

## ADAM SMITH'S INVISIBLE HAND AND THE VISIBLE HAND: THE (MIS)INTERPRETATION

Elfi<sup>1</sup>

<sup>1</sup>Universitas Pelita Harapan – Tangerang

e-mail: elfi.fisip@uph.edu<sup>1</sup>

### ABSTRACT

The invisible hand is one of Adam Smith's prominent theories. It argues that if individuals are left to pursue their self-interest, it will unintentionally lead to the public good. Scholars have been interpreting the invisible hand from many aspects: some regard it as a strong justification for selfish acts and that it is unethical, another sees it as a perfect competition among small and traditional firms, it is even read in a mystical nuance, and others consider him as a supporter of the laissez-faire economy. New theories are found in response to Smith's invisible hand. However, some are built on wrong interpretations of the invisible hand. Employing the literature review method, this paper probes three books and three articles, which are selected from ScienceDirect and Google Scholar, aiming to elaborate on how the invisible hand is interpreted and misinterpreted and hopes to provide a clear understanding of what was Smith's original idea with regards to the role of government. This paper finds that Smith is nowhere close to a laissez-faire figure. He even has an elaborative list of actions government should take to promote the public interest. Further research in other aspects of the invisible hand, i.e., theological and moral perspective, will contribute to a more conclusive comprehension of Smith's invisible hand.

Keywords: Adam Smith, invisible hand, government intervention, laissez-faire, visible hand.

### 1. Introduction

The invisible hand is a term coined by Adam Smith and is found in his book, *The Wealth of Nations* (Smith, 1776). Although the term invisible hand has only been used once in the book (Pack, 1996), it is a prominent work of Smith that has been discussed extensively over time. The invisible hand is the concept that when everyone is looking out for themselves (practicing natural liberty), it will lead to the public good. In a famous quote from *The Wealth of Nations* (Smith, 1776), "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own

interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.", Smith argues that self-interest will unintentionally serve the public interest.

Smith has been seen as a supporter of the laissez-faire economy by some classical economists, including Nassau Senior and John Stuart Mill (Farmer, 2003). A market economy is when people and firms make decisions that affect production and consumption. It is a system where market players compete freely, involving pricing strategies and market structure, resulting in profits or losses for individuals and firms in the market. Firms produce and sell products

with the highest profits and the lowest cost. People consume products based on their needs and want, depending on their income. In French, *laissez-faire* means “leave us alone”. A *laissez-faire* economy is an extreme version of the market economy where government intervention is minimum and market decisions should be left to the marketplace. The opposite of a market economy is a command economy (Samuelson & Nordhaus, 2010). It is a system in which all major decisions about production and distribution are made by the government. The government controls most of the production factors, operates & directs enterprises, and decides how outputs are distributed to the society. Today, the pure form of these economic systems is nowhere to be found. All countries are adopting mixed economies of different extents. Government role varies but focuses on some functions such as overseeing the market, issues laws regulating economic activities, provide public services, and maintaining the environment. (Samuelson & Nordhaus, 2010).

Smith’s invisible hand only works in perfect competition, and he recognized the limitations (Farmer, 2003). According to Samuelson and Nordhaus (2010), perfect competition has many small firms producing similar products and they compete mostly on the pricing. Those firms are so small to have any effect on the market price, and when the

market dictates the price, they have no option but to take it to survive in the industry.

In more than 200 years since published, the invisible hand has been both read and misread (Farmer, 2003). This paper will discuss the mis(interpretation) of the invisible hand related to the visible hand (government intervention), aiming to contribute to the correct understanding toward Smith.

## **2. Research Method**

The research was carried out using a literature review approach (books and articles). Keywords used were Adam Smith, invisible hand, government intervention, *laissez-faire*, and visible hand. The publications chosen as references are those describing invisible hand both correctly and incorrectly and can be fully accessed. The data was then extracted, focusing on the authors’ interpretations of the invisible hand with regards to the visible hand. Extracted data were analyzed to produce a clear conclusion.

## **3. Results**

The table below describes the details of the books/articles and their interpretation of the invisible hand in relation to the visible hand (government intervention), which by no means is exhaustive.

<b>Author(s) &amp; year of publication</b>	<b>Title</b>	<b>Interpretation of invisible hand</b>
Spencer J. Pack (1994)	“Adam Smith’s Invisible/Visible Hand/Chain/Chaos,” no. 1994: 181–95.	"... careful scholars of Smith have long known that Smith was not in favor of complete laissez-faire policies." "Smith's Lectures on Jurisprudence, especially the 1762-3 report clearly demonstrate that Smith could not have been blindly in favor of laissez-faire economic policies." (Pack, 1994, p. 4-5)
Alfred D. Chandler (1999)	“The visible hand, The Managerial Revolution in American Business”	In his book, Chandler describes visible hand as "...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." (Chandler, 1999, p. 1)
David John Farmer (2003)	Invisible Hand and Visible Management	Smith argued that a free market with minimum government intervention would produce the best results in line with the public interest. However, he was not a supporter of laissez-faire economics where impersonal market forces were the sole source of wisdom, as he was misunderstood. Although Smith argued for free trade, he also acknowledged that completely free trade was not practical and agreed on the protection toward infant industries and the navigation laws.
Paul A. Samuelson and William D. Nordhaus (2010)	Economics	“Just as Americans were proclaiming freedom from tyranny, Adam Smith was preaching a revolutionary doctrine emancipating trade and industry from the shackles of a feudal aristocracy. Smith held that government interference with market

