

IN DEFENSE OF THE INVISIBLE HAND

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Introduction

Despite the current intellectual popularity of free market philosophies and the increasing doubt cast on the idea that the political power of the state can improve upon the spontaneous workings of a decentralized, private property exchange system in the production of desirable social outcomes, criticism of the Invisible Hand hypothesis continues to flourish. Moreover, such criticism does not emanate solely from the members of some socialist ancien régime anxious to preserve an intellectually spent economic dynasty but from some of the most original and sophisticated economic and social theorists currently writing. Two outstanding contributions to this critique of classical economic liberalism are those of Frank Hahn and Amartya K. Sen, whose Fred Hirsch Memorial Lectures have attracted much attention.¹ What is of interest to the Invisible Hand theory in these articles, especially that of Hahn, is not that its critics wish to amputate the limb and replace it with some allegedly superior steering device, but that they seek only to expose infirmities in its joints and muscles and indicate some unsureness of its grasp. Nevertheless, the hand of friendship proffered by these writers seems limp enough to provoke some defensive reflections on behalf of spontaneous market forces.

The criticisms of Invisible Hand processes cover a wide range of economic and social issues. At the level of pure theory, there is the question of whether rational economic agents, driven only by self-interest, will produce an economic "equilibrium" and, further, whether

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¹See Frank H. Hahn, "Reflections on the Invisible Hand," *Lloyds Bank Review*, April 1982, pp. 1-21; and Amartya K. Sen, "The Profit Motive," *Lloyds Bank Review*, January 1983, pp. 1-20. See also Frank Hahn, "General Equilibrium Theory," in *The Crisis in Economic Theory*, ed. D. Bell and I. Kristol (New York: Basic Books, 1981), pp. 123-38.

“equilibrium” is a useful description of economic reality. With regard to welfare economics, the critics argue that the optima described by the theorems of market equilibrium have no necessary connection with economic justice, since the optima are consistent with any given distributions of property holdings. Sen, especially, challenges the utility of the market in relation to employment and welfare policy in industrialized countries and seriously questions its success in promoting prosperity in developing areas. Generally, both Hahn and Sen express skepticism about the possibility that economic agents can actually advance their personal interests by obeying the egoistic injunction of the laissez-faire theory. Sen at least implies that such a postulate does not capture a desirable or adequate ethical goal. This paper examines these criticisms of the Invisible Hand theory in light of Hayek’s insights concerning the market process, and in light of the recent developments in public choice theory and property rights theory.

The Invisible Hand as a Competitive Market Process

The defense of the Invisible Hand process must begin at the theoretical level with an accurate and coherent account of what is being claimed in the economic philosophies of those who utilize it. For it can be argued, with ample justification, that much of the initial plausibility of the criticism of the Invisible Hand theorem derives from a systematic misrepresentation of the spontaneous market order that it describes. In fact, the description of a competitive market system given in the orthodox texts of neoclassical economics bares little resemblance to the theory of competition advanced by Adam Smith and his successors. The differences center on the conceptions of human action that underlie rival models of economic competition.

The difficulty of understanding the significance of the Invisible Hand theorem is that, in economics at least, it has become inextricably bound with the notion of equilibrium: the search for the presence of an Invisible Hand process has been misdirected toward the search for the existence of equilibrium in a decentralized market economy. To anticipate what is to follow, the critics of the market system claim that the absence of a stable equilibrium in real economies entails the refutation of the Invisible Hand theorem. I maintain that this is false.

The Shortcomings of Hahnian Equilibrium

Although Hahn is a distinguished exponent of general equilibrium economics, it is not always clear what exactly he means by the con-

cept or how it is to be used in economic analysis. However, the policy implications he draws from equilibrium theory are fairly clear.

