

# **Adam Smith, Behavioral Economist**

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## I. Introduction

Even those college students most bored by economics, and confused about which direction those two stupid curves slope, are likely to remember the phrase “the invisible hand” or the famous quotation from Adam Smith’s *The Wealth of Nations* (WN): “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” (WN I, ii, 18). With the benefit of insights provided by later economists, Smith’s quote can be interpreted as a conjecture about how decentralized markets populated by self-interested agents can lead to Pareto-optimal allocations, even when no one is trying to help others.

Ironically, while Smith argued in WN that “benevolence” is not the source of Pareto-optimal exchange, he clearly didn’t believe that people are never benevolent. Indeed, his other famous book, *The Theory of Moral Sentiments* (TMS), is full of insights about benevolence, as well as other psychological phenomena such as loss aversion, willpower, and fairness, which have been the focus of modern behavioral economics (see Camerer and Loewenstein, 2004, for a recent review). This essay investigates Smith’s behavioral economics, showing that it not only presages many insights that have appeared in the literature (cf. Smith, V., 1998) but also suggests promising new directions for research.

At the center of Smith’s behavioral economics is the idea that behavior is determined by a struggle between two processes which he termed the “passions” and the “impartial spectator.” The passions, in Smith’s framework, included drives such as hunger and sex, emotions such as fear and anger, and motivational feeling states such as pain. Smith viewed behavior as under the direct control of the passions, but believed that people have an ability to override passion-driven behavior by viewing their own behavior as if from the perspective of an outsider – the impartial spectator -- a “moral hector who, looking over the shoulder of the economic man, scrutinizes every move he makes” (Grampp, 1948: 317). The “impartial spectator” plays many roles in Smith’s theory. When it comes to intertemporal choice, it serves as the source of “self-denial, of self-government, of that command of the passions which subjects all the movements of our nature to what our own dignity and honour, and the propriety of our own conduct, require” (TMS I, i, v, 26), much like a farsighted “planner” entering into conflict with short-sighted ‘doer’-like passions (Shefrin and Thaler, 1981). In social situations it plays the role of a conscience, weighing conflicting social needs while judiciously putting aside a person’s impassioned self-interest. Yet, Smith was acutely aware of the limits to impartial perspective taking, and recognized that the impartial spectator could be led astray or rendered impotent by sufficiently intense passions:

There are some situations which bear so hard upon human nature that the greatest degree of self-government... is not able to stifle, altogether, the voice of human weakness, or reduce the violence of the passions to that pitch of moderation, in which the impartial spectator can entirely enter into them. (TMS I, i, v, 29)

Smith’s psychological perspective in TMS is remarkably similar to ‘dual-process’ frameworks advanced by psychologists (e.g., Kirkpatrick and Epstein, 1992; Sloman, 1996; Metcalfe and Mischel, 1999), neuroscientists (e.g., Damasio, 1994; LeDoux, 1996;

Panksepp 1998) and behavioral economists (Loewenstein and O'Dohoghue, 2004) based on behavioral data and detailed observations of brain functioning.

## II. Applications of the dual-process perspective

### A. Basic preferences

**Loss aversion:** Smith's work is packed with basic insights about preferences. Perhaps most significantly, approximately 200 years before Kahneman and Tversky (1979) identified the regularity that has come to be known as 'loss aversion', Smith displays an acute awareness of the phenomenon. He writes that "breach of property, therefore, theft and robbery, which take from us what we are possessed of, are greater crimes than breach of contract, which only disappoints us of what we expected" (TMS II, ii, *ii*, 121), and later he expresses loss aversion in even bolder form: "Pain.. is, in almost all cases, a more pungent sensation than the opposite and correspondent pleasure. The one almost always depresses us much more below the ordinary, or what may be called the natural state of our happiness, than the other ever raises us above it" (TMS III, *ii*, 176-7).

