The Real Truth about the Invisible Hand in Economics and its Impact on Trust

By Robert Porter Lynch

In the latter half of the twentieth century, economists of the rational self-interest school expounded on the idea that an *invisible hand* controlled economic behavior. This idea, which now underpins much of our economic structure, proposes that if multiple transactions occur in a rational market place which is free of constraints and coercions, the supply, demand, and price structures will reach an equilibrium that realistically defines market value.

The origin of the concept is based on Adam Smith's eighteenth century *Wealth of Nations (1776),* a book considered to be the foundational writing on Capitalistic Theory. It makes some powerful assumptions about human behavior which impact a lot of our thinking today. (We paraphrase and abbreviate his lengthy passage to alleviate the reader's pain of having to wade through Smith's awkward terminology and convoluted sentence structure):

> Every investor seeks the most advantageous return on their capital, which means:.
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> > First, every investor seeks the least risky investment, provided he can receive a reasonable return with people he can trust; and if he is deceived by them, he knows the local laws for initiating a law suit against them.
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> > Second, every investor seeks to put capital in industries that create the most value and thus provide the greatest return or profitability.
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> The annual productive revenue of a society is the sum of the productivity of all the individual investments. While the individual investors are not aware they are intending to promote the public interest, their combined labors benefit the good of all, because, by making wise investments, while intending only to serve his self-interest, the investor is led by an *invisible hand* to promote the well being of all.
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> Merchants whose decisions are driven primarily to serve the public good are imprudent. Governments that attempt to steer capital investments, such encouraging or discouraging investment in certain industries, are mistaken because it's useless or harmful to believe the multitude of investors are wiser than the few who guide government policy. What's prudent for people can hardly be folly for government.[1]

Economists have developed sophisticated theories of free markets, justified deregulation, and produce detailed financial analyses based on Smith's theory. For transactional exchanges, this perpective is viable. However, it does have its limits, because it does not adequately explain highly collaborative enterprise, as we have described in mutual value creation. While trust is helpful in transactional exchange, it is vital to highly collaborative business relationships.

Rational Self-Interest

One of the chief proponents of the Rational Self-Interest school of thought was Alan Greenspan, who built his economic models on the foundation of Milton Friedman and Ayn

[1] Smith, Adam; *The Wealth of Nations*, Chapter II – Restraints on Importation from Foreign Countries on such goods as can be produced at home, 1776

Rand, who was his mentor. In Rand's book, *Capitalism: the Unknown Ideal*, Greenspan penned these words, launching the "greed is good" era with this mantra:

> "Protection of the consumer against dishonest and unscrupulous business practices has become a cardinal ingredient of [the] welfare state. Left to their own devices, it is alleged, businessmen would attempt to sell unsafe food and drugs, fraudulent securities, and shoddy buildings. Thus, it is argued, ….numerous regulatory agencies are indispensable if the consumer is to be protected from the "greed" of the businessman.
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> "But it is precisely the 'greed' of the businessman or, more appropriately his profit-seeking, which is the unexcelled protector of the consumer."
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> Greenspan then went on to say that "It is in the self-interest of every businessman to have a reputation for honest dealings and a quality product."[2]

His rational idealism was based on a false belief that self-interest had its own moral imperative…..

> "…the crucial importance of moral values which are the motive power of capitalism. Capitalism is based on self-interest, self-esteem; it holds integrity and trustworthiness as cardinal virtues and makes them pay off in the marketplace, thus demanding that men survive by means of virtues, not of vices."[3]

This unabashed rational idealism, of course, laid the theory barren and was proven incredibly naïve, simplistic, and romantic as the financial community tore down the protective shield of investment laws like Glass-Steagall on its incestuous March to Meltdown. Greenspan got snookered by credit default swaps, mortgage fraud, and deceptive lending practices, which laid the foundation of capitalism open to economic collapse.

After the 2008 Financial Meltdown, Greenspan testified before Congress, incredulous that the financial community he had served was incapable of regulating itself. He simply could not accept the fact that the finance industry was a magnet for attracting crooks, connivers, and con-artists – the very people who extolled his "greed is good" philosophy and helped keep him in power.

On the other hand, Greenspan took a very jaundiced view of all government regulation, including oversight of drugs, medicine, building codes, and financial institutions. In his commentary, his libertarian words were harsh and unequivocal:

> "Government regulation…does not build quality into goods or accuracy into information…At the bottom of the endless pile of paperwork which characterizes all regulation lies a gun...
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> "Regulation – which is based on force and fear – undermines the moral base of business dealings. It becomes cheaper to bribe a building inspector than to meet his standards of construction….

[2] Greenspan, Alan; The Assault on Integrity, Chapter 9 in Rand, Ayn; *Capitalism: The Unknown Ideal*, New American Library, 1966, p 112

[3] Greenspan, Ibid, p 116 [Author's note: Greenspan seems to combine Romantic Idealism with Aristotlean Rationalism and Ethics, in a naïve world-view that denies the existence of evil and corruption, while at the same time extolling the virtues of greed and excoriating the vices of fear.]

