

The Mystery of Adam Smith's Invisible Hand Resolved¹

Abstract:

Several new interpretations of Adam Smith's invisible hand have recently been published in leading general-interest economic journals. These interpretations attempt to bring Smith forward in time, to make him more modern, and to fashion him in the image of the modern welfare theorist. Here we go back in time and find the source for both of Smith's economic applications of the invisible hand in Richard Cantillon's model of the isolated estate. With this connection established, we know what Smith read and dubbed the invisible hand.

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¹ The author would like to thank DC, IHD, RBE, GSF, PM, JMJ, JT, DRT and PW for their comments and suggestions.

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Smith's three explicit references to the "invisible hand" do not add up to a unified notion. Maybe future research can unearth why Smith used the term in an inconsistent manner. Meanwhile, we can only work with the three texts, and these texts do not provide a uniform sense of the term. In any case, none of these references lends support to the modern understanding of the metaphor as (being) about the first law of welfare economics.²

Introduction

We now know a great deal about the intricacies and details of Adam Smith's life and economics. Scholars have, for example, poured over his views on the organization of religion,³ his views of the corporation,⁴ and even his tenure as a tax collector,⁵ and have established definite conclusions. In contrast, Smith's most famous concept—"the invisible hand"—has in recent years been placed in an intellectual quagmire as a result of a surprising resurgence of interest in the meaning of the concept. Several new interpretations of the concept have been published in the leading general-interest economic journals, as well as those that specialize in the history of economic thought.

This widespread effort to discover the "true" meaning of the invisible hand appears to have muddied the conceptual waters almost beyond recognition. There are now at least a dozen different versions of the invisible hand ranging from the more traditional interpretations to those which attach the phrase to such things as slavery and national defense. Smith's invisible hand now suffers from multiple-conception disorder

² Khalil, p. 54.

³ Ekelund, Hébert, and Tollison (2005).

⁴ Anderson and Tollison (1982).

⁵ Anderson, Shughart, and Tollison (1985).

and the lack of an acceptable definition could render Smith's concept scientifically useless. The opening quote from Khalil represents one of the few sensible modern interpretations of Smith (the process theorist) because it shows both how far modern interpreters have gone astray—painting Smith forward in time as a modern neoclassical welfare (end state) theorist, and why there is so much confusion—Smith's three different uses of the phrase.

In order to resolve the mystery of the meaning of the invisible hand, we go backward in time and show that Smith discovered the general conceptual framework for the invisible hand in Richard Cantillon's *Essai sur la Nature du Commerce en Général* (hereafter, *Essai*).⁶ Cantillon's model of the isolated estate represents a revolutionary breakthrough in economic theory and both of Smith's economic applications of the invisible hand—which hitherto have been understood to be disconnected—can be found in it. This linkage between Smith and Cantillon permits us to describe the invisible hand as the processes that constitute price theory, competition, and distribution. First, however we will briefly describe the heated debate in the general-interest journals over the meaning of the invisible hand and then present the broader connections that scholars have made between Cantillon and Smith.

⁶ *Essai sur la Nature du Commerce en Général* (hereafter, *Essai*) was written around 1730 and circulated privately until it was published in 1755 therefore it might not have been available to Smith when he wrote the *History of Astronomy* in 1749, but probably was available for writing *Theory of Moral Sentiments* and was obviously available to him for the writing of *Wealth of Nations*. The *Essai* was also an important impetus to the establishment of the Physiocrats in 1756. Page numbers for references to the *Essai* are given for (the original French edition-1755/the Higgs translation-1931/the Brewer edition-2001)

Why all the Mystery?

Given that the concept has been around since the very beginnings of economic science you would think that we would have a very definite notion of what the invisible hand is all about. However, because the concept is so obviously nebulous, individual scholars may have a very good idea of what the concept means to them, but that meaning can differ from individual to individual. Some of the confusion can also be attributed to Smith's failure to describe the meaning of the phrase and from the fact that he used it in three different ways in the *History of Astronomy* (1749, hereafter *HA*), the *Theory of Moral Sentiments* (1759, hereafter *TMS*) and the *Wealth of Nations* (1776, hereafter *WN*).⁷

A veritable cottage industry has sprung up in recent years to define the true meaning of Smith's phrase and to capitalize on its widespread recognition and use. For example, Spenser Pack found that the invisible hand leads to increased destitution among

⁷ His first use of the phrase is in the *History of Astronomy* (1749, hereafter *HA*), where he scorned those who attribute a divine presence for things that can be explained scientifically. This was written before Cantillon's *Essai* was published in 1755 and although others had read the *Essai* in manuscript form—including in all probability Smith's friend David Hume—it is less likely that Smith was influenced here by Cantillon. The first application also differs fundamentally from the second and third which are economic applications of the phrase. The second use is in the *Theory of Moral Sentiments* (1759, hereafter *TMS*), where Smith described the vile landowner who is forced to distribute the majority of the bounty of his land to the peasants in order to obtain their labor and the goods and services that he wishes. As a result, people get almost the same sustenance as if the land was divided equally. By the time he wrote *TMS* Smith already had a general notion of the universe as a type of divinely inspired machine (which he derived from Hutchison and Newton), but it will be shown here that the specific content of this application is in Cantillon's *Essai*, most specifically in Cantillon's model of the isolated estate. The third and most famous use of the phrase appears in the *Wealth of Nations* (1776, hereafter *WN*), where the invisible hand is used as a metaphor for self-interest—in that people pursuing their self-interest unintentionally promote the general interest and the largest possible production. We know for sure that Smith had read Cantillon by this time because in *WN* he references Cantillon concerning his estimate of the minimum wage necessary to maintain a stable population. Cantillon's "invisible hand" directly follows his estimate in the chapters on entrepreneurship and the model of the isolated estate.

the poor and slaves while benefiting the wealthy.⁸ Syed Ahmad offers us four "invisible hands" and William Grampp reviews ten different possibilities.⁹ We are told that the invisible hand derives from Smith's theology, that it is an important secular device, and that it is an ironic, but useful joke.

