

## Chapter 2

# Adam Smith and the Free Market

**Abstract** In this chapter I show Adam Smith's great admiration for the new free market economy that is exemplified by his report on the enormous productivity of the pin-factory. Smith attributes this great productivity to the division of labor which allows workers to specialize and which encourages them, out of self-interest, to look for machines to help in their work. On the demand side, the new economy relies on the human tendency to barter where self-interest replaces friendship as the means to get what one wants. This tendency to barter entices the system to produce what people want at the cheapest possible price. This is, according to Smith, the presence of a kind of "invisible hand." It is not the result of a (government) plan. Next, I show that Smith, provides an argument that the help of the government is needed in the case of the provision of roads thereby prefiguring the modern concept of public goods. I show how Smith anticipates the modern concept of merit good in his discussion of education, monopolies and the need of governmental control of banking. Smith even discusses the danger of lobbying to influence the regulatory power of the state.

**Keywords** Adam Smith • The new economy • Self-interest • Tendency to barter • Invisible hand • Public goods • Merit goods • Function of the government • Banking regulations • Lobbying

### 2.1 Introduction

In preparation for our reflections on the financial crisis of 2007–2008 and the subsequent recession, I would like to highlight some of the most important insights that Adam Smith has given us about the new emerging economy of his time, now referred to as the free market economy or capitalism. Adam Smith's text, of course, provides elegantly formulated arguments for a free market liberated from undue interference by the government.

Adam Smith's text, however, also gives convincing arguments for a humble helping function for the government. Thus, where individuals are not motivated by their self-interest to pay for a service which is beneficial for the whole society,

then, so argues Smith, the government should help. But the government should provide the help in such a way that the ones who benefit directly from the service and benefit the most are forced to pay relatively the most. Modern economic theory has developed this insight into the technical problem of the efficient and just provision of public goods: i.e., goods which many can enjoy without the enjoyment of another consumer diminishing the enjoyment of the first but where the enjoyment is possible as soon as one consumer has bought the service without the possibility of excluding the non-paying consumer. These two curious characteristics of some economic goods are, in contemporary economic theory, referred to as being non-rival in consumption and being non-excludable. Adam Smith already saw that public goods could be provided in such a way that the self-interest of all consumers was respected, even if the help of the government might be necessary to provide the service.

Adam Smith also argues that in some cases the government can, on moral grounds, overrule the self-interest of consumers. Thus, he advocates the idea that the government should provide help for the education of the poor because that is the right thing to do. Clearly, in such a case, the principle that the benefitting consumer should pay does not apply. Adam Smith then provides a new method of paying: i.e., ability to pay. Centuries later, Richard Musgrave created a name for such goods and called them merit goods. Indeed, Musgrave defined merit goods as goods that are so meritorious that there are morally legitimate reasons for interference with consumer sovereignty. When Adam Smith advocates the idea that banking should be regulated in order to safeguard the banking system we see in that argument another clear example of Musgrave's concept of merit good (Smith, 308 and 313).

The opposite of merit goods are called demerit goods. Demerit goods are goods which have such detrimental effects that there are moral reasons for interfering with consumer sovereignty in order to diminish the level of consumption of such goods. Many problems have been raised in the economic literature about the validity (McLure; Wildavsky) and the applicability (Mackscheidt; Head; Folkers; Brennan & Lomasky) of this new concept. In a subsequent chapter I argue that there are eleven domains where the government has moral grounds to impose a regulatory function on the free market. I will also show how Rajan uses seven of these categories to explain the financial crisis of 2007–2008 and the subsequent recession. Let us, however, return to Adam Smith.

## **2.2 Adam Smith's Admiration for the Productivity of the New Economy**

Adam Smith was overwhelmingly impressed by the new free market economy of his time. This impression was the incident that caused him to think about the principles that made the new economy so successful. As I want to make use of Adam Smith to develop the principles that we should be using in order to analyze our contemporary economy, I want to quote Adam Smith rather than paraphrase him.

Adam Smith exemplified the enormous success of the new economy by means of the example of the pin factory. Here is his enthusiastic description of his observation:

To take an example, therefore, from a very trifling manufacture; but one in which the division of labour has been very often taken notice of, the trade of the pin-maker; a workman not educated to this business (which the division of labour has rendered a distinct trade), nor acquainted with the use of the machinery employed in it (to the invention of which the same division of labour has probably given occasion), could scarce, perhaps, with his utmost industry, make one pin in a day, and certainly could not make twenty. But in the way in which this business is now carried on, not only the whole work is a peculiar trade, but it is divided into a number of branches, of which the greater part are likewise peculiar trades. One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which, in some manufactories, are all performed by distinct hands, though in others the same man will sometimes perform two or three of them. I have seen a small manufactory of this kind where ten men only were employed, and where some of them consequently performed two or three distinct operations. But though they were very poor, and therefore but indifferently accommodated with the necessary machinery, they could, when they exerted themselves, make among them about twelve pounds of pins in a day. There are in a pound upwards of four thousand pins of a middling size. Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day. Each person, therefore, making a tenth part of forty-eight thousand pins, might be considered as making four thousand eight hundred pins in a day. But if they had all wrought separately and independently, and without any of them having been educated to this peculiar business, they certainly could not each of them have made twenty, perhaps not one pin in a day; that is, certainly, not the two hundred and fortieth, perhaps not the four thousand eight hundredth part of what they are at present capable of performing, in consequence of a proper division and combination of their different operations (4–5).

