Adam Smith – a Primer

too: its prescriptions, such as trade liberalisation, started making their way into public policy.

Commissioner of Customs

Smith was rewarded with the post of Commissioner of Customs in Edinburgh, on a handsome salary of £600. The arch-critic of Britain's arbitrary and inefficient customs system was now in a position to do something about it, and he was diligent in this work.[7] He advised on other issues too – against trade restrictions on Ireland, for example, and on the American colonial 'disturbances'. Later, Prime Minister William Pitt adopted Smith's principles in forging a trading pact with France and in implementing a widespread reform of the nation's tax system.

Smith loved discussion and debate with friends. In July 1790, during one of many such evenings in Edinburgh, he felt tired and retired to bed, saying that the discussion would need to continue in some other place. He died a few days later and was buried under a generous but restrained monument in the churchyard near his Canongate home.

7 Campbell and Skinner, *Adam Smith*, pp. 200–203.

3 *THE WEALTH OF NATIONS*

The book's broad themes

Adam Smith wrote *The Wealth of Nations* partly to provoke politicians out of their policy of restricting and distorting commerce, rather than letting it flourish. So he uses plain language, which is still accessible today.

But Smith was also trying to create a new science of economics. It was pioneering work, and his terms and concepts can be hard to reconcile with today's. His text is discursive, full of long digressions and afforested with facts, from the price of silver in China to the diet of Irish prostitutes in London. All this makes his book hard to navigate. So let us first focus on some of its main themes.

The most obvious theme is that *regulations on commerce are ill-founded and counterproductive*. The prevailing view at the time was the 'mercantilist' idea that a nation's wealth was the amount of money that it possessed. This implied that to become richer, a nation needed to sell as much as possible to others, in order to get as much coin as possible in return; and it needed to buy as little as possible from others, in order to prevent its cash reserves leaking abroad. This view of trade led to the creation of a vast network of import tariffs, export subsidies, taxes and preferences for domestic industries, all designed to limit imports and promote exports.

Smith's revolutionary view was that wealth is not about how

much gold and silver sits in a nation's vaults. *The real measure of a nation's wealth is the stream of goods and services that it creates*. He had invented the idea, so common and fundamental in economics today, of gross domestic product.[1] And the way to maximise that product, he argued, was not to restrict the nation's productive capacity, but to set it free.

Another central theme is that this *productive capacity rests on the division of labour* and the *accumulation of capital* that makes it possible. Huge efficiencies can be won by breaking production down into many small tasks, each undertaken by specialist hands. This leaves producers with a surplus that they can exchange with others, or use to invest in new and even more efficient labour-saving machinery.

Smith's third theme is that a country's *future income depends upon this capital accumulation*. The more that is invested in better productive processes, the more wealth will be created in the future. But if people are going to build up their capital, they must be confident that it will be secure from theft. The countries that prosper are those that grow their capital, manage it well and protect it.

A fourth theme is that *this system is automatic*. Where things are scarce, people are prepared to pay more for them: there is more profit in supplying them, so producers invest more capital in order to produce more. Where there is a glut, prices and profits are low and producers switch their capital and enterprise elsewhere. Industry thus remains focused on the nation's most important needs, without the need for central direction.

But *the system is automatic only when there is free trade and*

1 A point made neatly by P. J. O'Rourke, *On The Wealth of Nations*, Atlantic Monthly Press, New York, 2006, pp. 7–8.

competition. When governments grant subsidies or monopolies to favoured producers, or shelter them behind tariff walls, they can charge higher prices. The poor suffer most from this, facing higher costs for the necessities that they rely on.

A further theme of *The Wealth of Nations* is how *different stages of economic progress produce different government institutions*. The early hunter-gatherers had little of any value. But when people became farmers, their land, crops and livestock were important property and they developed government and justice systems to protect it.

In the age of commerce, as people accumulate capital, property becomes even more significant. But this age is populated by merchants who have much to gain from distorting markets in their favour and who have the guile to use the political process to help them. *Competition and free exchange are under threat from the monopolies, tax preferences, controls and other privileges that producers are able to extract from the government authorities.*

For all these reasons, Smith believes that *government must be limited*. It has core functions such as maintaining defence, keeping order, building infrastructure and promoting education. It should keep the market economy open and free, and not act in ways that distort it.

Production and exchange

The first of the five 'Books' in *The Wealth of Nations* explains the mechanisms of production and exchange, and their contribution to national income.

The benefits of specialisation

Using the example of a pin factory, Smith shows that the *division of labour* – labour specialisation – generates enormous increases in output. Pin-making seems a 'trifling manufacture', but is really quite complicated. Wire must be drawn out, straightened, cut and pointed. The top must be ground flat for the head, which in turn must be made and affixed. The pins must be whitened and put into paper. Indeed, there are about eighteen different operations in the process.

A single person, he says, doing all these different operations, could probably not make as many as twenty pins in a day (and if they also had to mine and smelt the metal required, perhaps not even one pin a year). But in the factory the work is divided between different people, each of whom does only one or two of the separate operations. Between them, the ten-strong team of pin-makers can actually make 48,000 pins in a day – equivalent to 4,800 each, or 240 times the daily output achievable by a single person.

This specialisation is so efficient that it emerges not just within companies, but between industries and even between countries. Farmers specialise in raising crops or livestock: their land is consequently much better tended, and more productive, than if they had to spend time making all their household items too. But manufacturers are very happy to supply household goods and leave the production of their food to the farmers. Similarly, countries specialise by exporting the goods they produce best and importing the goods that others produce better.

