1999

Relationships Economics

L. Dwight Israelsen  
*Utah State University*

Richard L. Ratliff  
*Utah State University*

Follow this and additional works at: [https://digitalcommons.usu.edu/eri](https://digitalcommons.usu.edu/eri)

Recommended Citation

[https://digitalcommons.usu.edu/eri/163](https://digitalcommons.usu.edu/eri/163)
RELATIONSHIPS ECONOMICS

by

L. DWIGHT ISRAELSEN

Department of Economics
Utah State University
3530 Old Main Hill
Logan, UT 84322-3530

RICHARD L. RATLIFF

School of Accountancy
Utah State University
3540 Old Main Hill
Logan, UT 84322-3540

March 1999
RELATIONSHIPS ECONOMICS

L. Dwight Israelsen, Professor
Department of Economics
Utah State University
3530 Old Main Hill
Logan, UT 84322-3530

Richard L. Ratliff, Arthur Andersen Alumni Professor
School of Accountancy
Utah State University
3540 Old Main Hill
Logan, UT 84322-3540

The analyses and views reported in this paper are those of the author(s). They are not necessarily endorsed by the Department of Economics or by Utah State University.

Utah State University is committed to the policy that all persons shall have equal access to its programs and employment without regard to race, color, creed, religion, national origin, sex, age, marital status, disability, public assistance status, veteran status, or sexual orientation.

Information on other titles in this series may be obtained from: Department of Economics, Utah State University, 3530 Old Main Hill, Logan, Utah 84322-3530.

Copyright © 1999 by L. Dwight Israelsen and Richard L. Ratliff All rights reserved. Readers may make verbatim copies of this document for noncommercial purposes by any means, provided that this copyright notice appears on all such copies.
The concept of the importance of healthy relationships in the economic system can be traced back to Adam Smith’s writings of the last quarter of the 18th century. Smith believed that self-interest, the profit motive, competition, and frequent human interaction in the marketplace, within the framework of the rule of law, would induce market participants to develop moral virtues of honesty, generosity, and trust. Sellers who failed to develop these attributes would lose customers to competitors. The loss of customers would lead to business failure. Because sellers also had alternatives, buyers who failed to maintain good relationships with sellers would find no one willing to deal with them. Survival in the marketplace dictated the development of moral virtue and healthy market relationships. Smith also recognized the superior ability of the market system, with the efficiencies created by specialization, division of labor, and capital accumulation, to increase the material well-being of individuals and nations. He believed that increased wealth would encourage individuals who had already developed the moral virtues of honesty, sympathy, and trust, to cultivate the higher moral virtues of benevolence and sympathy. A market system, then, would lead to a better society.

Our argument is that the information age, or age of relationships, will help fulfill Smith’s vision of the full potential of the market system—a better society—in two ways. First, the new technology both allows and requires the return to the more frequent interactions among market participants that Smith saw in the early days of capitalism. Second, the new technology, by
widening markets and increasing economic efficiency, leads to ever-increasing material wealth. The frequent interactions among market participants requires a new system of relationships management that can allow individuals and nations to realize the full potential of the market system by reducing transaction costs and concomitant production costs. As in Smith’s day, economic success is once again heavily dependent on the development of healthy market relationships. These better economic relationships, made operational in the lives of individual market participants (Smith’s moral virtues), combined with the increased material wealth they help produce, show every promise of promoting the good society Smith spoke of more than two centuries ago.
RELATIONSHIPS ECONOMICS

Government, business, and academic leaders frequently refer to our time as the emerging “age of technology” or as “the information age.” Perhaps so, but the era we have entered is much more, and is at least as promising, and as revolutionary, to the world of the 21st century as the Industrial Revolution was to the world of the late 18th century. This age of technology or information age seems to be changing the very nature of how we conduct our lives. Not only is there a dramatic change in our physical environment and in the number of economic and related personal opportunities available to us; but perhaps more importantly, there seems to be a fundamental change in the very motivations—and probably the moral and cultural climate—driving economic markets around the world. There seems to be the real possibility that today’s emerging economics can (and probably will) make us better people, better able to get along together. The staggering advances in technology and information systems are playing a major role in this new economic order.

