

Economics, Ethnic and Public Policy

Edited by

C H A R L E S K . W I L B E R

Economics, Ethics, and Public Policy

EDITED BY
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INTRODUCTION

This book focuses on the interaction between ethics and economics, in both economic theory and economic policy. There are three ways in which ethics are important in economics: (1) Economists have ethical values that help shape the way they do economics; (2) Economic actors have ethical values that help shape their behavior; and (3) Economic institutions and policies impact people differently and thus ethical evaluations must supplement economic evaluations. In this book, philosophical moral theories will be introduced and used as the framework for later discussion of public policy issues.

Part I: Economists, Value Judgments, and Economic Theory deals with the following issues. Economists, as persons, bring a viewpoint with them that structures the questions they ask, the methods they use, the evidence and answers they deem acceptable. Is this merely Joseph Schumpeter's "preanalytic vision" or does it lead to the value permeation of theory? If there is no objective access to the "real" world an economist is forced to see that world through the lenses of theory. Does that mean "facts" are theory-laden? And value-laden? What would this mean for economic theory?

Part II: Rationality, Ethics, and the Behavior of Economic Agents focuses on the following issues. All evidence indicates that economic actors (consumers, workers, firms) act out of more than calculated self-interest. Thus the assumption of rationality may be insufficient or inappropriate depending on the situation. People's behavior is influenced by many things including ethical norms. What impact does this have upon the ability of economic theory to predict outcomes of economic policies? For example, given imperfect information actors might be tempted into strategic behavior that will result in suboptimal outcomes. Morally constrained behavior might reduce that opportunism.

Part III: Ethical Theories and Theories of Justice surveys the major ethical theories that dominate discussion in philosophy and then attempts to show how they might help a decision maker in an organization—whether a business firm, a government agency, or some other group. These ethical theories focus

on guiding individual decision making. They are analogous to microeconomic theories. Theories of justice are analogous to macroeconomics. They are concerned with the way the economic system as a whole is organized and operated.

Part IV: Economic Institutions and Ethics addresses the fact that institutions—such as markets and property rights—have an impact on people's welfare that needs to be evaluated in ethical terms. Specific examples—future generations, surrogate motherhood, discrimination, development—are analyzed to discover the ways they embody ethical issues.

Part V: Economic Policies and Ethics considers economists' use of the concept of Pareto optimality as their measuring rod when evaluating economic policies, a convention based on the notion that individual preferences are the ultimate measure of welfare. This assumption has caused considerable controversy, raising the question of where individual preferences come from and whether some preferences are unworthy. Cost-benefit analysis, a primary tool of policy evaluation based on the assumption that individual preferences are what count, is treated at length.

This is a book that emphasizes questions, not answers. The various articles claim that ethics are important to economics—both its study and its practice. Economic ethics is a more wide-ranging field than business ethics or medical ethics and far less studied. From the economist's side, this might be because of the value-free claims made for so long by economists. As the value-free position becomes more difficult to sustain, there is hope that discussion of ethics by economists will become less self-conscious and better informed. If this book helps promote that discussion the work will have been worthwhile.

I want to thank my friend and noted moral philosopher, James Sterba, for his help and willingness to listen patiently to an amateur ethicist rambling on. His guidance was invaluable. My research assistants, John Blanford and Greg Hannsgen, contributed bibliographic searches, draft summaries of readings, and insightful conversation that contributed significantly to the completion of this work. I also want to thank the undergraduate students in my Economics, Ethics, and Public Policy class over the past three years for their enthusiasm and criticism of successive versions of the readings. Finally, I must thank all those people who responded to my bibliographic requests on the ACE, IDEAL, and SOC-ETHIC listservs. They gave me many great suggestions for readings.