The increased efficiency comes not just from the skill acquired when people do the same task many times, says Smith. Less time is wasted in moving from one operation to another, and specialisation allows people to use dedicated, labour-saving machinery to increase output even further. Consequently: 'The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgement with which it is any where directed, or applied, seem to have been the effects of the division of labour.'[2]

The division of labour harnesses the cooperation of many thousands of people in the production of even the most basic of everyday objects:

> The woollen coat, for example, which covers the day-labourer, as coarse and rough as it may appear, is the produce of the joint labour of a great multitude of workmen. The shepherd, the sorter of the wool, the wool-comber or carder, the dyer, the scribbler, the spinner, the weaver, the fuller, the dresser, with many others, must all join their different arts in order to complete even this homely production.[3]

Moreover, the transportation of the wool will have required sailors, shipwrights and sail-makers; even the shears for cutting the wool would need miners and ironworkers. The list seems endless. But this collaboration of thousands of highly efficient specialists is the source of developed countries' great wealth, and makes items such as woollen coats accessible even to the poorest – what Smith calls 'that universal opulence which extends itself to the lowest ranks of the people'.[4]

2 *Wealth of Nations*, Book I, ch. I, p. 13, para. 1.
3 Ibid., Book I, ch. I, p. 22, para. 11.
4 Ibid., Book I, ch. I, p. 22, para. 10.

The mutual gains from exchange

Smith's quintessential Chapter II explains how *material exchange* spreads the benefits of this productive efficiency around the community. Through some particular mental or physical talents, he conjectures, one person in a 'primitive country' might be better than others at making arrows, while another is better at metal-working. By specialising, the fletcher produces more arrows, and the smith more blades, than either can use. So they exchange arrows for blades. Both now have a useful mix of tools and each has benefited from the other's efficient, specialised production.

The propensity to 'truck, barter, and exchange', claims Smith, is a natural and universal feature of human behaviour, precisely because both parties benefit. Indeed, the exchange would not occur if either side thought themselves the loser by it. And this is a crucial insight. In Smith's world, like ours, most goods were exchanged for money rather than bartered for other goods. Since money was regarded as wealth, it seemed that only the seller could benefit from the process. But Smith shows that the benefit is mutual. By exchanging, both sides get the goods they want for less effort than they would have to expend in making them for themselves. Each is made richer by the exchange. Wealth, in other words, is not fixed, but is *created* by human commerce. It was a groundbreaking idea.

Another crucial insight is that exchange still benefits both sides, even though each party proposes and accepts the bargain entirely in their own self-interest and not with the other side's welfare in mind. That is fortunate, because it gives us a way to induce other people to part with things we want. In Smith's famous words:

> 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 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.[5]

By 'self-love' or 'self-interest', Smith does not imply 'greed' or 'selfishness'. His meaning is an eighteenth-century one: not some unpleasant readiness to gain by making others worse off, but an entirely due and appropriate concern to look after our own welfare. This is so natural and important to human beings that in *The Theory of Moral Sentiments* he calls it 'prudence'.[6] In the same book, he stresses that 'sympathy' (or as we would say, empathy) for others is one of humanity's salient characteristics, and justice (not doing harm to others) is one of its fundamental rules.

Wider markets bring bigger gains

The benefits we get from exchange are what drive us to specialise and so increase the surplus that we can exchange with others. Just how far that specialisation can go depends on the extent to which exchange is possible, says Smith – that is, on the extent of the *market*.[7] Only a 'great town' provides enough customers for porters, for example; while scattered communities may be unable to support even specialist carpenters or stonemasons, forcing people to do more of these tasks for themselves.

One thing that definitely does extend the market is *money*.[8]

5 Ibid., Book I, ch. II, pp. 26–7, para. 12.
6 *The Theory of Moral Sentiments*, part VI, section I.
7 *The Wealth of Nations*, Book I, ch. III.
8 Ibid., Book I, ch. IV.

Life would be tedious if hungry brewers always had to search out thirsty bakers. That is why we commonly use the medium of money – exchanging our surplus product for money, then exchanging money back for other products that we want.

The index of value

But, whether mediated through money or not, what is it that determines the rate at which different products are exchanged? It was a puzzle to Smith that something essentially useless (like a diamond) has a high 'value in exchange', when something vital (like water) has almost none. Today we might solve it with marginal utility theory: since diamonds are so rare, an additional one is a great prize; but since water is so plentiful, an extra cupful is actually of little use to us. Or we might invoke supply and demand analysis.

Unfortunately, the first tool did not yet exist and, at this point in *The Wealth of Nations*, Smith had not yet perfected the second. So he struggles to identify what it is about a product which gives it a particular value.

It seemed natural to him that in primitive societies, value originally must have reflected the *labour* put into the item's production.[9] After all, we put 'toil and trouble' into creating the product we sell precisely to spare ourselves the effort of creating the product we buy. There is no point in either side buying something they could create with less effort themselves; so the ideal rate of exchange should reflect equal effort.