### 2.3 Adam Smith on the Production Side of the New Economy

Adam Smith's first conclusion concentrates upon the production side of the new economy. He will later pay attention to the demand side of the economy.

Adam Smith stresses the fact that the new economy has miraculous productivity and he connects that productivity with the division of labor. He observes that: "The division of labour, however, so far as it can be introduced, occasions, in every art, a proportionable increase of the productive powers of labour"(5). Adam Smith then argues that:

This great increase of the quantity of work which, in consequence of the division of labour, the same number of people are capable of performing, is owing to three different circumstances; first to the increase of dexterity in every particular workman; secondly, to the saving of the time which is commonly lost in passing from one species of work to another; and lastly, to the invention of a great number of machines which facilitate and abridge labour, and enable one man to do the work of many (5).

Adam Smith pays special attention to the third point. For the first time, he here connects the idea of economic productivity with the miraculous incentive created by self-interest. He does so by the plausible, but probably mythical, story of the boy who wanted more play time and invented an improvement of the engine not for the greater profitability of the factory where he worked but for his own self-interest in more playtime. This is a humble introduction of an idea which he later will make a general principle when writing: “he intends only his own gain, and he is in this, as in many other case, led by an invisible hand to produce an end which was no part of his intention” (423).

About the connection between self-interest and the invention of better or new machines he writes:

I shall only observe, therefore, that the invention of all those machines by which labour is so much facilitated and abridged, seems to have been originally owing to the division of labour. Men are much more likely to discover easier and readier methods of attaining any object, when the whole attention of their minds is directed towards that single object, than when it is dissipated among a great variety of things. But in consequence of the division of labour, the whole of every man's attention comes naturally to be directed towards some one very simple object. It is naturally to be expected, therefore, that some one or other of those who are employed in each particular branch of labour should soon find out easier and readier methods of performing their own particular work, wherever the nature of it admits of such improvement. A great part of the machines made use of in those manufactures in which labour is most subdivided, were originally the inventions of common workmen, who, being each of them employed in some very simple operation, naturally turned their thoughts towards finding out easier and readier methods of performing it. Whoever has been much accustomed to visit such manufactures, must frequently have been shewn very pretty machines, which were the inventions of such workmen, in order to facilitate and quicken their own particular part of the work. In the first fire-engines, a boy was constantly employed to open and shut alternately the communication between the boiler and the cylinder, according as the piston either ascended or descended. One of those boys, who loved to play with his companions, observed that, by tying a string from the handle of the valve which opened this communication, to another part of the machine, the valve would open and shut without his assistance, and leave him at liberty to divert himself with his play-fellows. One of the greatest improvements that has been made upon this machine, since it was first invented, was in this manner the discovery of a boy who wanted to save his own labour (9).

While meditating about the great productivity of the new economy Adam Smith makes an economic, a sociological and a world historical observation. The economic observation made by Smith is that this division of labor multiplies the need for exchange. Thus he writes:

It is the great multiplication of the productions of all the different arts, in consequence of the division of labour, which occasions, in a well-governed society, that universal opulence which extends itself to the lowest ranks of the people. Every workman has a great quantity of his own work to dispose of beyond what he himself has occasion for; and every other workman being exactly in the same situation, he is enabled to exchange a great quantity of his own goods for a great quantity, or, what comes to the same thing, for the price of a great quantity of theirs (11).

The sociological observation Smith makes is that everybody in a society with the new economy is better off, and presumably necessarily so. This crucial

observation and/or conclusion will appear again later and is important to keep in mind. Adam Smith writes:

He [every workman] supplies them [every other workman] abundantly with what they have occasion for, and they accommodate him as amply with what he has occasion for, and a general plenty diffuses itself through all the different ranks of the society (11).

The world historical observation, even if done in a discriminatory tone not acceptable today, is that in the new economy a frugal peasant is better off than an African king. Here is how Smith says it:

Compared, indeed, with the more extravagant luxury of the great, his accommodation must no doubt appear extremely simple and easy; and yet it may be true, perhaps, that the accommodation of an European prince does not always so much exceed that of an industrious and frugal peasant, as the accommodation of the latter exceeds that of many an African king, the absolute master of the lives and liberties of ten thousand naked savages (12).