Whatever its true meaning, the issue is important enough that the *American Economic Review* (AER), *Journal of Economic Perspectives* (JEP), and *Journal of Political Economy* (JPE) have all recently published articles on the meaning of the invisible hand. Add to that the numerous articles and book-length treatments of the subject—including an entire book of entries from the *New Palgraves*¹⁰ published under the title *The Invisible Hand* and you have not only a major debate, but a puzzle regarding the true importance of it all.

Because we are taking an entirely different route to the meaning of the invisible hand, it is not necessary to survey all the various interpretations or to provide a complete set of critiques and refutations. However, to get the flavor of the disparity between the interpretations, a summary of Grampp's survey of ten invisible hands and his critiques is presented here.

1. Self-interest promotes the general interest. This is the most common interpretation according to Grampp, but he claims this only holds true in competitive markets when capital is maintained domestically and only when people actually follow their self-interest (and Grampp gives several reasons why they often do not).

⁸ See Pack (1996).

⁹ Ahmad (1997) and Grampp (2000).

¹⁰ Eatwell, Milgate and Newman (1989).

2. The invisible hand is the price mechanism. This is another common interpretation that Grampp rejects because Smith's equilibrium only maximizes welfare when wealth is maximized by traders who restrict their trading to domestic markets.
3. Grampp labels the Neo-Austrian view of the invisible hand as the metaphor for how beneficial social orders emerge from the unintended consequences of individual actions. To the extent that it is a true rendering of the Neo-Austrian view, it tells us nothing of value for the economist—the hand essentially remains invisible.
4. The invisible hand is competition. Grampp finds that Smith did not discuss competition when describing the invisible hand and did not declare it present in all competitive markets or self-interested acts.
5. The invisible hand is the mutual advantage from exchange. This mutual advantage is not at all invisible in Smith and he does not discuss it in describing the role of the invisible hand.
6. The invisible hand is a joke. A recent and novel interpretation in the *AER*¹¹ based on the idea that the meaning of the term is not consistent in its three uses. While there are three uses with distinct meanings, this hardly means the term is a joke or without meaning.
7. Acquiring skills and knowledge in business leads to increases in wealth. You could use an invisible-hand explanation for this process, but this process has nothing to do with Adam Smith's use and like #3 provides nothing of use for the economist.
8. The invisible hand is God. In one use Smith condemns religious explanations for natural phenomena, in the *TMS* he makes a deistic reference, and in *WN* it is clearly not a religious reference—he does not write “as if”—but is referring to tangible human forces so this interpretation is on weak grounds.
9. The invisible hand promotes the national defense by preventing the export of capital. Grampp likes this explanation best of all because it is most like his own (i.e. #10). This interpretation is based on Smith's use of the phrase in *WN*, it refers

¹¹ Rothchild (1994).

to what the invisible hand does, and it relates to the geographic location of wealth. The only problem is that it is not complete.

10. Grampp's interpretation, which he claims is Adam Smith's own interpretation, is that when individuals' self-interest leads them to keep their capital at home, rather than exporting it, this promotes the national defense. In his own words, the "invisible hand then is self-interest operating in this circumstance, the circumstance in which a private transaction yields a positive *externality* that augments a *public good*."¹²

From my perspective, this list proceeds from the most commonly held and most plausible interpretations to the least common and least plausible interpretations. With the possible exception of number three, the first five interpretations are the most common and plausible explanations for what Smith meant by the invisible hand. For example, if you asked an economist to explain the invisible hand you would likely hear a response that involved some combination of the first five interpretations.¹³

The second five range from the silly and non-economic to the contrived. The seventh interpretation is just an application from evolutionary psychology and can be dismissed as only necessary for the list of interpretations to reach the magic number ten. Number six, which was published recently in the *AER*, declares that the invisible hand is a joke. Number nine—published in the *JEP*—provides the phrase with a taste of both mercantilism and public goods theory by claiming the invisible hand was about retarding the export of capital to enhance the national defense.

¹² Grampp (2000, p. 451, emphasis added).

¹³ For example: "The invisible hand is individuals who pursue their self interest, who make exchanges of labor and goods with others to their mutual benefit. These exchanges result in the development of markets and competition between buyers and sellers and this competition drives the price system resulting in maximum production and consumer satisfaction."

The tenth interpretation is an elaboration of ninth that includes an externality argument. While it is certainly true that wealthier nations are better able to defend themselves, this has nothing to do with what Adam Smith meant by the invisible hand itself. It is not worth cataloging all the problems with this position as it has already been subjected to a withering and lengthy critique that details most of the problems—certainly enough of them—to dismiss the matter.¹⁴ One is tempted to label this interpretation a “blind man’s bluff” in that it seems to be based largely on the few words that surround the phrase in *WN* and ignores almost everything else in order to impress the imprint of modern economics onto Smith.