> Regulation … is an act of expropriation of wealth…Businessmen are being subjected to governmental coercion *prior* to the commission of any crime."[4]

Further, while this rational self-interest perspective is a reasonable explanation of how *investors* make decisions, it does not explain how *businesses* make decisions. It's important to note that business is made up of investors, entrepreneurs, employees, managers, customers, and suppliers, among others. Their decisions are not always driven by monetary gain, and when it is, the question of short-term versus long-term gain is always a critical distinction, as well as their appetite for risk. For example, while investors typically like more liquid, short-term gains, employees want longer-term security of their jobs.

While economists based their free market theory on the *Wealth of Nations,* for the most part they selectively overlooked Adam Smith's other definition of the invisible hand, which was elucidated more fully in his earlier work, *Theory of Moral Sentiments (1759)* (again we paraphrase and abbreviate his lengthy passage):

> Those in power must avoid the temptations of gluttony and greed, by acting unselfishly through honesty and justice, to ensure that those less powerful, whose labor produces goods and services, receive their fair share. Morality and sympathy, which are the gifts of divine Providence, serve as the guiding power behind the *invisible hand,* by which those in power advance the interests of society as a whole. And thus will the people be happy and secure. Regardless of rank or status, all citizens are equal in their need to share in the bounties of the earth and experience a life of happiness.
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> The principle of beauty and order in a social system, which needs no conscious effort, requires that a person balance their desire to satisfy their own self-interest with their compassions for the greater good of their community and country. Those who value the means more than the ends fail to realize the impact of their actions on others and on the larger community.
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> All the constitutions of government are valued only in proportion to the extent they promote the happiness of those who live under it. This is their sole use and end.[5]

Here Smith was very clear that there are two forces at work within the wise person's spirit – both self-interest and concern for the greater good. It is a concept he observed himself and built on earlier work based on readings of the Greeks.

The transactional exchange, rational self-interest, free market paradigm is seductively deceptive, perhaps even tragically flawed, because it fails to embrace the existence of a parallel, trust-based model of economic activity. This parallel economic model exists where buyer and seller do *not* see their interests transactionally, *not* based on *exchange* but rather on the *mutual creation of value.* In this case, the buyer and seller are strategically linked in an alliance, and see their interests as synergistically linked. In which case, individuals or businesses or suppliers and customers work together to do build or develop something jointly that could not be done alone.

Distinguishing between tactical-transactional exchange and strategic mutual value creation implies there are *two invisible hands:* one that controls transactional exchange, the other that guides mutual value creation. For example, in a mutual value creation arrangement, a real

[4] Greenspan, Ibid, p 113-115

[5] Smith, Adam; *Theory of Moral Sentiments*, Section IV, Chapter 1, Paragraphs 10-11; 1759. Authors Note: The astute reader will see the similarities of Adam Smith's beliefs and the framers of the U.S. Constitution.

estate developer may take a piece of raw land, bring together a team including planners, architects, and building contractors to transform the land into a housing development. They might choose to form a joint venture to share the risks and rewards of their efforts.[6] In this case, transactional trade is not an appropriate means of understanding their economic behavior.

In the *value creation* model of capitalism, *mutual* benefit is essential to success of the *strategic relationship (*this relationship should not be referred to as a *deal,* which is a term meaningful only to transactions*)*. A strategic relationship requires a strong foundation of trust that enables synergies to generate additional value. Collaborative strategies and structures are ideal generating innovation in this situation. As discussed in our book *Trusted to Lead,* trust is a propellant of innovation. Yet, because trust, creativity, and synergy tend to be largely "invisible," economic theorists have shied away from developing an economic model for this type of "creative capitalism."

For example, software is one of the most cheaply reproduced products in the world. Most of it can be moved across continents instantaneously on the internet for virtually nothing. As demand increases, the supply is not used up; the incremental cost of multiplying it is negligible. Then, once it is installed on a computer, the more it is used, the more valuable it becomes as each user creates data and adds value by sharing knowledge. Using the software more does not create less of it; to the contrary it produces more of it. Therefore, the traditional economic laws of supply, demand, and price do not prevail in the system of economic of *abundance*. We call this the *Economics of Expandables.*

Other examples proliferate. When a person, team, or business partners engage creatively to invent a new product, process, technology, or idea, their creative "juices" are not used up when they are put into play. Quite to the contrary, their creativity expands based on their trust of each other and their willingness to *share* resources.

The problem occurs when deal makers and strategists, who do not grasp the nature of trust and collaboration, focus solely on the self-interest based *exchange* model and fail to see or understand the *value creation* model may be a more effective alternative. For the *exchange* model, trust is useful, while absolutely essential for *value creation.*

Thus, the principle of the *invisible "hands"* seems to have a mighty impact on business and economics, but more like Adam Smith thought of it, not as it was twisted to meet the needs of the "greed is good" economic theories.

[6] This is actually a very old model dating back to pre-industrial era capitalism. Most shipping ventures were transacted this way between the 17th and 19th century. See Lynch, Robert Porter, *The Practical Guide to Joint Ventures and Strategic Alliances*, John Wiley, 1988, Chapter 1