What is emerging may be described as “relationships economics.” More than 200 years ago, Adam Smith, the father of economics, saw a complete vision of the market economy’s potential. He believed that the material well-being of the participants in competitive markets would rise because of the gains from trade, specialization, division of labor, capital accumulation, economies of scale, and efficient resource allocation inherent in the market system. He also believed that since the market system required frequent interactions between buyers and sellers (who needed to please their customers), it would promote the moral virtues such as honesty and sympathy necessary for a better society. Part of Smith’s vision is realized in

---

1L. Dwight Israelsen is Professor of Economics and Richard L. Ratliff is Arthur Andersen Alumni Professor of Accounting at Utah State University, Logan, Utah.
the tremendous increase in living standards during the past 200 years, particularly in the industrialized nations. As impressive as these achievements have been, the future of economics seems to offer even more and better choices of goods and services to everyone in safer, more reliable, more convenient, and more pleasant market, living, and work environments. It offers a fuller realization of Smith's vision of a better society. A key to understanding this new system of "relationships economics" is to realize the difference between economic exchanges and economic relationships. An economic exchange basically is a transfer of rights and associated property of economic value between parties. While an economic relationship includes economic exchanges, it also includes conditions influencing how the parties feel about and treat each other attendant to the exchanges.

Two tenets provide the foundation for relationships economics:

Tenet 1: Markets are developed by the establishment of relationships among market entities in the deployment of economic resources and the distribution of income and wealth.

Tenet 2: Greater market efficiency is achieved by healthy market relationships.

**Relationships**

Essential to understanding relationships economics is a basic understanding of relationships. A *relationship* may be defined, for present purposes, as "a purposeful, mutually influential, interaction between the parties involved." By *purposeful* is meant that the parties involved have purposes that can be met by association with each other. By *mutually influential*
is meant that each party influences the other’s knowledge, attitudes, and behavior, usually resulting in one or more responsive actions. By *interaction* is meant some exchange of information, goods, and/or services. An economic relationship would be one in which the parties have economic purposes, where the parties influence each other’s economic behavior, and where the interactions include economic exchanges.

Research at Utah State University shows that a healthy economic relationship has two criteria and four conditions that are both necessary and sufficient for good health of the relationship.2 These may be described as cooperative relationships. The two criteria are:

- **Criterion 1:** Both parties must be *benefitted*, i.e., their purposes for the relationship must be achieved.
- **Criterion 2:** The relationship must be *pleasant* for both parties.

To the extent either of these criteria is not met, the cooperative relationship is threatened. The greater the violation of either of the criteria, the greater the threat. Monitoring these criteria is much like monitoring the major life signs—e.g., pulse and temperature—of a patient by a doctor.

The four conditions required for a healthy cooperative economic relationship are:

- **Condition 1:** There must be an *intersection of purposes*, either in the form of common purposes (e.g., both parties seeking passage of a tax law) or symbiotic purposes (e.g., buyer-seller purposes).
- **Condition 2:** There must be mutual *trust* between parties, i.e., (1) neither party must feel threatened by the other or by the relationship, and (2) each party must feel that the other will do things to help him/her meet his/her purposes for the relationship. This condition suggests that the parties trust that they will be treated well by each other.
- **Condition 3:** There must be mutual *respect* between parties, i.e., both parties must have confidence in the other’s: (1) competence to fulfill his/her responsibilities

---

in the relationship; (2) integrity; and (3) sense of responsibility to the relationship, such as fulfilling responsibilities and keeping promises. This condition suggests that each party believes that the other has and exercises the attributes to fulfill his/her role in the relationship satisfactorily.

Condition 4: The *means* are provided to satisfactorily conduct the relationship. These means include the following:

- Each party provides the product (information, good, or service) required by the relationship to meet the other’s effectiveness, cost, quality, time, service, and safety requirements.
- There is effective communication in the relationship, in that both parties are good listeners and keep each other adequately informed.
- Good manners are demonstrated by the parties.
- Adequate administrative support is provided for the relationship in the way of: (1) physical means by which to conduct the relationship (e.g., phones, meeting rooms, computers, etc.); (2) accessibility of the parties to each other; and (3) an administrative culture that fosters the relationship.

If all four conditions are present, then regardless of other related conditions, the relationship is virtually guaranteed to be healthy (i.e., the four are *sufficient* for a healthy cooperative relationship). To the extent any one or more of the four conditions is compromised, the relationship is threatened (i.e., the four are *necessary* for a healthy cooperative relationship). Where relationships are to some degree unhealthy (i.e., the criteria are weak), they may be diagnosed by testing the four conditions to determine what treatments are most likely to improve the relationships.