What is worth noting is how badly three of the top general interest journals in economics have presented Adam Smith’s invisible hand. It would seem that the journals and their contributors are trying to paint Adam Smith in their image of a modern economist. Astoundingly, another depiction in the *AER* even uses the invisible hand as a description of how bureaucrats and entrepreneurs interact.¹⁵ Ironically, of the five implausible or non-economic interpretations (6-10), the one that best holds its water is the one that sees God as the invisible hand. At least this interpretation tells us something about Adam Smith himself and gives us some connection to the system of natural liberty (based on natural law) that Smith described and espoused.¹⁶

Also worth noting is the problematic entry on the invisible hand in the New Palgrave by Karen Vaughn (the basis of interpretation number three). This prominent

¹⁴ Minowitz (2004).

¹⁵ Frye and Shleifer (1997).

¹⁶ For an interesting attempt to expose a religious interpretation of Smith’s invisible hand see Denis (2005). It was Thorstein Veblen that most famously interpreted Smith’s invisible hand as natural law. See Jackson (2005) for an important recent application of Smith thought and Evensky’s (1993) article in *JEP* on the ethical dimension of the invisible hand.

reference work is often the first source scholars and students consult when researching a topic. Here they will find a black hole where the invisible hand is described—over and over again—as the emergence of social orders that were unintended. The actual *economics* of the invisible hand are mostly ignored, except for minor references to self-interest. Here the concept is said to be composed of three “logical” steps: 1. Human action leads to unintended consequences, 2. Invocation of the law of large numbers and evolutionary time and you get what appears to be intelligent design, and 3. the end result is beneficial and desirable even though it was unintended. Step one is unnecessary, step three is normative, and step two is devoid of economic content. It is normally not a problem to invoke phrases like “spontaneous order” and “invisible hand,” but when presenting such concepts in a dictionary, it should be pointed out (and well illustrated) that it refers to a step-by-step real-world process of individual actions that are generally very much intended and very much designed.¹⁷ Hand waving expressions of the invisible hand should probably be condemned as Smith similarly did in his *HA*.

It is also worth noting that even before these modern interpretations were “discovered,” the invisible hand already had a major image problem because while the phrase was appreciated by many, it is also widely disparaged as mere apologetics for capitalism. This is where invisible hand’s “Vaughn problem” comes into play: leaving the concept vague and nebulous and not based on specific real-world processes. For example, David Hull—coming from the philosophy of science perspective—found that “the real problem with invisible-hand explanations is the specification of the mechanism that is supposed to bring about the result.” Philosophers of science have found that for

¹⁷ To distinguish the invisible hand of the Scottish Enlightenment from others views it should be pointed out that all the relevant human action need not be “purposeful” and that all unintended consequences need not be the result of a spontaneous order.

invisible-hand explanations to be successful they must make explicit the mechanisms or processes that they are based on and how the results are achieved, or as Hull asks:

Can the mechanisms responsible for this behavior in science be set out explicitly? Are these mechanisms adequate to bring about the effects I claim for science, or do they merely appeal to mysterious coincidences that serve only to paper over these anomalous states of affairs?¹⁸

Therefore, making explicit the mechanisms of the invisible hand will lead to a better understanding of the term by its proponents and will also reduce the level of normative disagreement between the forces and foes of Smithian economics. A good application of the invisible hand is provided by Selgin and White.¹⁹ They describe the mechanisms of several competing visions of what the invisible hand might look like in the area of money and banking.

Where is the Invisible Hand?

Adam Smith was not the first person to use the phrase the invisible hand, as it was already in use to describe supernatural action.²⁰ Indeed, that is how Smith (1980, p. 49) used the phrase—derisively—in his *History of Astronomy* where he used the “invisible hand of Jupiter” to describe the beliefs of polytheism, savages, and the superstitious who would attribute all the irregular events in nature, like thunder and lightning, to the invisible gods. Smith was scorning those who concoct special explanations, when in

¹⁸ Hull (1997, p. S119).

¹⁹ Selgin and White (1994).

²⁰ Spengler (1984, p. 73) shows that seventeenth century writer Joseph Glanville used the phrase. Rothbard (1995) argues that Smith got the general conception of what the invisible hand is from his teacher Francis Hutchinson and it certainly is true that Hutchinson was a critical influence on Smith in terms of the system of natural liberty that both espoused.

Smith's view these irregular events should be seen and studied scientifically as part of the natural order of the universe. This use of invisible hand should not be seen as completely at odds with its use in *TMS* and *WN*.²¹ It is after all an expression of Smith's scientific spirit and is a comment concerning the methodological foundation on which he would build his science of natural laws. However, it is also quite different in the sense that there is no economic content to the passage. This is important because it was written before the time period when Smith was in all likelihood exposed to Cantillon's *Essai*.

In *The Theory of Moral Sentiments* (1759) Smith described his philosophy whereby nature produces results which seem to be divine. In the passage where he invokes the invisible hand he is addressing the massive inequality of land ownership that characterized his world. He shows that despite the huge landholding, the land owner does not consume all that is produced, but only a small fraction of it. There is of course a limit to how much the land owner can eat, but more importantly he must feed and support all those who work for him; who work the fields, who maintain his house, who produce his clothes and luxury goods. Land owners support the poor to address their "insatiable desires," not as a matter of justice or humanity. As a result, Smith finds that the distribution of goods is nearly equal, with the land owners getting merely the first choice of quality.

They 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, without knowing it, advance the interest of the society, and afford means to the multiplication of the species.²²

²¹ Macfie (1971).

²² Smith (1976 [1759], p. 184-5.