PART I

ECONOMISTS, VALUE JUDGMENTS, AND ECONOMIC THEORY

This section deals with the role of values in economics. Many economists argue that while values might have a place in what is termed normative economics, they should be kept out of the everyday scientific business of the profession—the development and testing of falsifiable propositions—which is often referred to as positive economics. This separation, as the writers in this section show, is problematic. Economists, as persons, necessarily work from a viewpoint that structures the questions asked, the methods, the evidence, the answers deemed acceptable. Is this merely Joseph Schumpeter’s “pre-analytic vision” or does it lead to the value permeation of theory? If there is no objective access to the “real” world an economist is forced to see that world through the lenses of theory. Does that mean “facts” are theory laden? And value laden? What would this mean for economic theory? The question becomes: How does one do economics in a world where facts and values cannot be conveniently disentangled?

In looking for an answer to this question, economists might find, to their surprise, that they have much to learn from Adam Smith. Jerry Evensky, in the first chapter of this section, shows that Smith’s economic theory was closely related to his moral thought. For example, while Smith often used the metaphor of the watch in describing how the self-interested actions of individuals worked for the good of the whole, he saw the “machine” itself as the product of a beneficent God, which moreover depended on the virtues of individual actors to operate smoothly. As Evensky points out, Smith’s *Theory of Moral Sentiments*, written before the *Wealth of Nations*, offers a rich moral vision of society that

contrasts with the thin gruel of “rational economic man.” Smith argued that over the course of history, society advanced through successive stages, each requiring more advanced values than the previous. Smith became less sanguine about moral progress over the course of his life, but moral standards continued to play a crucial role in his work.

Since the work of Thomas Kuhn and other historians of science, it has been increasingly recognized that scientists cannot be neutral in matters of value. The next two chapters in this collection agree that values are inevitably part of economics, though they disagree on the exact nature of their role. Charles Wilber and Roland Hoksbergen survey what others have had to say about value neutrality in economics, showing that there has been a lively debate on the subject in the years since 1970. One group of economists argue that economists can successfully separate values from facts, which are “out there” in the world, by adhering to a positivist methodology. According to this group, a failure to maintain this distinction will lead to a disastrous slide into relativism.

Critics of value neutrality, on the other hand, marshal a wide variety of arguments to make their case. It is argued, for example, that since there is no access to objective reality except through the lenses of a theory, the values shared by the community of economists color their judgment in determining just what the relevant “facts” are.

Wilber and Hoksbergen themselves come down on this side of the issue in the final part of their paper, in which they argue that economists share a “world view”—a notion of the good, which shapes their analysis of the economy. This world view includes three main elements:

1. People are rational and self-interested.
2. The purpose of life is to pursue happiness as people define it.
3. The ideal world is one in which people are free to compete to meet their ends and in which market forces lead to optimal equilibrium outcomes.

This is certainly a set of value judgments, in need of justification like any other; if these judgments indeed correctly characterize economics, they should be openly debated, rather than tacitly assumed.

Samuel Weston, in the following chapter, concedes that value judgments are inevitably part of economics, but argues that nevertheless it is possible and desirable to maintain the positive/normative distinction. Economists must recognize the inevitable value-permeation of their doctrine, even as they attempt to sort out positive from normative aspects of the field. Because of value permeation, economists cannot avoid taking sides on normative issues.

There are several benefits of nevertheless continuing to make the distinction between the two types of issues. First, it is necessary to distinguish different types of questions and avoid fallacious reasoning from positive to normative

statements. Second, economists should label certain subjects as “normative” to acknowledge economists’ lack of competency to deal with them in an authoritative way. Third, the distinction should be made in order to avoid casting factual issues inappropriately in terms of “good” versus “evil.” Finally, facts and values should be kept separate in order to maintain objectivity, which Weston characterizes as an openness to critical scrutiny. To sum up Weston’s prescription, “if freedom from ethical values ceases to be viewed as an attainable goal for economics, the next step might be the ‘legalization’ of normative economics” (p. 15). If Weston’s prescriptions were accepted, the kind of value judgments pointed out by Wilber and Hoksbergen would be brought out into the open for discussion and debate.