In his Fred Hirsch Lecture, Hahn appears to be describing the “pure theory” of the Invisible Hand as equilibrium theory. An economic system is postulated in terms of a perfect coordination of economic actions in which the price structure reveals no possibility of further changes. According to Hahn:

The economic environment of any one person is fully specified once the prices of all tradeable objects are given. These prices are the terms at which one good can be exchanged for another and it is a basic assumption that all individuals can trade to any extent they wish at these prices. One notices that the economic information is conveyed very economically—the individual knows everything that he needs to know once he knows prices.²

From this it follows that all individuals are price-takers (no one person can influence price), they are endowed with perfect knowledge of all possible states of affairs, and markets are “complete,” that is, there are terms of exchange that enable individuals to make any trades they wish. Individuals then react in the manner of automatons to their environment, and their actions can be predicted by an external observer. These actions are, in Hahn’s own words, “machine-like responses of agents to prices.”³ The argument therefore for the operation of the Invisible Hand is reduced to the abstract *mathematical* proof of the proposition that in a world of decentralized trading the actions of transactors will “mesh”; there will be no discoordination to be corrected by further trading.

A more adequate statement of Hahn’s position on equilibrium can be found in his earlier essays,⁴ where two sorts of equilibrium are differentiated: the timeless static world described in the original Arrow-Debreu⁵ model and a more dynamic version in which the sequential movement of an economy is explored. Although no different policy conclusions follow from the two representations, a fair treatment of Hahn’s views requires that they be examined.

The latter is much more interesting and, as S. C. Littlechild has pointed out, has much in common with the Hayekian⁶ version of

²Hahn, “Reflections on the Invisible Hand,” p. 2.

³Ibid., p. 6.

⁴In particular, see Hahn, “The Winter of Our Discontent,” *Economica* 40 (August 1973): 322–30; and his inaugural lecture at Cambridge University, *On the Notion of Equilibrium in Economics* (Cambridge: Cambridge University Press, 1973).

⁵K. J. Arrow and G. Debreu, “Existence of an Equilibrium for a Competitive Economy,” *Econometrica* 22 (July 1954): 265–90.

⁶F. A. Hayek, “Economics and Knowledge,” in *Individualism and Economic Order* (London: Routledge and Kegan Paul, 1948).

equilibrium. It represents a significant departure from the original Arrow-Debreu model, for instead of using equilibrium theory to represent or "objectify" a static and unchanging picture of perfect coordination, it addresses the question of how individuals, through a learning process, adjust their plans through time so as to bring about that equilibrium state. This "subjectivist" view of economics sees the task of equilibrium theory as one of incorporating an explanation of individual action in a less rarefied world than that of comparative statics. Hahn puts the matter accurately when he says that this "requires that information processes and costs, and also expectations and uncertainty be essentially included in the equilibrium notion. This is what the Arrow-Debreu construction does not do."⁷

In Hahnian equilibrium, which sees economic action as sequential action, each individual has a theory of how the economy will develop over time, and his theory will be modified (through a learning process) in accordance with his perception of changes in the data that confront him. If every change is perfectly foreseen then each individual is in equilibrium: An economy is in equilibrium when all the individual theories or plans are mutually compatible. Thus, Hahn's notion of equilibrium is similar to that used by Hayek in the *Pure Theory of Capital*. Hahnian equilibrium is undoubtedly an improvement on the Arrow-Debreu model, which, by objectifying a once-and-for-all state of affairs, is unable to accommodate change. But it is not at all clear that Hahn's modified version improves our understanding of how real markets work or contributes to an explication of the Invisible Hand theorem.

The crucial point is that Hayek sees the *limitations* of equilibrium theory, as Mises did before him (although the Misesian construction of an "evenly rotating economy" is less useful since it does not accommodate change). A theory of equilibrium is a deliberate abstraction from reality, a limiting case, which enables us to understand how and in what ways the behavior of real economies departs from the theoretical model. Thus, far from extending and refining the basic postulates of equilibrium theory so that they provide a truer picture of reality, Hayek goes on to take account of other economic mechanisms.⁸ Notable here, of course, is entrepreneurship (completely absent from any equilibrium model), which explains how an

⁷Hahn, *On the Notion of Equilibrium in Economics*, p. 16. See also, S. C. Littlechild, "Equilibrium and Market Process," in *Method, Process, and Austrian Economics*, ed. Israel Kirzner (Lexington, Mass.: D.C. Heath, 1982).