		competition is almost certain to be injurious.” (Samuelson & Nordhaus 2010, 29)
Warren J. Samuels (2011).	Erasing the invisible hand: Essays on an elusive and misused concept in economics	“... government is portrayed by Smith as, among other things, a facilitator of commerce. His position is not that government needs to stay out of the way and let individual enterprises reign. Rather, he lays out a specific (and lengthy) set of activities for government to undertake if it wishes to promote the national wealth.” (Samuels 2011, 192)
Gheorghe Băileşteanu & Anda Laura Lungu (2014)	“The “invisible hand” and the “social visible hand” in the economic mechanism of the market.”	The invisible hand is understood as a laissez-faire economic system with government intervention as the “coercive hand”. The authors propose The Third Way which they call Social Visible Hand that operates between laissez-faire and command economy.

#### 4. Discussion

In his discourse, Smith does not relate the invisible hand directly to the role of government. He discusses the invisible hand with regards to the differences between a businessman’s security of his assets in the home market and foreign markets (Samuels et al., 2011). Despite so, scholars have been relating the term to the government's economic functions. Some read it correctly, some don't.

##### 4.1. Adam Smith is a supporter of the laissez-faire economy and another misinterpretation

##### 4.1.1. Smith supports the laissez-faire economy

Many scholars argue that Smith is a

laissez-faire figure. Smith’s concept of natural liberty is understood as anti-government intervention, that the market should be left to operate by itself. Spencer J. Pack makes a notion of Maurice Allais’ argument about Adam Smith’s invisible hand metaphor. In Allais’ words as quoted by Pack: “Smith's book brought to bear a stinging criticism of interventionism by governments. ... Without a doubt, Smith's whole exposition rests on one fundamental guiding idea, namely that the free decentralized action of economic agents in a system of competition and private property brings advantages for each of them.” Despite the strong (Pack, 1994).

In their influential textbook titled “Economics”, Samuelson & Nordhaus (2010)

write that Smith is against government interference. According to them, Smith sees government intervention as almost harmful. This is in line with Samuelson's argument in his article titled "Economists and the History of Ideas", in his own words: "... Smith's attacks on mercantilism and state interference ... his spirited championing of laissez-faire. ... his definite role for limited government" (Samuelson, 1962, p. 7).

Among the many other scholars who think of Smith as supporting the laissez-faire economy and limited government role are Harvey Rosen, William C. Mitchell, Edwin G. West, Joseph Stiglitz, and Richard Musgrave (Samuels et al., 2011; Rosen, 2002; Mitchell, 2001; West, 1990; Stiglitz, 1988; Musgrave, 1985). Galbraith (1987) even states that Smith limits government role to national defense, law and order enforcement, and public utilities. (Samuels et al., 2011)

#### **4.1.2. "A Third Way, The Social Visible Hand" (Băileşteanu & Lungu, 2014)**

Băileşteanu & Lungu (2014) interpret Smith's invisible hand as a market with no rules, and that government interference means limiting the freedom of the market. They use the term "coercive hand" to refer to government intervention. They understand the invisible hand as the extreme opposite of the coercive hand and introduce a Third Way, which they name the Social Visible Hand (SVH) (Băileşteanu & Lungu, 2014).

SVH is the middle way that is claimed to, in their words, "control the sideslips of power" and overcome the downsides of the

invisible hand. Utilizing a third party, particularly, rating agencies, Băileşteanu & Lungu believe that SVH can provide a self-monitoring-mutual control that is objective and trustworthy. Despite the good monitoring functions SVH may offer, Băileşteanu & Lungu found the concept based on a misinterpretation (Băileşteanu & Lungu, 2014).

#### **4.1.3. "The Visible Hand, The Managerial Revolution in American Business" (Chandler, 1999)**

In this book, Chandler introduces his theory of the visible hand. The theme comes up in response to Smith's invisible hand. He argues that the visible hand is to replace Smith's invisible hand of market forces. Chandler puts together production and distribution practices of different industries in the U.S. and how they are managed. The industries included in his book are food, tobacco, oil, rubber, chemical, paper, glass, metal, textile, apparel, and machinery (Chandler, 1999).

Chandler describes the visible hand as modern management employed by big enterprises controlling the market activities as opposed to how small traditional family firms do business. He equates the invisible hand with competition among small, traditional firms (Chandler, 1999), which is not part of Smith's discourse, in line with Mathews' (2000) argument.