Two centuries later, we not only have a fuller appreciation of the source of this phenomenon (brain imaging shows that losses and gains are processed in different regions; O'Doherty et al., 2001), but of its significance for economics. When coupled with narrow bracketing of decisions – the tendency to take decisions one-at-a-time without considering the big picture -- the influence of loss-aversion is evident in asset returns (Benartzi and Thaler, 1997), labor supply (Camerer et al, 1997), the reluctance to sell losing stocks and houses (Odean, 1998; Genesove and Mayer, 2001), and large gaps between buying and selling prices (Kahneman, Knetsch and Thaler, 1990).

**Intertemporal choice and self-control:** Intertemporal choice is perhaps the most straightforward application of Smith's dual process model. Smith viewed the passions as largely myopic. "The pleasure which we are to enjoy ten years hence," he observed, "interests us so little in comparison with that which we may enjoy to-day, the passion which the first excites, is naturally so weak in comparison with that violent emotion which the second is apt to give occasion to, that the one could never be any balance to the other, unless it was supported by the sense of propriety" [i.e., the impartial spectator] (TMS IV, *ii*, 273). For the impartial spectator, in contrast, the present and what is likely to be their future situation are very nearly the same: he sees them nearly at the same distance, and is affected by them very nearly in the same manner..."The spectator does not feel the solicitations of our present appetites. To him the pleasure which we are to enjoy a week hence, or a year hence, is just as interesting as that which we are to enjoy this moment" (TMS IV, *ii*, 272).

The struggle between the myopic passions and farsighted impartial spectator appears later in behavioral economics in the form of a "doer" and "planner" in Shefrin and Thaler (1981) (see also Benabou and Pyciak, 2002; Bernheim and Rangel, 2002). Two-piece  $\beta$ - $\delta$  hyperbolic discounting models (Laibson, 1997) in a similar spirit have also been used by Angeletos et al (2001) to study life-cycle saving, by O'Donoghue and Rabin (1999) to study lifecycle temptation, and by Ashraf et al (2004) to study demand for committed savings in the Philippines. Mapped roughly onto Smith's terms,  $\beta$  is the weight on future outcomes, representing the strength of the passions which prefer immediate rewards, and  $\delta$  is a conventional discount rate (Smith's passage above suggests that the impartial spectator uses  $\delta=1$ ). In fact, recent research in which decision-

makers' brains were scanned while they made intertemporal choices vindicates Smith's view that decisions that provide the potential for pleasures which we may enjoy today activate emotional regions of the brain in a way that decisions involving all delayed outcomes do not (McClure, Laibson, Loewenstein and Cohen, 2004).

**Overconfidence:** A large amount of recent research by psychologists and decision researchers provides systematic empirical support for Smith's observation, based solely on his personal observations, of the "over-weening conceit which the greater part of men have of their own abilities." According to Smith, "the chance of gain is by every man more or less over-valued, and the chance of loss is by most men under-valued, and by scarce any man, who is in tolerable health and spirits, valued more than it is worth" (WN I, x, 1). Smith's "overweening conceit" reappears in modern behavioral economics in the form of executive "hubris" which motivates the failure of so many mergers (Roll, 1986), other widespread business failures (Camerer and Lovallo, 1999), and has been reverse-engineered in evolutionary economics models (Postelwaite and Compte, 2001; Heifetz and Spiegel, 2000). Moreover, Smith's caveat that wishful thinking only applies to those in "tolerable health and spirits" anticipates modern studies showing that people who are not in tolerable health and spirits—specifically, the clinically depressed—are the exceptional ones among us who are *not* optimistic wishful thinkers (e.g., Taylor and Brown, 1994).

## **B. Social preferences**

**Altruism:** As already mentioned, despite the popular view taken from WN, Smith did not view people as inherently selfish. In fact, judging from the extensive treatment he gave it in TMS, Smith viewed sympathy as one of the more important passions. However, he viewed it as an extremely unreliable guide to moral behavior.

