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### **Smith's Economic Morals: An Introduction**

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## Abstract

This article introduces the moral philosophy underlying Smith's contributions to economics and emphasises the close connection between Smith's two principal works, the *Theory of moral sentiments* and the *Wealth of nations*.

*Keywords:* Adam Smith; economic development; moral philosophy; history of economic thought; markets; government intervention; *das Adam-Smith-Problem*.

## SMITH'S ECONOMIC MORALS: AN INTRODUCTION

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Adam Smith is probably known most as the man who founded economics – particularly *market economics*. Those who have not read much of his work tend to ascribe to him a view of the world where government is non-existent, and society is simply left to the vagaries of people acting selfishly to make as much money as possible. People will perhaps differ only in how they perceive the consequences of Smith's supposed prescription. Those on the Left will see it as a recipe for social callousness, inequity, and poverty; while those on the Right will idealise it as a world of order and efficiency.

I should probably begin at the end, however, by telling you some unexpected things. Smith did *not* think that society could survive without government or a State: indeed he thought the State was indispensable if markets were to function, and he had quite definite ideas about the roles it should play. He also did *not* extol self-interest – he used the term “prudence” – as being the best of all possible human virtues; on a scale of moral values, he would have preferred “beneficence” or charity instead. Finally, as an economist he was not concerned primarily with how to allocate given resources efficiently among alternative uses; rather he was a development thinker seeking to understand how countries could be raised from poverty.

### A short biography

Adam Smith was born in 1723 in Scotland in Kirckaldy, a small town across the Firth of Forth from Edinburgh. Except for a three-year sojourn in France and Switzerland (1764-1766), he never again left Britain, nor indeed Scotland; he died in Edinburgh in 1790, still unmarried but enjoying international renown. Smith was an academic for his entire life, and there are amusing tales of his being the quintessential “absent-minded professor”, completely absorbed in his thoughts, to the extent of walking outdoors in his night shirt on a cold night.

Smith studied moral philosophy at Glasgow and Oxford, and his first book on the topic, the *Theory of moral sentiments* (1752), proved an instant bestseller and early on already served to establish his reputation. He lectured on moral philosophy, jurisprudence, and public policy at Glasgow for thirteen years, served as tutor to the nobility for three, and could retire comfortably on a pension by his early forties. It was at that point, from 1766, that he began to work on his second great opus, the *Wealth of nations*, which appeared in 1776, the year of the American Revolution. That book turned out to be an even bigger bestseller and established Smith's reputation internationally. Because of his literary reputation, Smith came to hold several honorific positions and sinecures and was a famous man (though still living the modest life of an old bachelor) by the time he died in 1790.

Smith was a major figure of what came to be known as the “Scottish Enlightenment”, a remarkable phenomenon of the late 18<sup>th</sup> century (ca. 1740-1800) which saw the proliferation of brilliant world-class thinkers in what had until then been an economic and social backwater – namely Scotland. Apart from Smith, this wave of intellectual achievement included not only philosophers like David Hume and Francis Hutcheson but also practical-minded people like the agronomist James Anderson and the engineer James Watt; theoretical physicists such as James Clerk Maxwell and Lord Kelvin; as well as the writer Walter Scott. Voltaire himself is famously said to have remarked: “We look to Scotland for all our ideas of civilisation.”

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## Smith's moral philosophy

Those who know Adam Smith only through his contributions to economics tend to overlook the fact that his entire work was devoted to the development of a moral philosophy, which studies how people do or ought to behave towards one another in society. The problems he contended with attempted to answer questions like the following: How can and should people get along with one another for their mutual benefit? What rules or restrictions on their behaviour should they accept? What are those they are justified in rejecting?

In answering these questions in the *Theory of moral sentiments*<sup>1</sup> (TMS), Smith did not proceed by trying to design or describe an ideal society and the ideal people who should inhabit it, or the ideal government that would rule such men. He began instead by observing people, societies, and governments *as they existed*. He recognised that people were imperfect and he proceeded from this fact. He criticised various system-builders who are so "enamoured with the supposed beauty of [their] own ideal plan of government", who seemed to think they "can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board" [TMS V.ii.2.17]. (This proved prescient, considering the inevitable terrors that attended visionary experiments such as the French and Soviet Revolutions, or in recent times, the Khmer Rouge regime.)

Smith's approach to moral philosophy (and to his economics) therefore was not to impose any vision or system of what people "could be" or "ought to be". Rather he took people as he found them, warts and all, and found them to be neither meek and benevolent angels, nor snarling predators. Instead they seemed to be a combination of both.