Therefore if among hunters 'it usually costs twice the labour

9 Ibid., Book I, ch. V.

to kill a beaver which it does to kill a deer, one beaver should naturally exchange for or be worth two deer'.[10] Of course, Smith observes, not all labour is equal. One production process may be harder work, or require more ingenuity, or demand a long period of training and experience. But these factors will be accounted for 'by the higgling and bargaining in the market'.[11]

This part of *The Wealth of Nations* has been much criticised as a 'labour theory' of value, which in turn allowed Karl Marx to claim that the labour of the workers was routinely stolen by the capitalist bosses. If so, it certainly did the world no good.

Yet Smith is not really leading us to a labour theory of value. He is actually trying to understand what today we see as a key economic measure, the *total costs of production*. In the hunting society, these costs are almost entirely labour. But we have evolved away from this; and Smith goes on to identify the other *factors of production* – land and capital – that are employed in more modern economic systems. This idea again has become a fundamental concept in economics today. And later, Smith brings in supply and demand, examining not just their effects on price, but how they drive the whole production and distribution system. It is pioneering stuff and it takes him several chapters, which need to be taken together, and which trace how society evolved away from labour as the sole source of value.[12]

Land, labour and capital

For modern production of any kind you need people to do the

10 Ibid., Book I, ch. VI, p. 65, para. 1.
11 Ibid., Book I, ch. V, p. 49, para. 4.
12 Ibid., Book I, chs V–XI.

work, equipment such as tools and machinery for them to do it with and space in which to work. Total costs can therefore be divided between *three broad factors of production*, asserts Smith.[13] Unlike in the hunting economy, these factors are owned by different people, who are therefore entitled to a share in the earnings from what is produced. There is the *labour* of the workers, of course, reflected in *wages*. There is also the *capital* (Smith says *stock*) put up by the employers, reflected in *profits*. And there is the use of *land*, reflected in the *rents* paid to landlords.

Land, capital and labour therefore all contribute to production, making workers, employers and landlords all interdependent. But their mutual dependency goes beyond mere production; since much production is intended for exchange, they are crucially involved in the valuation and distribution of that product too. Smith is leading us gradually to the realisation that the production, valuation and distribution of the nation's output do not exist in isolation, but all take place simultaneously as interrelated parts of a functioning economic *system*, of which everyone is a part. That too was a huge theoretical innovation.

How markets drive production

Smith then explains how this system *drives and directs production*. The 'market price' at which products actually exchange, he says, may be higher or lower than their total production cost (which he calls the 'natural price').[14] It depends on the demand for the product (or at least, the 'effectual' demand of customers with the money to buy) and on how much of it is brought to market. If the

13 Ibid., Book I, ch. VI.
14 Ibid., Book I, ch. VII.

market price is higher than sellers' total production costs, they make a profit; if it is lower, they make a loss.

The market price can never remain below production costs for long: sellers would withdraw, rather than suffer persistent losses. But nor can it long be very much higher. That would alert competitors that there are profits to be made; supply would increase and the market price would be bid down again. So industry's aim is to bring exactly the equilibrium amount to market.

Of course, competition may be imperfect. Regulations may restrict market entry. A monopolist may force up prices by keeping the market understocked. Or information may be deficient: for example, the inventor of a cheaper production process may enjoy extraordinary profits for years, until competitors also discover it. So 'natural' and market prices may diverge.

Wages depend on economic growth

Such imperfections exist in the *labour market* too. Land, capital and labour may be interdependent, but the struggle between workers and employers and landowners is an unequal one. Employers promote laws forbidding collusion between workers, says Smith, although collusion between employers is 'constant and uniform'.[15] But employers should remember that keeping wages low is a false economy: better pay and conditions can raise productivity and so generate higher returns.

The workers' best friends, he surmises, are rising national income and capital growth, because they bid up wages. A landlord with surplus revenue will hire more servants. A weaver or a

15 Ibid., Book I, ch. VIII, p. 84, para. 13.

shoemaker with surplus capital will hire assistants. In other words, the demand for labour rises when – and only when – national wealth rises. The 'liberal reward of labour' depends entirely on economic growth.

Yet the real measure of wages is how much they will buy; and Smith notes that while taxes had raised the price of candles, leather, alcohol and other luxuries of his time, food and other essentials were all getting cheaper, thanks to the market system. That helped the poor in particular, which was no bad thing, since: 'No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable.'[16]

Market wage rates

In theory, Smith ventures, the returns from labour should tend to equalise. If one trade were better rewarded, people would flock in from other professions and the market would soon correct the balance. So why do wage rates actually differ?

His answer is that we must look not just at the 'pecuniary' rewards, but the non-monetary rewards of labour too. Some professions are hard or disagreeable (which is why butchers and executioners are better paid than weavers). Some trades (like bricklaying) are seasonal. Others (such as medicine) command a premium because they require great public trust. Some professions are costly to learn (the law, for example); and even after such investment, the chance of real success might be slim (opera singers). All these factors will affect the market price of labour in particular trades.

16 Ibid., Book I, ch. VIII, p. 96, para. 36.

Wages and politics

But *political* factors affect incomes and profits too. Regulations prevent people from entering particular professions. Smith cites by-laws that forbid Sheffield cutlers from having more than one apprentice, or Norfolk weavers and English hatters more than two. These entry barriers keep up the incomes of the few who qualify as master cutlers, weavers and hatters – but only by robbing other people of the 'sacred property' of their own labour. And they prevent workers migrating from declining trades into ones where they are needed more.

