

Information and Incentives: The Economics of Carrots and Sticks

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Extract

The Invisible Hand

In a lecture that will deal chiefly with ignorance, it may seem natural to begin with Adam Smith's most famous contribution to economics, his vision of independent selfish beings who by living and working together in the economic system somehow do what is best for one another. First, in *The Theory of Moral Sentiments*, he said

The rich only select from the heap what is precious and agreeable. They consume little more than the poor, and in spite of their natural selfishness and rapacity ... 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 necessaries of life which would have been made, had the earth been divided into equal portions among all its inhabitants. (IV.i. 10)

This is far from the later conception of an economic equilibrium that is 'optimal' in Pareto's sense. Indeed as quoted, Smith's early claim is not very plausible. It does set the major themes: the working of the economy as a system, and the good or otherwise, for everyone, that can flow from it. Later in the *Wealth of Nations*, he argued correctly that individual profit-maximisation implies maximisation of what we would call national income, and goes on to say that,

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