Self-love therefore is a driving element in Smith's system of natural harmony where even the "unfeeling landlord" is forced to share with all. In this way the wealthy members of society are actually deceived by the meaning of their wealth. Smith ends his point by noting that the lowest members of society even have some advantages over the highest:

In ease of body and peace of mind, all the different ranks of life are nearly upon a level, and the beggar, who suns himself by the side of the highway, possesses that security which kings are fighting for.²³

In building his moral philosophy of social harmony, the near equality in the distribution of goods—despite the tremendous inequality of land ownership—plays a key role because it is an example of harmony that involves basic necessities and is more or less seen as an automatic process after it is theoretically revealed to the reader. After reading the entire passage, the invisible hand aspects seem obvious, but only after we "view it in this abstract and philosophical light" of Smith's model of the landlord's estate.²⁴

The third and final appearance of the invisible hand occurs in *WN*; here Smith invokes the phrase in his famous assault on mercantilism. Smith notes that population is limited by production and production is limited by the amount of capital. Individuals direct their capital according to self-interest to achieve the greatest value, but there are economic reasons why the capital is often employed domestically. By seeking to obtain the greatest value from his capital, the individual is part of the nation achieving its greatest level of production.

²³ Ibid, p. 185.

²⁴ Ibid p. 183.

By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, *as in many other cases*, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it.²⁵

As a way of ameliorating people's fears about free trade, Smith wrote that investors who faced equal profit opportunities at home and abroad will choose to invest domestically because there are fewer risks involved (i.e., "his own security"). In other words, the economics of self-interest in capital markets will propel people to keep a large portion of their capital employed domestically.²⁶ Smith believed that we could rely on self-interest—not some government decree—to direct and maintain the capital that we subsist on. Capital flight is just an example of the "many other cases" where we can count on the invisible hand.²⁷

Demonstrating that Adam Smith's invisible hand is based on Cantillon's *Essai* is based on three linkages. First we know that Smith read Cantillon because Smith mentions Cantillon in the *Wealth of Nations* and discusses Cantillon's famous calculation that "the lowest species of common labourers must everywhere earn at least double their own

²⁵ Smith (1976 [1776] p. 456, emphasis added). This important phrase indicates that Smith meant the process applied "in many other cases."

²⁶ Incidentally, while Smith was writing to the mercantilists, he is also "answering" Gomory and Baumol (2000) who use the fear of capital flight in recent years to construct an infant-industries argument for protectionism.

²⁷ Contrary to Grampp, it is the risks of foreign investment (e.g. goods lost in transit due to storms or pirates) that is at issue here, not national defense. Foreign investments in the carrying trade can be quickly liquidated and easily transferred in the event of war, even during Smith's day. Indeed, the argument of linking the invisible hand to defense is so weak that Grampp is forced to acknowledge: "At this point the thoughtful reader may demur and wonder if what Smith said about the invisible hand can reasonably be interpreted to mean it promotes defense. He (p. 454) does not use the word defense; what he expressly says is that the invisible hand increases domestic capital." Grampp even notes in his paper that the "anonymous and learned referee" finds fault with the notion that the invisible hand is related to defense, not capital. Grampp attempts to shore up his position by adding that local capital creates more employment and that a more rigorous economy contributes to a nation's power. Rather than seeking a full confession here, I will reserve the right to recall Smith's views on the employment of capital—domestic and foreign—and proceed to the positive case for Cantillon.

maintenance”²⁸ Second we can be quite sure that Cantillon was very influential on Smith’s economics because numerous scholars have identified Cantillon’s influence on a variety of Smith’s economic concepts—concepts such as competition and the circular flow which are components of invisible hand explanations. Finally, and most importantly, both of Smith’s economic applications of the invisible hand—which have long thought to have been disconnected from each other can both be found in Cantillon’s model of the isolated estate (in chapters that follow his famous estimate) where he explained how the estate owner will continue to get all the goods and services he demands after he turns over the direct management of his properties to farmers in exchange for rents.

Scholars have long compared and contrasted Smith with Cantillon on a variety of subjects and have found numerous similarities and several key differences.²⁹ For example, according to McNulty, Adam Smith gave competition “an intellectual and ideological significance,” but he was not the discoverer of how competition functioned.

On the contrary, he incorporated into the *Wealth of Nations* a concept of competition already well developed in the economic literature of his time...the essence of which was the effort of the individual seller to undersell, or the individual buyer to outbid, his rivals in the marketplace, and had earlier been employed and developed by a number of writers including Cantillon.³⁰

McNulty found that the *model* of competition was invented by Cantillon and was adopted and developed by others, but that it was Smith’s *presentation* of the concept that made

²⁸ We know that Smith read Cantillon’s *Essai* because Smith calls on Cantillon as an expert witness regarding the calculations Cantillon made regarding the minimum wages necessary to sustain a stable population of low-skilled workers. See Smith (1937 [1776] p. 68).

²⁹ One example of a difference between Cantillon and Smith is on issue of the supply of money. Smith must have been aware of the Cantillon-Hume analysis of the impact of increasing the supply of money, but choose not to adopt it, possibly because it was too complex for his audience, or because it might seem to open the door to mercantilist thinking. There is good evidence to suspect an important influence on Smith, David Hume, was influenced by Cantillon and we know that the Physiocrats were also strongly influenced by Cantillon.

³⁰ McNulty, p. 647.

Smith the prophet of competition—doing for economics what Newton did for physics and astronomy.³¹

Several scholars have connected Smith with Cantillon on the distinction between market price and natural price.³² According to Robertson and Taylor, Smith’s “natural price formula is applied only to the natural price of labour, and hardly goes beyond—if indeed it goes as far as—Cantillon.”³³ This is an important connection because Cantillon’s concept of “intrinsic value,” was an attempt to describe the value of a good in terms of the amount of land and labor that were entered into its production. This would certainly appear to resemble both Adam Smith’s natural price and the modern long-run equilibrium price. Cantillon then tried to determine a par value of land in terms of labor.³⁴ He found that you could not calculate such a number, but his theoretical answer was that a worker would have to be paid roughly twice the amount of subsistence in order to maintain the size of the workforce over time. This is what Smith attributes to Cantillon when he is referred to in *WN*.