Smith famously asserts that: 'People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.'[17]

But (he continues immediately) politicians and the law are complicit, since they pass and enforce the regulations that make such collusion more likely and more effective. He has in mind the sort of privileges enjoyed by the craft guilds (or 'incorporations'), which, since the Middle Ages, had guarded jealously their own monopolies, restricted who could join the profession and on what terms, kept registers of those they licensed to practise and raised funds from members for the welfare of their own poor.

But a law establishing a public register of a profession's members, says Smith, puts them in easy contact with each other and so makes these conspiratorial meetings more likely to happen. Compulsory trade welfare funds make such meetings inevitable, since members of the profession have to come in to pay their levies. And where the law goes farther, allowing professions

17 Ibid., Book I, ch. X, part II, p. 145, para. 27.

to decide policy on a majority vote, it 'will limit the competition more effectually and more durably than any voluntary combination whatever'.[18]

To Smith, the only 'real and effectual' discipline over businesses is the fear of losing customers.[19] A free market in which customers are sovereign is a surer way to regulate business behaviour than any number of official rules – which so often produce the opposite of their avowed intention.

Capital and profits

Equally perverse regulations also affect the next factor of production, which Smith calls *stock*.[20] This, as he explains later,[21] includes goods reserved for immediate use, such as clothes or stocks of food; fixed capital, such as machinery; and circulating capital, including work in progress and goods that have been made but are still on the shelf.

Smith comments that the profit of stock – that is, the return to those who invest in productive enterprises – is very variable. It depends on commodity prices, on how competitors are faring and 'a thousand other accidents' that can happen to goods when they are being transported or stored.[22] Interest rates, however, provide a rough measure of profitability: if people are willing to pay a lot to borrow money, it suggests that they can make a handsome profit when they apply those borrowed funds to production.

By way of illustration, he points to the very high interest rates

18 Ibid., Book I, ch. X, part II, p. 145, para. 30.
19 Ibid., Book I, ch. X, part II, p. 146, para. 31.
20 Ibid., Book I, ch. X.
21 Ibid., Book II, ch. I.
22 Ibid., Book I, ch. IX, p. 105, para. 3.

pertaining in the American colonies, where there is abundant land, but relatively little capital or labour to cultivate it. Land is therefore cheap but capital and labour expensive – as reflected in high profits, high interest rates and high wages.

Land and rents

Smith's views on land and rents[23] show that he loves landlords no more than he loves employers: they enjoy a 'monopoly price' not through effort, but through the mere ownership of land and its location and fertility. Moreover, the desire of wealthy merchants to own impressive country estates increases the demand for land, and therefore land prices and rents, even more.

Land provides minerals as well as food and space, of course. Smith's long *Digression on Silver* assembles a mass of evidence to support his thesis that as national income grows manufactures get cheaper, but land gets more expensive.

An automatic system

To recapitulate: a country's 'annual produce' resolves itself into rent, wages and profits, meaning that landowners, workers and employers are inevitably interdependent.[24] They are parts of a seamless system of flows in which goods are created, exchanged, used and replaced – and resources are put to their best use – all quite automatically.

But the process can be perverted by vested interests, who use government power to distort this free market system for their

23 Ibid., Book I, ch. XI.
24 Ibid., Book I, ch. XI.

own benefit. Landowners may be too indolent and workers too powerless: but employers have both the incentive and the acuity to promote regulations that stifle competition. Therefore:

> The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.[25]

The accumulation of capital

Book II of *The Wealth of Nations* is about building up *capital*, which Smith asserts is an essential condition for economic progress. The creation of surpluses makes exchange and specialisation possible. This specialisation helps build even greater surpluses, which in turn can be reinvested in new, dedicated, labour-saving equipment. It is a virtuous circle. Thanks to this growth of capital, prosperity becomes an expanding pie: one person (or one nation) does not have to become poorer in order for another to become richer. On the contrary, as wealth expands, the whole nation becomes richer.

25 Ibid., Book I, ch. XI, p. 267, para. 10.

Money

Money, according to Smith, has no intrinsic value.[26] It is only a tool of exchange. Real wealth resides in what money buys, not in the coins themselves. After all, the purchasing power of gold and silver fluctuates. And a person who receives a guinea of income today may spend that same guinea tomorrow, thus providing the income of a second; and that person may spend the same guinea on the next day, providing the income of a third. So the amount of money in circulation is clearly not the same as the total income of the nation. The mercantilists are wrong to confuse the two.

Yet money does have its effects. When it lies around, it is a useless tool – 'dead stock' – but efficient banking can make it work harder. Today's fiat money (where governments simply declare the notes they print to be legal tender) did not exist in Smith's world, but banks issued notes backed by their gold reserves. This, he thought, could make it easier to keep cash moving, though he saw a risk if banks over-issued their notes – he was writing just after the 1772 banking crisis in which many Scottish banks collapsed. He thought that the threat of competition should keep the banks prudent, but still saw a role for banking regulation. (Smith is not against all economic regulation: only that designed to promote particular interests over the general welfare.)

Consumption and investment

Smith makes another innovative distinction, between gross and net income – total income minus the cost of achieving it.[27] Chapter III, on labour and savings, continues the analysis and is a core

26 Ibid., Book II, ch. II.
27 Ibid., Book II, ch. II.

part of *The Wealth of Nations*, though its terminology can confuse modern readers. Smith divides labour into *productive* and *unproductive*. By *productive labour* he means work that exceeds its costs and produces a surplus that is available for reinvestment – such as the labour of manufacturing staff. By *unproductive labour* he means work that is consumed immediately, like that of doctors or musicians, lawyers or puppeteers, public officials or buffoons, and which does not produce revenue that can be reinvested. He is making the distinction, so basic to economics today, between the manufacturing and service sectors.