#### **4.2. Adam Smith is NOT a supporter of the laissez-faire economy**

Besides Chandler's visible hand and Băileșteanu's & Lungu's Social Visible Hand, there are a plethora of scholars who misinterpret Smith's as a supporter of the laissez-faire economic system as discussed in part 1.1. However, there have been studies conducted challenging the view. Smith recognizes that market forces will drive the market dynamics. He uses the term to picture that when the market is left to operate by itself, it will unintentionally lead to the public interest. Despite so, he also is aware of the limitations and sees perfect competition as a utopia (Farmer, 2003).

Pack (1994) stands that it is not indicated by Smith's invisible hand that he encourages an extensive laissez-faire economy. The many government rules and regulations Smith was opposed to back then were already obsolete or passed for the interest of people with wealth and power. He does not reject any or all government rules and regulations, but only the two types mentioned above. The 1762-3 report of Smith's Lectures on Jurisprudence distinctly shows that Smith is never an advocate of the laissez-faire economy.

Smith is certainly against mercantilism, but also in no way a supporter of a laissez-faire economy. In the later part of his book, Smith supports protection for infant industries and navigation laws (laws regulating the trade and commerce among the British Empire, its colonies, and other countries). He also acknowledges that government must have a role in serving the public interest. One of them is to ensure the

provision of public goods such as water and electricity as well as to maintain law and order. (Farmer, 2003)

Smith also elaborates an extensive-and-detailed list of actions government should implement to achieve national wealth in Book V of the Wealth of Nations (Samuels et al., 2011). He describes the government as a *facilitator* of commerce. It is nothing close to the notion of limited or minimal government intervention (Samuels et al., 2011). Naming Smith as the godfather of the laissez-faire economy is doing him a disservice.

## 5. Conclusion

Many scholars have made their interpretations of Adam Smith's invisible hand. Some read the term from the government's economic functions, another from the theological/mystical nuance, and others from a moral perspective. This paper focuses on how the invisible hand is interpreted related to the role of government and puts together interpretations from various researchers.

This paper finds that Smith does not intend to directly relate his invisible hand concept with the government's role, but rather a metaphor to describe how the selfish interest of people works on its own to achieve the public good. However, he is considered the godfather of the laissez-faire economy by many. He has been misunderstood as promoting a limited and minimal role of government, but in fact, he does not. He even has a detailed list of actions the government

should implement to pursue public interest.

The finding from this paper should contribute to a correct understanding of Smith's invisible hand from the government role's perspective. Further research on other

aspects of the invisible hand, i.e. theological and moral perspective, will help in establishing a richer comprehension of the term.

## REFERENCES

- Băileșteanu, Gheorghe, and Anda Laura Lungu. (2014). "The 'Invisible Hand' and the 'Social Visible Hand' in the Economic Mechanism of the Market." *Procedia - Social and Behavioral Sciences* 124: 100–106. <https://doi.org/10.1016/j.sbspro.2014.02.465>.
- Chandler Jr, Alfred D. (1999). "The visible hand, The Managerial Revolution in American Business", Fifteenth Printing. Harvard University Press.
- Farmer, David John. (2003). "Invisible Hand and Visible Management." In *Handbook of Organization Theory and Management: The Philosophical Approach, 2nd edition*. Boca Raton: Taylor & Francis Group, 227–255.
- Galbraith, J. K. (1987). *Economics in Perspective: A Critical History*, Houghton Mifflin Company Boston.
- Matthews, Don. (2000). "The Visible Hand? The Economics of Alfred Chandler." *Essays in Economic & Business History* 18, no. 1: 163-173.
- Mitchell, William C. (2001). "The Old and New Public Choice: Chicago versus Virginia," in William F. Shughart II and Laura Razzolini, eds., *The Elgar Companion to Public Choice*, pp. 3–2. Aldershot: Edward Elgar.
- Pack, Spencer J. (1994). "Adam Smith's Invisible / Visible Hand / Chain / Chaos," no. 1994: 181–95.
- Rosen, Harvey S. (2002). *Public Finance*, 6th ed. New York: Irwin/McGraw-Hill.
- Samuels, Warren J. (2011). "Erasing the invisible hand: Essays on an elusive and misused concept in economics". *Cambridge University Press*.
- Samuelson, P. (1962). *American Economic Association Economists and the History of Ideas Author (s): Paul A. Samuelson Source: The American Economic Review, Vol. 52, No. 1 (Mar 1962), pp. 1-18 Published by: American Economic Association Stable URL: [http://www.js. 52\(1\), 1–18](http://www.js.52(1), 1–18).*
- Samuelson, Paul A., and Nordhaus, William D. 2010. "Economics", 19th ed. (New York: McGraw-Hill).
- Stiglitz, J. E. (1988). *Economics of the Public Sector* (2nd ed, New York, and London).
- West, Edwin G. (1990). *Adam Smith and Modern Economics: From Market Behaviour to Public Choice*. Aldershot: Edward Elgar.