Smith also broke down the price of goods into their component incomes of wages, rents and profits in a way similar to Cantillon. Schumpeter found that Cantillon, with econometric help from Quesnay, developed a circular-flow model of the economy based on class categories that were interdependent. This simplified model of the economy was adopted by Adam Smith, although Schumpeter notes that he and others “fumbled” some aspects of the model.³⁵ Cannan also explicitly links Smith with the “Economic Table.”³⁶

³¹ McNulty, p. 646.

³² See for example Spengler (1954, p. 423) who finds that Cantillon influenced Smith on value theory, distribution theory, market and natural price, as well as wage differentials and the wages fund.

³³ Robertson and Taylor, p. 192.

³⁴ It now appears that when Cantillon used the term “intrinsic value” that what he meant is best approximated by our modern concept of opportunity cost. See forthcoming paper by the author.

³⁵ Schumpeter, pp. 239-43.

Indeed, Cannan found several likely and possible connections between Cantillon and Smith, especially in terms of analysis and description in Part 1 of the *Essai*, most notably on wage differentials in the chapter that precede the chapters on intrinsic value and par value that Smith references in *WN*.³⁷ Brewer also found numerous similarities and probable influence of Cantillon on Smith, as well as the Physiocrats who are thought to have positively influenced Smith.³⁸ Aspromourgos correctly cautions that Smith could have derived his inspiration on a variety of microeconomic points from the likes of Quesnay and Turgot, rather than directly through Cantillon.³⁹ However, indirect influence still counts as influence and we are quite sure, in any case, that Smith, Quesnay and Turgot all read Cantillon.⁴⁰ There is also evidence that Cantillon influenced Hume, who was an important influence on Smith's economics.⁴¹ It would therefore seem that Smith read the *Essai* and was influenced by Cantillon on a number of key points, *including several that are related to the traditional interpretations of the invisible hand* including the price and wage system, competition, and the circular-flow nature of the economy.⁴²

Now let us look at the textual connection between Cantillon's *Essai* and Smith's invisible hand. In *TMS* Smith wrote how the average person might view the wealthy land owner with contempt and envy because they see only the results of a grand inequality and

³⁶ Cannan, p. 123.

³⁷ Smith, Adam. (1937 [1776]).

³⁸ Brewer (1992).

³⁹ Aspromourgos (1996).

⁴⁰ There are several sources that tie the Physiocrats and Turgot to Cantillon. For example, Blaug (1991, Introduction) notes that Cantillon's *Essai* "circulated in manuscript among French and English economic writers and was widely quoted and even plagiarized by, among others, Hume, Turgot, Mirabeau, Steuart and Adam Smith." He goes on to note that "for someone (Cantillon) writing half a century before Adam Smith, his treatment is amazingly post-Smithian."

⁴¹ Reference to a forthcoming paper by the author.

⁴² Blaug (1991, Introduction) found that Smith "totally neglected" Cantillon's discussion of entrepreneurship (leading to its disappearance from economics for over a century) where everyone trade at risks and creates a *system* of "arbitrage through time and across space," but I would argue that Smith mention the entrepreneur and he probably invoked the invisible hand, in part, to encapsulate for his readers the detailed processes involved in concepts like entrepreneurship, which Smith knew little about.

not the system that produced it. However, Smith described it as a “deception” where the wealthy are deceived into improving the economy and transforming the globe, including arts and science, by their efforts. But the “unfeeling landlord....without a thought for the wants of his brethren” can only consume the production of his extensive fields in his imagination. Smith finds that the land owner will consume little more than that of the lowest peasant. The deception is so great that in some respects the poor actually are better off in terms of leisure and stress so that Smith can conclude: “When Providence divided the earth among a few lordly masters, it neither forgot nor abandoned those who seemed to have been left out in the partition.”⁴³

Cantillon similarly wrote that land inevitably tends to come into the possession of the few and that it “does not appear that Providence has given the right of the possession of land to one man preferably to another.”⁴⁴ This quote begins Chapter 11 of the *Essai* where Cantillon constructs the estimate of how much the property owner has to “pay” his slaves, vassals, and other labor that Smith cites in *WN*. Cantillon also explained that land would be acquired by successful entrepreneurs and lost by profligate landowners and that land is also gained or lost in immense parcels by war and conquest.

In the next chapter Cantillon demonstrates how production is distributed among the owner, the farmers, the workers, and other trades. He goes on to develop a circular-flow closed economy where goods and labor flow between farmers and employees, owners and artisans, city and country. By demonstrating this mutual interdependence he noted that the owner has the incentive to maximize production and incomes:

⁴³ Smith, *TMS* (1980 [1759], pp. 185).

⁴⁴ Cantillon (39/31) Alternative translation: It does not appear that God has given the right of the possession of land to one man over another.

Hence the proprietors have need of the inhabitants as these have of the proprietors; but in this economy it is for the proprietors, who have the disposition and the direction of the landed capital, to give the most advantageous turn and movement to the whole.⁴⁵

Note especially that the proprietors “give the most advantageous *turn* and movement to the whole”⁴⁶ is suspiciously similar to Smith’s property owners who have fallen victim to a “deception” and “have *turned* the rude forests of nature into agreeable and fertile plains, and made the trackless and barren ocean a new fund of subsistence.” By wanting more for himself the property owner maximizes output and income for the populace.

