not fundamentally on grounds of principle. Alexander Hamilton, our first Secretary of the Treasury and author of *The Report on the Manufacturers*, quoted or paraphrased Smith in that report in a number of places, but mostly to refute him—or, more accurately, to try to do so. He ended with proposals that Smith would have rejected out of hand. Hamilton proposed a tariff system, a system of protection for domestic industry, strictly contrary to the whole message of *The Wealth of Nations*.

Although the United States did have elements of protection throughout the nineteenth century—at least by comparison with the situation in Britain when Smith wrote, or as it is today in the United States—the United States had nearly complete freedom of trade at that time. The role of government was relatively small throughout the century. Except for the Civil War, total government spending in the United States never exceeded 10 percent of the national income, and two-thirds of that was state and local spending. Spending by the federal government never exceeded 3 percent of the national income, and most of that was for military expenditures. The major source of revenue was the tariff, which was in large part a revenue tariff, though to some extent it was also a protective tariff.

The situation is very different today. We are now drifting away—or, it would be more accurate to say, rushing away—from laissez-faire and free enterprise and toward collectivism. We have, I maintain, come full

circle with respect to policy. Government plays a nearly dominant role in the economy. Total government spending has reached 40 percent of the national income, and two-thirds of it is federal. There is hardly an action that a business enterprise can undertake which does not require the approval or the oversight of one or another of those masses of bureaucrats who check on our every activity.

If Smith was wrong in his time in believing that free trade could not be restored, perhaps what today appears to be an almost impossible job of restoring it will turn out to be possible. Perhaps history *can* repeat itself, and, just as in Britain a popular crusade swept away the corn laws and the other restrictions on trade, so I would not rule out the possibility that in the United States a popular crusade, a revolt against big government, a revolt against bureaucracy, a revolt against heavy taxes could sweep away the interferences with free trade.

In judging that possibility and in analyzing our present state, what Adam Smith had to say two hundred years ago is as pertinent to our problems today as it was to the problems about which he talked. Let me suggest examples.

Consider a comment by Smith which could be applied to our national primaries, “That insidious and crafty animal, vulgarly called a statesman or politician, whose councils are directed by the momentary fluctuations of affairs.” Or consider what he might have said about the Humphrey-Hawkins bill. That bill currently is a revised version of what was formerly the Humphrey-Javits bill and the Humphrey-Hawkins bill. It is supposed to bring central national planning to the country and to guarantee full employment. Here is what Adam Smith might have said about it: “The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.” A pretty accurate description of Mr. Humphrey, isn’t it?

Or consider Smith’s comment on the effect of growth of government intervention. In his time it took forms different from ours, but if he were making these comments today, he would surely have in mind the

growth of the Interstate Commerce Commission, the Federal Communications Commission, the Federal Trade Commission, Amtrak, Conrail, and so on. Here is what he said: “Though the profusion of government must, undoubtedly, have retarded the natural progress of England toward wealth and improvement, it has not been able to stop it.” Also, “The uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement, in spite both of the extravagance of government and of the greatest errors of administration.”

That seems a particularly pertinent comment. The fundamental question of this Tuck School conference is whether we have made progress because of interventions like the ICC and FCC or despite them. I share Smith’s view that progress has clearly been despite and not because.

Let me suggest what Smith might have said about Ralph Nader or John Kenneth Galbraith and consumer protection laws: “It is the highest impertinence and presumption in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. They are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will.” Even Wayne Hayes could read that with profit.

Or consider another subject that is particularly relevant to the Tuck School. Students of Tuck have been heavily burdened with the question of social responsibility of corporations. Adam Smith had a succinct and pithy comment: “I have never known much good done by those who affected the trade for the public good.” Or consider Smith’s comment on taxes: “There is no art which one government sooner learns of another, than that of draining money from the pockets of people.”

The great achievement of Adam Smith, which I think is over and beyond these wise comments on particular areas, the achievement that establishes *The Wealth of Nations* as the beginning of scientific economics, was his recognition of the “invisible hand”—of the way in which voluntary acts of millions of

individuals each pursuing his own objectives could be coordinated, without central direction, through a price system. Let me quote his great key passage:

As every individual, therefore, endeavors 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 be of the greatest value; every individual necessarily labors 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. 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 submit that that's an extremely sophisticated and subtle insight. As we look about the world, what looks like chaos at first sight is, Smith points out, a system. Here somehow or other are millions of people all over the world cooperating, people who do not know one another, who have never heard of one another, who do not speak the same language, yet they are cooperating without being told to do so, and without central direction. Every day we are using in one way or another the output of people in faraway lands.

Leonard Read in a talk once used the marvelous example of a lead pencil: "You know, it's a funny thing, nobody knows how to make a pencil." He is right. In order to make a pencil you have to have wood; in order to have wood you have to cut down trees; to cut down trees you have to have saws; to get saws you have to make steel; to get steel you have to mine the ore, build blast furnaces, and so on. In a single pencil somehow or other is incorporated all of that knowledge and activity, and more besides. The graphite that is the center of it comes from mines in South America or somewhere. I do not know exactly where. The red rubber tip of the pencil probably came from Malaya. The rubber tree was not even native to Malaya, it was imported into Malaya from South America by individuals who were seeking only their own interest. How is it that people in Malaya know that they are supposed to produce rubber for you to use on that pencil? Where is the genius sitting in some central office sending orders to Malaya telling people, "produce a little bit of rubber for that pencil?" Somehow or other knowledge and abilities, scattered and diversified among millions of people and not accessible to a central intelligence or a central knowledge, are coordinated and organized by an impersonal price mechanism which nobody created, nobody invented, nobody deliberately organized.

