Point of View

In Search of the Invisible Hand

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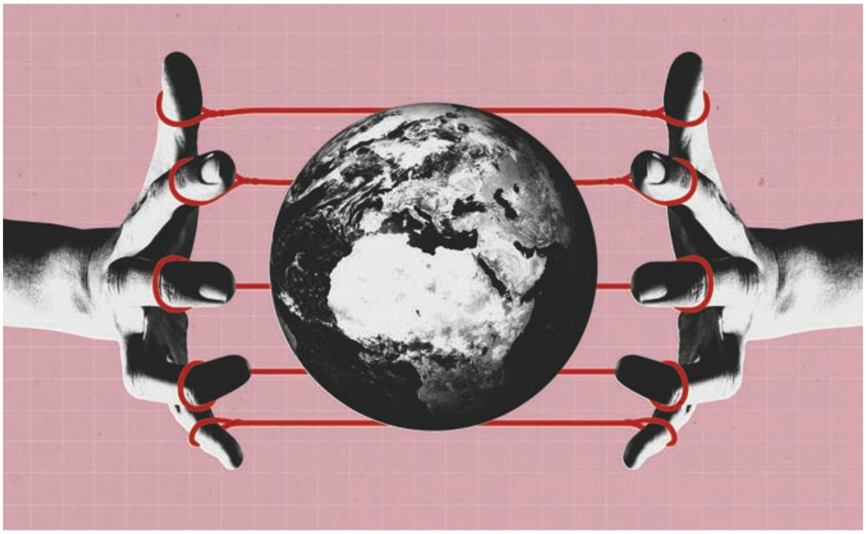
Adam Smith's capitalism demands constraints on markets, not blind faith in them



The academic economist's dry prose usually benefits from an evocative metaphor. But we would all be better off if Adam Smith had skipped the bit about "the invisible hand." He meant little, if anything, by it—he used the term only once in the entire two volumes of *The Wealth of Nations*, as he had a single time, in an entirely different context, in *The Theory of Moral Sentiments*.

But in the second half of the 20th century, economists built an entire worldview around it, engendering the baseless assumption that, in the words of Pat Toomey, a former US senator, "capitalism is nothing more than economic freedom," that, left untended, it just works. Like the cartoon character Wile E. Coyote, they marched forward with plans lacking any means of support. Except it is not the economists who fell to the bottom of the ravine when their folly was discovered, it was the average citizen.

Understanding the term requires first visiting it in its natural habitat: "By preferring the support of domestic to that of foreign industry, he intends only his own security," Smith wrote, "and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention." The invisible hand did not refer to a magical force, but to the preference for domestic industry and the determination to direct industry toward produce of the greatest value.

And so, for most of its history, the invisible hand was given precisely the little attention it deserved. But drop "led by an invisible hand" into Google Ngram, plotting the frequency with which it appears across all English-language books since 1800, and just after World War II the phrase begins an inexorable march upward. Determined to defend democratic capitalism from enthusiasm for communism's central planning, economists like Paul Samuelson and Friedrich Hayek adopted Smith's metaphor and placed it at the center of their free market's logic.

Blind faith

Jonathan Schlefer, longtime editor of the Massachusetts Institute of Technology's *Technology Review*, has shown how Samuelson's *Economics*, first published in 1948 and the discipline's leading textbook for decades, contorted this modest insight into a declaration of blind faith and placed it at the center of the econo-

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Illustration by Chantal Jahchan

mist's worldview. Students learned that Smith had written, "He intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end which was no part of his intention." Not even an ellipse.

Hayek elevated the principle to a religion, professing "faith" in "spontaneous forces." He was proud to "assume that, especially in the economic field, the self-regulating forces of the market will somehow bring about the required adjustments to new conditions, although no one can foretell how." By the 1990s, economic historian Amity Shlaes could write in the *New York Times* that Adam Smith had created the "powerful image" of the "'invisible hand,' the hand of free commerce that brings magic order and harmony to our lives." What had been a description of the conditions under which markets *can* advance the common good became a claim that, regardless of conditions, they miraculously and automatically would.

Release Smith's conditions, though, and the logic immediately falls apart in theory, and has indeed collapsed in practice. If the hard, capital- and labor-intensive work of extracting natural resources, practicing agriculture, building infrastructure, and manufacturing products offers the best return on capital, businessmen pursuing their private interest will indeed advance the common good. If those activities consistently offer a less attractive investment profile than trying to build a unicorn cloud-based application that might scale to millions of users in a year or two with just a few employees, capitalism may generate a facsimile of GDP growth, but it will not work in the sense Smith described and that a nation requires.

National decay

If growth and margin expansion depend on investing in higher worker productivity, innovation will occur, wages will rise, and prosperity will spread. But if firms can most easily grow sales while reducing costs by offshoring production to foreign labor or bringing that labor into the United States for "jobs Americans won't do," capitalism will not work. If

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top business talent find they can earn more money trading piles of assets in circles than making productive investments in the real economy, capitalism will not work. The market will deliver the profits, as the US has learned, but also national decay.

Press economists on how they can be confident that capitalism will deliver prosperity under globalization, and the account drifts gently off into the void. To be sure, capitalism *can* work, but only with constraints that ensure the ensuing pattern of trade is indeed mutually beneficial. How does the Ohio worker benefit when a local investor moves capital to Shenzhen in search of a higher return? Hayek promised that "some necessary balance, between demand and supply, between exports and imports, or the like, will be brought about without deliberate control." The US trillion-dollar trade deficit begs to differ.

The reductio ad absurdum of the imaginary invisible hand is the confidence projected from Wall Street that the metastasizing financialization of the economy must be good for the nation because this is how people are choosing to pursue profit. For instance, University of Chicago professors Todd Henderson and Steven Kaplan have argued in the *Wall Street Journal* that private equity investments generate "enormous social value" based solely on the fact that they achieve gross returns in excess of market averages. But no actual theory or evidence in economics supports the idea that the strategies delivering the highest returns to leveraged buyout funds bear any correlation to the forms of investment that best, in Smith's words, "promote the public interest."

Market fundamentalism

Unlike the market fundamentalism fostered by a misunderstanding of the invisible hand, Smith's actual thought provides quite useful guidance to contemporary policymakers. How can we create a preference for "the support of domestic to that of foreign industry" and ensure that "directing… industry in such a manner as its produce may be of the greatest value" is the path to greatest profit? Those conditions, alongside "freedom," are the prerequisites to a well-functioning capitalist system.

Encouragingly, the surging popularity of the invisible hand in Google Ngram reaches an abrupt halt in 2014–15 and then begins a plunge equally steep. Those years happen to be the ones when David Autor and colleagues published their "China Shock" research and Anne Case and Angus Deaton called attention to the calamitous rise in "deaths of despair." The following year, the United Kingdom voted to leave the European Union and the United States elected Donald Trump president. As if by an invisible hand, our political systems do respond to failure and create the opportunity to make amends. F&D

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