Cantillon begins Chapter 12: “All Classes and Individuals in a State subsist or are enriched at the Expense of the Proprietors of Land” by noting that if the owner decided not to cultivate his lands the people could not be supported and that the people are an expense to the owners.

The land belongs to the proprietor but would be useless to them if it were not cultivated. The more labor is expended on it, other things being equal, the more it produces...Hence the proprietors have a need of the inhabitants as these have of the proprietors. It is need and necessity which enable farmers, mechanics, officers, soldiers, sailors, domestic servants and all the other classes who work or are employed in the state to exist. All these working people serve not only the Prince and the proprietor but each other.⁴⁷

In the next chapter Cantillon shows that everyone is an entrepreneur, except the property owners and those on fixed income, and that these entrepreneurs are always at risk and their profits are uncertain. Then in Chapter 14 he presents his model of the isolated estate where the property owner who directs his own estate “will necessarily use part of it for corn to feed the laborers, mechanics, and overseers who work for him.” Next the owner

⁴⁵ Cantillon (59-60/47).

⁴⁶ Cantillon (p. 60) “à donner le tour & le mouvement le plus avantageux au tout.”

⁴⁷ Cantillon (55-56/43)

decides to break up the estate and lease lands to farmers who then direct and sustain their workers. The owner uses rent from the farmers to buy goods from artisans and entrepreneurs so that “after this change all the people on this large estate live just as they did before...and that the farms of this great estate will be put to the same use as it formerly was.” This is so because if the farmers produced more of a good than previously, there would be a surplus and price would fall and according to Cantillon (79-81/61) “farmers always take care to use their land for the production of those things which they think will fetch the best price at market.” He described how the transition from the command economy to one based on the price system—where the motivation of profit and loss drive the economy—will (*ceteris paribus*) move to harmony or equilibrium. Next, he introduces a change in taste on the part of the estate owner to show that changes in taste “bring about the variation of demand which cause the variations of market prices”⁴⁸ and a new market equilibrium. Cantillon thereby presented a model of the mechanisms of the market and thereby demonstrated that there is a force that we now call consumer sovereignty. These chapters in Cantillon certainly provide a foundation for Smith’s use of the invisible hand in *TMS* and most of the foundation for its use in *WN*.

Now we turn to Smith’s use of the invisible hand in *WN*. Cantillon explained in Chapter 15 of Part 1 that population depended on the decisions of the property owners in allocating their capital and that increases in population also contributed to overall production. He also explained in Chapter 13 of the *Essai* that everything on the supply side of the economy is actually directed by entrepreneurs operating within the mechanism of the profit and loss system. All who are not on a fixed income including farmers, merchants, craftsmen, manufacturers, and shopkeepers are entrepreneurs because they are

⁴⁸ Cantillon (84-5/65)

at risk in the marketplace. Frugal entrepreneurs can even become as wealthy as the great land owners and profligate land owners can ruin and bankrupt themselves. In Chapter 14 Cantillon developed his model of the *isolated estate* where the world consists of a single property owner who can either directly manage his land or divide the land among a number of farmers who pay rent for the use of the land. The farmers maintain or pay their own workers and the owner sells the production he receives in rent for silver which he uses to buy goods and services from those on the estate that make clothing, shoes, furniture, etc. The owner's purchases can cause changes in demand which result in changes in market prices resulting in individual suppliers reaping profits or suffering losses. This causes a redirection of resources because "farmers always take care to use their land for the production of those things which they think will fetch the best price at market."⁴⁹ Or, as Smith put it (in leading up to the invisible hand):

Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of the society, which he has in view. But the study of his own advantage naturally, or rather necessarily, leads him to prefer that employment which is most advantageous to the society.⁵⁰

Smith then follows with his example where people prefer to keep their capital at home when profits are equal and that the more capital at home means more work and a larger population—points first made by Cantillon. This final issue of the use of capital in foreign trade is discussed at great length in Part III of the *Essai* where Cantillon explained that there are expenses and risks with placing capital in international trade:

The charge of exchange between Paris and Chalons is rarely fixed at more than 2½ or 3 per cent over or under par. But from Paris to Amsterdam the

⁴⁹ Cantillon (81/61).

⁵⁰ Smith, *WN* (1976 [1776], pp 453).

charge will amount to 5 or 6 per cent when specie has to be sent. The journey is longer, the risk is greater, more correspondents and commission agents are involved. From India to England the charge for carriage will be 10 to 12 per cent. From London to Amsterdam it will hardly exceed 2 per cent in peace time.⁵¹

Therefore all the components of Adam Smith's invisible hand—as it appears in *WN*—can be found in Cantillon's *Essai* including entrepreneurship and self-interest (Chapter 13), the role of prices and profits and losses and consumer sovereignty (Chapter 14), and even the relationship between capital and production and population (Chapter 16). Finally, Smith's statement regarding the risks of employing foreign capital can be found in Part III of the *Essai*. As a professor Smith would not likely have firsthand knowledge of this information at this time in his career, but Cantillon was a merchant banker and was intimately familiar with such details.

Conclusion

What at first appears as two different economic versions of Smith's invisible hand can now be seen as derived from a single source, specifically chapters 12-15 of Part I of Cantillon's *Essai*, especially his model of the isolated estate. What exactly Smith was thinking, what he meant, etc., can still be debated, but it would now appear that Smith's source for the invisible hand was his reading of Cantillon's *Essai*. This does nothing to diminish Smith's accomplishment, it simply adds clarity and definition to the concept and provides a more certain foundation for understanding of Smith's invisible hand.

⁵¹ Cantillon (334/252-3).