Ultimately Smith observed that it was people's instinct or desire for self-preservation and for the advancement of their interest – their *prudence* – that appeared to be the first and most "reliable" (that is, the most ubiquitous) principle of behaviour:

Every animal was by nature recommended to his own care, and was endowed with the principle of self-love for the sake of preserving its existence and perfection [TMS VII.ii.1.15].

And then again:

Every man is, no doubt, by nature, first and principally recommended to his own care; and every man is certainly, in every respect, fitter and abler to take care of himself than of any other person [TMS II.ii.2.1].

Smith was fully aware, of course, that society would be impossible if people acted purely selfishly, i.e., behaved like wolves towards one another. How, then, does society become possible? The answer was that in practice, prudence was tempered by two other elements, namely a sense of *beneficence* and *justice*, both of which people also regarded as being virtuous qualities.

But how do people realise whether and to what extent certain qualities are virtuous? According to Smith, people knew what was virtuous or not, and to what extent it was so, owing to an ability to place themselves in each other's shoes. As Emma Rothschild [2001:224] puts it, for Adam Smith "The essential disposition of moral life...is to think oneself into the feelings of others, to feel sympathy." In doing this, people are assisted by a faculty that Smith termed the *impartial spectator* – the equivalent of what a pious person might call a conscience.

How selfish soever man may be supposed, 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... The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it. [TMS I.i.1]

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<sup>1</sup> Citations of TMS refer to the Book, Section, Chapter, and paragraph. Hence [TMS II.ii.1.4] for example refers to Book II, Section ii, Chapter 1, and paragraph 4, as found in the edition by Raphael and McFie [Smith 1976(1752)]. Citations of the WN refer similarly to book, chapter, and paragraph.

The impartial spectator helped a person see himself as others might see him: it was society internalised in himself. But Smith did not think this impartial spectator was placed in man by any God or Creator – indeed the bulk of the evidence suggests that like his friend David Hume, who was generally accused of being irreligious, Smith was not a deist.<sup>2</sup> Rather than being instilled by God, Smith's impartial spectator was *formed* in people as they reflected on their actual experiences and their conversations with others. Hence people ask: what do we observe others doing? how do those people explain the reasons for their actions? What are the observed consequences of those motivations and actions? Which of these are worth emulating? In so doing, we internalise the views of others and their interests, and we begin to care what others think, and also how we think of ourselves.<sup>3</sup>

To reiterate: for Smith, it is the urgings of the impartial spectator that decide the relative importance to us of the different virtues. Having said this, let us go through each of the "virtues" recognises and ask about their adequacy as foundations for social behaviour.

Smith agreed that a society founded on freely-given charity or *beneficence* would be best. The problem with kindness or beneficence, however, was that it seemed to be naturally forthcoming only among one's intimate circle of immediate relatives or closest acquaintances. Outside that circle, charity is limited and at most optional. The reason is that a person's capacity to sympathise with anonymous strangers is extremely circumscribed. Moreover, Smith notes, even the impartial spectator would not damn a person lacking in beneficence:

*Beneficence is always free, it cannot be extorted by force, the mere want of it exposes to no punishment; because the mere want of beneficence tends to do no real positive evil.* It may disappoint of the good which might reasonably have been expected, and upon that account it may justly excite dislike and disapprobation: it cannot, however, provoke any resentment which mankind will go along with. [TMS II.ii.1.1]

Though Nature, therefore, exhorts mankind to acts of beneficence, by the pleasing consciousness of deserved reward, she has not thought it necessary to guard and enforce the practice of it by the terrors of merited punishment in case it should be neglected. *It is the ornament which embellishes, not the foundation which supports the building, and which it was, therefore, sufficient to recommend, but by no means necessary to impose.* [TMS II.ii.3.4]

Smith's point is clear: since there is no way for beneficence to be enforced – enforced charity or compulsory generosity, after all, is an oxymoron – it cannot be regarded as a *reliable basis* upon which to found human relationships, particularly in a complex society engaged in impersonal and often even anonymous exchange.

The first part of Smith's answer to this question, therefore, is to re-examine the virtue of prudence, or self-love. In the first place, self-love itself does not really mean narrow egoism. At one extreme, part of self-love also involves the effort to win the regard and esteem of others. Because we see ourselves through others' eyes, we also want to be loved by our fellow human beings. This aspect of prudence may in turn induce us to perform benevolent acts (e.g., a Warren Buffet donating two-thirds of his wealth to charity, or locally, John Gokongwei, Sr. doing the same thing). The rewards from this type of beneficence takes the form of the esteem and regard of others. For that same reason, however, the motivation to engage in it, like any kind of beneficence, is likely to be weak.

