

Chapter 7

Smithian political economy

We saw in the previous chapter that Smith believed the key to increasing prosperity was the division of labor. He argued that specialization would lead to increasing production, which leads to decreasing prices, which in turn leads to increasing standards of living. We also saw that he thought this story of prosperity could ensue only in a “well-governed society,” which for him is one that, whatever else is the case, has “an exact administration of justice.” In Chapter 10, we will look more specifically at the role Smith believes the government should play in society. But can we say a bit more about how Smith thinks prosperity is generated? What, for him, are the causes of the wealth of nations?

Smith’s overall political-economic argument proceeds on the basis primarily of three linked arguments, which I call the Economizer Argument, the Local Knowledge Argument, and the Invisible Hand Argument. Let us look at these in turn.

The Economizer Argument

Smith writes: “Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command” (WN: 454). This is connected with Smith’s discussion elsewhere (and repeatedly) of the “natural effort of every individual to better his own condition” (WN: 540), and his (again, repeated) claim that “It is the interest of every man to live as much at his ease as he can” (WN: 760). We might less charitably call this the “human laziness argument,” but it is more accurately described as the claim that all people naturally—that is, without being told to do so—look for the most efficient means to achieve their goals, whatever they are. Do you want to learn to play the piano? To run a marathon or learn French or get a job as an attorney? Whatever your goals, the Economizer Argument holds

that you will assess the limited resources available to you—including your time, your skills and abilities, and your money—and you will look for ways to reach your goals in the surest, fastest, most complete ways, or with the least cost to any other goals you have, given your available resources. You look, as it were, for the best returns on your investment of resources; in other words, you *economize*. Hence the name, Economizer Argument.

The Local Knowledge Argument

Smith writes: “What is the species of domestick industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him” (WN: 456). As Smith develops it, this argument proceeds as a three-step syllogism:

- Premise 1:** People’s individual situations, along with their values, purposes, and opportunities, are known best by individuals themselves.
- Premise 2:** To be made wisely, decisions about allocating resources must exploit knowledge of situation, value, purpose, and opportunity.
- Conclusion:** Therefore, the person best positioned to make such decisions is ... the individual.

Smith’s claim is not that individuals are infallible or that they never make mistakes; obviously we all make mistakes, frustratingly often. And of course there might be special cases—for example, children or the mentally infirm—where individuals are not, in fact, best positioned to make decisions in their own cases. But for the vast majority of normally functioning adults, Smith’s claim is that their personal knowledge of their own situations exceeds that of others. Hence, if making good decisions requires utilizing this knowledge, then in the vast majority of cases the persons who should be making decisions is those persons themselves.

Smith goes on to claim: “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 be nowhere so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise

it” (WN: 456). Smith does not mince words about the conceit of such statesmen. But look more closely at two specific claims he makes in that passage: the statesman’s attention is “unnecessary,” and it would result from “folly.” It is “unnecessary” because, as Smith explained in his Economizer Argument, people do it already: we are naturally constructed to seek out the best return we can on our scarce resources, so the statesman does not need to attend to it. It is “folly” because, as Smith explains in his Local Knowledge Argument, the statesman does not possess the local knowledge of individual people’s circumstances, values, goals, and resources that he would need in order to make good decisions for them. Does the statesman know whether you should go to law school? Whether you should work for that company, buy that car, get a hamburger or a salad, marry that person? Of course not—and his presumption that he can make decisions for you nonetheless is folly.

An objection

A criticism of the Local Knowledge Argument comes, however, from the work of some recent behavioral economists. Richard Thaler and Cass Sunstein, for example, in their 2009 book *Nudge* claim that recent empirical study of human decision making has revealed that we often make mistakes, even mistakes that we ourselves judge to be mistakes after the fact.⁵ This is hardly a new discovery, but their claim is that psychologists and economists have uncovered systematic patterns of mistakes that human beings are likely to make. These include, for example, our susceptibility to present pleasures that come at the expense of other, more remote, or longer-term but greater goals we have. Perhaps we wish to be fit and healthy, and yet when someone offers us a doughnut, we eat it. We might wish to have a secure and comfortable retirement, and yet we spend our money on things today whose benefit to us we would see is not as great as that provided by a comfortable retirement—if only we would take the long view. Thaler and Sunstein argue that perhaps a role for government is to help structure the choices we make so that we are more likely to make choices that are the right ones, all things considered, even if that means marginally restricting our liberty to choose. They might concede that in Smith’s day, when we did not actually know much about human biology, psychology, health, or nutrition, perhaps an argument for free markets

5 Richard Thaler won the 2017 Nobel Prize in economics for his work in behavioral economics.

and for allowing people to make decisions in a trial-and-error fashion might have been justifiable. Today, however, when we have learned a great deal about human biology, psychology, and so on, there seems little reason to allow people to experiment and try things out. Indeed, it seems almost cruel to let them do so, when we know that people will make mistakes.

This argument takes aim at Smith's Local Knowledge Argument. Smith claimed that individuals themselves know their own situations best, but the Thaler and Sunstein argument, and much contemporary behavioral economics, beg to differ. How would Smith respond? He would no doubt acknowledge the great strides made by the modern advances in the sciences of humanity, and concede that we know much more today than anyone did in the eighteenth century. But he would probably also argue that much of what we know, or at least believe we know (remember that experts routinely change their minds and reverse or change their recommendations), is general and abstract, not tied to individuals. For example, we might know that obesity is not only growing in incidence in the United States today but that it poses significant health risks and health costs. But does that mean that I should not eat the doughnut offered to me? Does it mean I should work out more than, or differently from, how I do now? Does it mean I should skip lunch today and continue working on this book? Questions like these cannot be answered by experts from afar, because those experts do not possess the relevant information about my particular circumstances—and yet those are the decisions facing me, and every other individual. So although we might know in general that obesity is bad, that unfortunately gives little guidance for any particular person or for any particular decision a person must make.

The worry that Smith would have about granting such centralized experts authority about decisions like these in our lives is not, then, that they are not in fact experts. It is, rather, that their expert knowledge is general and abstract, not individualized and particularized. So their recommendations will either be too general to be of much use to a specific individual, or, if they try to make their recommendations more binding on individuals, they will often end up steering individuals in wrong directions because they do not know those individuals' goals, purposes, values, circumstances, preferences, and so on. Erecting experts' judgments into laws or regulations runs, then, the substantial risk of unintended negative outcomes for individuals.

But Smith has a larger worry. Here we might make note of a remarkable passage in Smith's *Theory of Moral Sentiments*. In a discussion of the proper role of the statesman, Smith describes a certain type of political leader, whom Smith calls the "man of system," who "is apt to be very wise in his own conceit; and is often so enamoured with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it" (TMS: 233–4). Smith continues that such a person "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 chess-board. He does not consider that the pieces upon the chess-board 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 chuse to impress upon it" (TMS: 234).

Human beings are actors and decision makers, and their capacity for making free decisions means they are recalcitrantly—or gloriously, depending on one's perspective—unpredictable. That means that any plan a legislator, regulator, or other political leader has for steering, or "nudging," people in the directions he wants is destined to be frustrated. With "principles of motion of their own," people will undoubtedly depart from the "ideal plan" of the "man of system." In that case, the man of system faces a dilemma: either he gives up on his ideal plan, allowing people to order and organize their own lives for themselves, thus returning to the Smithian "obvious and simple system of natural liberty" (WN: 687); or he imposes his ideal plan by force, with all the risks and dangers that entails. The Smithian preference is clear.