The authors mentioned so far have emphasized how economists bring certain values to their interpretation of the facts, for example, by imposing a neo-classical template on the world they observe. Robert Frank, Thomas Gilovich, and Dennis Regan go a step further. They experimentally demonstrate that economists’ values can affect the “real world” itself—and not just economists’ interpretations of it. This happens when economists “export” values in the classroom by teaching the economic theory of rationality. The authors report several experiments, in one of which they put students in a prisoners’ dilemma situation, with actual cash at stake. In a regression model of the resulting data, with the decision to defect as the dependent variable, an economics-major variable was significantly positive; those who had studied economics the most were more likely to take the most self-interested action. If this kind of effect is common, then even clearly self-interested behavior may not constitute an independent verification of the theory of rational self-interest, but instead may be a *product* of that theory.

The authors in this section thus provide us with several different approaches to the relationship between facts and values in economics. They demonstrate that the role in economics of ideals such as objectivity are unsettled. The debate is a longstanding one, and it continues.

ETHICS AND THE INVISIBLE HAND

Jerry Evensky

Introduction

As modern economists, we use Adam Smith's "invisible hand" metaphor confident that we all know what it means in our discourse: it reflects our admiration for the elegant and smooth functioning of the market system as a coordinator of autonomous individual choices in an interdependent world. But in Adam Smith's moral philosophy, the invisible hand has a much broader responsibility: if individuals are to enjoy the fruits of a classical liberal society, the invisible hand must not only coordinate individuals' choices, it must shape the individuals into constructive social beings—ethical beings. Revisiting Smith's metaphor provides a valuable lesson: the foundation of success in creating a constructive classical liberal society lies in individuals' adherence to a common social ethics.¹

I begin by presenting the philosophical basis for Smith's invisible hand, describing the sense in which the hand is invisible, and whose hand it is.² I then describe the story Smith tells of the invisible hand creating and maintaining a constructive classical liberal society, and show how Smith's story evolved as his faith in the ability of the invisible hand to shape an appropriate ethical foundation waned. I conclude with some thoughts on the legacy of Adam Smith and of our predecessors in economic inquiry more generally.

The Philosophical Basis of the Invisible Hand

Smith did not believe that philosophers are engaged in discovering Truth. In his view, philosophers can only *imagine* what connecting principles give rise to the order we observe. To illustrate this point, Smith (1980, pp. 42–43) contrasts a philosopher's perspective on nature with that of a spectator who is awed by the wonder of the special effects at an opera.

Upon the clear discovery of a connecting chain of intermediate events, it [our wonder] vanishes altogether. Who wonders at the machinery of the opera-house who has once been admitted behind the scenes? In the Wonders of nature, however, it rarely happens that we can discover so clearly this connecting chain. With regard to a few even of them, indeed, we seem to have been really admitted behind the scenes.

Nature's Truth lies in the machinery behind the scenes. "Philosophy . . . *pretends* [emphasis added] to lay open the concealed connections that unite the various appearances of nature," wrote Smith (1980, p. 51). The great philosophers are the ones who have the creativity to imagine what those "concealed connections" might be. And the greatest of all philosophers, according to Smith, was Sir Isaac Newton.

Smith's essay on the "History of Astronomy" concludes with a review of Newton's work. There Smith (1980, pp. 104–105) asserts that Newton's representation of the connecting principles that order the physical universe "prevails over all opposition . . . with principles [that], it must be acknowledged, have a degree of firmness and solidity that we should look in vain for any other system." Smith sees Newton's work as a triumph of the imagination and is awed by its brilliance. In fact, Newton's representation is so powerful that it is easy to be seduced into using the language of Truth when one describes it. Nevertheless, Smith concludes his review of Newton's work with a reminder to his reader, and it seems to himself, that even this great philosophical triumph is simply a flight of imagination, a great story. Smith (p. 105) writes:

And even we, while we have been endeavouring to represent all philosophical systems as mere inventions of the imagination . . . have insensibly been drawn in, to make use of language expressing the connecting principles of this one, *as if* [emphasis added] they were the real chains which Nature makes use of to bind together her several operations.