In some cases, Smith believed, natural sympathy falls short of what is morally justified by mass misery. Thus, in one typically evocative passage he noted the striking lack of sympathy that a resident of Europe would be likely to have of an earthquake that eliminated the population of China. After expressing "very strongly his sorrow for the misfortune of that unhappy people," Smith wryly commented, such an individual would likely "pursue his business or his pleasure, take his repose or his diversion, with the same ease and tranquility as if no such accident had happened... If he was to lose his little finger to morrow, he would not sleep to-night; but, provided he never saw them, he will snore with the most profound security over the ruin of a hundred millions of his brethren" (TMS III, *iii*, 192-193).

In other cases, however, Smith believed that people experience sympathy that is completely out of proportion to the plight of the individual one feels sympathetic toward. "We sometimes feel for another, a passion of which he himself seems to be altogether incapable," Smith wrote. "What are the pangs of a mother, when she hears the moanings of her infant, that, during the agony of disease, cannot express what it feels? In her idea of what it suffers, she joins, to its real helplessness, her own consciousness of that helplessness, and her own terrors for the unknown consequences of its disorder; and out of all these, forms, for her own sorrow, the most complete image of misery and distress. The infant, however, feels only the uneasiness of the present instant, which can never be great" (TMS I, *i*, *i*, 7-8). Smith adds dryly, that "we sympathize even with the dead" (TMS I, *i*, *i*, 8), who themselves experience nothing.

If humans were under the lone control of their passions, one could expect to observe callousness alternating with remarkable generosity, with little utilitarian logic governing

the consistency of these attitudes. This tendency is manifested in the “identifiable victim effect,” in which people sympathize more with a known victim than with a statistical likelihood that a not-yet-known person who is likely to be victimized (Schelling, 1984; Small and Loewenstein, 2003). In the political economy, fluctuations in sympathy probably influence public policies, creating huge inconsistencies in how different policies value human life (Tengs and Graham, 1996).

Carefully controlled economics experiments show some of the fluctuations in expressed sympathy that Smith’s astute observations about the fickleness of sympathy predict. For example, in dictator game experiments people simply divide a known sum of money between themselves and another person. Absent any knowledge about the target recipient, people offer an average of 20% (offers of nothing and half are most common; Camerer, 2003, chapter 2). When dictators know the recipient is the Red Cross, rather than a fellow student, the average allocation doubles (Eckel and Grossman, 1996). When the recipient stands up and gives a few facts about him or herself, the average amount given goes up to half and the variance increases-- as if dictators generally sympathize when they know a little about somebody, but also make snap character judgments of who is deserving and who is not (Bohnet and Frey, 1999).

These sorts of fluctuations in the effects of sympathy are moderated, according to Smith, by the impartial spectator. Returning to the case of devastation in China, Smith asks whether, given his lack of visceral empathy, the European would be willing to “sacrifice the lives of a hundred millions of his brethren” to save the injury to his little finger. Smith concludes that the answer is “No”: “Human nature startles with horror at the thought, and the world, in its greatest depravity and corruption, never produced such a villain as could be capable of entertaining it” (TMS III, *iii*, 192). Just as the impartial spectator is indifferent between our own well-being at different points in time, Smith suggests the impartial spectator is indifferent between our own well-being and that of others. The impartial spectator recognizes that “we are but one of the multitude, in no respect better than any other in it” (TMS III, *iii*, 194).

***Fairness:*** Although Smith viewed altruism as a somewhat erratic force in human affairs, he believed that other motivations played a more reliable civilizing role. Chief among these was fairness. Smith writes:

Nature has implanted in the human breast, that consciousness of ill-desert, those terrors of merited punishment which attend upon its violation, as the great safe-guards of the association of mankind, to protect the weak, to curb the violent, and to chastise the guilty (TMS II, *ii*, *iii*, 125)

Smith believed this natural sentiment towards fairness was the source of the virtue of justice, which he saw as the “main pillar that upholds the whole edifice. If it is removed, the great, the immense fabric of human society... must in a moment crumble to atoms” (TMS II, *ii*, *iii*, 125). Moreover, he viewed the desire for justice as something primal: “All men, even the most stupid and unthinking, abhor fraud, perfidy, and injustice, and delight to see them punished. But few men have reflected upon the necessity of justice to the existence of society, how obvious soever that necessity may appear to be” (TMS II, *ii*, *iii*, 129). Had Smith been aware of modern research showing that Capuchin monkeys will reject small rewards when they see other monkeys they perceive as undeserving

getting more than they do (Brosnan and de Waal, 2002), he could have extended his argument even beyond stupid and unthinking *men*.<sup>1</sup>

