2005

Adam Smith and Greed

Jonathan B. Wight
University of Richmond, jwight@richmond.edu

Journal of Private Enterprise, Volume XXI, Fall 2005

Adam Smith and Greed

Jonathan B. Wight
University of Richmond

The virtues of greed have been widely promoted by some economists in the 20th century. Allegedly it is Adam Smith who provides this new dignity to greed (Lerner, 1937, ix). Kenneth Arrow and Frank Hahn in the *General Equilibrium Analysis* (1971), for example, implicitly assume that Adam Smith's self-interest is the greed that promotes economic efficiency (quoted in Evensky, 1993, 203). Walter Williams (1999), a devoted follower of Smith, writes in his column that, "Free markets, private property rights, voluntary exchange, and greed produce preferable outcomes most times and under most conditions." These pronouncements have become part of the cultural tableau. The noted investment banker Ivan Boesky gave a commencement address to MBAs declaring, "You can be greedy and still feel good about yourself" (Andrews, 1966).[1] In a movie loosely based on his story, the character Gordon Gekko in *Wall Street* (1987) opines that, "[G]reed is good.... Greed works. Greed clarifies, cuts through and captures the essence of the evolutionary spirit." In other words, greed is said to promote survival in Smith's competitive environment.

Ethical egoism may be flourishing in American culture, but the association of Adam Smith with these views is simply wrong. Smith decried selfishness often and at length. The quotes above do relate to Adam Smith's dictum that in exchange we should appeal not to the butcher's humanity but rather to his self-love, and never address our

[1]Three months later Boesky pled guilty to insider trading charges and was sent to serve three years in prison.

own necessities but only his own advantages (1981, 26-27). But Smith drew sharp distinctions between greed and selfishness on the one hand and prudent (and virtuous) self-interest on the other. The confusion about Smith's view arises in part from the fact that modern economists put man into the psychological box of *homo economicuss*—an isolated, rational, calculating, materialist with no social or moral connections with other human beings, and no scope for heroism. By contrast, Smith found man to be a fundamentally social animal with at times weak powers of rationality and a great capacity for heroic action.

Given the problems of asymmetric information that are inherent in many economic relationships, self-control is needed on the part of economic actors. Self-control is encouraged within an institutional setting of competitive markets because economic actors have an incentive to create good reputations for the long term. Hence competitive markets support the development of virtuous behaviors (McCloskey, 1994, 181). Yet Smith's system goes far beyond enlightened self-interest in explaining the internal controls that humans develop as they become properly socialized. Smith's moral system is based on sympathy, and Smith states emphatically that "Sympathy, however, cannot, in any sense, be regarded as a selfish principle" (Smith, 1982, 317).

Accordingly, this paper seeks to clarify Smith's views on the difference between self-interest and greed. It argues for a subtler, and richer, understanding of the role of self-interest in the economy–one that extols virtue and not vice as a more reliable defender of freedom. To begin this discussion we first examine the "greed is good" philosophy in its two components: a demand-side view (that lust and vanity will prop up flagging sales to maintain full employment) and a supply-side view (that envy and avarice will spur greater work effort). Both views relate to ideas found in Adam Smith.

The Demand-side View

The notion that one's personal vices (such as selfishness) could benefit the broader society by stimulating demand was an idea promulgated by Bernard de Mandeville in a famous poem, *The Fable of the Bees* (1714). Mandeville imagines a macroeconomy composed entirely of exemplary citizens who are living lives of frugality, simplicity, and virtue. Such saintliness leads to economic disaster, however, because aggregate demand collapses. Like a good Keynesian, Mandeville would stimulate demand by tempting people with vices: "Avarice, prodigality, luxury, pride, envy, vanity, folly, fickleness, and inconstancy employed millions / encouraging ingenuity and industry and creating pleasures and comforts." In Mandeville's poem the beehive is kept economically employed because "every part was full of vice/Yet the whole mass a paradise" (Mandeville, 1723).