Smith seeks to do for moral philosophy what Newton had done for natural philosophy. He wants to tell a story of the connecting principles of the human order with commanding and compelling persuasive power. But, as with Newton, Smith's story does not begin with these principles. Both men take the story back to the origin of these principles, and it is here that we meet the "invisible

hand.” Newton and Smith believed that the connecting principles which give rise to the order we observe reflect the planning and handiwork of a designer. But who is the artificer that designed and constructed this great work? Smith and Newton both believed in the Deity as designer.

In the classic enlightenment analogy, the Deity is to the universe as the watchmaker is to a watch. In each case it is the hand of the designer that arranges the springs and pins and wheels, and sets the system in motion. But in both cases that hand is invisible to the spectator who observes only the product of the effort: the orderly progress of the hands of the watch, or of the sun, the moon, and the planets; we see nothing of the designer, we see only the effects of the design.³

The Invisible Hand and Ethics

Smith’s “invisible hand” metaphor reflects his view that he is representing the invisible connecting principles of the “immense machine of the universe” (Smith, 1976b, p. 236) that are the handiwork of the Deity. To fully appreciate the impact of this perspective on Smith’s moral philosophy, however, one must bear in mind that Smith (1976b, p. 166) saw the Deity as not only handy, but also benevolent.

The happiness of mankind, as well as of all other rational creatures, seems to have been the original purpose intended by the Author of nature, when he brought them into existence. No other end seems worthy of that supreme wisdom and divine benignity which we necessarily ascribe to him . . .

This is the Deity who endowed all humans with self-love, and in so doing set the spring that gives motion to human industry. This is the Deity who arranged the connecting principles such that the actions of all those seeking their own advantage could produce the most efficient allocation of resources, and thus the greatest possible wealth for the nation. This is indeed a benevolent designer.

Smith’s *Wealth of Nations* is the story of those socially desirable unintended consequences of individual action that result when events are allowed to follow their “natural course,” the course consistent with the Deity’s design. But while that course is natural, it is not inevitable (Smith, 1976b, p. 316):

Human society, when we contemplate it in a certain abstract and philosophical light, appears like a great, an immense machine, whose regular and harmonious movements produce a thousand agreeable effects. As in any other beautiful and noble machine that was the production of human art, whatever tended to render its movements more smooth and easy would derive a beauty from this effect, and, on the contrary, whatever tended to obstruct them would displease upon that account: so virtue,

which is, as it were, the fine polish to the wheels of society, necessarily pleases; while vice, like the vile rust, which makes them jar and grate upon one another, is as necessarily offensive.

For the wheels to turn easily, for the machine to run smoothly, there must be virtue. Human virtue is the *sine qua non* of the fruitful classical liberal society Smith envisioned.

In *The Theory of Moral Sentiments*, Smith explores the ethics consistent with the Deity's design, the ideal of ethics, presenting his view of how an individual would in theory personally define and enforce that ethical position. With this limiting point of the ethical ideal as a reference, he then turns to the real.

Smith takes human frailty as a given and thus recognizes the impossibility of achieving the ideal in any individual, much less in society as a whole. For example, remembering his dear, recently deceased friend David Hume, Smith wrote: "Upon the whole, I have always considered him, both in his lifetime and since his death, as approaching as nearly to the idea of a perfectly wise and virtuous man, as perhaps the nature of human frailty will permit" (Smith, 1977, pp. 217, 221).

Smith saw Hume as a model of the kind of being society should seek to nurture. For, in Smith's moral philosophy, it is the degree to which individuals in society approach the ethical limit that determines the degree to which society as a whole will enjoy the fruits of living in the classical liberal construct of the Deity's design.