⁸See especially, "The Meaning of Competition," in *Individualism and Economic Order*. The most sophisticated contemporary competitive theory is Israel Kirzner's *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973).

economy tends to move toward that state of perfect coordination described by abstract theory.

But Hahn believes, mistakenly, that further progress in economic science can only come from the continual refinement of the general equilibrium model. While accepting (emphatically) that this does not reflect reality, he claims that “The student of general equilibrium believes that he has a starting point from which it is possible to advance towards a *descriptive* theory” (*italics added*).⁹ Thus Hahn is not interested in economic processes, *genuine* competition, entrepreneurship, or innovation, all of which characterize real economies, but in routine, regularized, and repetitive behavior that can be encapsulated in equations. As Alan Coddington points out,¹⁰ this is entirely because Hahn is wedded to the formal deductive method in economic theory. But the real work of the Invisible Hand is done in those coordinating market processes that cannot be captured by axiomatic reasoning. Hahn shows some recognition of this when he concedes that “general equilibrium is strong on equilibrium and very weak on how it comes about,”¹¹ but he never takes up the market process theory that is hinted at here.

What is worse, as again Coddington points out, Hahn uses theory in a systematically misleading manner.¹² Although he occasionally concedes that general equilibrium is a self-contained (mathematical) exercise that does not picture reality, he uses it to “falsify” the major claim of the Invisible Hand theory: that an unhampered, decentralized market economy will tend to produce a Pareto-optimum. He does this by showing that, in comparison to the perfect coordination of plans described by pure theory, existing markets display many “inefficiencies” that could in theory be eliminated. The argument, however, is misleading because general equilibrium theory is not a causal explanation of how markets work but rather a self-contained logical exercise that deliberately excludes coordinating processes.

Implicit also in Hahn’s analysis is a skillfully concealed piece of normative economics. What he wants to show is that in a variety of areas the (alleged) failures of the market—in terms of the standards set by abstract theory—can be corrected by government and administrative action, presumably informed by the equations of general equilibrium theory. What he does not consider is that although

⁹Hahn, “Winter of Our Discontent,” p. 324.

¹⁰Alan Coddington, “The Rationale of General Equilibrium Theory,” *Economic Inquiry* 13 (December 1975): 547.

¹¹Hahn, “Winter of Our Discontent.”

¹²Coddington, “Rationale of General Equilibrium Theory,” pp. 541–43.

existing markets may not provide “perfect” solutions to the problems of, say, exhaustible resources, externalities, public goods, and so on, this still leaves “wide open the possibility that the imperfectly-functioning markets perform better than any of the available (administrative) alternatives.”¹³

Thus even though the full description of Hahnian equilibrium includes some subjectivist elements, it no more captures the essence of the Invisible Hand theorem than does the static model he is so anxious to refine. He has not produced an account of its movement at all but engineered a sophisticated sleight of hand. His sequential equilibrium is still a description of the outcome of a market process and not an account of the process itself. An economic “end-state” has been postulated after the Invisible Hand has done its work, but what is not revealed is how this work is done.

The Invisible Hand Process

The notion of the Invisible Hand must be seen as a metaphor that illuminates a continuing process of exchange and competition between individuals which brings about a coordination of plans and purposes. It must not be seen as a picture of an end-state of perfect equilibrium in which all plans have already meshed, since that implies the cessation of human action. The Invisible Hand image refers to an unending process of change and adjustment and not to a perfectly harmonious end-state in which incentives to change have been removed. It is because we cannot know in advance of a market process the details of the price structure of an economy in perfect equilibrium that the description of a market economy in those terms is quite misleading: It is merely a theoretical abstraction that has no necessary connection with real markets.

