

## The Real Adam Smith

### ADAM SMITH'S LOST LEGACY

BY GAVIN KENNEDY

NEW YORK: PALGRAVE MACMILLAN, 2005, 285 PAGES

REVIEWED BY THOMAS M. HUMPHREY

Adam Smith was a great economist, arguably the most influential of all time. But this does not mean, as some would have it, that his *Wealth of Nations*, published in 1776, marks the birth of modern political economy. On the contrary, Smith's book and the economics it contains owe much to his own previous work. More important, they draw heavily from the ideas of earlier English, Scottish, and French economists as well as from continental and Scottish philosophers writing in the natural law and historical-empirical traditions.

Nevertheless, it was Smith who, more clearly and systematically than his predecessors, saw the economy as a unified system of coordinated and interdependent markets across which the play of free competition and individual self-interest produces optimal resource allocation without the need for central planning or conscious design. From his *Wealth of Nations* comes an economic growth model in which specialization and division of labor, by spurring productivity and output, act to expand the scope of the market, thus permitting further division of labor and further market expansion in an upward cumulative spiral.

To Smith we owe a price-theoretic analysis in which flows of labor and capital in response to excess or deficient rewards in particular industries cause short-run market prices to converge to their long-run natural equilibrium, or cost-of-production, levels. At this point, rewards are equalized such that no further incentives exist for resources to move and the resulting composition of output just matches that demanded by consumers. His celebrated theory of relative wages attributes wage differentials to agreeableness of work, cost of acquiring skills, regularity of employment, trust and responsibility imposed, and probability of success in different occupations.

But it is to his free trade doctrine that his name is most durably linked. He showed that trade is a positive-sum game in which all parties gain when they buy goods from others more cheaply than they can produce themselves. Smith applied this idea to explode the protectionist fallacies of the Mercantilists and to demonstrate that free trade, by expanding

the extent of the market, promotes greater division of labor and growth. These contributions, together with the following additional insights, mark him as an exceptionally perceptive and creative economist: (1) national wealth consists of goods and services rather than the nation's stock of monetary metals; (2) gross domestic product resolves into its distributive-share components of wages, profits, and rent whose sum total is nothing less than aggregate effective demand; and (3) capital formation and technological progress, both of which support division of labor, are vital to growth.

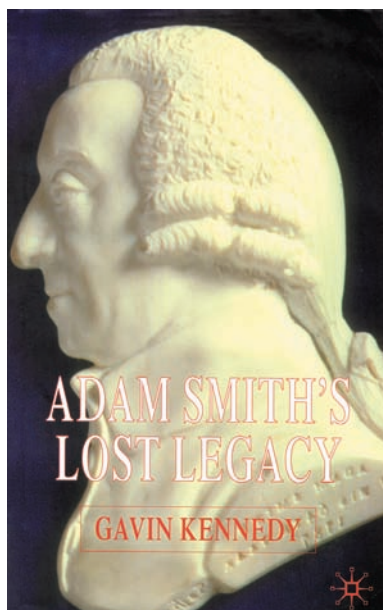
### Smith and Laissez Faire

In *Adam Smith's Lost Legacy*, Gavin Kennedy, an economist at Edinburgh Business School, touches on these contributions. But his main concern is to dispel the myth that Smith was a laissez faire zealot who believed that market failure is inconceivable and that government intervention is never needed. Actually, Smith argued that a strict policy of complete laissez faire is warranted only in the ideal state of natural liberty where free competition and perfect factor mobility prevail in all markets. Absent these conditions, market failure can occur making restorative intervention desirable.

Far from glorifying businessmen, Smith saw them, often operating in collaboration with the government, as the source of anticompetitive trade restrictions. He described how rent-seeking businessmen conspire to monopolize markets, restrict output, raise prices, and lower wages. To this end they lobby politicians to grant them exclusive privileges, legal monopolies, protective tariffs, and the like. When the

politicians, their class interests more aligned with the lobbyists than with other groups, comply, businessmen are benefited at the expense of the community at large. A government wanting to improve the welfare of all its citizens would break free from the dictates of its business petitioners and remove all restrictive practices. It would act to restore competition, not undermine it.

Kennedy further notes that far from positing a minimum caretaker ("anarchy plus the constable") role for government, Smith charged the state with such basic tasks as providing national defense, justice, enforcement of contracts, security of life and property for its citizens, and elementary education for its poor (albeit on a fee-for-performance basis to induce diligence in teaching, diligence that would



be lacking if teachers were paid a fixed stipend regardless of results). Noting that the spillover social benefits of primary schooling justify its public funding, Smith held that higher education, in which the pupils themselves capture all the benefits such that their private incentives already are aligned with the social good, merits no such funding.