Much of *The Theory of Moral Sentiments* is dedicated to an examination of ethics at a social level. According to Smith, hope for improving human virtue and thus for improving society lies in social evolution and socialization. Social evolution brings the improvement of the human condition through stages: from the rude state of hunting and gathering, through the progressively more productive and refined stages of pasturage and agriculture, to the most advanced stage, a commercial society. Since each stage requires a progressively more refined system of human values, the movement of a society from stage to stage is simultaneous with the development of that society's value system. For human progress to occur, each generation must refine the values it inherited from the last, and then must pass those enhanced values on to the next generation through the socialization of its children.

Smith sees each individual as being shaped by and in turn, given that person's experience, shaping society. The dynamic and continuity of human social evolution derive from this coevolution: communities contribute the continuity as individuals come and go, and individuals contribute the dynamic to the degree that they draw on their extra-community experience to act on the community during their stay. This coevolution of individual and society makes human improvement possible, for through this process individuals and fac-

tions can meld into a community, sharing common values that provide common ground for constructive competition among all parties.

Smith recognized that any given society might move forward, and then stagnate or even regress. But at the level of humankind, we again encounter the power and beneficence of the invisible hand. It not only guides the elegant, frictionless ideal human society; the invisible hand guides the evolution of the human condition through the stages toward that ideal. Or so Smith saw it as a young man. Experience brought Smith more of an appreciation for the dynamic power of factions, and with that experience his faith in the dexterity and strength of the invisible hand seemed to fade.

In particular, prior to the 1770s, Smith did not fully appreciate the dynamic nature of mercantilism. It was upon his arrival in London (1773) to publish *The Wealth of Nations* that he encountered firsthand the stark reality of the growing influence of commercial interests in Parliament.⁴ This influence, reflected in the immense expense incurred in the wars to protect and preserve the colonies⁵ (a classic mercantilist policy), seems to have disabused Smith of much of his optimism.

The "Additions and Corrections" to *The Wealth of Nations*, published in 1784, represents the only major revision of that text. The focus of those changes is how mercantilism was distorting commercial society, the last stage in the sanguine dynamic Smith had envisioned as guided by the invisible hand. This concern represented more than a change of perspective from sanguine to skeptical; it struck at the heart of Smith's analysis. If the invisible hand would not guide society toward the ideal, how could we hope to get there? Smith addressed this question in revisions to *The Theory of Moral Sentiments* made in the last year of his life.

In the 30 years since *The Theory of Moral Sentiments* was first published, Smith had made no significant revisions to that work. But in 1789, in advanced age and weakened frame, he set to that task. Smith made revisions throughout the text, but by far the most significant change was the addition of (Smith, 1977, pp. 319–20) "a compleat new sixth part containing a practical system of Morality, under the title of the Character of Virtue." In these revisions, Smith appeals to all citizens to put the well-being of the society before that of any particular faction to which they might belong, and he makes a special plea to those who might be statesmen to step forward and construct a moral society by deed and example.

Smith's conception of how to develop a moral society is driven by his notion that society is made up of a layered web of communities with divergent interests,⁶ and that these differences can be the seeds of destructive factions. He argues that to avoid this destructive tendency there must be a balance: the values of the society must respect the diversity of values among the communities it encompasses, and these communities' values must not undermine the commitment of individuals to the core set of values that give order to society.⁷

In Smith's view, this balance of respect and commitment is crucial for the society to be a constructive environment within which the individuals and groups that make up society can not only survive but flourish (Smith, 1976b, pp. 219–20, 235–37). And as they flourish, so too will society.

By the end of his life, Adam Smith was no longer looking to the invisible hand to guide society to the conditions necessary for a constructive classical liberal state. Instead, he called upon the visible hand of moral leadership from all individuals, and especially statesmen, to create those conditions and thereby that society. This appeal and the sacrifice he makes to present it (the work on the revisions weakened him so that he died within six months of completing them) reflect the centrality of ethics to his vision of a classical liberal society.