Even when it comes to a passion as inherently social as fairness, the impartial spectator still plays an essential role. In Smith's view, the impartial spectator causes men to internalize other people's sense of fairness by viewing their own actions through the eyes of an objective observer. As he expressed it, "There is no commonly honest man who does not dread the *inward disgrace* of such an action" (TMS III, *iii*, 195, emphasis added).

### ***Social Preferences and the Market***

Smith believed that this fear of negative appraisal by the impartial spectator – of inward disgrace – played an essential role in market interactions, allowing repeated transactions, and the material gains they enable, to occur. As Boulding (1969, p. 5) points out: "there is a minimum degree of benevolence even in exchange without which it cannot be legitimated and cannot operate as a social organizer". Arrow (1974) also notes the importance of trust as a lubricant of exchange, economizing on the costs of gathering information about trading partners.

In experiments, norms of positive reciprocity often create trust where it has no business flourishing (according to the textbook view that emphasizes moral hazard when contracts are incomplete)— among strangers in one-shot transactions. For example, in simple 'trust game' experiments subjects decide how much money to put in a mailbox, and their investment is tripled (representing a socially productive return). A second subject takes the tripled money out and can keep it all, or repay some to the investor if she feels morally obliged to. Most experiments show that the second subject *does* repay money, even in one-shot games that control for anonymity, and they typically repay just enough to make the investment worthwhile (Berg et al, 1995; Camerer, 2003, chapter 2). Experiments run in Russia, South Africa and the U.S. showed that many trustors do not even expect to make money, but are motivated to "invest" by pure "warm-glow" altruism (Ashraf et al, 2003) – i.e., by what Smith termed the "principles in his nature, which interest him in the fortune of others... though he derives nothing from it except the pleasure of seeing it" (TMS I, *i*, *i*, 3). Simple models that incorporate a preference for fairness or equality have been developed and applied to a broad range of games (Rabin, 1993; Fehr and Gächter, 2000).

Furthermore, trust as measured in simple surveys is strongly correlated with economic growth (Knack and Keefer, 1997). Moreover, an anthropology experiment involving 15 small-scale societies found that offers in ultimatum games were correlated with the degree of market trading in those societies. Societies in which people buy and sell more often in markets are, somewhat surprisingly, characterized by ultimatum offers closer to equal sharing (Henrich et al, 2004).

Thus, while Smith's most famous passage cited at the outset of this essay denies the necessity of benevolence in making markets work, the cross-country and anthropological data show that other-regarding preferences, as measured by trust or fairness in ultimatum bargaining, are correlated with the success and prevalence of market trade. The benevolence of the butcher, baker and brewer may not be *necessary* for

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<sup>1</sup> In fact, cotton-top tamarins will pull a lever to give marshmallows (which tamarins love) to other tamarins who have altruistically rewarded them with marshmallows in earlier lever-pulls, more often than they will pull levers to tamarins who were not previously altruistic (Hauser et al., 2003).

markets to work, but benevolence manifested in experimental analogues to simple exchange does seem to be *correlated* with market behavior. The Adam Smith who wrote about moral sentiments would not be surprised by these facts, but it remains a challenge to the economics profession to explain them.

### **C. Consumption and its discontents**

In the sections of WN dealing with the invisible hand, Smith certainly seems to be advocating the idea that individuals pursuing their own self-interest will promote the public good. However, TMS provides a severely contrasting perspective on what Smith thought actually resulted from the pursuit of self-interest.

First, Smith seemed to be well aware of the transience of pleasure and pain, as documented by considerable modern research showing short-term impacts on happiness of both positive and negative outcomes due to hedonic adaptation (Frederick & Loewenstein, 1999). "By the constitution of human nature," Smith (TMS III, iii, p. 209) commented, "agony can never be permanent." Following a calamity, he noted, a person "soon comes, without any effort, to enjoy his ordinary tranquility."