In contrast to cooperative economic relationships are adversarial relationships, which cannot be ignored, even in an ideal economy. Adversarial relationships occur in a variety of contexts, such as the context of adversaries in legal conflict over property rights, labor and management in conflict over organizational responsibilities and distribution of income, and
product competitors. In such circumstances, the adversaries may have conflicting purposes rather than common or symbiotic purposes; each may be threatened by the other and by the relationship and neither may be inclined to help the other; even if each may be competent, each may doubt the other's integrity and may doubt the other's willingness to act responsibly or dependably; products, if delivered, may be in doubt; communication is likely to be ineffective and manners offensive. It would appear that healthy relationships between adversaries could be virtually impossible.

Adversarial relationships are a natural occurrence in market economies, if for no other reason than because of the existence of scarce resources. Unchecked, adversarial relationships can hurt the parties involved and damage other proximate peripheral relationships either directly or indirectly. The four required conditions, where they exist, can largely assure the success of a cooperative relationship and the achievement of all parties' purposes; however, adversarial relationships need help. They cannot simply be avoided, but rather, must be negotiated carefully.

The success of these relationships usually is dependent upon rules governing the conduct of such relationships. The purpose of the rules may be to: (1) protect the parties involved from potential harm by the other, (2) minimize the damage of peripheral relationships that might be affected, and (3) facilitate and improve the required conditions for a more cooperative relationship between the would-be adversaries. The rule of law may be invoked on many such occasions; arbitrators and rules of negotiation also may be employed. These rules-based environments provide a culture in which adversarial relationships can be conducted successfully. The development of labor law in the United States is an obvious application of these principles.
In some situations, potential adversaries can form cooperative relationships, as in the formation of cartels (legal in many countries), networks, and strategic alliances.

**Some Brief History**

Relationships economics and management is emerging from the Third Industrial Revolution, the high-technology revolution of the last quarter of the 20th century. Each previous industrial revolution has been characterized by five supporting pillars—new technology, capital accumulation and concentration, centralization of labor, expansion of markets, and a mass management system that can be referred to as bureaucracy.

The First Industrial Revolution began in England in the last quarter of the 18th century. It was centered in the cotton textile and iron industries, where new technology made possible the production of large quantities of goods at relatively low cost, using large machines. Improvements in transportation reduced distribution costs, and markets expanded. Financial and economic capital was concentrated at first among a relatively few people, who desired it to remain that way. Labor had to be brought in from craft shops and an agrarian countryside. Laborers were predominantly uneducated and untrained in working in large, integrated, synchronized groups. The Second Industrial Revolution began in the United States in 1790, when Samuel Slater built a spinning mill in Pawtucket, Rhode Island, from plans he had memorized as a spinning apprentice in England. In 1814, Francis Cabot Lowell of Massachusetts built the first successful power loom and the first modern, integrated factory, with spinning, weaving, and inventory control in the same building. For his labor force, he recruited young farm women, who worked long hours under strict supervision. Lowell’s system was
widely admired and imitated, and, in time, larger and larger operations were established in the textile, iron, and other industries.

A management system was needed in this environment to manage very large tasks—only recently unthinkably large. The system that evolved was bureaucratic management, with its key tenets of specialized labor, rigid structure and vertical chains of command, formal detailed policies and procedures, and limited span of management control. These tenets provided the management means to move mountains, armies, masses of people, commodities, and great wealth.

Despite a remarkable and elegant maturation process culminating in a standard of living in industrialized nations almost unimaginable in the 18th century, the seeds have been sown for the demise of the traditional system of bureaucratic management. The pillars of the industrial revolution are crumbling under the weight of their own success. The conditions which gave rise to the need for bureaucracy are eroding away. Technology has now advanced to the point that small machines can compete successfully, with greater flexibility and better quality, against large machines. Capital is available from highly dispersed, highly diversified sources. Labor is very sophisticated, capable of self-management and remarkable innovation, and—with appropriate technology—frequently no longer restricted to centralized work sites. Technology has expanded markets world-wide, and customers are well-financed, highly sophisticated, and uncompromising, with multiple alternative choices of suppliers of virtually any good or service.