Of all the differences that mark off abstract equilibrium models from existing markets it is the omnipresence of ignorance and uncertainty that is most germane to real markets. Because market transactors are necessarily ignorant of most of the facts of the economic universe, all of their actions are speculative; they make guesses about a necessarily unknowable future. From this it follows that they cannot be passive price-takers responding automatically to a given set of data, but are active makers of various futures. Economic activity consists of continually exploiting price differences that exist in a necessarily imperfect world. It is this, of course, that constitutes profit, a phenomenon which is absent from an equilibrium world. Yet if there were no possibility of profit there would be nothing to

¹³Ibid., p. 554.

drive the system toward equilibrium. In Hayek's instructive phrase, the market is a "discovery procedure" by which transactors adjust to ever-changing circumstances, rather than an "allocative device" by which means are somehow mechanistically directed to the production of given ends.

We can now see how genuine market competition differs from the ersatz version described in "perfectly competitive equilibrium" models. As Frank Knight said, "in perfect competition there is no competition." If there are no mistaken prices to correct, as is the case with perfect competition, there is no opportunity for the intense rivalry that characterizes economic action to manifest itself and no need for entrepreneurship to play its coordinating role.¹⁴

In economics the point of the Invisible Hand theorem is to show how there can be order without a designing mind and without anyone intending specifically to produce such an order. Hayek's famous observation that the social sciences should be concerned with the investigation of phenomena that are "the result of human action, but not of human design"¹⁵ shows there are "natural" processes at work that, if left undisturbed, will produce an order infinitely more complex than that which emanates from deliberate human will. This is because no one mind can have access to that dispersed knowledge which is a feature of a natural system: To think this is possible is, according to Hayek, to be a victim of the "synoptic delusion." As Hayek has been at pains to point out, a self-correcting economic system is not the only example of a natural social process; legal systems and languages, for example, display similar properties.

Sen's Objection to Spontaneous Order

Sen thinks that this is rather an "unprofound" thought.¹⁶ He supports this contention by giving a trivial example of an action—crossing the street—from which certain results occurred that were not specifically designed; for example, crossing the street led to a passing car being delayed. This is quite disingenuous, for the fascinating thing about Invisible Hand theories is that they produce surprising and *untrivial* results. The typical modern intellectual is a victim of the synoptic delusion: It is inconceivable to him that a market can coordinate in the absence of a central human agency, or that judges,

¹⁴F. A. Hayek, "Competition as a Discovery Procedure," in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge and Kegan Paul, 1978), pp. 179–90.

¹⁵See Hayek, *Studies in Philosophy, Politics and Economics* (London: Routledge and Kegan Paul, 1967), pp. 96–105.

¹⁶Sen, "Profit Motive," p. 3.

in a case-by-case manner, accidentally generate a more predictable legal order than that produced by a legislature. Yet it is these processes that are orderly and the human will that is capricious.

The most that Sen concedes to the market is that it is appropriate only for those matters over which people's interests converge, but that it is quite irrelevant for those areas where there is a conflict of interests. In one sense, Sen is uttering a tautology: market relationships *are* convergent ones and, where there are irreconcilable conflicts, trading is impossible. The interesting point about the familiar institutions of market society, however, is that they enable individuals to find out those areas where cooperation and gains from trade are possible. We cannot know what coordination can take place until we allow people to exercise their "natural propensity to truck, barter and exchange." The danger of overemphasizing the conflictual side of human relationships is that it licenses "politics" to dominate men's lives, and politics has an almost irreversible tendency to conceal the opportunities for agreement among people.

Normative Implications of Conventional Invisible Hand Theory

We are now in a better position to scrutinize more critically the normative implication, noted above, that lurks in the complexity of the conventional version of the Invisible Hand theory. The obvious imperfections, such as monopoly power, of real-world markets are held up as departures from some imaginary social optimum crying out for governmental correction. But if no social optimum exists independently of the actions of economic transactors, how can there be an infallible touchstone that measures so exquisitely all of our economic variables? The familiar market imperfections, since they represent opportunities for speculative gain, are themselves being constantly corrected by enterprising individuals through the market process. If there is nothing in economic behavior apart from the actions of individuals, from where do we derive an instrument for calibrating those actions?