Before reflecting on the demand side of the new economy, Adam Smith again anticipates the principle of the “invisible hand.” He writes: “This division of labour, from which so many advantages are derived, is not originally the effect of any human wisdom, which foresees and intends that general opulence to which it gives occasion” (13).

## 2.4 Adam Smith and the Demand Side of the New Economy

Adam Smith next turns to the demand side of the new economy. He points to the idea of bartering within the context of a contractual exchange as central for thinking about the demand side of the new economy. He writes that the new economy is not the result of human wisdom or planning but rather results from “the propensity to truck, barter, and exchange one thing for another” (13). He then further specifies that this tendency to barter

is common to all men, and to be found in no other race of animals, which seem to know neither this nor any other species of contracts. Two greyhounds, in running down the same hare, have sometimes the appearance of acting in some sort of concert. Each turns her towards his companion, or endeavours to intercept her when his companion turns her towards himself. This, however, is not the effect of any contract, but of the accidental concurrence of their passions in the same object at that particular time. Nobody ever saw a dog make a fair and deliberate exchange of one bone for another with another dog. Nobody ever saw one animal by its gestures and natural cries signify to another, this is mine, that yours; I am willing to give this for that (13).

Adam Smith makes some additional observations upon the role of bartering in the new economy; first, he points out that without the tendency or the willingness to barter, the productive miracle of the new economy would not make sense. He writes:

without the disposition to truck, barter, and exchange, every man must have procured to himself every necessary and conveniency of life which he wanted. All must have

had the same duties to perform, and the same work to do, and there could have been no such difference of employment as could alone give occasion to any great difference of talents (16).

But with the tendency to barter, everybody can make use of the skills and productivity of everybody else. Adam Smith says it this way:

the most dissimilar geniuses are of use to one another; the different produces of their respective talents, by the general disposition to truck, barter, and exchange, being brought, as it were, into a common stock, where every man may purchase whatever part of the produce of other men's talents he has occasion for (16).

Second, Smith in two steps introduces the idea that the new economy requires a new social ethic. That new ethic cannot be based on the Christian idea of love and friendship but must be based on that non-Christian idea of self-interest. The inability to use friendship as the basis of the motivation for the new economy is demonstrated by a simple common sense observation. Smith writes:

In civilized society he stands at all times in need of the cooperation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons. In almost every other race of animals each individual, when it is grown up to maturity, is entirely independent, and in its natural state has occasion for the assistance of no other living creature. But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only (14).

Having shown that the new economy cannot depend on friendship, love or benevolence, Adam Smith reintroduces as basic motive on the demand side of the economy the same motive he found to be so central on the production side: self-interest. He says it this way:

Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. 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. Nobody but a beggar chuses to depend chiefly upon the benevolence of his fellow-citizens (14).

Adam Smith thus corrects Hobbes. Both agree that human beings can be and, de facto unavoidably are, competitors if not enemies. However, Adam Smith sees that the tendency to barter within an environment of socially protected contracts avoids the need for deadly Hobbesian competition and replaces it with the co-operative competition of the new economy.

Adam Smith then reflects on what could be an obstacle for the indefinite expansion of the benefits of the new economy. He asks the simple question as to what people will do with the ever increasing amount of goods that this new productive economy is producing. Adam Smith says it this way:

As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market. 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 (17).

Adam Smith then links the extent of the market to the availability of cheap transportation which allows for more people to exchange products without the cost of transportation thus making the products excessively expensive. He then points out that waterways have often been the natural way of providing cheap transportation. In a beautiful summary Smith states:

In Bengal the Ganges and several other great rivers form a great number of navigable canals in the same manner as the Nile does in Egypt. In the Eastern provinces of China too, several great rivers form, by their different branches, a multitude of canals, and by communicating with one another afford an inland navigation much more extensive than that either of the Nile or the Ganges, or perhaps than both of them put together. It is remarkable that neither the ancient Egyptians, nor the Indians, nor the Chinese, encouraged foreign commerce, but seem all to have derived their great opulence from this inland navigation.

All the inland parts of Africa, and all that part of Asia which lies any considerable way north of the Euxine and Caspian seas, the ancient Scythia, the modern Tartary and Siberia, seem in all ages of the world to have been in the same barbarous and uncivilized state in which we find them at present. The sea of Tartary is the frozen ocean which admits of no navigation, and though some of the greatest rivers in the world run through that country, they are at too great a distance from one another to carry commerce and communication through the greater part of it. There are in Africa none of those great inlets, such as the Baltic and Adriatic seas in Europe, the Mediterranean and Euxine seas in both Europe and Asia, and the gulfs of Arabia, Persia, India, Bengal, and Siam, in Asia, to carry maritime commerce into the interior parts of that great continent: and the great rivers of Africa are at too great a distance from one another to give occasion to any considerable inland navigation (20–21).