The traditional system of bureaucratic management is struggling to adapt, but its impersonalized emphasis on deliberate rigidity makes it particularly unsuited for application in today’s smaller micro and virtual organizations. These organizations require agility, production
and delivery speed, and on-line innovation, all with uncompromising quality and pleasant service tailored to individual needs and wants. What is needed now is a management system adaptable to large and small tasks, capable of stability within an unstable technological environment, and capable of timely responses to changing and diversified demands locally and world-wide. What is needed is a relationships management system. Also what is needed is an economic justification for the replacement of bureaucracy with relationships management. How can relationships management improve economic performance?

**Some Economics**

In recent years, scholars and researchers in economics and related business disciplines have become increasingly interested in a variety of seemingly disparate topics, such as principal-agent problems, interfirm networks, strategic alliances, organizational incentive structures, regulation, rent-seeking, and the coexistence of large and small firms in the same industry. All of these topics have two things in common: they deal with relationships and they deal with transaction costs. The relationships involved include producer-producer, supplier-producer, producer-customer, producer-government, management-management, management-employee, and employee-employee varieties. Transaction costs, or institution costs, are normally defined as the costs associated with economic exchanges other than direct production and distribution costs. They include such things as the costs of obtaining, processing, and disseminating information; the costs of searching for exchange partners (including employees); the costs of bargaining and negotiation; the costs of monitoring; the costs of regulation; and the costs associated with risk avoidance or hedging. Because all of these costs affect the price of the good or service produced,
and because the outputs of one producer are inputs of other producers, transaction costs also affect direct production costs.

It is generally recognized in the literature that “good relationships” between the kinds of economic agents listed above result in lower transaction costs associated with relevant economic exchanges. Lower transaction costs lead to greater economic efficiency, and greater economic efficiency creates larger profits for producers, larger incomes for the suppliers of labor and other resources, and greater benefits for consumers. In addition, by increasing labor effort and productivity, healthy relationships between management and labor may also reduce production costs, hence, raise economic efficiency, directly. A new management strategy that reduced transaction costs would produce the same kind of beneficial effects on economic efficiency and on economic agents as would a new technology that reduced production or transportation costs.

Allocative efficiency in an economy is generally defined as the production of the maximum possible amount of a particular good or service, for a given production of all other goods and services, subject to the available economic resources and technology. If it is impossible, by reallocating resources, to produce more of any good without producing less of at least one other good, allocative economic efficiency has been achieved. Distributive economic efficiency is defined as the distribution of goods which maximizes the economic well-being, or utility, of a particular consumer, for a given level of utility for all other consumers. If it is impossible, by reallocating resources, goods, and services, to make any consumer better-off without making at least one other consumer worse-off, distributive economic efficiency has been achieved. Technological improvements in production processes or management lead to greater economic efficiency in the sense that it becomes possible to produce more goods and services
with the same resources; hence, the same resources can be allocated in a way that makes all consumers better-off as a result of the improved technology.

For an individual market, economic efficiency requires that price (which measures the marginal benefit to society from consuming the product, as well as the marginal revenue to the seller) equals marginal cost. The competitive forces of supply and demand and the profit motive move markets toward this outcome automatically—Adam Smith’s famous “invisible hand” doctrine. In the long run, competitive markets also move toward technical efficiency—the production of goods at the lowest possible average cost. For an individual producer, profit maximization requires that any given level of output be produced at the lowest possible cost, and that the level of output chosen be the one at which marginal revenue equals marginal cost. In competitive markets this is the economically efficient level of output, since marginal revenue equals price.

While economists have a well-defined concept of economic efficiency, and a set of tools that are useful for determining whether or not a particular economy, market, or producer is efficient; economic and business researchers have not yet developed a definition of what constitutes a healthy economic relationship, or a technique for determining whether any particular relationship is healthy. Rather, they tend to look at the outcome of an economic process as an indicator of whether the underlying economic relationship is healthy or unhealthy. Because many factors influence economic outcomes, this approach is fraught with danger. At best, the researchers can infer the health of an economic relationship by looking at the outcome adjusted for other economic determinants that are measurable. By identifying the criteria and conditions of healthy economic relationships, we have provided the basic tools necessary to
monitor economic relationships and diagnose problems related to the health of the relationships—the first steps in the development of relationships management. The authors have developed a comprehensive relationships management paradigm on the basis of these criteria and conditions. The potential benefits of relationships management on economic efficiency, profits, incomes, and economic well-being are enormous. Recall Tenet I of relationships economics:

Markets are developed by the establishment of relationships among economic entities for the deployment of economic resources and the distribution of income and wealth.