Second, Smith observed that people often overestimate the duration of happy and sad feelings, again consistent with a large body of contemporary psychological research (c.f., Wilson & Gilbert, 2003). As Smith noted,

"A man with a wooden leg suffers, no doubt, and foresees that he must continue to suffer during the remainder of his life, a very considerable inconveniency. He soon comes to view it, however, exactly as every impartial spectator views it; as an inconveniency under which he can enjoy all the ordinary pleasures both of solitude and of society... He no longer weeps, he no longer laments, he no longer grieves over it, as a weak man may sometimes do in the beginning. (TMS III, iii, p. 209).

Smith's example is amazingly prescient of a classic study by Brickman, and Coates and Janoff-Bulman (1978) showing that happiness of paraplegics and lottery winners tends to revert surprisingly close to a normal baseline after their respective tragic and wonderful life-changing events.

In a few other passages in TMS, Smith argues that much economic activity is the product of exactly such a forecasting error – the illusion that acquiring wealth, possessions and status will make us eternally happy. At numerous points in TMS, Smith expresses skepticism about the pleasure derived from possessions: "How many people ruin themselves by laying out money on trinkets of frivolous utility? What pleases these lovers of toys, is not so much the utility as the aptness of the machines which are fitted to promote it" (TMS IV, i, 259).

Smith also believed that the primary purpose of wealth-accumulation, beyond a minimal level that provides economic security, was not for consumption, but for the social attention that wealth conveys. "What are the advantages which we propose by that great purpose of human life which we call bettering our condition?" Smith asked in TMS. "To be observed, to be attended to, to be taken notice of with sympathy, complacency, and approbation, are all the advantages which we can propose to derive from it. It is the vanity, not the ease, or the pleasure, which interests us." (TMS I, iii, ii, 70-1). Yet, even when it came to vanity, Smith believed that the anticipation was much better than the

realization. Indeed, he devotes numerous pages of TMS to describing the many ways in which the pursuit of status can backfire.

Yet, while questioning the utility of trinkets and vanity at the individual level, Smith seemed to believe that these misguided motives were beneficial at the aggregate level because they created the unlimited desire for consumption that fuels economic progress:

...the rich man consumes no more food than his poor neighbour...The desire for food is limited in every man by the narrow capacity of the human stomach; but the desire of the conveniences and ornaments...seem to have no limit or certain boundary. (WN I, xi, ii, 183)

For Smith, then, the market economy is driven by a “deception” – the misguided belief that wealth brings happiness. Yet it is a deception that proves useful for productivity. As Smith notes, “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.” (TMS, IV, i, 263-4). The desire to fulfill these unlimited needs motivates capitalist growth through promoting investment that will lead to greater wealth.

#### **D. Unexploited ideas**

Much as one might show that one's pet theory predicts all sorts of facts that are already established empirically, we have shown that The Theory of Moral Sentiments anticipates numerous central ideas in modern behavioral economics. Can Smith be used - - much as new theories are ideally used to predict phenomena that have not yet been documented -- to predict future developments in behavioral economics? While we cannot predict what directions behavioral economics will take, this seems likely to be the case. TMS is packed not only with insights that presage developments in contemporary behavioral economics but also with promising leads that have yet to be pursued. Here we enumerate four of them.

**Posterity:** One motive that certainly drives the efforts of many academic economists, but to our knowledge has rarely been discussed by them, is posterity. As Smith comments, "Men have voluntarily thrown away life to acquire after death a renown which they could no longer enjoy. Their imagination, in the meantime, anticipated that fame which was in future times to be bestowed upon them" (TMS, III, ii, 169). Posterity might be thought of something that is reserved for the richest and most powerful members of society, who certainly do seem to care about it based on the frequency with which they provide large charitable donations for named buildings in universities and hospitals, but it is almost certainly not limited to the rich. Even the desire for children, to 'carry on the family name' is no doubt partly fueled by this motive. Economists have studied the bequest motive, but have not yet explored what may be far more potent desires for posterity that take other forms.