The limited availability of transportation by water naturally poses the question of other means of transportation. This will allow Adam Smith to give the government a modest and limited role in the new economy. The government should play a role in the provision of infrastructure needed for the new economy, particularly roads.

## 2.5 Adam Smith's General Principles for a Productive Economy

While making astute observations about the new productive economy, Adam Smith inductively introduces general principles which can explain the productivity of the new economy. These general principles will then become normative for the idea of the free market. A first such general principle is the idea that government intervention in the economy is mostly counterproductive. Smith comes to such a conclusion in two steps. First, he analyzes the economic effects of the human tendency to barter and, simultaneously, to keep their self-interest in mind. Second, he studies the historical periods where the government managed the economy by either mercantilist or physiocratic principles.

When analyzing the human tendency to barter, Adam Smith argues that human beings will offer to pay more for goods they want and that are in short supply. He also argues that producers will be forced to accept a lower price for goods that are



overproduced in order to be able to sell them. Smith thus argues that self-interest in exchange will entice everybody to produce most efficiently what everybody wants. This is how Smith says it:

The market price of every particular commodity is regulated by the proportion between the quantity which is actually brought to market, and the demand of those who are willing to pay the natural price of the commodity, or the whole value of the rent, labour, and profit, which must be paid in order to bring it thither. Such people may be called the effectual demanders, and their demand the effectual demand; since it may be sufficient to effectuate the bringing of the commodity to market. It is different from the absolute demand. A very poor man may be said in some sense to have a demand for a coach and six; he might like to have it; but his demand is not an effectual demand, as the commodity can never be brought to market in order to satisfy it.

When the quantity of any commodity which is brought to market falls short of the effectual demand, all those who are willing to pay the whole value of the rent, wages, and profit, which must be paid in order to bring it thither, cannot be supplied with the quantity which they want. Rather than want it altogether, some of them will be willing to give more. A competition will immediately begin among them, and the market price will rise more or less above the natural price, according as either the greatness of the deficiency, or the wealth and wanton luxury of the competitors, happen to animate more or less the eagerness of the competition. Among competitors of equal wealth and luxury the same deficiency will generally occasion a more or less eager competition, according as the acquisition of the commodity happens to be of more or less importance to them. Hence the exorbitant price of the necessities of life during the blockade of a town or in a famine (56).

Adam Smith then develops the second part of his argument for limited government when he analyzes the different systems of political economy which preceded the new economy in book five of *The Wealth of Nations*: the Mercantile system and what Smith calls the Agricultural system or what is known nowadays as the Physiocratic system. After having demonstrated the deficiencies of these two government policies which justified the intervention in economics, Adam Smith generalizes his own conclusion as follows:

It is thus that every system which endeavours, either by extraordinary encouragements to draw towards a particular species of industry a greater share of the capital of the society than what would naturally go to it, or, by extraordinary restraints, force from a particular species of industry some share of the capital which would otherwise be employed in it, is in reality subversive of the great purpose which it means to promote. It retards, instead of accelerating, the progress of the society towards real wealth and greatness; and diminishes, instead of increasing, the real value of the annual produce of its land and labour (650–651).

The above analysis invites Smith then to give a laudatory statement for the new economic system of full free enterprise. He says it eloquently as follows:

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. 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 (651).



Let us notice some strong conclusions. First, Adam Smith forcefully argues that the government has generally no constructive role to play in the new miraculously efficient economy based on division of labor and self-interested bartering. If the government has nevertheless a possible function it will have to be argued for sharply. We will provide later Smith's arguments for two categories of justified government roles: i.e., proper provision of public goods and interference for the provision of merit goods. Second, Smith makes the assumption that once the government stops meddling with the economy then "the obvious and simple system [of natural liberty of the new free market economy] establishes itself of its own accord" (651). Third, Adam Smith puts one explicit limit to the pursuit of self-interest namely the "laws of justice" (651). And where the neo-liberals will show that cartels and trusts are a permanent danger to the new economy, there Smith softly suggests that monopolies might be regulated. Thus he writes: "upon the expiration of the term [of a patent], the monopoly ought to determine ["to determine" means "to end"]" (712). Smith goes on to say:

By a perpetual monopoly, all the other subjects of the state are taxed very absurdly in two different ways; first, by the high price of goods, which, in the case of free trade, they could buy much cheaper; and, secondly, by their total exclusion from a branch of business, which it might be both convenient and profitable for many of them to carry on (Ibid).

He then makes the proposal that "where there is an exclusive corporation, it may perhaps be proper to regulate the price of the first necessary of life [i.e., bread]" (142). But Smith immediately expresses his opinion that a free competitive market will do better. Thus he writes: "But where there is none [i.e., an exclusive corporation], the competition will regulate it much better than any assize." (Ibid).