From the perspective of an entire market, there is a myriad of economic entities. From the perspective of a particular entity, the primary types of relationships are those with customers, employees, external suppliers of goods and services, investors, and regulators. The absence or dysfunction of any one of these kinds of relationships is likely to cause a fatal weakness in an individual entity’s ability to operate. A systematic absence or dysfunction of any one or more of these relationships among the entities within a potential market is likely to cause a fatal weakness in the market’s ability to operate. Fewer markets, or fewer participants within a given market, restrict choice and reduce the volume of economic exchanges, with a concomitant reduction in the gains from trade and the level of economic well-being.

Tenet 2 of relationships economics states that:

Greater market efficiency is achieved by healthy market relationships, i.e., healthy economic relationships generate greater economic well-being for a larger number of people and economic entities.

Effective relationships management can lead to a better “fit” between producers, customers, and suppliers, and between management and labor. Healthy relationships between

---

producers and suppliers reduce uncertainty, and hence, transaction costs. Healthy relationships between producers and customers reduce information costs and allow for a more efficacious assortment of goods and services to be produced. Healthy relationships between management and labor increase worker job satisfaction and reduce monitoring costs, turnover costs, and other costs associated with the principal/agent problem. In addition, healthy management/labor relations promote greater labor effort and productivity, which leads to higher profits and higher wages. Healthy relationships between firms lead to more effective strategic alliances and other kinds of interfirm networking. In turn, effective alliances and networks lead to larger, more efficient markets, lower information and other transaction costs, greater innovation, and larger profits. In the macroeconomic realm, the lower transaction costs associated with effective relationships management frees up resources otherwise devoted to information gathering, processing, and dissemination; to risk avoidance and hedging; to searching; and to monitoring; and directs them to the production of additional goods and services, including capital goods. This increased output raises the standard of living in the short run, and the increased rate of investment and innovation raises the rate of economic growth, hence the standard of living, in the long run.

Ineffective relationships management leading to the failure of one or more of the conditions necessary for healthy economic relationships increases transaction costs and reduces economic efficiency. Weak or imbalanced intersections of purposes between entities create additional costs associated with searching for better-matched partners. Lack of trust between participants creates additional costs associated with avoiding or hedging against the risk of harm or performance failure. Similarly, lack of respect between parties diverts resources away from
production in search of other possible relationships with more competent entities, with higher integrity, who are more responsible and dependable. The delivery of products that do not meet entities' needs leads to additional transaction costs associated with finding suitable products from other sources. Poor communication between parties creates inefficiencies and resource misallocation, with associated costs. Poor manners is a type of communication that reduces trust and respect, thereby increasing those related costs. A lack of administrative support increases the costs of conducting and administering the relationship. In every case, violation of the required conditions for a healthy relationship increases transaction costs and reduces market efficiency. The more costly the relationships, the greater the inefficiencies.

**The Role and Effect of Technology**

In economics, technology refers to the manner in which resources are combined to produce goods and services. An improvement in technology is defined as a change that reduces the costs of producing and distributing goods and services. A given technological improvement may entail the use of a different kind of physical input, e.g., a better machine, or it may entail more effective organization of the production process, e.g., a better management system. A technological improvement, then, must lower production costs or transaction costs (including relationship costs), or both.

During the earlier industrial revolutions, extraordinary innovations in the technology of applied physical science generated extraordinary increases in production capacity. At the same time, the theory and application of bureaucracy provided the management technology necessary to realize the market potential of that production capacity. Today, science is advancing at an
ever-increasing rate, again yielding improvements in production capacity, efficiency, flexibility, and quality of a magnitude requiring corresponding new management techniques.

It is clear that recent, pending, and potential improvements in technology will continue to generate additional capability to reduce transaction costs. These technological improvements have the effect of converting local and national markets into international and world markets through a tremendous reduction in the costs of obtaining, processing, and disseminating information, goods, and services. In so doing, the technology greatly expands the pool of potential participants in economic relationships for virtually every economic entity. One need not look further than the Internet to realize the magnitude of the increase in potential customers and suppliers made possible primarily by technology. Experts in e-commerce emphasize the crucial role of relationships in the Internet environment, and the risks involved to established firms that fail to nurture relationships as they enter that environment. This expanded market, with the greater range of choice of economic relationships it entails, is prompting a demand, even an expectation by market entities for less threatening, more helpful, more competent, and more responsible partners, with higher integrity, in market relationships. Such relationships would be characterized by a distribution of products better meeting the needs of participating parties, with better communication, better manners, and better administrative support, and, therefore, lower transaction costs. Greater choice, larger markets, and lower transaction costs lead to corresponding increases in the number of economic exchanges, the gains from trade, and economic efficiency.