The more significant important social relationship arising from prudence, however, was the possibility of a weaker form of relationship, which is *reciprocity*, or contractual exchange:

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<sup>2</sup> In the words of Emma Rothschild [2001:231]: "Hume's and Smith's systems of moral sentiments are scrupulously cleansed of everything, or almost everything, which is a matter of revelation. They are systems of *secular virtue*" [My emphasis].

<sup>3</sup> There is reason to think that Smith in fact viewed social morality as the outcome of a long autonomous evolutionary process in human history. In this he proved far-sighted, for many of his conjectures, e.g., regarding reciprocity, have been surprisingly vindicated by recent experimental results from evolutionary psychology, economics and anthropology. (See, e.g., Henrich, et al. [2001] and Smith [1998].)

But though the necessary assistance should not be afforded from such generous and disinterested motives, though among the different members of the society there should be no mutual love and affection, the society, though less happy and agreeable, will not necessarily be dissolved. *Society may subsist among different men, as among different merchants, from a sense of its utility*, without any mutual love or affection; and though no man in it should owe any obligation, or be bound in gratitude to any other, *it may still be upheld by a mercenary exchange of good offices according to an agreed valuation* [TMS II.ii.3.2] (Emphasis supplied.)

From this there is a seamless connection with the language of the *Wealth of nations*, as can be seen in the following:

...[M]an has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them...[WN I.1.ii.2]

In other words, society is possible even among mutual strangers. It is not necessary for them to love each other, only that it is *privately useful* for them to so collaborate. And unlike beneficence, which is icing on the cake, people can be relied on to act regularly in this way because it is in their self-interest to do so, a self-interest that, as we saw, was the first and most reliable motive of behaviour among people.

Indeed, Smith notes how surprising it is that the expansion of commerce based on self-interest can even lead to secondary virtues such as honesty and trustworthiness. Business people who are interested in maintaining long-run relationships and keeping repeat customers are unlikely to take a short-sighted view by cheating; they are more likely to want to maintain their reputation by being honest:

Whenever commerce is introduced into any country, probity and punctuality always accompany it. ... A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes perhaps 20 contracts in a day, he cannot gain so much by endeavouring to impose on his neighbours, as the very appearance of a cheat would make him lose. Where people seldom deal with one another, we find that they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury which it does their character.

Wherever dealings are frequent, a man does not expect to gain so much by any one contract as by probity and punctuality in the whole, and a prudent dealer, who is sensible of his real interest, would rather chuse to lose what he has a right to than give any ground for suspicion [*Lectures on jurisprudence* (1766), "Police", Part II. paras. 326-327].

These are examples, then, of transactions being completed which are *self-enforcing*, i.e., requiring no external force to implement them, beyond the reputations of the individuals involved and the prospect of the continuation of mutually beneficial long-term relationships – all of them based, not on a suspension of self-interest, but on its existence.

Still, however, Smith readily admitted that short-sighted pursuit of self-interest could and did occur – even among merchants. When social exchange is infrequent, when the customer is unknown, and when, as Avner Greif would say, "the *quid* is separated by time and space from the *quo*", people may advance their self-interest through cheating, stealing, or worse, violence. For this reason, the second part of Smith's answer to reconciling social and individual interest is the need for external *justice*, by which is meant *commutative* justice (as distinct from *distributive* justice). Commutative justice is as it is classically understood (e.g. in Aristotle's *Nicomachean Ethics*): giving a person what is his due. It includes, among others, the prevention of violence to a person, the protection of property rights, and the honouring of contracts or agreements that are freely made. Unlike beneficence, which Smith regarded as "an ornament", justice is

... the main pillar that upholds the whole edifice. If it is removed, the great, the immense fabric of human society ... must in a moment crumble into atoms. In order to enforce the observation of justice, therefore, Nature has implanted in the human breast that consciousness of ill-desert, those terrors of merited punishment which attend upon its violation ... to protect the weak, to curb the violent, and to chastise the guilty. [TMS II.ii.3.4]

Beneficence, therefore, is less essential to the existence of society than justice. Society may subsist, though not in the most comfortable state, without beneficence; but the prevalence of injustice must utterly destroy it. [TMS II.ii.3.3]

Not to practise beneficence – i.e., failing to help others – may be objectionable and extremely disagreeable, but it cannot be regarded as a crime. Violating justice, however, is to do *positive harm to others*:

It is, therefore, the proper object of resentment, and of punishment, which is the natural consequence of resentment. As mankind go along with, and approve of the violence employed to avenge the hurt which is done by injustice, so they much more go along with, and approve of, that which is employed to prevent and beat off the injury, and to restrain the offender from hurting his neighbours. [TMS II.ii.1.5].