The great and subtle insight of Smith, the “invisible hand,” is the way in which the price system operates silently and invisibly. We do not see its external tracks. Yet it works. People are seldom aware of a complicated machine as long as it is working. Only when your car breaks down at three o’clock in the morning on a dark and lonely road do you realize what a complicated mechanism it is. Only when the price system breaks down because it is not permitted to operate—as has been the case in many places, most recently in Argentina—do we realize what a complex and delicate system it is.

The second reason why it is difficult for people to appreciate this great insight is that it is commonly believed that explicit reason and rationality are necessary in order for a system to be created. In many ways, the most difficult idea to grasp is that it is possible for a complex, interrelated system to develop and to function through the autonomous behavior of many people without any central intelligence. The economic system is by no means the only system that has developed or that operates in such fashion.

The language in which we talk to one another is also a product of the same kind of voluntary cooperation. It was unintended, something which grows like Topsy and which nobody designed. Nobody today decides what words to add to the English language, what changes to introduce into meaning. We do that through our voluntary behavior. Yet the English language that results is a system.

The distinction is apparent even more sharply in the field of law. Today law connotes to most people legislative law, law that is made, deliberately shaped. Yet the great bulk of the law that guides our lives is not legislative law at all, it is common law, which grows out of the same kind of subconscious cooperation among many people, each adding a little bit here and a little bit there without anybody designing it or setting it down. Almost all attempts to codify the whole body of common law have come a cropper.

Smith’s greatest achievement is misunderstood and unappreciated partly because of the difficulty of appreciating how complicated and subtle the price system is and of recognizing how it can possibly develop on its own, and partly because the price system has been interpreted as one that is based on egotism and selfishness. In a sense that is right, but in a more fundamental sense it is wrong. The fact is that, whatever may be the system of organization, people are going to be driven by their interests as they perceive them. Those interests need not be selfish and narrow, they may be broad and far reaching. Smith’s insight that the

invisible hand will often be more effective than the visible hand is as relevant for eleemosynary and charitable activity as for commercial and material activity.

Let me return to the nineteenth century period in the United States, when we had the maximum of laissez-faire and individual enterprise. That was also the great period of eleemosynary activity. It saw the emergence of the private, voluntary, nonprofit hospitals around the country, of the public libraries, of the mission societies, of the Society for the Prevention of Cruelty to Animals. It was a period of the establishment and growth of many private colleges and universities, not by any central direction but by the invisible hand whereby people who wanted to pursue certain common objectives were able to cooperate with one another in that effort. What Adam Smith would have argued was precisely that the invisible hand was a more effective way of mobilizing sympathy, as well as of mobilizing the attempt to improve one's material conditions.

More fundamentally, Adam Smith was a realist. He recognized the character of people and the scarcity of sympathy. There is nothing that needs to be economized more, and the problem with almost all alternative ways of organizing society is that they are wasteful of the limited stock of sympathy. Smith, not in *The Wealth of Nations* but in his earlier book *The Theory of Moral Sentiments*, recites a parable that is worth contemplating today. He said:

Let us suppose that the great empire of China was suddenly swallowed up by an earthquake. A man of humanity in Europe would, I imagine, express very strongly his sorrow for the misfortune . . . would make many melancholy reflections upon the precariousness of human life, and the vanity of all the labors of man. And when all this fine philosophy was over he would pursue his business or pleasure with the same ease and tranquility as if no accident had happened. The most frivolous disaster which could befall himself would occasion a more real disturbance. If he was to lose his little finger tomorrow, he would not sleep tonight; but, provided he never saw them, he will snore with the most profound security over the ruin of a hundred millions of his brethren.

What Smith was pointing out then, and what is equally true now, is that sympathy is like gravitation: its strength decreases as the inverse square of the distance. We have far more sympathy for those close to us and dear to us than we can possibly have for those far away. That is why Smith saw little good to come from those who profess to trade for the public good.

The error of modern, well intentioned liberals, central planners of the Humphrey-Hawkins type, the error of those who seek to attack major social problems by the political mechanism, is brought out, I think, extremely well in my favorite quotation from Smith, again from *The Theory of Moral Sentiments*. Smith had a name for the kind of man you all are familiar with, who believes that society should be run by central direction, who believes that able, smart men should design a system for the rest of us, who believes that these men should sit in a central location with tentacles spread throughout the society, deciding social priorities and who should do what. He called such people “men of system,” and this is what he had to say about them:

The man of system seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chessboard; he does not consider that the pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it. If these two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder.

Now that last sentence is not a bad description of the present. “Society must be at all times in the highest degree of disorder.” Why? Because a man of system has tried to treat the individual citizen of a country as if he were a piece on a chessboard, instead of an autonomous human being with his own motives, his own urges, his own values. The failure to understand this central insight of Adam Smith is the reason why I believe that there is an invisible hand in politics as there is in economics, but one that works in the opposite direction. Adam Smith pointed out that in the economic market, the man who intends only his own good will tend to promote the good of society better than the man who intends to promote the good of society. In the political world, the invisible hand operates in the other way. The well meaning reformer who intends solely to promote the interest of society is led by an invisible hand to promote private interest that it was no part of his intention to promote. And he and his fellows produce in the process that “highest degree of disorder.” That is, above all, the lesson Adam Smith has to teach.