## 2.6 Adam Smith About Some Necessary Functions for the Government

We should notice that Adam Smith amends his laudatory statement for the new free market economy with a simple caveat. There are things the government has to do. Smith enumerates three functions for the government: defense against foreign invasions; guaranteeing justice for one's own citizens; and the provision of public works. All three of which are more likely the wealthier a nation is. This is how Smith formulates it:

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 societies; secondly, the duty of protecting, as far as possible, every member of the 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 institutions which it can never be for the

interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society (651).

When Adam Smith discusses the method of payment for government services he gives a slightly larger series of government functions. Here is that larger list of government functions:

The expense of defending the society, and that of supporting the dignity of the chief magistrate, are both laid out for the general benefit of the whole society. It is reasonable, therefore, that they should be defrayed by the general contribution of the whole society, all the different members contributing, as nearly as possible, in proportion to their respective abilities.

The expense of the administration of justice, too, may, no doubt, be considered as laid out for the benefit of the whole society. There is no impropriety, therefore, in its being defrayed by the general contribution of the whole society. The persons, however, who gave occasion to this expense are those who, by their injustice in one way or another, make it necessary to seek redress or protection from the courts of justice. The persons again most immediately benefited by this expense are those whom the courts of justice either restore to their rights or maintain in their rights. The expense of the administration of justice, therefore, may very properly be defrayed by the particular contribution of one or other, or both, of those two different sets of persons, according as different occasions may require, that is, by the fees of court. It cannot be necessary to have recourse to the general contribution of the whole society, except for the conviction of those criminals who have not themselves any estate or fund sufficient for paying those fees.

Those local or provincial expenses of which the benefit is local or provincial (what is laid out, for example, upon the police of a particular town or district) ought to be defrayed by a local or provincial revenue, and ought to be no burden upon the general revenue of the society. It is unjust that the whole society should contribute towards an expense of which the benefit is confined to a part of the society.

The expense of maintaining good roads and communications is, no doubt, beneficial to the whole society, and may, therefore, without any injustice, be defrayed by the general contribution of the whole society. This expense, however, is most immediately and directly beneficial to those who travel or carry goods from one place to another, and to those who consume such goods. The turnpike tolls in England, and the duties called peages in other countries, lay it altogether upon those two different sets of people, and thereby discharge the general revenue of the society from a very considerable burden.

The expense of the institutions for education and religious instruction is likewise, no doubt, beneficial to the whole society, and may, therefore, without injustice, be defrayed by the general contribution of the whole society. This expense, however, might perhaps with equal propriety, and even with some advantage, be defrayed altogether by those who receive the immediate benefit of such education and instruction, or by the voluntary contribution of those who think they have occasion for either the one or the other.

When the institutions or public works which are beneficial to the whole society either cannot be maintained altogether, or are not maintained altogether by the contribution of such particular members of the society as are most immediately benefited by them, the deficiency must in most cases be made up by the general contribution of the whole society. The general revenue of the society, over and above defraying the expense of defending the society, and of supporting the dignity of the chief magistrate, must make up for the deficiency of many particular branches of revenue (767–768).

Besides adding the duty to support the chief magistrate, Adam Smith also adds the duty of providing education and religious instruction. In this latter quotation we find that Adam Smith introduces two different principles for financing the many functions of the government: the first principle is described for defending the society and for the financing of the “dignity of the chief magistrate” and also applies, at least partially, for the administration of justice and education. Here is Smith’s articulation of that principle for paying for the costs of these government services: they are “laid out for the general benefit of the whole society,” (767) hence “they should be defrayed by the general contribution of the whole society, all the different members contributing, as nearly as possible, in proportion to their respective abilities” (767). The second principle which applies for maintaining good roads and communication is described as follows:

This expense, however, is most immediately and directly beneficial to those who travel or carry goods from one place to another, and to those who consume such goods. The turnpike tolls in England, and the duties called peages in other countries, lay it altogether upon those two different sets of people, and thereby discharge the general revenue of the society from a very considerable burden (767).

The second principle is what is now called the principle of financing “public goods.” According to that principle individuals should pay according to their benefit of the service. Such financing has its technical difficulties, but obeys where possible Smith’s principle of bartering: “Do ut des.” The first principle is a totally different method of paying for government services. It does not connect one’s utility of the service to the amount one is charged. Instead one is charged according to ability to pay. In this case the much praised principle of self-interest cannot be called upon to justify the imposition of payments. Instead Smith appeals to another principle: the payment is laid out for a service which is to “the general benefit of the whole society” (767). Adam Smith provides specific justifications for defense and education. Adam Smith presents the argument that in the case of training for defense or in giving education, the government is providing a good worthy of itself. Adam Smith explicitly excludes the utility calculus for these goods. Thus about cowardice which is countered by training for defense, Adam Smith writes the following:

But a coward, a man incapable either of defending or of revenging himself, evidently wants one of the most essential parts of the character of a man. He is as much mutilated and deformed in his mind as another is in his body, who is either deprived of some of its most essential members, or has lost the use of them. He is evidently the more wretched and miserable of the two; because happiness and misery, which reside altogether in the mind, must necessarily depend more upon the healthful or unhealthful, the mutilated or entire state of the mind, than upon that of the body. Even though the martial spirit of the people were of no use towards the defence of the society, yet to prevent that sort of mental mutilation, deformity, and wretchedness, which cowardice necessarily involves in it, from spreading themselves through the great body of the people, would still deserve the most serious attention of government, in the same manner as it would deserve its most serious attention to prevent a leprosy or any other loathsome and offensive disease, though neither mortal nor dangerous, from spreading itself among them, though perhaps no other public good might result from such attention besides the prevention of so great a public evil (739).

And about the need for education, Adam Smith has this to say:

The same thing may be said of the gross ignorance and stupidity which, in a civilized society, seem so frequently to benumb the understandings of all the inferior ranks of people. A man without the proper use of the intellectual faculties of a man, is, if possible, more contemptible than even a coward, and seems to be mutilated and deformed in a still more essential part of the character of human nature. Though the state was to derive no advantage from the instruction of the inferior ranks of people, it would still deserve its attention that they should not be altogether uninstructed (739–740).<sup>1</sup>

We feel that this group of services neatly fits the category of goods described by Musgrave as “merit” or “demerit” goods. They have moral value and do not respect the self-interest principle in the financing method. Adam Smith in several specific cases of what we like to call merit good provisions explicitly mentions either the limitations of self-interest or the limitations of freedom in describing the provision of such services. Thus about education and training for defense he writes:

The public can impose upon almost the whole body of the people the necessity of acquiring those most essential parts of education, by obliging every man to undergo an examination or probation in them before he can obtain the freedom in any corporation, or be allowed to set up any trade either in a village or town corporate.

It was in this manner, by facilitating the acquisition of their military and gymnastic exercises, by encouraging it, and even by imposing upon the whole body of the people the necessity of learning those exercises, that the Greek and Roman republics maintained the martial spirit of their respective citizens” (738).

Adam Smith makes a similar argument about property rights. He writes:

The acquisition of valuable and extensive property, therefore, necessarily requires the establishment of civil government. Where there is no property, or at least none that exceeds the value of 2 or 3 days labour, civil government is not so necessary.

Civil government supposes a certain subordination. But as the necessity of civil government gradually grows up with the acquisition of valuable property, so the principal causes which naturally introduce subordination gradually grow up with the growth of that valuable property (670).

Or even more sharply: “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” (674).

It is worth noting, in light of the financial crisis of 2007–2008, that Adam Smith himself advocates also certain limitations on the banks. Thus he writes:

Where the issuing of bank notes for such very small sums is allowed and commonly practised, many mean people are both enabled and encouraged to become bankers. A person

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<sup>1</sup> James Stanfield wrote a brief and perceptive article on several aspects of Smith’s views on education. See: [http://research.ncl.ac.uk/egwest/articles/ieaarticles/Adam\\_Smith\\_on\\_Education.pdf](http://research.ncl.ac.uk/egwest/articles/ieaarticles/Adam_Smith_on_Education.pdf)

whose promissory note for five pounds, or even for twenty shillings, would be rejected by everybody, will get it to be received without scruple when it is issued for so small a sum as a sixpence. But the frequent bankruptcies to which such beggarly bankers must be liable may occasion a very considerable inconvenience, and sometimes even a very great calamity to many poor people who had received their notes in payment.

It were better, perhaps, that no bank notes were issued in any part of the kingdom for a smaller sum than five pounds. Paper money would then, probably, confine itself, in every part of the kingdom, to the circulation between the different dealers, as much as it does at present in London, where no bank notes are issued under ten pounds value; five pounds being, in most parts of the kingdom, a sum which, though it will purchase, little more than half the quantity of goods, is as much considered, and is as seldom spent all at once, as ten pounds are amidst the profuse expense of London (307).

Adam Smith explicitly acknowledges that these restraints are a limitation on freedom, but he justifies them in the name of the good of the banking system as a whole. Here is how he explains his worry and simultaneously his defense for banking regulations:

To restrain private people, it may be said, from receiving in payment the promissory notes of a banker, for any sum whether great or small, when they themselves are willing to receive them, or to restrain a banker from issuing such notes, when all his neighbours are willing to accept of them, is a manifest violation of that natural liberty which it is the proper business of law not to infringe, but to support. Such regulations may, no doubt, be considered as in some respects a violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments, of the most free as well as of the most despotical. The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty exactly of the same kind with the regulations of the banking trade which are here proposed (308).