Adam Smith was familiar with this argument and in his first book, *The Theory of Moral Sentiments* (1982 [1759], 312-313), rejects it, calling it a "fallacy" and "wholly pernicious." There is no evidence that Smith ever changed his view on this, since he took *Moral Sentiments* through six editions and had ample opportunity to modify its content. Smith's objection to Mandeville is that the author takes away altogether the distinction between vice and virtue (1982, 308).

For Adam Smith it is not vice, per se, but *misperception,* that causes a demand-side stimulus. The rich landlords of his day are certainly less than virtuous in Smith's eyes. This vain and insatiable lot do not know the limits of their own appetites. By misjudging their capacity for gluttony, the rich over-buy (or cause over-production), resulting in a surplus which is then distributed to the poor: Because of this misperception,

> "[The rich] 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..." (Smith,1982).

Hence, while the poor do not own the assets (land) needed to bring about full employment, the landlord's inability to judge his own consumption leads to surplus production, and a consequent "trickle-down" of spillover benefits for the poor.[2]

The Supply-side View

The more prevalent supply-side view of the "greed is good" philosophy derives from Adam Smith's *Wealth of Nations*:

> It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages (1981 [1776], 26-27).

Self-interest supplies motivation that stimulates productivity. To Smith, however, people often sadly misunderstand their own self-interest. They seek power and riches, even though such ambition will generally fail to make them happy. In reality, Smith says, the imagined view of the life of the rich turns out to be a deception:

> 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. 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 (1982, 185).

This is part of that same misperception of economic costs and benefits

[2] For an interpretation of Smith's different invisible hands, see Grampp (2000).

that leads landlords to overproduce and people to overwork themselves. Yet Smith provides a positive spin to this, arguing that "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" (1982, 183). Thus, the misperception that riches will make us happier makes us work harder, which leads to continual progress (1982, 183-184).

To summarize Smith's line of thinking, man is an imperfect animal, capable of wildly inaccurate judgments. Yet some of our imperfections, particularly our misjudging of self-interest in the benefits from wealth, work to advance society.

Is Greed the Same as Self-interest?

Accepting Smith's notion from *The Wealth of Nations* that self-interest (within the proper institutional setting) works to advance society's interests, can one say that these views support the greed is good doctrine? For this to be so, greed and self-interest must coincide. The *American Heritage Dictionary of the English Language* defines greed as "An excessive desire to acquire or possess more than what one needs or deserves, especially with respect to material wealth." The relevant descriptor is the word "excessive." An undue or disproportionate desire is a craving. A person under the influence of a craving is out of balance. Obtaining equilibrium in one's life requires moderation and self control, according to Smith.

Smith has no difficulty with people seeking material success—indeed he applauds it. Yet the excessive pursuit of it can lead one to violate the rights of others or to ignore one's duty to the community. Smith decries such selfishness and notes that it is difficult for business leaders to follow the right path because of an undue zeal for their own narrow interests: "the candidates for fortune too frequently abandon the paths of virtue; for unhappily, the road which leads to the one, and that which leads to the other, lie sometimes in very opposite directions" (1982, 64). Hence, it is virtuous to be boisterously self-interested, to pursue actively and vigorously one's own success—yet this ambition must be encapsulated within a larger moral framework.

The literature on Smith's moral framework is immense. For aspects of it, see Fleischacker (2004), Wight (2002), Evensky (2001), Tribe (1999), Brown (1997), Evensky (1993), and Campbell and Skinner (1981). To Smith, self-interest means carefully considering one's own advantage and security when making decisions. Greed, by contrast, means *only* considering one's narrow advantage in making decisions, regardless of the needs and rights of others. On many occasions Smith denounced this approach, writing, "When the happiness or misery of others depends in any respect upon our conduct, we dare not, as self-love might suggest to us, prefer the interest of one to that of many" (1982, 137-138). While Smith acknowledges that humans have an innate selfishness, he argues that we learn to control this impulse so as to bring our actions into conformity with our duties to others in society. Smith wrote *The Theory of Moral Sentiments* (1759) to explain why humans, who are born selfish and narrowly focused, also care genuinely about others. Sociability diminishes the further removed in time and place one is, and hence caring is virtually non-existent in economic markets that are purely atomistic. Yet, as will be shown below, social connectivity does exist in many markets and can lead to important economic outcomes—especially in the construction of the invisible hand.