By consuming these immediate services, however, we leave ourselves less surplus to invest in the maintenance and expansion of the capital on which our future income depends. The more we consume now, the more future growth and income must we forgo.

In fact, we can consume so much that we have nothing left with which to expand our productive capacity; so much, indeed, that we cannot even *maintain* it. That amounts to *consuming* our capital – as a 'prodigal' does, says Smith, by 'not confining his expense within his income', but paying 'the wages of idleness with those funds which the frugality of his forefathers … consecrated to the maintenance of industry'.[28]

Capital can also be dissipated by bad investment decisions (what Smith calls 'misconduct'). This, he reminds the mercantilists, does not diminish the nation's gold and silver deposits, but certainly reduces its productive capacity. And if there is no rule of law, capital can be stolen – reducing people's incentive to accumulate it in the first place.

28 Ibid., Book II, ch. II, p. 339, para. 20.

But 'great nations are never impoverished by private, though they sometimes are by public prodigality and misconduct'.[29] Ordinary people know that they must save and invest if they are to better themselves. Governments, however, have less focus on the importance of maintaining capital: their role is to spend on current services, not to invest in production. Almost the whole revenue of governments, observes Smith, is thus employed in maintaining *unproductive* hands. So:

> It is the highest impertinence and presumption … in kings and ministers, to pretend to watch over the economy of private people. … They are themselves always, and without any exception, the greatest spendthrifts in the society. … If their own extravagance does not ruin the state, that of their subjects never will.[30]

A 'profusion of government' may force taxpayers to 'encroach upon their capitals' until 'all the frugality and good conduct of individuals may not be able to compensate the waste and degradation of produce' that results. But the market economy remains a powerfully robust system. Big government may set nations back, but it can rarely stop them:

> The uniform, constant, and uninterrupted effort of every man to better his condition … is frequently powerful enough to maintain the natural progress of things toward improvement, in spite of both the extravagance of government, and of the greatest errors of administration.[31]

29 Ibid., Book II, ch. III. p. 342, para. 30.
30 Ibid., Book II, ch. III, p. 346, para. 36.
31 Ibid., Book II, ch. III, p. 343, para. 31.

Further reflections on capital

Smith observes that capital can be used in different ways.[32] Some assets (such as fisheries) provide for immediate consumption; others (like machinery) are used for manufacturing or transporting raw and finished goods; and, often ignored but equally important and productive, retail capital is used to break goods down into smaller, consumable units – so that when we want meat we do not need to buy a whole ox.

(This propels Smith into an amusing aside on official measures to restrict the number of retailers in any place, such as licensing ale-houses. 'It is not the multitude of ale-houses,' he says, 'that occasions a general disposition to drunkenness … but that disposition … necessarily gives employment to a multitude of ale-houses.'[33] Retail trades, like any other, follow demand.)

The core message of Book II, however, is that saving part of our product, instead of consuming it all, allows us to grow our productive capital; which in turn allows us to increase our product in the future. It is an expanding circle of wealth – unrelated (mercantilists please note) to the quantity of metal in our bank vaults.

Through the accumulation of capital, more specialist and more labour-saving processes can be developed. The division of labour will be deepened, which in turn, says Smith, will require more labour. As capital expands, therefore, wages will rise. (Smith was of course writing before the full force of the Industrial Revolution had become apparent and at a time when manual labour was fundamental to the economy. He does not seem to imagine machines actually replacing labour.)

In other words, the market economy is unparalleled at

32 Ibid., Book II, ch. V.
33 Ibid., Book II, ch. V, p. 360, para. 7.

boosting national wealth, and this wealth diffuses right down to the poorest workers. Indeed, the poor in the rich countries that adopt this system live better than the rich in the poor countries that do not. It is a globalisation message: countries make themselves better off if they do not try to remain self-sufficient or raise trade barriers against others.

The history of economic institutions

Book III looks at the development of economic relations, sometimes through historical conjecture, sometimes through a wealth of historical fact. Smith begins by tracing the evolution from agriculture to industry. The growth of towns, and the interdependence of towns and the countryside, is entirely natural, he asserts. Artisans need farmers to produce their food, but farmers need artisans to make their equipment, and towns to provide markets for their goods: indeed, the larger the town, the bigger the market. It is not (as the French 'physiocrat' economists of the time contended) that the towns simply live off the country: both sides add value from the exchange of their different contributions.

Smith charts the breakdown of the feudal order in Europe and explores the origins of feudal law after the fall of the Roman Empire and how commerce led to it being supplanted.[34] Before the age of trade and commerce, he speculates, wealth resided with the great landlords; and these barons inevitably became the local legal authorities too. It was an arbitrary power, however, and feudal law developed as an attempt to moderate it – though with only partial success. But the rise of trade and commerce saw the wealth

34 Ibid., Book III, ch. IV.

(and thus the power) of the landowners being eroded and their retainers becoming independent tenants. Those tenants, now with aspirations of their own, demanded more security, and the feudal system gave way to a rule of law that applied to the great and the humble alike. The rise of commerce had separated economic from political power: and economic power is powerful indeed.