Smith's Legacy and the Mentoring Past

The image of individual actions guided as if by an invisible hand to an unintended optimal outcome has been passed down to modern economic discourse. For example, listen to Arrow and Hahn in their introduction to *General Competitive Analysis* (1971, pp. vi–vii):

There is by now a long and fairly imposing line of economists from Adam Smith to the present who have sought to show that a decentralized economy motivated by self-interest . . . would be compatible with a coherent disposition of economic resources that could be regarded, in a well-defined sense, as superior to a large class of possible alternative dispositions. . . . It is important to understand how surprising this claim must be to anyone not exposed to this tradition. The immediate "common sense" answer to the question "What will an economy motivated by individual greed and controlled by a very large number of different agents look like?" is probably: There will be chaos.

But the Smithian story told by Arrow and Hahn—and they are representative of modern economists—is an abridged edition. The spring that motivates action in Smith's story has been carried forward, but much of the rest of his tale has been forgotten. Unfortunately, this has become the standard treatment of the works of the great economists of the past. They are not read for the fullness of their vision; they are cited for the pieces we have inherited.

This approach to our past reflects a modern sense that the development of economic thought has been an inexorable progress toward greater understanding. In this view, the greats among our predecessors have in their own time pushed understanding of the world into new frontiers. Like other trailblazers of the past, their once freshly cleared path is now well-trod and the cutting edge lies far beyond. We appreciate them, not for where they

reached, but for where their efforts have allowed us to reach. The actual works of those greats are treated as “classics,” cited by many, and read by few.

The cost of this approach to our past is the loss of much of our rich legacy. The modern adaptation of Smith’s invisible hand story is, I believe, a case in point. To tell that story without ethical dimension is to lose much of its richness and relevance. Smith’s story weaves self-love and the invisible hand into a tale about the human condition that is much more telling than can be developed with those concepts alone. He begins with an exploration of the ethical ideal, moves on to the evolution of social ethics and socialization as a dynamic that ameliorates the corrosive effects of human frailty, and then develops this evolutionary foundation into a tale about the emergence and functioning of an elegant and efficient classical liberal society. In Smith’s story ethics is the hero—not self-interest or greed—for it is ethics that defend the social intercourse from the Hobbesian chaos. Once the veil of “classic” is lifted from Smith’s work, it can be read again as a thoughtful commentary on the state of modern classical liberal societies, and as an underutilized resource for the development of the models that economists use to analyze and construct those societies.

Notes

I would like to express a special thanks to Joe Persky for encouraging me to do this piece, and to Celia Kamps and Timothy Taylor for excellent editorial assistance. Needless to say all opinions and errors are my own.

1. There is a growing interest in this subject. In recent years we have seen, for example, works by James Buchanan (1991), Amitai Etzioni (1988), Robert Frank (1988), Jane Mansbridge (1990), as well as Pope John Paul II’s Encyclical Letter “Centesimus Annus” address this issue. The presentation here builds on my earlier work (Evensky, 1987, 1989, 1992a, 1992b, forthcoming).

2. Smith actually uses the “invisible hand” metaphor only once in *The Wealth of Nations* (Smith, 1976a, p. 456), once in *The Theory of Moral Sentiments* (Smith, 1976b, p. 184), and once in the *Essays* (Smith, 1980, p. 49); but the image is central to his moral philosophy.

3. See Smith (1976b, p. 87) for an example of his use of this watchmaker image. This “design argument” (Hurlbutt, 1965) is expressed in eloquent and absolute terms by Cleanthes in David Hume’s *Dialogues Concerning Natural Religion* (Hume, 1947, p. 143):

Look round the world: contemplate the whole and every part of it: you will find it to be nothing but one great machine, subdivided into an infinite number of lesser machines, which admit of subdivisions, to a degree beyond what senses and faculties can trace and explain. All of these var-