It follows then that there are two problems for the general equilibrium versions of the Invisible Hand theorem. First, there is the epistemological argument that the nature of free economic activity, which is essentially unpredictable, precludes any observer having the *knowledge* needed to make any statement about a social optimum meaningful. Second, even if the idea of such an optimum could be made operational, how would we guarantee that government action would produce it more effectively than private agents? Why should

political officials be more informed about profitable opportunities than market traders who risk their own resources? Furthermore, as the public choice school of political economy has shown, we cannot be at all confident that political officials will maximize such social optima in the absence of strict constitutional rules. In fact, the reverse is likely to be the case, that is, officials will maximize their private interests.

The market is a process that operates through time; it is not characterized by the instantaneous adjustment of carefully programmed automatons. If the Invisible Hand's operation were that described in the general equilibrium theory, there would be no need for money, the firm, entrepreneurship, and all the other economic categories that exist only because of the ineradicable uncertainty that pervades economic life in the real world. The interesting question concerns not the existence of perfect coordination in abstract equilibrium, but the nature of the coordinating process that the Invisible Hand generates.

Here there would appear to be some disagreement between the various anti-equilibrium schools of political economy. The Austrian tradition, as exemplified by Mises and Hayek, holds that there is a tendency to equilibrium: This does not consist of an instantaneous price and quantity adjustment, but of a learning process in which individual plans are coordinated. However, a more extreme subjectivist position, associated mainly with the work of G. L. S. Shackle,¹⁷ holds that because economic life consists entirely of thoughts and expectations about the future, which may turn out to be wrong, one cannot even posit a tendency to equilibrium. The world is "kaleidic" rather than smoothly coordinating, and the entrepreneur is a creative innovator rather than an agent that merely brings about an alignment of dispersed information.

The failure of the Invisible Hand derives not from considerations advanced by Hahn and Sen, but from a subtle interpretation of the very process that their models conceal. We cannot here go into the intricacies of Shackle's position, but experience strongly indicates that the disruptions to the coordinating process that do occur come from government intervention rather than from some endogenous features of the exchange system. Throughout the 20th century, government mismanagement of money has had catastrophic dis-coordinating effects, and the plethora of welfare and trade union legislation has systematically rendered large parts of the labor force virtually

¹⁷See his *Epistemics and Economics* (London: Cambridge University Press, 1972).

immobile. In other words, the Invisible Hand is not naturally arthritic: It has artificially imposed impediments that confine its movements.

Critics of the Invisible Hand theorem sometimes concede that under specified conditions, a decentralized exchange process will generate a Pareto-optimum, a state of affairs in which no reallocation of resources is possible without making (at least) one person worse off.¹⁸ But they are quick to point out the limitations of this notoriously weak principle of welfare economics. It is, of course, nice to know that unplanned markets can generate Pareto-improvements, but the potential *beneficence* of this principle is severely qualified by the fact that it is silent on the morality, or otherwise, of the distribution of property rights from which trading is to start. Of course, there are as many Pareto-optimal outcomes as there are possible property distributions. As Sen rightly points out: "A state in which some people are suffering from acute deprivation while others are tasting the good life can still be Pareto-optimal if the poor cannot be made better off without cutting into the pleasures of the rich."¹⁹

This is a much labored objection to free market economics, but its significance is vastly overstated. All it says is that if the Invisible Hand mechanism is to function as something more than a scientific explanation of economic order, it must produce separate principles that establish the legitimacy of the original property holdings of market traders. As a matter of logic, an exchange process must begin with objects that were acquired by means other than exchange. This, however, is not a special problem of the Invisible Hand explanation but a general problem of justification in politics and ethics.

Invisible Hand theorists become political liberals when they produce logically independent arguments for the justification of individual acquisition of previously unowned resources, of inheritance, gifts, and other forms of entitlement. Some of these arguments may not be persuasive, but can it really be maintained that socialist arguments for just acquisition are morally superior? Most of these, in fact, maintain the moral fiction that the "community" can somehow own valued things, a proposition that, in practice, has subverted not only the morality of individual freedom but also those individualistic mechanisms that power the exchange system.