Adam Smith then almost boastingly reports what he sees as the great achievement of imposing this limited restraint on banking:

A paper money consisting in bank notes, issued by people of undoubted credit, payable upon demand without any condition, and in fact always readily paid as soon as presented, is, in every respect, equal in value to gold and silver money; since gold and silver money can at any time be had for it. Whatever is either bought or sold for such paper must necessarily be bought or sold as cheap as it could have been for gold and silver (308).

Adam Smith finishes his reflections on banking by putting his advocated restrictions on banking as a minor exception within the overall rule of free competition being the ideal for the new economy. He says it this way:

If bankers are restrained from issuing any circulating bank notes, or notes payable to the bearer, for less than a certain sum, and if they are subjected to the obligation of an immediate and unconditional payment of such bank notes as soon as presented, their trade may, with safety to the public, be rendered in all other respects perfectly free. The late multiplication of banking companies in both parts of the United Kingdom, an event by which many people have been much alarmed, instead of diminishing, increases the security of the public. It obliges all of them to be more circumspect in their conduct, and, by not extending their currency beyond its due proportion to their cash, to guard themselves against those malicious runs which the rival ship of so many competitors is always ready to bring upon them. It restrains the circulation of each particular company within a narrower circle, and reduces their circulating notes to a smaller number.

By dividing the whole circulation into a greater number of parts, the failure of any one company, an accident which, in the course of things, must sometimes happen, becomes of less consequence to the public. This free competition, too, obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away. In general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so (313).

## 2.7 Adam Smith and Ethical Expectation of the New Economy

We also find in Adam Smith the idea that the raising of income for the working class must be considered a good thing for the whole society since the working class is the majority of the people and what is good for the majority [and does not hurt other people]<sup>2</sup> cannot be bad for the society as a whole. Adam Smith thus puts forward a humanistic goal for the economy which is splendidly fulfilled by the new economy: improve the lives of everybody including the poor by a steady economic growth. Thus he writes:

The common complaint that luxury extends itself even to the lowest ranks of the people, and that the labouring poor will not now be contented with the same food, clothing and lodging which satisfied them in former times, may convince us that it is not the money price of labour only, but its real recompense, which has augmented.

Is this improvement in the circumstances of the lower ranks of the people to be regarded as an advantage or as an inconveniency to the society? The answer seems at first sight abundantly plain. Servants, labourers and workmen of different kinds, make up the far greater part of every great political society. But what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they who feed, cloth and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, clothed and lodged (78–79).

Adam Smith stresses the role of a growing economy for the well being of the poor when he writes:

It deserves to be remarked, perhaps, that it is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the labouring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state. The progressive state is in reality the cheerful and the hearty state to all the different orders of the society. The stationary is dull; the declining melancholy (81).

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<sup>2</sup> This exception is not explicitly stated in Adam Smith. We need to add it to make the principle plausible. But I believe that Smith's line of thinking is compatible with the exception I included.

## 2.8 Adam Smith About Social Classes and Lobbying

Adam Smith was also aware that his society was not monolithic. He saw at least three different classes with different interests, that sometimes coincided with that of the whole society and sometimes not, and that these different groups were very different in the forcefulness and shrewdness by which they were putting forth their own interest even if it was against the well-being of the society as a whole. Here is what Smith wrote:

The whole annual produce of the land and labour of every country, or what comes to the same thing, the whole price of that annual produce, naturally divides itself, it has already been observed, into three parts; the rent of land, the wages of labour, and the profits of stock; and constitutes a revenue to three different orders of people; to those who live by rent, to those who live by wages, and to those who live by profit. These are the three great, original and constituent orders of every civilized society, from whose revenue that of every other order is ultimately derived.

The interest of the first of those three great orders, it appears from what has been just now said, is strictly and inseparably connected with the general interest of the society. Whatever either promotes or obstructs the one, necessarily promotes or obstructs the other. When the public deliberates concerning any regulation of commerce or police, the proprietors of land never can mislead it, with a view to promote the interest of their own particular order; at least, if they have any tolerable knowledge of that interest. They are, indeed, too often defective in this tolerable knowledge. They are the only one of the three orders whose revenue costs them neither labour nor care, but comes to them, as it were, of its own accord, and independent of any plan or project of their own. That indolence, which is the natural effect of the ease and security of their situation, renders them too often, not only ignorant, but incapable of that application of mind which is necessary in order to foresee and understand the consequences of any public regulation.