In short, even an impartial spectator would approve of the use of coercion and violence to prevent an injustice, or to punish perpetrators, or to make amends to the victims. In this straightforward manner, Smith lays down the moral foundation for an external force – the State (“the safeguards of the association of mankind”) – to curb the expression of individual self-interest if required. In a sense, people themselves would tolerate and even demand a curtailment of their self-interested actions to the extent warranted by justice: one’s rights end where they begin to infringe the rights of another.

It is important to note that Smith never wavered in his insistence that justice was indispensable for society. In the *Wealth of nations*, he would list the “exact administration of justice” – together with national defence and the initiation of certain types of public works and infrastructure – as one of the three *irreducible* functions of a minimal State. More explicitly, he would write that markets could not function without being founded on justice:

*Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government [WN V.iii (5). 7]. (Emphasis supplied.)*

To summarise, therefore, Smith sees that prudence, beneficence, and justice are mutually reinforcing virtues that help constitute society and facilitate transactions among human beings. Of the three, prudence is the most crucial, not because it is necessarily the noblest and highest-minded virtue, but simply because it is the most reliable and omnipresent. A society seeking to co-operate based purely upon love and benevolence will find this motivation to be deficient and unreliable, particularly as society expands beyond the circle of one’s family, friends, and acquaintances to encompass strangers. Nor would it do, of course, to completely legislate people’s obligations to one another. Relying on the operation of prudence minimises these problems. Self-love itself would encourage some degree of beneficence, to the extent people sought the approval of their fellows; and self-love in the context of utilitarian reciprocal exchange could also enforce the proper discharge of obligations that was synonymous with commutative justice. But where the demands of enlightened self-interest fail, there was always the very visible hand of coercion by the State that could take over.

### **The wealth of nations**

Smith’s work as represented in the *Wealth of nations* is clearly a logical continuation and extension of his system of moral philosophy.<sup>4</sup> In the TMS Smith made the claim that a real social order could be founded not primarily on altruism, but rather on self-love, tempered by justice. His task in the *Wealth of nations*, therefore, was to demonstrate the details of how such a reciprocal relationship among individuals could be established in practice. How does allowing self-interest to operate lead to opulence in society? Does

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<sup>4</sup> We thus consider closed the old debate over the existence of “*Das Adam-Smith-Problem*”, an issue was raised by the German Historical School of economics, which purported to detect an inconsistency between the society ruled by selfish interest in the WN and that ruled by sympathy in the TMS.

such a mechanism exist? Smith's answer was that such a task could be accomplished by operation of the free and competitive markets.

Smith's own Introduction to the WN provides a good summary of his argument. His stated objective is to uncover the reasons that nations become rich. In other words, Smith was talking about *economic development* – it is sometimes important to recall that Great Britain at the time was still in the initial stages of industrialisation. In this sense, the things Smith writes about are probably more relevant to poor countries like the Philippines than they are to today's affluent countries.<sup>5</sup>

There is neither the time nor space to devote to a full rendering of all of Smith's ideas on development, but the broad logical sweep of his argument may be briefly summarised as follows:

1. Underlying Smith's argument is his fundamental claim that it is in people's nature to engage in reciprocal exchange for mutual benefit. Smith calls this "an inherent tendency to truck and barter". It will be seen that this is in fact an extension of the moral philosophy Smith had already laid down in the TMS. On the one hand, people stand in need of each other's assistance; on the other hand, there is no more reliable means of eliciting assistance than through an appeal to the other person's self-love. While one may appeal to the another person's charitable motives, this is an inherently weak incentive; the only reliable incentive is for him to realise that you can perform a service for him in exchange (*do ut des* = I give and you give). Hence this famous line:

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities, but of their advantages [WN I.ii.2].

2. The second point Smith makes is that such exchange or commerce encourages specialisation, or the division of labour ("the division of labour is limited by the extent of the market"). Smith's argument is brilliant in this regard. Historically, most early settlements have begun by producing all of their needs themselves. Farmers are part-time cultivators, part-time carpenters, part-time metal smiths, and so on, mostly supplying their own needs. To persuade a person to devote himself full-time to any occupation, there must be some assurance that all that he can produce beyond his own needs from such an occupation can be sold. But this will occur only if there is a big enough market for the goods he produces, either in terms of geographic area, or strength of their purchasing power.

When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment for want of the power to exchange all that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men's labour as he has occasion for [WN I.iii.1].

This simple observation has far-reaching theoretical and practical implications: for example, it points to the importance of infrastructure in encouraging specialisation, since transport connections have the effect of expanding markets geographically; it also explains why specialisation is more developed in large towns (they have higher incomes). On a larger scale, openness to trade with foreign countries would also encourage a greater degree of specialisation among people in a country.