**Negative reactions to being misjudged:** Economics generally assumes that people care about outcomes, not about the source of such outcomes. However, there is quite a bit of research pointing to the limitations of this assumption. Tom Tyler, for example,

has done research on 'procedural justice' showing that defendants in trials care as much about whether they believe that their trial was fair as about the outcome of the trial. Smith seems to have been well aware of these notions, and drew special attention to one particular situation – that of "unmerited reproach," which, he noted, "is frequently capable of mortifying very severely even men of more than ordinary constancy... An innocent man, brought to the scaffold by the false imputation of an infamous or odious crime, suffers the most cruel misfortune which it is possible for innocence to suffer" (TMS III, ii, 174). This insight has interesting implications for principal-agent theory, which deals with situations in which, because effort is unobservable, the principal needs to reward output. Smith's insights suggest that grave damage could be done, in such situations, if the principal inadvertently, and in good faith, ends up penalizing an agent who put out a high degree of effort which, due to bad luck, resulted in a low level of output.

***Mistaken belief in objectivity of tastes:*** Another example of Smith's as-yet largely unpursued insights involves people's attributions of their own tastes. Beginning with the huge cross-cultural differences in tastes for food, there is ample evidence that tastes are very subjective, a matter of culture, familiarity, and so on. However, Smith argued that people underestimate such influences, believing instead that their tastes are based on the objective characteristics of the goods. As he commented, "few men... are willing to allow, that custom or fashion have much influence upon their judgments concerning what is beautiful, .. imagine that all the rules which they think ought to be observed in each of them are founded upon reason and nature, not upon habit or prejudice." (TMS V, i) Ross and Ward (in press) call this prejudice "naïve realism", the tendency for people to think their own tastes and beliefs are more legitimate and more widely shared than they really are. Naïve realism has important implications for economics-- for gift-giving, for multi-issue negotiations, in which people are likely to think that their own preferences are shared by the other side more than they are, in principal-agent situations in which the principal has to set rewards for the agent, in sales and marketing (Davis, Hoch and Ragsdale, 1986), and intercultural misunderstanding. If we believe that we don't like to eat monkey because monkey is *inherently* disgusting, then we are likely to disparage monkey-eaters, rather than treat our own distaste and their taste as akin to tastes for opera or smelly cheese. Besides conflict, naïve realism can lead to bans on products a ruling government thinks wrong-thinking citizens have no right to consume (such as religious prohibitions on food, speech, and clothing).

***Admiration for the rich:*** As a final new application, peculiarly, and contrary to the sensible notion that one should sympathize with those less fortunate than oneself, Smith argued that there is a natural tendency to experience the most profound sympathy toward the high and mighty:

When we consider the condition of the great, in those delusive colours in which the imagination is apt to paint it, it seems to be almost the abstract idea of a perfect and happy state. It is the very state which, in all our waking dreams and idle reveries, we had sketched out to ourselves as the final object of all our desires. We feel, therefore, a peculiar sympathy with the satisfaction of those who are in it. We favour all their inclinations, and forward all their wishes. What pity, we think, that any thing should spoil and corrupt

so agreeable a situation!. It is the misfortunes of kings only which afford the proper subjects for tragedy (TMS I, iii, ii, 72-3).

The giant crowds who mourned the accidental deaths of Princess Diana and the American royalty equivalent (John F. Kennedy Jr.) sound very much like what Smith refers to in his last sentence above. Visit the newsstand and pick up *Us* or *People* magazine to see the further impact of Smith's conjecture in the economy. Those magazines, and similar highly-rated TV shows, are filled with stories about where athletes and stars shop (some are very minor stars-- Ryan Phillippe is a mainstay), what they eat and wear, and chronicling the many ups and downs of their often-zany love lives. Celebrity worship has an economic effect through the use of celebrities as marketing vehicles and brand umbrellas. Big stars like Jennifer Lopez sell clothes and perfume bearing their names. Their comparative advantage is obviously in associating their names with those products, hijacking the sympathetic process Smith notes, rather than in making products which are better or cheaper.