The interest of the second order, that of those who live by wages, is as strictly connected with the interest of the society as that of the first. The wages of the labourer, it has already been shewn, are never so high as when the demand for labour is continually rising, or when the quantity employed is every year increasing considerably. When this real wealth of the society becomes stationary, his wages are soon reduced to what is barely enough to enable him to bring up a family, or to continue the race of labourers. When the society declines, they fall even below this. The order of proprietors may, perhaps, gain more by the prosperity of the society, than that of labourers: but there is no order that suffers so cruelly from its decline. But though the interest of the labourer is strictly connected with that of the society, he is incapable either of comprehending that interest, or of understanding its connection with his own. His condition leaves him no time to receive the necessary information, and his education and habits are commonly such as to render him unfit to judge even though he was fully informed. In the public deliberations, therefore, his voice is little heard and less regarded, except upon some particular occasions, when his clamour is animated, set on, and supported by his employers, not for his, but their own particular purposes.

His employers constitute the third order, that of those who live by profit. It is the stock that is employed for the sake of profit, which puts into motion the greater part of the useful labour of every society. The plans and projects of the employers of stock regulate and direct all the most important operations of labour, and profit is the end proposed by all those plans and projects. But the rate of profit does not, like rent and wages, rise with the prosperity, and fall with the declension of the society. On the contrary, it is naturally low in rich, and high in poor countries, and it is always highest in the countries which



are going fastest to ruin. The interest of this third order, therefore, has not the same connection with the general interest of the society as that of the other two. Merchants and master manufacturers are, in this order, the two classes of people who commonly employ the largest capitals, and who by their wealth draw to themselves the greatest share of the public consideration. As during their whole lives they are engaged in plans and projects, they have frequently more acuteness of understanding than the greater part of country gentlemen. As their thoughts, however, are commonly exercised rather about the interest of their own particular branch of business, than about that of the society, their judgment, even when given with the greatest candour (which it has not been upon every occasion) is much more to be depended upon with regard to the former of those two objects, than with regard to the latter. Their superiority over the country gentleman is, not so much in their knowledge of the public interest, as in their having a better knowledge of their own interest than he has of his. It is by this superior knowledge of their own interest that they have frequently imposed upon his generosity, and persuaded him to give up both his own interest and that of the public, from a very simple but honest conviction, that their interest, and not his, was the interest of the public. The interest of the dealers, however, in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they naturally would be, to levy, for their own benefit, an absurd tax upon the rest of their fellow-citizens. 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 to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it" (248–250).

Adam Smith thus warns against

The proposal of any new law or regulation of commerce which comes from this order (the employers), 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 (250).

I think we can interpret this warning as a warning against all proposals to change—or even not properly adapt—governmental regulations of the economy. One needs to be specifically alert if the proposal comes from a group whose interest in the case is in conflict with that of the society as a whole. One needs to be super alert if it comes from a group with shrewd power to influence the government. Adam Smith identified deep knowledge of the economic situation as being an important element in the power to influence the government.

## 2.9 Conclusion

We have seen that Adam Smith greatly admired the productivity of the new economic order he observed. He considered the division of labor a crucial factor in the great productivity of the new economic order. This division of labor made

human beings all more dependent upon each other. Human beings produced very efficiently what they specialized in, but they needed to find other human beings with whom to exchange what they had in abundance with what they lacked. On the production side, self-interest pushed human beings to be productive as they were the beneficiaries of their efficiency. On the consumption side, people could count on the self-interest of the producers to offer the products they wanted. Thus self-interest replaced friendship as the reliable motive for the new economy. Furthermore, the self-interest of both the consumers and the producers encouraged the production of what people wanted because of the latter's willingness to pay. Thus Adam Smith presents the free market as the system forced to be efficient on the basis of the self-interest motive of the economic actors.

Adam Smith then demonstrates the inefficiencies of economic systems in which the government systematically interferes in economic matters, like Mercantilism and the Physiocratic economic system. The main theme of Adam Smith in his *The Wealth of Nations* is thus that the free market is efficient without the government and that economic systems where the government is involved are inefficient.

However, Adam Smith also presents a second line of thought. Thus he argues that the miracle of productive efficiency of the new economy is limited by the extent of the market. Smith even states that "to widen the market may frequently be agreeable to the interest of the publick" (250). And the market can be increased by proper transportation. This allows Adam Smith to argue that the government can provide a helping role. He then sketches the beginnings of the modern economic theory of public goods provision.

Adam Smith also introduces the idea of merit goods: i.e., goods which are so good that the government can interfere with the preferences of consumers. For such goods Adam Smith provides moral arguments such as the argument for education and for military training in order to instill courage and avoid cowardice. He also proposes a different justification for the financing of merit goods than the one he proposed for public goods. And as part of a meritorious economy Adam Smith points to the expectation that the working class too should benefit from the increased productivity of the new economy.

Finally, Adam Smith warns against what we would now call lobbying efforts.

We believe that this balanced view of the free market economy can provide us the intellectual framework to understand some of the most sophisticated analyses of the financial crisis of 2007–2008 and the subsequent depression.

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