Irrespective of these more substantive liberal considerations, one important indirect political implication of the classical liberal version of the Invisible Hand theorem is scarcely considered at all. This is the view that we cannot simply choose *any* distribution of property

¹⁸Hahn, "Reflections on the Invisible Hand," p. 4.

¹⁹Sen, "Profit Motive," p. 6.

rights, since the choice is likely to have unintended consequences that are impossible to foresee.²⁰ This argument derives from the antirationalist version of the Invisible Hand theory and presses home the case that there are self-correcting mechanisms at work—not merely in the market economy but in the legal and social system generally—that produce outcomes which an unaided reason is powerless to improve upon. A good example is the evolving common law system, which has historically coordinated an individual's actions much better than the imposed statutes of rationalist planners. It is because of our ignorance that we cannot plan the future and, therefore, in a utilitarian sense, it is advisable to accept inherited institutions. This would dispose us then toward accepting a received system of property rights, which in most cases has developed accidentally, rather than planning them anew according to some arbitrarily imposed abstract principle.

Although the extension of the Invisible Hand theory appears to involve a descent into an uncritical traditionalism, which is too conservative for radical laissez-faire economists, its importance in the debate about the institutional framework within which market exchanges take place is frequently overlooked. Even those who favor free exchange and production for the satisfaction of *individual* wants (such as the “market socialist” thinkers of the 1930s) blithely presuppose that property rights can be shuffled and reshuffled endlessly so as to produce some socialist Pareto-optimal end-state without there being any adverse effects on the institutional framework of economic society.

Alleged Deficiencies of the Invisible Hand

Much of the contemporary criticism of the Invisible Hand theory is directed less to theoretical concerns and more to the alleged real-world deficiencies—economic, political, and ethical—of a system based on the spontaneous interaction of basically selfish economic agents. The argument here concerns the need for state action to correct an unhampered market that would otherwise periodically produce mass unemployment, pockets of poverty amid affluence, “externalities” in the form of pollution and damage to the environment, and fail to generate economic growth in Third World countries. In all this there is scarcely any recognition of the obvious fact that no other economic system has remotely approached capitalism in its productivity and ability to satisfy consumer wants. Centrally planned

²⁰See Hayek, *The Constitution of Liberty* (London: Routledge and Kegan Paul, 1960), pp. 124–30.

systems not only depend on capitalist systems for vital technological know-how but also, and more important, for the whole range of pricing signals provided by the international market system. In the absence of the latter, the productive process in a planned system would lack any kind of rationale.

In light of this, it is incredible for Sen to claim that, in the market economies of the West, people do not go begging for food because of the "social security that the state has offered."²¹ It is surely obvious that the high welfare payments in capitalist economies are paid out of a surplus created by an economic system driven by the profit motive. Indeed, the social security payments in capitalist economies in many cases exceed the incomes of employed workers in planned economies. Again, it is neither naive nor callous to suggest that much of the unemployment that characterizes market economies is a result of those very same welfare payments that cramp the movements of the Invisible Hand. People who choose subsidized leisure over paid employment are responding rationally to the signals of a distorted market. It is intellectual duplicity to argue that economic inefficiencies caused by interventionist inhibitions in the working of the Invisible Hand constitute evidence of its failings.

Sen²² pays some attention to the version of market theory that stresses the inviolability of the property rights of the participants to the exclusion of any consequentialist considerations that would normally be thought relevant to an evaluation of the outcome of the exercise of those rights. Thus he concludes that actual instances of mass starvation in developing countries can be attributed to the property rights structure of market society. Here, the Invisible Hand is said to fail in a welfare sense because it does not distribute food, in conditions of no overall deficit in food availability, to those who clearly need it.

No doubt such cases have occurred, although their frequency in the terms so described may be disputed. However, this is not a criticism of the Invisible Hand as such, but of the property rights structure within which it operates; as I suggested earlier, a variety of moral considerations may be brought to bear on the question of property entitlements. The apparent failure of a spontaneous market to distribute food to the needy may be the result of some previous violent acquisition of land and resources by a minority.