Although Smith believed that the "disposition to admire, and almost to worship, the rich and the powerful, and to despise, or at least, to neglect, persons of poor and mean condition... is... the great and most universal cause of the corruption of our moral sentiments" (TMS, I, iii, iii, 84), he also believed that it was "necessary both to establish and to maintain the distinction of ranks and the order of society" (TMS, I, iii, iii). This is based on a moral mistake: "that wealth and greatness are often regarded with the respect and admiration which are due only to wisdom and virtue; and that the contempt, of which vice and folly are the only proper objects, is most unjustly bestowed upon poverty and weaknesses, has been the complaint of moralists in all ages" (TMS, I, iii, iii, 84). However, it is a mistake which provides the order and social stability necessary for ever-expanding wealth. It may also help to explain one of the puzzles of capitalism: the failure of the teeming multitudes in democratic societies such as the U.S. to impose high taxes on the richest members. One explanation that has been offered is that people expect to get rich themselves, and there may be some element of truth to this (even if it doesn't make much sense logically). However, Smith's perspective provides another possible mechanism; maybe people don't want to tax the rich because they don't want to "spoil and corrupt" what they perceive as their "agreeable situation"!

#### IV. Conclusion

While he is most famous for the observation in the *Wealth of Nations* that Pareto-optimal allocations can result even if market participants are not benevolent, the rich tapestry of Adam Smith's writing, and especially the ideas presented in *Theory of Moral Sentiments*, present a very different picture. Smith's economy is not inhabited by the dispassionate, rational, agents that most economists would assume based on a casual or second-hand reading of WN. Smith's economic agents are driven by an internal struggle between their impulsive, fickle (but entirely indispensable passions), and their impartial spectator. They weigh out of pocket costs more than opportunity costs, have self-control problems, and are overconfident. They display erratic patterns of sympathy, but are consistently concerned about fairness and justice. Perhaps most strikingly, they are motivated much more by ego than by any kind of direct pleasure from consumption, and, though they don't anticipate it, ultimately derive little pleasure from either.

Smith is viewed as the ultimate champion of free markets, yet he believed that the motive force driving economic activity in such markets was an illusion -- the mistaken belief that wealth, power and status will bring happiness. Some of the overly-ambitious academics we know (not ourselves, of course!) might do well to put aside the Wealth of Nations and to heed the counsel of the Theory of Moral Sentiments , which is, in any case even more enjoyable reading. If they read it carefully, they will come upon the following cautionary passage:

Through the whole of his life he pursues the idea of a certain artificial and elegant repose which he may never arrive at, for which he sacrifices a real tranquility that is at all times in his power, and which, if in the extremity of old age he should at last attain to it, he will find to be in no respect preferable to that humble security and contentment which he had abandoned for it. It is then, in the last dregs of life, his body wasted with toil and disease, his mind galled and ruffled by the memory of a thousand injuries and disappointments which he imagines he has met with from the injustice of his enemies, or from the perfidy and ingratitude of his friends, that he begins at last to find that wealth and greatness are mere trinkets of frivolous utility, no more adapted for procuring ease of body or tranquility of mind, than the tweezer-cases of the lover of toys. (TMS IV, *i*, 260-261)

The invisible hand finds its way into TMS too, but with a strikingly different significance. Because they pursue ends that fail to make them happy, or even make them unhappy, Smith believed, the rich end up being no more happy than the poor: “In ease of body and peace of mind, all the different ranks of life are really upon a level, and the beggar, who suns himself by the side of the highway, possesses that security which kings are fighting for” and “in what constitutes the real happiness of human life, [the poor] are in no respect inferior to those who would seem so much above them” (TMS IV, *i*, 265). Yet, in seeking out the wealth that ultimately brings little if any pleasure, the wealthy end up inadvertently promoting the good of the poor. “In spite of their natural selfishness and rapacity,” Smith observes, “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 inhabitants; and thus, without intending it, without knowing it, advance the interest of the society” (TMS IV, *i*, 264, emphasis added).

(5351 words text)

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