---

In addition to the effects of technology on market expansion, management technology in recent years has generated innovations specifically intended to improve market relationships, thereby reducing both production and transaction costs. An example of these innovations is the emphasis on long-term relationships demonstrated in:

- strategic alliances,
- long-term customer-supplier contracts often involving extensive integration of design and production processes,
- development of employees, and
- performance-based pay schemes for everyone.

Improved technology, then, can both expand the market potential and improve its efficiency. Today's technology seems to have the potential to do both on an unprecedented scale.

The Economics of Adversarial Relationships

Adversarial relationships are costly to the parties involved and costly in terms of market efficiency. We already have noted how violation of the four conditions for healthy relationships increases transaction costs. The more serious and widespread the violations, the greater the transaction costs. An extreme example of the breakdown of healthy market relationships is seen today in Russia's economy, where an ineffective legal system creates such a degree of uncertainty about market outcomes that the economy is overwhelmed by adversarial relationships dominated by organized crime and official corruption. In the absence of the rule of law, so many economic resources are devoted to enforcing contracts and hedging against risk, there are relatively few resources available for the actual production of economic goods and
services. It is no wonder that Russia is having difficulty producing enough to meet the basic economic needs of its population, let alone the capital accumulation necessary for economic growth. Many observers also have noted the huge costs of litigation in the United States as a dangerously high transaction cost hurting this country’s global competitiveness. Steven N. S. Cheung has suggested that it is the ratio of transaction costs to the gains from specialization that is the primary determinant of a country’s standard of living.\textsuperscript{5} The development and enforcement of proper rules governing adversarial relationships can minimize the transaction costs created by those relationships. Such rules would protect the parties involved, would minimize the harm to those involved in peripheral relationships, and, where possible, would promote healthier, cooperative relationships between the would-be adversaries.

**Adam Smith’s Vision**

Most people who have obtained at least a passing acquaintance with economics are familiar with Adam Smith’s description of the superior efficiency and productive power of the market system as a way of organizing economic activity. Smith’s “invisible hand” of enlightened self-interest that automatically directs productive resources to their best economic use is mentioned in every economic principles text. In his 1776 book, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, Smith argued that the true wealth of a nation lies in its ability to produce and consume goods and services, and that a market system can produce a greater wealth for its citizens than can any known alternative. Time has proven Smith’s argument correct. (In the context of our discussion above, we would argue that this result

follows from the fact that a market system keeps the ratio of transaction costs to the gains from specialization lower than do other economic systems.) But Adam Smith was a moral philosopher, and his vision of the superiority of market capitalism as a way of organizing economic activity extended beyond the concepts of efficiency, productivity, and wealth.

In 1776, the First Industrial Revolution was in its infancy, and in Smith's native Scotland the market system was slowly displacing the old feudal system. Responding to the gross inequality of wealth and power in the world about him, where social class rather than ability or justice determined the quality of life, Smith argued for a moral philosophy based on "justice," "benevolence," and "sympathy." Because it encouraged frequent, free human interaction in seeking out parties with whom to conduct business, the market system would provide its participants with greater opportunity to develop the moral virtues and individual qualities (private morality, in today's vernacular) of trust, mutual sympathy, and benevolence that made society better. Smith believed that the market system contained two mechanisms that would induce individual participants in the market to become better people. First, because of competition from other producers, to be successful in a market economy, one "must acquire superior knowledge in his profession, and superior industry in his exercise of it. He must be patient in labor, resolute in danger, and firm in distress . . . . Probity and prudence, generosity and frankness, must characterize his behavior upon all ordinary occasions." Success, Smith said, depends on the "good opinion of their neighbors and equals . . . . The old proverb, therefore, that honesty is the best policy, holds, in such situations, almost always perfectly true." To be successful, a producer must keep his customers satisfied by being honest, prudent, generous, and

---

frank. “Man has almost constant occasion for the help of his brethren, and it is vain for him to expect it from their benevolence only,” Smith said. “He will be more likely to prevail if he can interest their self-love in his favour.” Hence, self-interest and competition, supported by the rule of law, induce individuals to develop the virtues that help form the basis for the good, moral society.

