

# AN ANALYSIS OF ADAM SMITH'S THEORY OF SELF-INTEREST THROUGH THE MECHANISMS OF THE PHILOSOPHY OF SCIENCE

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*Adam Smith's fundamental theory of self interest is widely used as the foundation for modern economic argument and theory. In this stimulating paper, Cian McCarthy deals with the philosophical underpinnings of self interest and derives conclusions which could fundamentally change our conception about corporations profit maximization.*

## **Introduction**

“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 self-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”

(Smith, 2008: 22)

This famous theory by Adam Smith, and the purported consequences of this feature of humanity; that the pursuit of self-interest by individuals will generate a “harmonious outcome for economic society” (Murphy, 2009: 122), has led Adam Smith to be considered the father of Capitalist or free-market economics (Fry, 1991). Smith’s argument is that, even though it is not done intentionally, when individuals act out of their own self-interest they are being guided by an “invisible hand” which results in them promoting the interest of the society as a whole. In truth, even though this theory is commonly attributed to Smith, the sentiment is more properly accredited to Pierre de Boisguilbert (Murphy, 2009). However, for the purposes of this essay, the source of the theory isn’t as important as its virtue as a scientific theory, and the consequences that it has on modern economics.

In this essay I plan to analyse Smith’s theory of human self-interest using the demarcation principle of the famous Philosopher of Science Karl Popper. The scientific value of Smith’s theory is important as one of the main results of the demarcation of a theory between being scientific, or non-scientific, is its ability to predict future events (Salmon,

1998). And as economics has become a science that has become more and more about expectations and predicting human behaviour (Friedman, 2004) I would consider it very important for Smith's theory that it is regarded as scientific, and not merely pseudo-scientific. I will then argue why it is a mistake to accept this theory and apply it to bigger institutions, namely corporations.

### **The Scientific Validity of Smith's Theory**

In their comprehensive anthology, Martin Curd and J.A. Cover introduce the demarcation criteria as the characteristics that a "field of study must possess in order to qualify it as genuine science" (Curd & Cover, 1998). A.F. Chalmers suggests that the popular conception of what distinguishes science from non-science, or pseudoscience, is "[that which is] derived from the facts" (Chalmers, 1999). Curd and Cover argue that science is confirmed by the facts, and observations, and without observational confirmation, science would be epistemologically useless. The view of induction as a "logic of discovery" has been largely forsaken, many still view it as a justifiable method of confirming a theory, and their belief is that the more observations that confirm a theory (as long as there are no observations that contradict it), the more probably it is to be true, making it a science (Curd and Cover, 1999). This principle could be feasibly applied to Smith's theory of self-interest. One can look at any economic (or possibly even social) transaction between two individuals and say that, in that particular case both individuals were acting purely out of self-interest and self-love. Now, one could consider the case where a baker gives bread away for free to a hungry peasant; doesn't this refute Smith's theory? In this case it could be argued that the baker may seem to be acting out of pure benevolence, but in fact it is really the case that he's still acting out of self-interest; perhaps he gives away free bread to gain a favourable reputation within the community so that others are more likely to support his business, or perhaps he gives free bread so that the peasant will owe him a favour and he has the full intention in recalling that debt in the future, or that he might get into heaven, etc. Therefore, it seems that Smith's theory is practically flawless by this criterion of a scientific theory, as it is seemingly impossible to find an observation that disproves it.

But Karl Popper believes that the formation of general theories from specific instances is not justified. In *The Problem of Induction*, Popper claims that "the various difficulties of inductive logic... are insurmountable" (Popper, 1959). One difficulty to which he is referring is that there is no logical way of concluding that any sum of observations leads to a general rule. But more importantly for him, he saw many theories that are supported by a wide range of facts, but noticed that these theories, such as Freud's psychoanalysis and Adler's individual psychology, failed to actually explain anything because they ruled out nothing (Popper, 1963). His example that refuted Adler's theory was presented in his essay "Science: Conjectures and Refutations" in which he presented the scenario of

a man seeing a young child drowning. Popper argued that Adler's theory that men are compelled by their sense of inferiority would explain any actions that the man would take, making it a completely redundant theory (Popper, 1963). Weak, non-scientific theories for Popper are ones for which there is no instance or possible observation that would refute the theory; they are not falsifiable. In contrast, a theory that is falsifiable would be Einstein's theory of relativity; there is a specific possible event that could occur that would lead followers of Einstein's theory to abandon it, and this for Popper was the necessary criterion to make it scientific. Chalmers points out that if a theory is unfalsifiable then the world can have any properties or behave in any way and the theory would still stand, which clearly means that it has no epistemological value (Chalmers, 1999). It now seems quite clear that Smith's theory of self-interest falls under the "unfalsifiable" branch. I argue that his theory, like Adler's, may seem to explain everything, but in fact explains nothing. No matter what the actions of individuals are, you could twist it to find a way of arguing that both actors are merely acting out of self-interest; it could actually rule out the place for any benevolence in our society. For that reason, it follows that Smith's theory also has no predictive powers. If all individuals, and therefore society, can act in any way, and Smith's theory still stands, then it has absolutely no power in predicting what could happen in a given transaction.