The state, according to Smith, also had the duty to construct and maintain public works infrastructure in the form of roads, canals, bridges, tunnels, and harbors when these projects prove too unprofitable for private firms to undertake. Other state functions approved by Smith included the post office, public health, standards of weights and measures, coinage, regulation of the small denomination bank note issue, and imposition of interest rate ceilings so as to remove lenders' incentives to channel credit away from prudent borrowers toward riskier ones (prodigals and spendthrifts) promising potentially higher returns.

Kennedy even finds Smith occasionally approving certain state-granted monopoly privileges such as patents, copyrights, and infant-industry protection in some cases, as well as supporting tariffs levied for retaliation and bargaining purposes, not to mention navigation laws requiring British traders to ship their goods in British vessels, thus assuring the navy a plentiful reserve of sailors. Enough intervention, as one economist mischievously put it, to please a modern socialist.

What Kennedy overlooks, however, is that these were isolated exceptions to *laissez faire* rather than a wholesale rejection of it. Overall, Smith championed unfettered markets, favoring only interventions that removed market imperfections and promoted free competition. Indeed, Kennedy fails to realize that most of the interventions winning Smith's approval — provision of defense, justice, security of contract, and laws protecting the mobility of labor, and the like — were designed to bolster free markets rather than supplant them. Such reforms removed barriers impeding the efficient functioning of markets and established the necessary framework, institutional and legal, within which *laissez faire* could flourish.

In general, however, Smith was skeptical of the ability and willingness of the government to implement even these beneficial reforms. This was particularly true of the British government of his time, which he saw as corrupt, incompetent, and biased in favor of merchants and manufacturers. Worse, state officials had the temerity to believe they could do better for private individuals than those individuals, guided by their own self-interest, could do for themselves. Under these conditions, it was hardly surprising, Smith thought, to find intervention creating more monopoly power than it removed. Until the behavior of the government improved, a policy of strict nonintervention, though not theoretically the best, might in practice be the least harmful.

### Order without Design

Having dispelled one myth, Kennedy seeks to dispel another, namely that selfishness is the prime motivator of economic behavior in Smith's analysis. Not so, says Kennedy. Simplistic

popularizers of Smith confuse selfishness, or sheer unadulterated greed, with enlightened self-interest. Smith did not make that error. Smith realized that purely selfish traders would be doomed to perpetual frustration. Seeking to capture all the gains from exchange for themselves, they would set their selling prices so high and their buying prices so low that no trade would take place.

By contrast, self-interested, or Smithian, traders realize that all parties must find trade advantageous, that is, must share in the gains from exchange, if trade is to occur. Consequently, they willingly settle for a price that leaves them better off given that their trading partners are better off too. They take the welfare of their trading partners into account in their own utility functions. They do the same for people less fortunate than themselves when they form voluntary associations to help the poor. Sympathy with one's fellow man, as Smith pointed out in his *Theory of Moral Sentiments*, published in 1759, is entirely consistent with enlightened self-interest. Sympathy generates demand for justice. And justice is vital to the working of a harmonious, peaceful social order within which economic growth and opportunity for personal advancement thrive.

Such mutual interdependence of individuals operating in society is, Kennedy claims, the essence of Smith's famous analysis of man's propensity to truck, barter, and exchange. Indeed, Kennedy sees in Smith's analysis the prototype of a modern bargaining model, albeit with a difference. Unlike most modern models (for instance, Nobel laureate John Nash's) that depict only the properties of the final equilibrium state, Smith's model traces the dynamic adjustment process by which equilibrium is reached. Smith's bargainers start off by asserting their all-or-nothing bid and ask prices, both of which are unacceptable to the other side. The resulting disappointment triggers an iterative sequence of offers and counteroffers leading to the set of mutually acceptable prices where trade occurs. Cooperation — benefiting others in order to benefit one's self — is the name of the game for Smith's bargainers.

### Conclusion

The book contains some surprises. Neither Smith's notion of the division of labor as limited by the extent of the market nor his celebrated pin-factory illustration of that concept originated with him. The former he borrowed from his teacher Francis Hutcheson and the latter he took from Denis Diderot's *Encyclopédie*. Even the invisible hand metaphor dates from Shakespeare's *Macbeth* rather than from the *Wealth of Nations*.