This was a happy outcome, in Smith's opinion, because it protected people's capital and allowed trade, commerce and manufactures to grow under the shelter of civil justice. Once again, a beneficial outcome was brought about by groups of people who had not the least intention of serving the general public, but were mindful only of their own property and security.

Economic theory and policy

In Book IV, Smith builds his critique of economic interventionism. He starts with mercantilism and its erroneous view that money and wealth are the same things – and its policy to restrict imports and expand exports so as to hold on to as much gold and silver as possible.[35]

Mercantilists and money

Money, Smith reminds us, is just a tool to facilitate exchange. Since foreign trade is a small part of total commerce, cross-border movements of gold are hardly likely to ruin a great nation.

Of course, the mercantilists say that gold is durable and that the countries that export to us could viciously accumulate it over

35 Ibid., Book IV, ch. I.

decades while we stupidly exchange perishable commodities for such a durable one. Smith retorts that we are perfectly happy to import (perishable) wines from France and export (durable) hardware in return. But the French are not so silly as to accumulate more pots and pans than they really need; and nor should we be so stupid as to hoard gold and silver beyond their useful quantities. An excess of inert metal is dead capital, and dead capital cannot make us rich.

Absolute advantage

When we restrict imports in the hope of preserving our gold and silver deposits, Smith continues, it means that domestic consumers have less choice: they have to buy from home producers, rather than from a range of foreign producers whose goods may be better or cheaper.[36] This makes the policy expensive and counterproductive. As with the division of labour between trades, countries too should do what they are best at and exchange their surpluses. This argument is an early rendition of the principle that today we call *absolute advantage*, and Smith seals the case with a vivid example:

> By means of glasses, hotbeds and hotwalls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines, merely to encourage the making of claret and burgundy in Scotland?[37]

36 Ibid., Book IV, ch. II.
37 Ibid., Book IV, ch. II, p. 458, para. 15.

Such interventionism is not only irrational and expensive. It is also corrupting:

> The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.[38]

Tariffs and subsidies

There might, Smith concedes, be a case for *temporary* tariffs if they forced other countries to drop theirs. But in general such policies are either pointless or harmful and we should be suspicious of people who advocate them. British tariffs on foreign wine and beer, for example, are defended on the grounds that they reduce drunkenness. But, Smith retorts, though alcohol may sometimes be abused, it is still better if we can buy it more cheaply than we can brew it ourselves. He notes also that the tariffs favour Portugal over France, on the argument that Portugal is a better customer for British manufactures. 'The sneaking arts of underling tradesmen', he complains, 'are thus erected into political maxims for the conduct of a great empire.'[39]

Nor should we necessarily worry about an adverse balance of trade, Smith tells the mercantilists. As long as a country is producing more than it consumes, it is saving and adding to its

38 Ibid., Book IV, ch. II, p. 456, para. 10.
39 Ibid., Book IV, ch. III, part II, p. 493, para. c8.

capital. Such a country could still import more than it exports and nevertheless continue to produce surpluses and grow richer.

Smith's review of other trade interventions, including 'drawbacks' (tax reliefs for exporters) and 'bounties' (subsidies),[40] provides an interesting snapshot of his period, and there is the occasional, telling gem. For example:

> The bounty to the white-herring fishery is a tonnage bounty; and is proportioned to the burden of the ship, not to her diligence or success in the fishery; and it has, I am afraid, been too common for vessels to fit out for the sole purpose of catching, not the fish, but the bounty.[41]

Colonial trade restrictions

The Wealth of Nations was published just months before America's seething discontents turned into outright rebellion. Smith's chapter on colonies[42] reveals his sympathy with the Americans, mainly on account of the mercantilist restrictions that have harmed their trade (and done Britain no good in the process) and partly because he feels that America's contribution to tax revenues should, as a matter of justice, entitle it to greater representation in Parliament.

Tracing the origins of colonies, Smith suggests that they are usually established with the hope of finding gold or silver, which of course the mercantilists equate with wealth. But America's great asset is land. It is plentiful and cheap, and much labour is needed to realise its potential yield. That makes labour expensive, but

40 Ibid., Book IV, chs IV and V.
41 Ibid., Book IV, ch. V, p. 520, para. 32.
42 Ibid., Book IV, ch. VII.

American agriculture is in fact so productive that labour remains affordable nonetheless. Indeed, America is so fertile and rich that even Britain's taxes and trade restrictions have not (yet) ruined it.

Unfortunately, the policy of forcing America to trade only with the home country has drawn Britain's capital and enterprise away from more productive uses – depressing its prosperity along with America's, and leading to slower capital accumulation and therefore lower future incomes in both. Britain, he says, has tried to make America 'a people of customers', but the policy instead has turned them from farmers into politicians: and since so much of Britain's industry is focused on the Atlantic trade, the political risk is large. Only trade – and political – liberalisation could reduce the threat, but Britain's investment has become so distorted that the necessary adjustment would be painful.

Britain's trade restrictions on America are yet another example of mercantilist thinking, where producer interests dominate. But: 'Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer.'[43]

The liberal alternative

Smith criticises the French physiocrats for their view that all value derives from land and agriculture – the town merchants and 'artificers' merely rearranging this wealth, but producing nothing themselves. He counters that the townspeople are in fact productive. They do not simply consume capital: they replace it. They are *productive*, not *unproductive* hands.