### **The Ramifications of This Analysis**

So the next question is, why does it matter that Smith's theory isn't entirely scientific? Let's say that Smith was wrong about the ultimate motivations for individuals in transactions and that it was in fact a strong balance between self-interest and benevolence, but because Smith's theory is unfalsifiable, we will never be able to prove that. This case wouldn't necessarily rule out the invisible hand consequent on Smith's overall theory, as it still could be true that in a laissez-faire system of economy, where individuals act with motives that are based on many different factors other than self-interest, that society will benefit as a whole.

However, the true problem with Smith's theory being viewed as true and scientific is when the actors in the transactions aren't necessarily being viewed as individuals any more, but also being applied to businesses and corporations. If Smith was correct, and that by acting purely out of self-interest individuals would end up benefiting society, in other words that "private self-interest is a public virtue" (Murphy, 2009), then logically that causal relationship would work when individual corporations are the players in the transaction. Now, there are many ways of a human fulfilling their self-interest that are not directly derived from the acquisition of short-term (or even long-term) profits, such as forming a loving relationship, gaining accession into heaven etc. that may be the reason that they act in a certain way in a transaction, as shown earlier. However, legally a corporation's success is measured by one factor alone: profit. This is true to such a level that it

is the legal obligation of corporations to make short-term profits for their shareholders (Bakan, 2004).

The problem for Smith in this case is that I think he would agree with me that there is a danger in transferring his theory from applying to people to applying to corporations as well. He warns of the problem of Moral Hazard in *The Wealth of the Nations*, by arguing that managers of corporations cannot be trusted with other people's money, and that if this happened, "negligence and profusion" would result (Smith, 2008). However, a series of legal cases in the United States in the following century led to the corporation being viewed by law as a legal person, with many of the same abilities to take part in economic activity as humans, such as ability to own property and other companies, being able to sue or be sued, being a party in a contract etc. (Bakan, 2004). The capitalist mindset that is so strongly influenced by Smith's theory now creates a system whereby corporations are legally required to make profits. In an interview with author Joel Bakan, Milton Friedman makes a clear link between Smith's theory of self-interest, and the legal requirement of corporations to work for no other end than to make money for its shareholders. He says that it's a "moral imperative" that CEO's act to make profit, as opposed to taking part in benevolent actions such as charity or caring for the environment (Bakan, 2004).

If Smith's theory was both falsifiable, and unfalsified (i.e. scientific and sound) then I would agree with Friedman that the best thing for a corporation to do would be to only act within their own self-interest, which for a corporation can only mean attempting to maximize short, and possibly medium, term profits. But as I showed earlier, the problem is that Smith's theory is not scientific, so applying human motivations to corporations doesn't work, as we don't truly know what those human motivations are. The whole legal system that corporations should only attempt to maximize profits is based on a theory of motivation that is unsound. The *laissez-faire* economic system could make sense in the days that Smith wrote *The Wealth of the Nations*, as corporations had been effectively banned in England for over 50 years after the Bubble Act of 1720 (Bakan, 2004), and the main players in the economy may not have been acting out of pure self-interest as Smith purported, but a mixture of self-interest as well as an explicit interest in the welfare of other individuals and society as a whole. But now, as Smith himself even warned, problems created by Moral Hazard mean that the adoption of the theory of self-interest to the corporation as an individual is flawed.

## Conclusion

Although he may not have wanted it to happen, and most likely did not foresee the changes that would occur in the following century as to the legal position granted to corporations in terms of corporate personhood, Smith's pseudo-scientific theory has been manipulated, albeit logically, by the law and by economists such as Milton Friedman, to apply to non-

human players in the market. This self-interest has led to corporations doing a lot of good for society, by creating jobs, investing in the community, fulfilling demand etc. but arguably a lot of bad as well. The emergence of sweatshops and other forms of labour exploitation in the third world is an example of undesirable outcomes that have occurred from the corporations receiving an unacceptable amount of legal leniency in the name of profit maximization for shareholders. Society is encouraging, and even requiring, corporations to act in a certain way, the justification of which resting on the scientifically dubious theory of Adam Smith. By assuming that benevolence does not play a part in any economic interactions between human individuals, we now require that it does not for any interactions involving corporations, a requirement which could have horrible consequences for the environment and our economy if Smith was wrong.

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