While self-interest and competition would encourage market participants to develop the virtues of honesty and trust, Smith believed that there were higher moral virtues inherent in human nature. “How selfish soever man may be supposed,” Smith wrote, “there are evidently some principles in his nature, which interest him in the fortune of others and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.”

“All the members of human society,” Smith claimed, “stand in need of each other’s assistance . . . . Where the necessary assistance is reciprocally afforded from love, from gratitude, from friendship, and esteem, the society flourishes and is happy. All the different members of it are bound together by the agreeable bonds of love and affection, and are, as it were, drawn to one common centre of mutual good offices.” The mechanism of the market that would induce individuals to adopt these higher moral virtues, Smith believed, was an unintended consequence of enlightened self-interest: the general increase in the prosperity of all members of society, the growth in the wealth of nations that accompanies the growth of markets. This increased wealth, Smith believed, would encourage individuals who had already developed the


virtues of honesty and trust to develop the higher moral virtues of benevolence and sympathy—they could better afford to care about others. In summary, Smith believed that the major characteristics of the market system—frequent interaction of individuals in the market, competition, and the creation of wealth—would combine to create a happier, more moral society.

Has Smith’s vision been fulfilled? The capital accumulation and technological improvements set in motion by the First Industrial Revolution, encouraged and facilitated by the institutions of market capitalism, helped much of the world realize handsomely Smith’s vision of a general prosperity unexcelled by any other economic system in the history of mankind. Some would argue that there also evolved a higher moral integrity within these markets than in other systems, though far less emphasis has been placed on this aspect of market capitalism. In fact, the very technological changes in production, distribution, and management that led to the fulfillment of the first part of Smith’s vision created conditions in the market system that made it more difficult to fulfill the second part. The factory system, mass production, standardized parts and products, mass marketing and distribution, and bureaucratic management that developed as a result of the early industrial revolutions reduced the opportunity and necessity for the kinds of frequent human interactions that Smith observed in the early days of capitalism. Direct interaction among buyers and sellers in local markets gradually gave way to department store, catalog, and supermarket shopping. Improvements in transportation that widened markets and increased economic efficiency also created larger and larger separations between buyers and sellers. Factory production of standardized goods replaced local production of customized

---

10Two notable exceptions are found in Walter Lippmann, The Good Society (Boston: Little, Brown & Company, 1943) and George Gilder, Wealth and Poverty (New York: Basic Books, Inc., Publishers, 1981), who argue that capitalism is a golden-rule system based on mutually beneficial exchange, where an individual’s well-being is increased by others’ good fortune, and where individuals willingly give (invest) for uncertain returns.
goods. Impersonal corporations replaced personal proprietors. Rigid bureaucratic rules replaced flexible decision-making, even in small businesses. Rising wages were accompanied by declining job satisfaction.

The Third Industrial Revolution, the high-tech revolution or "age of technology" referred to at the beginning of this piece, is changing all of that. The ease of communication, greater flexibility in production and distribution, and increased market size, along with greater affluence, has made it both possible and necessary for buyers and sellers; producers, suppliers and customers; management and employees to engage in more frequent interactions. The demand for sophisticated customized products made possible by the new technology requires close economic relationships between producers and customers. The production of such products requires close economic relationships between managers and employees, and among employees themselves. Increased affluence means that producers in markets that were previously dominated by one-time purchases are now competing with each other for repeat business. Hence, economic relationships have taken on increased importance. The replacement of adversarial economic relationships with cooperative relationships, as evidenced in strategic alliances and networks, requires frequent interaction between firms. Programs designed to reduce employee turnover and monitoring costs require healthy economic relationships between managers and employees.

Every day one sees a new book or hears a new advertisement that emphasizes the importance of economic relationships. Healthy economic relationships are the key to business success in the Third Industrial Revolution. If economic relationships are to be healthy, they must be based on trust, competence, responsibility, and integrity, moral virtues that Adam Smith believed would be promoted by the market system. If the current industrial revolution is
successful, Smith’s complete vision of market capitalism will be closer to fulfillment. For that to happen, relationships economics must play a key role.