²¹Sen, "Profit Motive," p. 12. Bastiat's famous description of the state as "that great fiction by which everybody tries to live at the expense of everybody else" is apposite here.

²²Ibid., pp. 10–11.

But even if it were the case that perfectly just acquisitions of resource holdings led to mass starvation in circumstances of aggregate adequate food supply, this does not refute the case for the Invisible Hand or establish the case for a *dirigiste* production and distribution system. Just because there have been occasional examples of such suffering under capitalist systems, it does not follow necessarily that collectivism itself would have prevented them. Surely, the more frequent cases of mass starvation under communism, as in the Soviet Union, are sufficient to tip the balance in favor of *laissez-faire* even in the least propitious cases.

This points to a more general problem with the approach of the critics of the Invisible Hand. Their obsessive concern with the alleged failures of the market process leads them to overlook the deficiencies of politics. All too often, the choice of methods is presented as if it were between the commands of a benevolent and omniscient legislator on the one hand and a messy and imperfect market on the other. However, the real comparison ought to be between political and economic means to generally agreed ends.²³

Such a comparison is particularly instructive when we look at the results of competition for votes in a democracy. Under conditions of unlimited government, as in the United Kingdom, we find that the state, far from being the infallible purveyor of the public good, becomes the plaything of interest groups who use legal and political privileges to secure their members incomes they could not earn in the market. The tragedy here is that such action is ultimately destructive of the interests of all in the political community. Whereas the corrective mechanisms of spontaneous markets act to harmonize the self-interested actions of individuals with the common interest, this cannot be said of the political system. Thus, when Sen talks of the prevalence of prisoners' dilemmas in economic society,²⁴ that is, where self-interested action is ultimately self-defeating, he neglects to observe that their most obvious manifestations lie in the public world of political actors rather than in the private world of economic maximizers. Indeed, the increase in government activity during the last four decades has come about not through the need for collective action to produce public goods, as Sen claims, but through the democratic process itself.

²³Samuel Brittan's work, especially *The Economic Consequences of Democracy* (London: Temple Smith, 1977), is most important in this respect.

²⁴Sen, "Profit Motive," p. 18.

The Self-Interest Postulate

This brings us face-to-face with the problem of self-interest and the validity of the now well-known thesis of the late Fred Hirsch that the classic motivational postulate of the Invisible Hand theorem is an inadequate mechanism for satisfying everyone's interests. Hirsch made much of the phenomenon of "positional goods," by which he meant those goods, such as rare works of art or uncrowded beaches, whose supply cannot increase with increase in demand. He implies, in other words, that a market economy produces a mass of unsatisfiable desires. Perhaps the novelty of the concept has been exaggerated. Positional goods have always been with us and, presumably, always will; their existence does not point to the failure of the Invisible Hand but to unalterable facts of the world. It seems to me that Hahn²⁵ has it about right when he suggests that the market will always provide an adequate supply (and immense variety) of augmentable goods, which makes the positional goods problem less pressing than is often supposed. Certainly, Hirsch's implicit claim that the only solution is to alter somehow individual wants has an unduly depressing (and faintly sinister) ring to it.

There is, however, in Hirsch's work a more direct argument that the pursuit of self-interest is counterproductive, that rational individuals cannot achieve their undeniably selfish ends by the pursuit of *self-interest alone*. It is claimed that certain kinds of nonselfish behavioral motivations, such as "team spirit" or "loyalty," both of which may require individuals to sacrifice immediately beneficial opportunities, are required in order to generate the efficient outcomes that are supposed to be a product of unalloyed egoism. Sen²⁶ cites the Japanese commercial success as partly due to a peculiar ethos that has little to do with the individualistic spirit of Adam Smith.

The attack on self-interest, however, neither blemishes the Invisible Hand theory nor affects drastically the self-interest assumption frequently used by expositors of that theory. A universal self-interest is not a logically necessary feature of that theory, which merely claims that a social order will emerge from the spontaneous actions of individuals without the necessity for an all-powerful central institution. The importance of the self-interest proposition is to show how the public interest is an accidental and unintended outcome of private actions so that the appeal to a deliberate altruism is either redundant or positively harmful. As Adam Smith remarked, "I have never known much good done by those who affected to trade for the public good."