This inherent clash between selfishness and sociability is what gives rise to a conversation in the mind that is the precursor to a moral conscience, according to Smith. An impartial spectator begins to adjudicate one's internal conflicts. Using moral imagination, a well-developed person grows in time to acquire an internal regulator which places the interests of others squarely on one's radar screen. Eventually, people who listen to the inner tug of conscience strive for virtue and meaning beyond themselves—in essence, becoming *moral agents.* Instead of narrow prudence, which looks out only for oneself, Smith argues that we have the opportunity to acquire (through experience) greater wisdom, which leads to "a proper degree of self-command" (1982, 216). Self-command happens not simply because of a cost-benefit calculation of one's gains and losses, but because of one's internal desire to do the right thing, born out of one's genuine moral conscience.

Relevance

The distinction between greed and self-interest matters for three reasons. First, even if greed could make an individual better off, society could suffer. A medical researcher who fabricates the experimental results of a new drug therapy could selfishly achieve some personal short-run goal (publication, tenure, or wealth). But society is surely poorer for this as resources are wasted trying to replicate the results and third parties (patients) may be injured. Second, studies have shown that selfish attitudes (like other attitudes) are malleable (Frank, 1993; Frank, 1996). Teachers who profess that greed is good may inadvertently create more free riders and discourage civic behavior among their students. Third, it is not always the case that greed produces a superior outcome even for an individual. The now-famous Ultimatum Game has shown that greedy individuals (those who disregard basic fairness in making economic distributions) tend to earn less money than others in negotiations (Thaler, 1988). One likely reason for this is that greed can arouse feelings of malevolence (Boulding, 1969): some players incur a cost to themselves merely to punish a greedy player. Adam Smith was well aware of the negative social fallout from greed. He noted:

> "To be anxious, or to be laying a plot either to gain or to save a single shilling, would degrade the most vulgar tradesman in the opinion of all his neighbors" (1982, 173).

Accordingly, Smith felt that behavior was rightly constrained by the social network, enforced via the sympathetic responses of fellow citizens. This framework affirms the role of fairness and a regard for justice. Justice means the appropriate moral regard for our dealings with others, as adjudicated by the impartial spectator, in addition to laws and courts.

It is not difficult to imagine other circumstances in which greed lowers economic returns. As noted earlier, greed implies a type of self-interest that disregards the rights and interests of others (unless there is something to be gained by regarding them). The famous Prisoner's Dilemma illustrates the coordination problems that ensue without trust. Economic transactions between greedy individuals can entail higher transactions costs for monitoring and enforcing contracts. Trust and social capital are thus a form of comparative advantage (Fukuyama, 1993). Some evolutionary psychologists conclude that humans are hard-wired for cooperation (Cosmides and Tooby, 1994; Cosmides and Tooby, 1997).

These are all ideas found in Adam Smith's writings. Smith notes that virtue and trust lubricate the wheels of society (1982, 316). He says people go out of their way to deal with those whom they trust:

> Thus, upon equal or nearly equal profits, every wholesale merchant naturally prefers the home trade to the foreign trade .... *He can know better the character and situation of the persons whom he trusts....* (Smith, 1981, 454).

Smith writes that because of this trust, merchants prefer to invest their capital domestically, which thereby adds to the national wealth. This positive externality is what gives rise to Smith's invisible hand of *The Wealth of Nations* (Grampp, 2000). Trust and shared moral values thus play an integral part in producing the spill-over benefits of private markets to the broader society.