43 Ibid., Book IV, ch. VIII, p. 660, para. 49.

He nevertheless considers the physiocrats' economic philosophy as one of the better ones. They do not mistake output for money and they see perfect freedom of trade as the best way to maximise that output.

Smith holds that the market economy is strong enough to survive, even if freedom is less than perfect: but the joy of a free economic system is that it works automatically. In Smith's words, the 'obvious and simple system of natural liberty establishes itself of its own accord'. People are left free to pursue their own interests – and thereby, as we have seen, they unwittingly promote the interests of everyone. No central direction is needed:

> The sovereign is completely discharged from a duty [for 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.[44]

Which is fortunate in Smith's view, since every system that tries to steer resources in particular directions 'is in reality subversive of the great purpose which it means to promote'.[45]

The role of government

Smith explores the proper role of government in Book V. He is critical of government and officialdom, but is no champion of laissez-faire. He believes that the market economy he has described can function and deliver its benefits only when its rules are observed – when property is secure and contracts are

44 Ibid., Book IV, ch. IX, p. 687, para. 51.
45 Ibid., Book IV, ch. IX, p. 687, para. 50.

honoured. The maintenance of *justice* and *the rule of law* are therefore vital.

So is *defence*. If our property can be stolen by a foreign power, we are no better off than if our own neighbours steal it.

But Smith goes farther than this and argues that there is also a role for the government in *providing public works* and *promoting education*.

Defence

Smith conjectures that in a world of hunter-gatherers, everyone must defend themselves. But since hunters live for the day and have little or no property, there is little call for any central authority. In an agricultural age, however, people start to accumulate valuable property (crops and livestock, for example) and defending it becomes a priority. Under the division of labour principle, a specialist military is established. Those with most property have most to gain, but they compel everyone to contribute rather than remain 'free riders'. So defence has become a function of government.

Justice

The same historical argument applies to justice. As people move to a commercial, exchange society, those with property establish civil government to defend themselves against their neighbours who have none:

> The affluence of the rich excites the indignation of the poor, who are often both driven by want, and prompted by envy, to invade his possessions. It is only under the shelter of the civil magistrate that the owner of that valuable property, which is acquired by the labour of many years, or perhaps of many successive generations, can sleep a single night in security.[46]

It is obviously useful if everyone accepts the authority of independent judges. But the efforts of the rich and powerful to build a judicial shelter for themselves are abetted by a natural human tendency to respect the authority of personal qualities such as strength, wisdom, prudence, maturity, wealth and status.

Civil government, in other words, is the outcome of conflict and of the inequalities that emerge in a commercial society. It is a natural outcome, a generally helpful one, but is by no means perfect.

Civil government, so far as it is instituted for the security of property, is in reality instituted for the defence of the rich against the poor, or of those who have some property against those who have none at all.[47]

It is no surprise that the structure of government, having been built on these imperfect foundations, is imperfect too. The power to tax allows it to build up enormous resources, but it has much less incentive to manage its property as efficiently as would a private individual. Thus:

> When the crown lands had become private property, they would, in the course of a few years, become well-improved and well-cultivated … the revenue which the crown derives from the duties of customs and excise, would

46 Ibid., Book V, ch. I, part II, p. 710, para. c2.
47 Ibid., Book V, ch. I, part II, p. 715, para. 12.

> necessarily increase with the revenue and consumption of the people.[48]

This lack of incentive must be corrected: 'Public services are never better performed than when their reward comes in consequence of their being performed, and is proportioned to the diligence employed in performing them.'[49]

Public works and institutions

Smith's third duty of government is 'the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain'.[50]

These comprise *infrastructure projects* that facilitate commerce and *education*, which helps make people a constructive part of the social and economic order.

Public works

Prosperity requires commerce and commerce needs infrastructure, such as roads, bridges and harbours. Some of these, Smith believes, could never repay their cost, and tax funding is needed to build them. But at least part of the cost could be recovered by tolls on those who use them, rather than by taxes upon the whole nation. Likewise, if the main benefit is local and the cost cannot be recovered by tolls, a *local* tax is best: London

48 Ibid., Book V, ch. II, part I, p. 824, para. a18.
49 Ibid., Book V, ch. I, part II, p. 719, para. 20.
50 Ibid., Book IV, ch. I, part III, p. 723, para. c1.

taxpayers should pay for paving and streetlights in London, for example.

Smith also sees the need for public concessions to encourage people to open up trade with 'barbarous' countries. But this help should be given in the form of temporary local monopolies (such as patents or copyright) rather than subsidies from the general taxpayer.

Since *The Wealth of Nations* up to this point has been an extended condemnation of governments 'directing the capitals' of the people, these public expenditure proposals seem odd at best. Commerce certainly requires infrastructure, just as it requires rules of justice. It is not obvious, however, why roads, bridges and harbours should not be built commercially and the cost recovered entirely by charges on their users. Even paving and streetlights might be installed and paid for by local businesses, which could gain trade as a result. And if it is worth opening up new trade routes, why does the government need to be involved?

Perhaps we can excuse Smith on the grounds that today we have much more extensive financial instruments to provide the funding for new trade ventures and for laying down essential infrastructure. We also have better technologies for collecting payments from those who use roads, bridges and other facilities. But in the eighteenth century, government funding and initiative seemed the only way of doing certain things that everyone agreed were essential.

The education of youth

Smith sees the promotion of basic education as akin to infrastructure – something needed in order to allow commerce to thrive.

But here again, his analysis and prescriptions seem inconsistent with his general analysis.