3. Smith was pre-occupied with the promotion of the division of labour or specialisation, since he identified this as one of only two factors that contributed to increasing the wealth of nations. Indeed, he regarded the division of labour as *the main determinant of labour productivity* ("the skill, dexterity, and judgement with which labour is applied"). For this reason, the very first chapter of the WN is devoted to the division of labour, namely the famous pin-factory example. Division of labour raises productivity because constant engagement in a task makes the worker more dexterous, because it saves the time used up in changing from one task to another, and because the analysis and simplification of tasks

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<sup>5</sup> Writing on international trade, the economist Hla Myint [1958] was among the first to remind a later generation that Smith and classical writers were writing about development, not a problem of static resource-allocation.



facilitates the invention and application of machinery and equipment. From the pin-example many people come away with the impression that Smith celebrated primarily the factory system and the drudgery and dehumanisation that entailed. In fact, however, the division of labour for Smith was a much wider concept pre-dating the Industrial Revolution; it will have included, for example, the distinction between hunting and agriculture, the separation of town and country and their respective specialisation in crafts and agriculture; the spinoff of the various occupations: baker, butcher, brewer, blacksmith, carpenter, etc. Smith also recognised and deplored the fate of the detail labourer, much as Marx would do many decades later. On the other hand, what is undeniable even today is that specialisation raises labour productivity, and hence promotes economic growth.

4. The other major contributor to affluence is the accumulation of capital (a.k.a. investment) to be used in employing people productively. Smith noted correctly that per capita growth depended on the proportion of the population that was working productively. While Smith's notion of "productive" has not proved durable (he considered only labourers producing tangible goods as being productive; service workers were not), his main point about the need to invest to expand the productive sector of the economy still holds water. He noted that accumulation or investment was promoted by saving ("parsimony"), but that it was impaired, first, by wasteful consumption or governments' lack of fiscal discipline ("prodigality"), and by bad investment decisions ("misconduct").

Capitals are increased by parsimony, and diminished by prodigality and misconduct [WN II.iii.14]. .....  
Parsimony, and not industry, is the immediate cause of the increase of capital. Industry, indeed, provides the subject which parsimony accumulates. But whatever industry might acquire, if parsimony did not save and store up, the capital would never be the greater [WN II.iii.16].

Smith was highly critical of the extravagance of the courts and governments during his time, particularly of the size of the retinues of servants and courtiers, and the large bureaucracies and armies being maintained. He termed "unproductive" the resources so used, and pointed out that the nation could have benefited if they had been used instead to expand productive capacity, i.e., invested.

5. The core of Smith's argument was that both the direction of specialisation in society and the allocation of capital was best left to private initiative. Recall the claim in the TMS that society could be built on prudence: the validity of that claim depended on whether Smith could demonstrate a mechanism that would coordinate autonomous private decisions and lead to increasing the benefit or wealth of society. In attempting to do this, Smith was among the first to outline the process by which markets and prices coordinated people's actions.

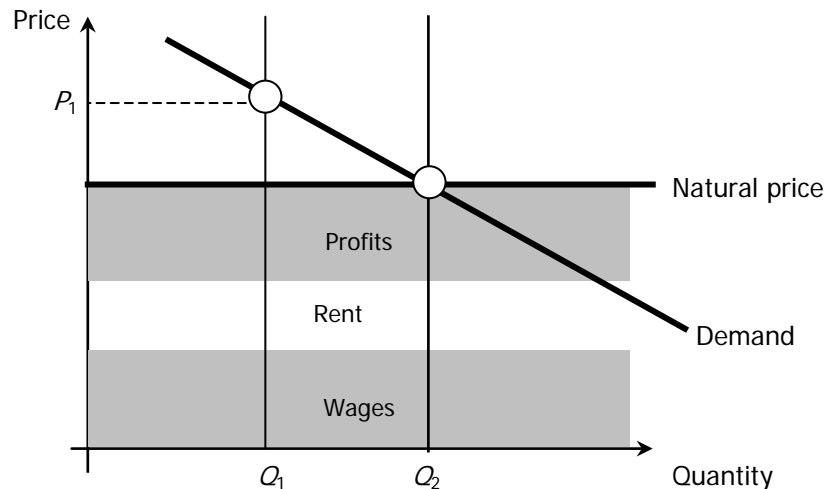
Smith begins by noting that the price of any good is the sum of wages, rent, and profits, depending on the amounts of labour, land, and capital that are used up in its production. There are, however, what he calls the "*natural levels*" of these factor incomes, and these depend on certain fairly general circumstances in the economy that were not easily altered, as well as on circumstances peculiar to certain employments. For example, Smith posited that the natural level of wages would typically be close to subsistence, since anything below that would mean the labour force begin to die off. Similarly, the rate of interest on capital would be determined by the degree of parsimony in society. The price that covered these natural levels of wages, profits, and rents was the "natural price" of that particular good. This was the price of the good that needed to be paid for workers, capitalists, and landowners to make available the resources needed to produce that good in indefinite quantities [See Figure on next page.]