The counter argument to this is that selfish individuals, calculating the economic gains derived from appearing to be trustworthy, will simply mimic this behavior and capture the benefits discussed above. Such enlightened selfishness can certainly produce positive externalities, leading to the quip, "There is honor among thieves." Yet enlightened selfishness is not at all what Adam Smith had in mind when he discussed the role of an impartial spectator acting as the fulcrum of one's conscience. The mistaken idea that selfishness always lies behind every action arises from a misinterpretation of self-interest. Smith observes: "That whole account of human nature, however, which deduces all sentiments and affections from self-love, which has made so much noise in the world...seems to me to have arisen from some confused misapprehension of the system of sympathy" (1982, 308). Smith's moral system is founded upon authentic sympathy, and as noted earlier, Smith unequivocally states that sympathy cannot in any sense be regarded as a selfish principle (1982, 317).

Modern advocates of the "greed is good" approach have been careful to qualify (either explicitly or implicitly) that they acknowledge that self-interest is tempered by some self-restraint. Walter Williams (cited earlier) makes clear that "property rights" are a key requirement of a good society, and presumably are protected both by force as well as honored by self-restraint: there is no police force large enough to protect private property if society at large is larcenous, and hence it is implicit in a good society that people have internalized some moral code (they shouldn't steal the property of others even if they could get away with it). Milton Friedman, in arguing that profits are the only social responsibility of business, carefully noted that businesses must still adhere to society's laws and the basic tenets of morality in pursuing riches (1970). Robert Heinlein, who strenuously insists that "selfishness is the bedrock on which all moral behavior starts" completes this same sentence by noting that such behavior "can be immoral only when it conflicts with a higher moral imperative" (2004). Hence, he explicitly acknowledges that a higher moral imperative exists, and sometimes must be operative.

However, there seems to be an internal contradiction in these approaches. If greedy individuals are voluntarily submitting to the rule of law, adhering to basic tenets of morality, and sometimes following a higher moral imperative, then such individuals are not being greedy at all. They may be self-interested and materialistic, but their pursuits are not excessive in the wider moral context. By contrast, a greedy person would always consider only his or her own interest, and have no other higher interest than himself or herself on which to base their actions. A greedy person would calculate whether it makes sense to obey laws and morality in a given case, and would obey only if it suits his or her interests.

Conclusion

The thesis of this paper is that the "greed is good" maxim, often used in teaching about private enterprise, is a concept in need of reconsideration. It neither represents Adam Smith's views nor is it defensible on purely economic grounds. Keith Tribe summarizes, saying:

> "The Smithian conception of self-interest is not an injunction to act egoistically and without moral scruple, safe in the knowledge that by doing so the public good would somehow or other result: it is embedded within a framework of social reciprocity that allows for the formation of moral judgment" (1999, 621).

Greed is the excessive pursuit of self-interest, with disregard for the rights of others. Swindlers and charlatans operate from this moral basis. Investors and consumers can and should take personal responsibility for protecting themselves from the risks of fraud through due diligence, diversification, and attention to their own economic affairs. But given the problems of asymmetric information that are inherent in fiduciary relationships, it is likely that consumers will often be alerted to swindles only after the barn door has been thrown open. Laws and regulations rigorously enforced can create negative incentives to deter such excesses. Yet here the lover of freedom has a quandary. Relying on government to enforce ever-more intrusive laws and regulations is not only expensive and inefficient, but it curtails citizens' freedom and privacy.

By contrast, Smith champions the concept of voluntary self-restraint, brought about by a personal commitment to moral responsibility. Societies that are able to function with a high degree of trust, brought about by shared moral precepts and the strong expectation that impulses of greed will be reasonably checked by self-control, will provide more agreeable conditions for the flourishing of a free society with a limited government. Accordingly, greed is not the same as healthy self-interest—not in our modern world, and not in the world of Adam Smith.