We should even credit Smith with being very observant and astute.⁵² The *Essai* was written in a difficult style, was highly rigorous—using new methods and terminology—and was an integrated presentation that carried across various chapters and sections. Consequently Cantillon’s *Essai* was often misunderstood by his readers. Smith appears to have understood the material—especially of Part I—and turned Cantillon’s *well-disguised hand* into his own invisible hand.

What then are the component parts of the invisible hand as constructed by Cantillon? Of central importance was his model of the isolated estate, where Cantillon starts with the property owner directing the activities of the estate and then transforms the estate into leased farms and independent entrepreneurs, markets, wages and prices. The land owner uses his rents to purchase goods and services for himself, but the vast majority of the production of the estate is ultimately consumed by his former slaves and servants. In the model, Cantillon moves the economy from the management of the visible hand of the property owner to the invisible hand of the market, and the resulting economy is presented as a circular-flow of production, distribution, consumption and most importantly, one of mutual interdependence. The market itself is directed by consumers whose choices are reflected in market prices that send signals to entrepreneurs who are directed by their self-interest to obtain profits and redirected by losses to ensure maximum production and consumer sovereignty. Savings (i.e., capital) enhances our ability to produce and wealth represents our ability to consume.

To the extent that this interpretation of Smith’s invisible hand can be sustained, it clearly supports the traditional interpretations of the invisible hand. Indeed it

⁵² It could be Smith’s friend David Hume that had alerted Smith to the genius of Cantillon or perhaps it was the Physiocrats that he visited who were “students” of Cantillon.

encompasses the interpretations of the role of self-interest, the price mechanism, competition, and the mutual advantage of exchange and adds to them both consumer sovereignty and the circular flow nature of the economy. What it probably is not, is the “spontaneous order,” although it could be an example of *a* spontaneous order. It also is probably not Smith’s system of natural liberty, but only a key aspect of it. Hopefully this interpretation is a sufficiently strong to prevent the invisible hand from succumbing to the multiple-conception disorder that currently threatens its future scientific use.⁵³

⁵³ Ironically, the best example of a concept losing its scientific usefulness due to a multiple conception disorder is mercantilism.

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Cantillon's Invisible Hand: Part 1 of the *Essai*

1. **Wealth** is our ability to consume
2. **Division of Labor**, Wages, and Income
3. **Isolated Estate Model** (visible hand of estate owner)
4. **Circular Flow Model** (the invisible hand takes over)
5. **Entrepreneurship and Self-Interest** are pervasive
6. **Prices** in general are based on land and labor entering production
7. **Market Price** changes signal resource reallocations
8. **Profits and Losses** weed out and promote entrepreneurs
9. **Consumer Sovereignty** (property owners ultimately decide everything)
10. **Capital** is the wages fund that determines population and the standard of living.

Referee Appendix: Excerpts from Adam Smith

Excerpt from *TMS* (1980 [1759], pp. 183-5, emphasis added):

But though this splenetic philosophy, which in time of sickness or low spirits is familiar to every man, thus entirely depreciates those great objects of human desire, when in better health and in better humour, we never fail to regard them under a more agreeable aspect. Our imagination, which in pain and sorrow seems to be confined and cooped up within our own persons, in times of ease and prosperity expands itself to every thing around us. We are then charmed with the beauty of that accommodation which reigns in the palaces and oeconomy of the great; and admire how every thing is adapted to promote their ease, to prevent their wants, to gratify their wishes, and to amuse and entertain their most frivolous desires. *If we consider the real satisfaction which all these things are capable of affording, by itself and separated from the beauty of that arrangement which is fitted to promote it, it will always appear in the highest degree contemptible and trifling. But we rarely view it in this abstract and philosophical light.* We naturally

confound it in our imagination with the order, the regular and harmonious movement of the system, the machine or oeconomy by means of which it is produced. *The pleasures of wealth and greatness, when considered in this complex view, strike the imagination as something grand and beautiful and noble*, of which the attainment is well worth all the toil and anxiety which we are so apt to bestow upon it.

And it is well that nature imposes upon us in this manner. *It is this deception which rouses and keeps in continual motion the industry of mankind.* It is this which first prompted them to cultivate the ground, to build houses, to found cities and commonwealths, and to invent and improve all the sciences and arts, which ennoble and embellish human life; which have entirely changed the whole face of the globe, have turned the rude forests of nature into agreeable and fertile plains, and made the trackless and barren ocean a new fund of subsistence, and the great high road of communication to the different nations of the earth. The earth by these labours of mankind has been obliged to redouble her natural fertility, and to maintain a greater multitude of inhabitants. *It is to no purpose, that the proud and unfeeling landlord views his extensive fields, and without a thought for the wants of his brethren, in imagination consumes himself the whole harvest that grows upon them.* The homely and vulgar proverb, that the eye is larger than the belly, never was more fully verified than with regard to him. *The capacity of his stomach bears no proportion to the immensity of his desires, and will receive no more than that of the meanest peasant. The rest he is obliged to distribute among those, who prepare, in the nicest manner, that little which he himself makes use of, among those who fit up the palace in which this little is to be consumed, among those who provide and keep in order all the different baubles and trinkets, which are employed in the oeconomy of greatness; all of whom thus derive from his luxury and caprice, that share of the necessities of life, which they would in vain have expected from his humanity or his justice.* The produce of the soil maintains at all times nearly that number of inhabitants which it is capable of maintaining. The rich only select from the heap what is most precious and agreeable. They consume little more than the poor, and in spite of their natural selfishness and rapacity, though they mean only their own conveniency, though the sole end which they propose from the labours of all the thousands whom they employ, be the gratification of their own vain and insatiable desires, they divide with the poor the produce of all their improvements. *They are led by an invisible hand to make nearly the same distribution of the necessities of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society,* and afford means to the multiplication of the species. *When Providence divided the earth among a few lordly masters, it neither forgot nor abandoned those who seemed to have been left out in the partition.* These last too enjoy their share of all that it produces. In what constitutes the real happiness of human life, they are in no respect inferior to those who would seem so much above them. *In ease of body and peace of mind, all the different ranks of life are nearly upon a level, and the beggar, who suns himself by the side of the highway, possesses that security which kings are fighting for.*