When the price of any commodity is neither more nor less than what is sufficient to pay the rent of the land, the wages of the labour, and the profits of the land employed in raising, preparing, and bringing it to market, according to their natural rates, the commodity is then sold for its natural price [WN I.vii.4].

Smith notes that markets will naturally adjust to demand:

The quantity of every commodity brought to market suits itself to the effectual demand. It is in the interest of all those who employ their land, labour, or stock, in bringing any commodity to market, that the quantity never should exceed the effectual demand; and it is in the interest of all other people that it never should fall short of that demand [WN I.viii.12].

If for any reason there should be excess demand, the market-price of that good would be bid up above the natural price; this means some factors of production would be overcompensated, encouraging them to bring more of the good to market, and causing the price to return to the natural price. Conversely, if there is an oversupply at the natural price, the market-price is bid down; some factors of production are underpaid and withdraw resources from producing this particular good; the oversupply disappears, and the price rises back to the natural price. This mechanism of the market, Smith thought, demonstrated how people acting based only on self-interest could coordinate their actions and remarkably create an order that – to use the language of the TMS – was “upheld by a mercenary exchange of good offices according to an agreed valuation”.



**Figure**

In the figure above, “natural price” is that level which allows the “natural levels” of profits, wages, and rents to be covered. Now suppose temporary conditions place the supply at  $Q_1$ . This yields a “market price” of  $P_1$ . Because this is higher than the natural price, it allows above-normal profits (or wages, or rent, or all of these) to be earned. Above-normal incomes encourage further production, pushing output to the right. This continues as long as the market price is different from the natural price and stops when the latter is re-established, with quantity  $Q_2$ .

6. Historically, Smith argued, the attempts of government to direct and manage the course of specialisation caused more harm than good. He criticised the then-prevailing system of economic philosophy, *mercantilism*, for its wrong-headed ideas of protecting certain sectors of the economy, discriminating against foreign goods, and creating monopolies. While the natural price was the lowest that could be gotten in the long run, monopolies raised prices to “the highest which can be got” [WN I.vii.27]. The main reason this occurred was that lobbies frequently managed to persuade lawmakers that “the prosperity of the nation depended upon the success and extension of their particular business”<sup>6</sup> [WN IV.viii.17]. “Like the laws of Draco”, Smith wrote, “these laws may be said to be all written in blood” [WN, IV.viii.17].

<sup>6</sup> Smith was referring here specifically to the woollen manufacturers, who not only managed to prohibit imports of made-up woollen goods, but also prohibited the export of live sheep and raw wool abroad, forcing domestic sheep-growers to sell to them exclusively.

Finally, as already noted, Smith also criticised the fiscal profligacy of governments, which reduced the capital available for investment (now known as the “crowding-out” effect). He thought it presumptuous that governments should presume to lecture private individuals regarding how to spend their resources:

*Great nations are never impoverished by private, though they are sometimes by public prodigality and misconduct [WN II.iii(2).10].*

*It is the highest impertinence and presumption...in kings and ministers to pretend to watch over the economy of private people, and to restrain their expence, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. They are themselves always, and without exception, the greater spendthrifts in the society. Let them look after their own expence, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will [WN II.iii(2).36] (Emphasis supplied.)*

On a fundamental level, however, Smith’s criticism of government intervention rested on the philosophical assessment that human beings are imperfect – people tend inherently to be self-centred and even if they were not, they have only the most imperfect and vaguest knowledge of the needs and priorities of others. The situation only becomes worse when people assume positions of power: great power and discretion can only magnify the opportunities for abuse, as well as the distance from the ruled.

For Smith, then, imperfect information and weak incentives always meant that government would at best be a blunt instrument for promoting public welfare. Even with the best intentions – which is far from being conceded – kings and politicians could never know the needs and priorities of private people in any great detail (remember: Smith believed that each person is the best judge of what is and is not good for him), nor could they ever possess the information regarding the best economic opportunities that resides collectively in millions of minds calculating their best interests. By contrast, free markets had the ability to mobilise these privately selfish and autonomous but collectively wise and informed actions:

As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it.

By preferring the support of domestic to that of foreign industry, he intends only his own security; 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. Nor is it always worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it [WN IV.ii.9].* (Emphasis supplied.)