His starting point is that, for all its benefits, the division of labour may have undesirable social consequences. The daily focus on repetitive tasks inevitably narrows people's views and interests:

> The man whose whole life is spent in performing a few simple operations, of which the effects too are, perhaps, always the same, or very nearly the same, has no occasion to exert his understanding, or to exercise his invention in finding out expedients for removing difficulties which never occur.[51]

Marx would later call it 'alienation' and Smith insists that education is needed to correct it. Education should focus on the labouring poor, who suffer most (manufacturers and traders live in a more stimulating world). And to facilitate commerce, says Smith, people need to 'read, write, and account'; geometry and mechanics are also useful.

The 'public' can facilitate this education by establishing schools – such as the local government-funded school that Smith went to in Kirkcaldy. But while the state might pay for school buildings, it should not pay the whole of teachers' wages. If teachers rely on fees from students, their performance will be that much sharper. Smith recalls with irritation his time in Oxford, where: 'The endowments of schools and colleges have necessarily diminished more or less the necessity of application in the teachers. Their subsistence [is] altogether independent of their success and reputation in their particular professions.'[52]

51 Ibid., Book V, ch. I, part III, p. 782, para. f50.
52 Ibid., Book V, ch. I, part III, article II, p. 760, para. f5.

He remains unclear on just how much the government should pay towards this basic education, though he expresses high regard for the private schools for skills like fencing or dancing, where the students pay the whole amount. But mindful of Smith's warnings about government enterprises, a modern reader might ask whether it is not better to subsidise needy students rather than their schools.

Education for all ages

Smith also sees a role for the government in promoting adult and religious education. Churchmen grow lazy when tithes pay their salaries, but the temptations of the growing towns mean that religious and moral education has never been more important. So he advocates at least some role for the government in encouraging the study of science, philosophy and the arts – though again, without being specific. And, he argues, a government should give 'serious attention' to combating the 'mental mutilation' of cowardice, just as it should prevent the spread of 'leprosy or any other loathsome and offensive disease'.[53]

The sovereign

A last item that should be paid out of taxation is maintaining the 'dignity of the sovereign', which includes the costs of the monarchy and criminal justice. But much *civil* justice should be paid by the protagonists in disputes, he maintains, since it is they who derive the principal benefit.

53 Ibid., Book V, ch. I, part III, article II, pp. 787–8, para. f60.

The principles of taxation

Having established that at least some taxation is necessary, Smith turns to the question of how best to raise it. Here he is on more familiar and secure ground. He is fully aware that: 'There is no art which one government sooner learns of another than that of draining money from the pockets of the people.'[54]

Plainly, then, some restraint is needed, and Smith proposes four famous principles of taxation. First, people should contribute in proportion to the income that they enjoy under the security of state protection. Second, taxes ought to be certain, rather than depend on the arbitrary decisions of tax officers. Third, tax should not be inconvenient to pay. Fourth, taxes should have minimal side effects: they should be cheap to collect; they should not hamper industry and enterprise; they should not be so onerous as to encourage evasion, such as smuggling; and they should not require 'frequent visits and the odious examination of the tax-gatherers'.[55]

Taxation is something that governments have to get right, says Smith. A tax on companies is unwise, for example, because – as he observes with great insight – the capital on which our income depends is highly mobile:

> The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease.[56]

54 Ibid., Book V, ch. II, part II, appendix to articles I and II, p. 861, para. h12.
55 Ibid., Book V, ch. II, part II, p. 827, para. b6.
56 Ibid., Book V, ch. II, article II, pp. 848–9, para. f8.

But there are inconsistencies in Smith's plans here too. He opposes taxes on consumption, but supports a tax on luxuries (including things that we would think rather basic today, such as poultry). He says that people should pay tax in proportion to their income, but wants the rich to pay 'something more than in that proportion'.

Public debts

While some of Smith's views on the role of government seem inconsistent with his general principles, and his policy prescriptions seem not to be thought through with his usual precision, he finishes in something more like his old style. Governments, he notes, have a tendency to spend even more than they can drain out of the pockets of the people. So he ends *The Wealth of Nations* with the parting warning that a large national debt is particularly harmful.[57]

By issuing debt, governments draw capital away from investment and growth, and steer it towards present consumption – in the shape of government activities – which means that growth necessarily falters. In addition, government borrowing allows politicians to take on more functions and boost their own power, without having to ask the people for more tax. And they often find ways of avoiding repayments anyway. For these reasons, national debt is not just a benign transfer from one group to another: it is a real threat to liberty and therefore a real threat to prosperity.

57 Ibid., Book V, ch. III.

The Wealth of Nations today

Smith's world was very different to ours, of course, before the Industrial Revolution changed everything. He was suspicious of the joint-stock companies that are the mainstay of capitalism today, arguing that 'an immense number of proprietors' could never keep them focused.[58] Perhaps he was right. He did not forecast the rise of union power, the problems of industrial pollution, fiat money inflation and much else that troubles economists today.

And yet, by showing how the freedom and security to work, trade, save and invest promotes our prosperity, without the need for a directing authority, *The Wealth of Nations* still leaves us with a powerful set of solutions to the worst economic problems that the world can throw at us. The free economy is an adaptable and flexible system, which can withstand the shock of the new and cope with whatever the future brings.

58 Ibid., Book V, ch. I, part II, article I, p. 744, para. e22.