Excerpt from WN (1976 [1776], pp 453-7)

The general industry of the society never can exceed what the capital of the society can employ. As the number of workmen that can be kept in employment by any particular person must bear a certain proportion to his capital, so the number of those that can be continually employed by all the members of a great society must bear a certain proportion to the whole capital of that society, and never can exceed that proportion. 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. It is his own advantage, indeed, and not that of the society, which he has in view. But 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; provided always that he can thereby obtain the ordinary, or not a great deal less than the ordinary profits of stock.

Thus, upon equal or nearly equal profits, every wholesale merchant naturally prefers the home trade to the foreign trade of consumption, and the foreign trade of consumption to the carrying trade. In the home trade his capital is never so long out of his sight as it frequently is in the foreign trade of consumption. He can know better the character and situation of the persons whom he trusts, and if he should happen to be deceived, he knows better the laws of the country from which he must seek redress. In the carrying trade, the capital of the merchant is, as it were, divided between two foreign countries, and no part of it is ever necessarily brought home, or placed under his own immediate view and command. The capital which an Amsterdam merchant employs in carrying corn from Konigsberg to Lisbon, and fruit and wine from Lisbon to Konigsberg, must generally be the one half of it at Konigsberg and the other half at Lisbon. No part of it need ever come to Amsterdam. The natural residence of such a merchant should either be at Konigsberg or Lisbon, and it can only be some very particular circumstances which can make him prefer the residence of Amsterdam. The uneasiness, however, which he feels at being separated so far from his capital generally determines him to bring part both of the Konigsberg goods which he destines for the market of Lisbon, and of the Lisbon goods which he destines for that of Konigsberg, to Amsterdam: and though this necessarily subjects him to a double charge of loading and unloading, as well as to the payment of some duties and customs, yet for the sake of having some part of his capital always under his own view and command, he willingly submits to this extraordinary charge; and it is in this manner that every country which has any considerable share of the carrying trade becomes always the emporium, or general market, for the goods of all the different countries whose trade it carries on. The merchant, in order to save a second loading and unloading, endeavours always to sell in the home market as much of the goods of all those different countries as he can, and thus, so far as he can, to convert his carrying trade into a foreign trade of consumption. A merchant, in the same manner, who is engaged in the foreign trade of consumption, when he collects goods for foreign

markets, will always be glad, upon equal or nearly equal profits, to sell as great a part of them at home as he can. He saves himself the risk and trouble of exportation, when, so far as he can, he thus converts his foreign trade of consumption into a home trade. Home is in this manner the centre, if I may say so, round which the capitals of the inhabitants of every country are continually circulating, and towards which they are always tending, though by particular causes they may sometimes be driven off and repelled from it towards more distant employments. But a capital employed in the home trade, it has already been shown, necessarily puts into motion a greater quantity of domestic industry, and gives revenue and employment to a greater number of the inhabitants of the country, than an equal capital employed in the foreign trade of consumption: and one employed in the foreign trade of consumption has the same advantage over an equal capital employed in the carrying trade. Upon equal, or only nearly equal profits, therefore, every individual naturally inclines to employ his capital in the manner in which it is likely to afford the greatest support to domestic industry, and to give revenue and employment to the greatest number of people of his own country.

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.

The produce of industry is what it adds to the subject or materials upon which it is employed. In proportion as the value of this produce is great or small, so will likewise be the profits of the employer. But it is only for the sake of profit that any man employs a capital in the support of industry; and he will always, therefore, endeavour to employ it in the support of that industry of which the produce is likely to be of the greatest value, or to exchange for the greatest quantity either of money or of other goods.

But the annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry, or rather is precisely the same thing with that exchangeable 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. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

What is the species of domestic 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. 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.

To give the monopoly of the home market to the produce of domestic industry, in any particular art or manufacture, is in some measure to direct private people in what manner they ought to employ their capitals, and must, in almost all cases, be either a useless or a hurtful regulation. If the produce of domestic can be brought there as cheap as that of foreign industry, the regulation is evidently useless. If it cannot, it must generally be hurtful. It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a tailor. The farmer attempts to make neither the one nor the other, but employs those different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours, and to purchase with a part of its produce, or what is the same thing, with the price of a part of it, whatever else they have occasion for.

What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage. The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished, no more than that of the above-mentioned artificers; but only left to find out the way in which it can be employed with the greatest advantage. It is certainly not employed to the greatest advantage when it is thus directed towards an object which it can buy cheaper than it can make. The value of its annual produce is certainly more or less diminished when it is thus turned away from producing commodities evidently of more value than the commodity which it is directed to produce. According to the supposition, that commodity could be purchased from foreign countries cheaper than it can be made at home. It could, therefore, have been purchased with a part only of the commodities, or, what is the same thing, with a part only of the price of the commodities, which the industry employed by an equal capital would have produced at home, had it been left to follow its natural course. The industry of the country, therefore, is thus turned away from a more to a less advantageous employment, and the exchangeable value of its annual produce, instead of being increased, according to the intention of the lawgiver, must necessarily be diminished by every such regulation.