7. From here we come to a seventh and last point: Smith’s idea of the role of the State. The State has a paradoxical role: you can’t do with it; and you can’t do without it. On the one hand, it had the capacity to be ham-handed, ill-intentioned, badly informed, and profligate. On the other hand, as was demonstrated in the TMS, society could not subsist exclusively on private prudence, since even market transactions had to be underpinned by justice, among others.

Smith’s solution to the dilemma was the *minimal state*, or what is sometimes called the “night-watchman state”. That is, the State was to be confined to its indispensable social roles, of which Smith identified only three: providing national defence; administering justice; undertaking infrastructure and public works that the private sector would not engage in.

According to the system of natural liberty, the sovereign has only three duties to attend to, three duties of great importance, indeed, but plain and intelligible to common understandings: first the duty of protecting the society from violence and invasion of other independent states; secondly, the duty of protecting...every member of society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and thirdly, the duty of erecting and maintaining certain public works and certain public infrastructure which it can never be in the interest of any individual or small number of individuals to erect and maintain [WN IV.ix.51].

The minimal State fulfilled both Smith’s negative and positive strictures: it would cease to involve itself in the detailed management of the economy; instead it would safeguard property and extend the

functioning of markets by protecting against foreign invasion, guard against civil disorder, administer justice, and reduce the costs of transactions through the provision of infrastructure. Finally, of course, a smaller State would also mean fiscal discipline, the avoidance of profligacy, and a lower tax burden for the people, since the upkeep costs of the State would be correspondingly smaller.

By doing this, Smith said:

The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient: the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society [WN IV.ix.51].

The result is a "system of natural liberty":

All systems either of preference or of restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, *as long as he does not violate the laws of justice*, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men [WN IV.ix.51] (Emphasis supplied.)

### Those who came after

Through the wide sweep of the foregoing, I have tried to show that Smith's work, from the *Theory of moral sentiments* to the *Wealth of nations*, forms a coherent whole. This has not always how Smith has been read. It is tempting to read Smith in bits and chunks – somewhat like how some people read the Bible – because his is a style of writing that contains small gems of wisdom or expression in certain places, which are apt and memorable whether or not you understand the main thrust of his work.

As it happened, with the passing of Smith, his successors devoted themselves to those parts of his work that they found analytically interesting or relevant to their own time. And, as often happens in the development of thought, the results of interpretation, abstraction, and development can lead one far from the ideas of the originator. Here I shall mention only a couple.

1. First, in terms of Smith's moral views, his cautious and brooding concerns regarding the merits and disadvantages of self-love as a human virtue became grossly simplified in the *utilitarian philosophy* of Jeremy Bentham, James Mill, and the young John Stuart Mill, among others. Bentham's philosophy posited that each individual's happiness (*utility*) was measurable, as on a scale, and that the moral task of each person was simply to maximise individual happiness. Where conflicts between one's self-interest and those of other members of society arose, that would be legislation that would decide according to a similar maximisation process, namely adhering to the maxim of "the greatest good for the greatest number"<sup>7</sup>.

These notions were, of course, quite different from Smith's own thinking on the matter. Smith believed that each person was essentially unique, with needs and priorities that could be known only to himself. Nor did a person simply maximise individualistic "utility", since the impartial spectator would have probably interposed various objectives involving other people (including considerations of beneficence and justice) for choosing actions in a given situation. For these reasons, it would not have been possible, in Smith's view, for society to adopt a simple utilitarian rule such as "the greatest good for the greatest number". In the first place, since there was no single quantity to maximise, "greatest" could not be defined. Second, since each person was unique, there was no sensible way that utilities might be added and their sum maximised.

In the event, the effect of utilitarian philosophy was thenceforth to impart a triumphalistic tone to the advocacy of free enterprise. The free-market, nay, capitalist society was no longer understood as just a

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<sup>7</sup> This phrase, however, originated from F. Hutcheson, Smith's professor at Glasgow.

functioning and attainable social arrangement that minimised the danger to individual freedom of action; it came to be regarded as an "optimal" or "efficient" state of affairs, indeed perhaps the best of all possible worlds. Economists from then on became less shy about talking of the Principle of Maximum Happiness or of Maximum Efficiency. As an aside, however, this same shift in thinking also facilitated the use of mathematical techniques in economic theorising.

2. A second idea of Smith's that spawned a subsequent literature was his theory of value. David Ricardo had come to the study of economics because he thought there was a confusion in Smith's statements regarding what caused a good to possess value. Smith himself was not very clear on the matter. In various parts of the *Wealth of nations* he seemed to refer to value as: (a) the amount of labour embodied in a good; (b) the amount of labour the good would exchange for; and (c) the amount of labour a person could have avoided if he purchased the good rather than produced it himself. Suffice it to say that Ricardo thought the right answer was (a). This "embodied-labour" theory of value was subsequently adopted by Karl Marx and reinterpreted to justify his own critique of the capitalist system. The respectable intellectual lineage of the theory (from Smith through Ricardo) helped Marx's revolutionary cause in no small degree.

