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The Invisible Hand Is Shaking

ADAM SMITH'S modern disciples are far more enthusiastic about his celebrated invisible-hand idea than he ever was. In their account, Smith's assertion was that purely selfish individuals are led by an invisible hand to produce the greatest good for all. Yet Smith himself was under no such illusion.

On the contrary, the relevant quotation from his “Wealth of Nations,” which describes a profit-seeking business owner, is far more circumspect. It says that this owner “is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.” It continues: “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.”

In short, Smith understood that the invisible hand is often benign, but not always.

This understanding has important implications for economic policy in general, and for the recent presidential campaign dust-up about gasoline taxes in particular.

If you believe, with Smith’s modern disciples, that unfettered pursuit of self-interest always promotes society’s interests, you probably view all taxes as a regrettable evil — necessary to pay for roads and national security, but also an unwelcome drag on economic efficiency. The problem, according to this view, is that taxes distort the price signals through which the invisible hand guides resources to their best destinations.

Smith’s more nuanced position supports a different view of taxes. When market prices convey accurate signals of cost and value, the invisible hand promotes the common good. But prices often diverge from cost and value and, in those cases, taxes can actually help steer resources toward more highly valued uses.

It’s helpful to look more closely at why the invisible hand works so well in many ordinary markets. Consider the market for potatoes: in it, production and consumption are determined by millions of separate cost-benefit calculations. Profit-seeking sellers are willing to offer an additional pound of potatoes for sale whenever the benefit of doing so — as measured by what buyers are willing to pay — is enough to cover the cost of production.

The market reaches equilibrium when the cost of producing the last pound is exactly equal to its value. If the costs incurred directly by sellers are the only relevant costs of expanding potato production, and if the benefits to potato buyers are the only relevant benefits, the invisible hand gets things just right.

The production and consumption of many other goods, however, generate costs or benefits that fall on people besides buyers and sellers. Producing an extra gallon of gasoline, for example, generates not just additional costs to producers, but also pollution costs that fall on others. As before, market forces cause production to expand until the seller's direct cost for the last unit sold is exactly the value of that unit to the buyer. But because each gallon of gasoline also generates external pollution costs, the total cost of that last gallon produced is higher than its value to consumers.

The upshot is that gasoline consumption is inefficiently high. Suppose that pollution costs are $2 for the last gallon consumed, but that its $4 price at the pump is just enough to cover its direct production costs. Reducing production and consumption by a gallon would then cause consumers to lose fuel that they value at $4, which would be exactly offset by the $4 in reduced production costs. The $2 in reduced pollution costs would thus be a net gain for society.

That simple example captures the classic breakdown in the invisible hand when a product's market price doesn't reflect all its relevant social costs and benefits. In such cases, the simplest solution is to discourage consumption by taxing it.

Doing so would not only raise revenue to pay for public services; it would also make the allocation of society's resources more efficient — hence economists' almost universal dismay when Senators John McCain and Hillary Rodham Clinton recently proposed eliminating the federal tax on gasoline for the summer.

The stated aim of their proposal was to ease the financial burden of sharply higher gasoline prices. But adopting inefficient policies is never the best way to help people in financial distress.

Efficiency is important because any policy that enlarges the economic pie necessarily lets everyone have a bigger slice than before. Economists opposed suspending the gas tax because doing so would make the economic pie smaller.

Of course, when millions of voters feel the pinch of rapidly rising prices, politicians find it hard to stand idly by. But as the late economist Abba Lerner once remarked, the main problem confronting the poor is that they have too little money. The best solution is not to reduce the prices they pay, but rather to bolster their incomes — for example, by selectively reducing the payroll tax for low-income workers or increasing the Earned Income Tax Credit.

Suspending the gas tax would encourage rich and poor alike to do more summer driving. It would also promote sales of fuel-intensive vehicles. Because the gas tax reduces waste, it actually makes more resources available to help low-income families.

Gasoline is one of a host of goods whose production or consumption generates costs that fall on outsiders. Noisy goods, like leaf blowers, for example, can jolt whole neighborhoods from calm. And goods that don’t biodegrade readily, like many plastic bags, can generate costly waste streams. The list goes on.

THAT the invisible hand often breaks down is actually good news. After all, we need to tax something to pay for public services. By taxing forms of consumption that generate negative side effects, we could not only generate enough revenue to eliminate budget deficits, but also help steer resources toward their most highly valued uses.

Because such taxes make the economy more efficient, it makes no sense to object that they impose hardships on low-income families. Again, an efficient policy is one that maximizes the size of the economic pie. And with a bigger pie, it's always possible for everyone to get a bigger slice.

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