References

Andrews, Robert. 1996. *The Columbia World of Quotations.* New York: Columbia University Press. www.bartleby.com/66/. Accessed March 28, 2003.

Brown, Vivienne. 1997. "'Mere Inventions of the Imagination': A Survey of Recent Literature on Adam Smith." *Economics and Philosophy* 13(2) (October): 281-312.

Campbell, R.H. and A.S. Skinner. 1981. Introduction to *An Inquiry Into the Nature and Causes of the Wealth of Nations.* R.H. Campbell and A. S. Skinner, eds., Glasgow Edition. Indianapolis, IN: Liberty Press.

Cosmides, Leda and John Tooby. 1994. "Better Than Rational: Evolutionary Psychology and the Invisible Hand." *American Economic Review* 84(2): 327-332.

Cosmides, Leda and John Tooby. 1997. "Evolutionary Psychology: A Primer." Center for Evolutionary Psychology, University of California at Santa Barbara, available at:

www.psych.ucsb.edu/research/cep/primer.html).

Evensky, Jerry. 1993. "Ethics and the Invisible Hand." *Journal of Economic Perspectives* 7(2):197-205.

Evensky, Jerry. 2001. "Adam Smith's Lost Legacy." *Southern Economic Journal* 67(3): 497-517.

Fleischacker, Samuel. 2004. *On Adam Smith's Wealth of Nations: A Philosophical Companion.* Princeton, NJ: Princeton University Press.

Frank, Robert H. 1996. "Do Economists Make Bad Citizens?" *Journal of Economic Perspectives*, 10, Winter, 187-192.

Frank, Robert H., Thomas D. Gilovich and Dennis T. Regan. 1993. "Does Studying Economics Inhibit Cooperation?" *Journal of Economic Perspectives*, Spring, 7, 159-171.

Friedman, Milton. 1970. "The Social Responsibility of Business is to Increase its Profits." *The New York Times Magazine*, September 13.

Fukuyama, Francis. 1993. *Trust: The Social Virtues & The Creation of Prosperity.* New York: The Free Press.

Grampp, William D. 2000. "What Did Smith Mean by the Invisible Hand?" *Journal of Political Economy,* 108 (3), 441-464.

Heinlein, Robert A. 2004. "Patriotism is Vital to Man's Survival." *Richmond Times Dispatch.* July 4, E1, reprinted from a speech delivered in 1973.

Lerner, Max. 1937. Introduction to *The Wealth of Nations*, Edwin Canaan, ed. New York: Modern Library Edition.

Mandeville, Bernard de. 1723. *The Fable of the Bees* (2nd edition, London: Bible and Crown, 1723).

McCloskey, Donald [Deirdre]. 1994. "Bourgeois Virtue." *American Scholar* 63(2)(Spring): 177-191.

Ross, Ian Simpson. 1995. *The Life of Adam Smith* .Oxford: Clarendon Press.

Smith, Adam. 1981 [1776]. *An Inquiry Into the Nature and Causes of the Wealth of Nations.* Two volumes. R.H. Campbell and A. S. Skinner, eds., reprinted by Indianapolis, IN: Liberty Press.

Smith, Adam. 1982 [1759]. *The Theory of Moral Sentiments.* D.D. Raphael and A.L. Macfie, eds. Glasgow Editions, reprinted by Liberty Press, Indianapolis, IN. Thaler, Richard H. 1988. "Anomalies: The Ultimate Game." *Journal of Economic Perspectives*, Fall 2(4): 195-206.

Tribe, Keith. 1999. "Adam Smith: Critical Theorist?" *Journal of Economic Literature* 27 (2): 609-32.

Wight, Jonathan B. 2002. *Saving Adam Smith: A Tale of Wealth, Transformation, and Virtue.* Upper Saddle River, NJ: Prentice Hall.

Williams, Walter. 1999. "The Virtue of Greed in Promoting Public Good." *Richmond Times-Dispatch*, October 6, A15.