3. Smith's theory of international trade (or at least one of them) was also improved on by Ricardo. One of Smith's arguments for free trade was that it was a waste of resources to try producing things that other countries could do better. It would be better to buy it from them instead and specialise in the things one's own country did best. This was an incomplete proposition, however, since Smith would have had no recommendation to countries that were inefficient at producing *all* goods. Ricardo's theory of *comparative advantage*, on the other hand, showed that even countries that were inefficient in all goods could benefit from free trade – by specialising in those goods in which they were least inefficient. This was an even stronger argument for free trade. This reformulation, however, lost sight of Smith's view of the powerful transformative impact of trade on countries with large resources that were unemployed or in backward sectors. Trade would henceforth become viewed primarily a problem of allocation and marginal efficiency rather than one of development and rising productivity.

4. There can be little dispute that Smith's major analytical contribution to economics is the vision and description of the role of markets in society, in particular, how prices function as signals to people regarding what to buy and what to produce; the effect of expanding markets and commerce on productivity and growth; and the institutional requirements for markets to exist and flourish, particularly the role of the state in supporting the functioning of markets. Later generations, however, would de-emphasise the developmental aspects of Smith's work and interpret him as if he were concerned merely with a static problem of allocating scarce resources among alternative uses. It is at this point – when Adam Smith's invisible hand is reduced to a mathematical maximum problem rather than being a statement about growth and development – that one leaves classical liberal political economy and one enters the world of *neo-classical economics* as practised by Walras, Jevons, and Marshall.

To sum up, some of Smith's ideas were adopted and diluted by the succeeding generation, while yet others were adopted and reinforced. This implies that if you wish to know what Adam Smith really said and whether he still speaks to us, you cannot trust earlier generations to summarise him for you: for they will have read him through their own biases and prejudices. You must therefore discover Adam Smith for yourself.

That, in any event, is the invitation. □

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## Annex<sup>†</sup>

The following is a simple algebraic model summarising some principal points regarding Adam Smith's idea of growth. Denote aggregate output by  $Y$ , total population by  $N$ , and productive labour by  $N_p$ . Then an identity is provided by the following:

$$(1) \quad \frac{Y}{N} = \frac{Y}{N_p} \frac{N_p}{N} = \delta \frac{N_p}{N}.$$

This encapsulates Smith's main proposition that the two sources of the "wealth of nations" are labour productivity  $\delta$ , or  $\frac{Y}{N_p}$  (the main factor in which is attributed to the division of labour), and the share of productive labour in the population  $\frac{N_p}{N}$ .

On the other hand, Smith was among those who believed in the "wages-fund" notion of capital, which implies that productive employment  $N_p$  depends on the amount of capital invested  $K$ , which is equal to the fund that pays workers the equivalent of the prevailing subsistence wage  $\omega$ . Hence one may write:

$$(2) \quad K = \omega N_p, \text{ which is equivalent to } N_p = \frac{K}{\omega}.$$

Investment in turn is equal to the proportion  $\sigma$  saved from the previous year's output:

$$(3) \quad K = \sigma Y_{-1}.$$

Substituting (3) into (2) produces

$$(4) \quad N_p = (\sigma/\omega) Y_{-1},$$

which when used in (1) yields:

$$(5) \quad \frac{Y}{N} = \frac{\delta(\sigma/\omega) Y_{-1}}{N}$$

Upon simplifying, one obtains a simple expression for the growth rate of total output  $\Gamma$ :

$$(6) \quad \frac{Y}{Y_{-1}} = (1 + \Gamma) = \delta\sigma/\omega.$$

To obtain an expression for the growth of per-capita output,  $\gamma$ , simply note that this is related to  $\Gamma$  as follows:

$$(7) \quad (1 + \gamma) = \frac{(1 + \Gamma)}{(1 + n)} = \frac{(1 + \delta\sigma/\omega)}{(1 + n)}$$

where  $n$  is the (exogenous) growth rate of the population. Therefore the growth of per-capita output (i.e., "the wealth of nations") varies directly with productivity and the saving rate, and inversely with the subsistence wage and the growth rate of total population. (The model can be further extended if, as Smith suggests,  $\delta$  is written as a function of  $\sigma$ , and  $\omega$  depends on the rate of growth of population, or vice-versa.)  $\square$

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<sup>†</sup> This appendix draws from Roncaglia [2005] and what Hicks [1965] called Smith's "pure economic model", also reviewed by Deane [1978].