²⁵Hahn, "Reflections on the Invisible Hand," p. 9.

²⁶Sen, "Profit Motive," pp. 14-15.

General reliance on the postulate of self-interest to explain economic behavior, however, does not exclude the possibility that more efficient orders may be produced by arrangements that rely on other motivations. A natural process will select out in an evolutionary manner the successful industrial forms, and these may well include some that are characterized by nonegoistic motivations. The organization of the firm is a response to the uncertainty of economic life, and we cannot know in advance of experience which is the most efficient mode of its operation. Certainly, we cannot use the examples of enterprises that depend less on self-interest and are still successful as a license to inculcate *deliberately* a nonegoistic spirit. Where this has been tried the results have been disastrous. The point overlooked when examples of successful “team spirit” enterprises are cited is that the institutional arrangements and psychological attitudes that are said to be the causal factors in these success stories have developed spontaneously. Where they have not so developed the traditional concept of man as a maximizer is still the only serviceable economic notion that we can have.

In fact, few of the Invisible Hand theorists ever supposed that a society could function entirely by selfish impulses. The prevalent view has been that although the coherence of the market order could be explained by this postulate, the social and legal context in which trading takes place depends on a measure of self-restraint and moral probity that appears to be excluded by the psychological assumptions of traditional theory. But, of course, such behavioral traits are not excluded. All that is excluded is the construction of rationalistic moral codes that presuppose that man can be other than he is or declare that a new altruistic man, unfettered by the ethics of greed, will emerge if only capitalist institutions can be overturned in a revolutionary manner.

There is no externality problem here—the market has not failed to produce the public good of morality and self-restraint. Laissez-faire economic arrangements are quite consistent with the traditional Western ethical values of honesty, fair-dealing, justice, and individual autonomy. The nonobligatory virtues of benevolence and charity flourish under capitalist systems. There is evidence of much greater selfishness and brutality in socialist regimes precisely because the market—the one area where egoism can beneficially materialize itself—has been suppressed.

Flaws in the Negative Externality Argument

In comparison with these rather grand themes, the other areas of alleged market failure, where the Invisible Hand has failed to steer

society in a smooth manner, seem almost routine and mundane. These cover the whole range of negative externalities, where private transactors impose costs on the community as a whole. This is now such a well-worn theme that a detailed summary would not be relevant here. It is sufficient to point out that the original argument (from Pigou) that an observed divergence between private and social costs automatically negated the case for the Invisible Hand and justified government intervention is no longer as plausible as it once was. This is so on at least two grounds. First, as mentioned earlier, it must not be assumed that government is an omniscient and benevolent institution that automatically maximizes the public interest. In fact, political failure is likely to be more common than market failure because political actors operate (normally) under fewer constraints than economic transactors. The public choice theorists have strengthened the case for the Invisible Hand with their systematic demonstrations of the failure of government, although this was probably not their deliberate intention.

Second, the rapidly expanding property rights literature has shown that many of the alleged externality problems could be internalized if the ownership of resources could be specified. In an appropriate legal framework, there would be many possibilities for trade between transactors in the face of apparent externalities. In many cases, there are already appropriate institutional arrangements so that the need for government to conjoin private and social costs by coercive taxation or prohibition is otiose. The common law itself contains remedies for people adversely affected by the economic actions of others.²⁷

Conclusion

Even these brief considerations suggest that economists should be more concerned with showing how institutional re-arrangements might assist in the working of the Invisible Hand rather than demonstrating gleefully how far some existing market allocation departs from an alleged optimum. If there is no Invisible Hand process then there are no economic regularities, and if there are no such regularities there is no economic science. In the absence of the Invisible Hand, the economic world becomes the plaything of, first (and very briefly), the delicate and elegant but headily unrealistic abstract theorist, and then the defenseless target of the clenched fist of the political commissar.

²⁷The classic work here is Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (October 1960): 1-44.