There is some speculation. Kennedy believes that Smith's deliberate, carefully calculated planning of his career proves that he was a judicious decisionmaker rather than the bumbling, absent-minded professor of legend. Again, Kennedy conjectures that Smith, in his last years, never published his *Lectures on Jurisprudence* for fear of appearing unpatriotic. The *Lectures*, championing as they did the kind of democratic principles adopted by the United States, might have been

seen as supporting an enemy country that had just recently won its war of independence from Britain. Against Kennedy's conjecture, however, is the fact that Smith in the *Wealth of Nations* already had gone on record as favoring emancipation of the American colonies on the grounds that they as well as the mother country would benefit from such independence.

There also are some omissions. Kennedy says nothing of Smith's monetary theory. And he is silent about the tension between the division of labor and Smith's assumption of small-firm competition that operates as an invisible hand to harmonize self-interest with the common good. The tension arises because division of labor implies increasing returns to scale in production. These scale economies mean that large firms, by permitting greater scope for division of labor, possess a cost advantage over small firms and so drive them from the market, contrary to Smith's assumption. Smith did not address this contradiction, nor did anyone else until Alfred Marshall in 1890, Allyn Young in 1928, and George Stigler in 1951 tried to resolve it in their works on increasing returns, competition, and division of labor.

But these omissions do little to mar a fine book. True, Kennedy says little that scholars Jacob Viner, Andrew Skinner, D. P. O'Brien, Mark Blaug, and others haven't said before. Nevertheless, his book is a welcome addition to the literature. Its numerous, short chapters (some no longer than three or four pages) make it a convenient companion to read simultaneously with the *Theory of Moral Sentiments* and the *Wealth of Nations*. Students and other first-time readers of Smith will want to refer to it as perhaps the most accessible and accurate account available today of what Smith really meant, as opposed to what popularizers, pundits, and politicians claim he meant. Kennedy's book is a healthy antidote to these bogus interpretations. Reading him is one way to retrieve Smith's purloined legacy. **RF**

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## BOOKNOTE

### **COMMON SENSE ECONOMICS: WHAT EVERYONE SHOULD KNOW ABOUT WEALTH AND PROSPERITY**

BY JAMES D. GWARTNEY, RICHARD L. STROUP, AND DWIGHT R. LEE  
NEW YORK: ST. MARTIN'S PRESS, 2005, 194 PAGES

In general, readers should be wary of books with titles that promise to tell them, and everyone else, what they need to know about a topic. This is an impossible task. First, there is the choice of subject matter. What should be included? We live in a complex world — one in which comprehensive answers to questions are hard to find and new information is constantly being discovered, often making what was true a year ago less true or even wrong today. So where should the authors start? Just as important, where should they end?

Second, different people will open the book with different levels of knowledge. How do you successfully pitch a book to all potential readers? Some will come away thinking the way the information was presented was too basic, while others will think it was too advanced. There is a real danger that, in the attempt to satisfy everyone, you will ultimately satisfy no one.

Still, one can understand the temptation that publishers face when marketing a book. They want people to buy it, after all, and making big claims in the title will persuade some customers to make a purchase. Happily, *Common Sense Economics: What Everyone Should Know about Wealth and Prosperity* is an exception. It actually delivers the goods — well, at least most of them. Readers from various backgrounds will benefit from this book. It does an excellent job of concisely laying out basic economic principles and tying them to real-world applications at both the macro and individual levels.

Gwartney, Stroup, and Lee, economists at Florida State

University, Montana State University, and the University of Georgia, respectively, start out by discussing the conceptual building blocks of modern economics, each under a separate header, such as “Incentives Matter” and “Decisions Are Made at the Margin.” They then consider how countries become rich, explaining the importance of transparent legal systems, efficient capital markets, and monetary stability, among other things. Next they argue that the government should take a relatively hands-off approach to handling the economy, comparing it to food — both are essential but when consumed excessively can lead to serious problems. Most economists would agree with this general outlook, but some will think the authors are too fervent in their denunciation of state action.

The last section concerns personal finance. “Often, the world of investment advice appears to be totally divorced from the world of economics,” they write. “Yet the principles that lead to financial security are largely the same ones underlying a prosperous economy.” For instance, individuals, like countries, should discover their comparative advantage and invest in acquiring human capital. Finally, the authors include a helpful glossary of economic terms.

While some readers will find the book disappointing, many more, I believe, will find it a useful guide to better understanding the world around them. If so, the publishers can be forgiven for the hyperbolic title.

— AARON STEELMAN

