Chapter 5

Making and working

The *Wealth of Nations* is a big book. The definitive Glasgow edition has two volumes with over 900 pages in total. It was a long time in the making. Published in 1776 its roots can with certainty be traced back to Smith's lectures at Glasgow University in the 1750s. His thinking was subsequently shaped by his time in France, where he met several thinkers working on related themes. He also received practical information from merchants in Glasgow and landowners in Scotland. Thanks to the generous pension from the family of the Duke of Buccleuch, he was able on his return from France to focus on composing the book. This took several years which were largely spent with his mother in Kirkcaldy.

The *Wealth of Nations* is the most famous book in the history of economics because it was 'the father of modern economic thinking'. Its fame rests on it being the first systematic analysis of what Smith called 'commercial society' (the term 'capitalism' is a later coinage). There were plenty of other books before Smith's that discussed the subjects he would cover. Many of these were pamphlets or books written to argue a particular case, such as a defence of trading companies like the East India Company or to support the balance of trade and the interests of merchants. There were others which, like the *Wealth of Nations*, did develop a general and more theoretical approach, and scholars have traced Smith's indebtedness to some of these. Smith himself is sparing in his references to other works (he makes an exception in referring to the work of Hume), but it is fair to say that none of these discussions had the range or depth of Smith's book. Hume wrote suggestive essays and Richard Cantillon, perhaps his most analytically sophisticated predecessor, unlike Smith, did not situate his analysis in a broad historical and social context.

The organization of the *Wealth of Nations*

Although systematic the book is complicated. It contains a number of what Smith explicitly calls 'digressions'. One of these (on the value of silver) runs to seventy pages. The book also addresses some immediate contemporary issues, most notably the increasingly fraught relation ship between Britain and the American colonies. The *Wealth of Nations* comprises five books, divided into chapters, some of which are then sub-divided into parts. There is a very brief Introduction. This brevity is helpful because it highlights what Smith himself judged to be key points.

Book I discusses the role and extent of the division of labour (what he calls in the Introduction, the productive powers of labour) and how the products of labour are distributed among the different sectors or ranks of society. In his summary of this book, Smith makes a point of contrasting the dire conditions of life in 'savage nations' with those in 'civilized and thriving nations' (*WN* 10). That contrast is a key theme that runs throughout the *Wealth of Nations*. It lies at the heart of his conviction that a commercial society is superior to earlier forms of social life.

Book II examines 'stock' or capital. It discusses how stock is accumulated and the different ways it is put to use. In the course of this discussion Smith distinguishes between unproductive and productive or useful labour. This is not a moral distinction, implying that the latter is better than the former. On his own criterion Smith himself as a professor or author is unproductive. Unlike the manufacturer (e.g. a pin-maker) who makes an enduring product from given materials (pins from metal) and thus creates capital that can be re-invested to promote economic growth (to make more—and better—pins), the author of the *Wealth of Nations* produces or generates nothing that is similarly 'productive'.

Book III reproduces more obviously the content of some of his Glasgow lectures. Its focus is more historical. It outlines how the feudal system of land tenure and the social and political power that ownership gave to the landowners was gradually replaced by a commercial society. This replacement illustrates a procession of unintended consequences, a central thread in the *Wealth of Nations* and throughout Smith's work.

Book IV is largely polemical. Smith takes aim at what he sees as the chief rival to the account he is providing. He calls this rival the mercantile system. This system aimed to regulate the economy on the principle that exports should be increased but imports restricted. The wealth of a nation consisted in a monetary surplus and benefited producers not consumers. But for Smith the wealth of nations lies in the productivity of labour and the better living standards that generates; an outcome that is best achieved by free trade. One of the reasons why the *Wealth of Nations* is such a big book is that Smith is not dogmatic. His reasoning is nuanced and his arguments frequently qualified, so his defence of free trade, for example, allows for exceptions.

Book V is the longest. It focuses on sources of revenue and expense. The latter of these deals with the maintenance of socially necessary tasks, like government and education, but which are unproductive in Smith's technical sense. The former examines how these tasks are to be funded or what are effective means to raise income from tax. This leads to the last topic. Revenue can also be gained by government borrowing or incurring public debt but, as he points out, it is an unintended consequence of this method that it can make matters worse.

Stages and the pre-history of a commercial society

As an educated man in the 18th century Smith had been schooled in the classics of Greek and Roman literature. He also got information from the reports of missionaries and voyagers on societies in the Americas, Asia, and more recently Polynesia that are very different to his own. There were, however, similarities between the accounts of the Iroquois provided by Father Lafitau in the early 18th century and of the German tribes provided by the 1st-century CE historian Tacitus (both writers are cited by Smith). But 18th-century Hesse is very different from the settlement of the Batavi in that location, while in Smith's time Glasgow was not that dissimilar to Antwerp. From this stock of knowledge two conclusions were drawn. Commercial society was only one type of society and it was modern. This enabled Smith, and other Enlightenment thinkers, especially his fellow Scots, to differentiate societies historically. Some forms of social life could be understood as more advanced than others.

In his lectures on jurisprudence delivered in Glasgow, Smith identified four types of society in a rough historical sequence, developing through hunter, shepherd, agricultural, and commercial stages. His context was the development of property rights. This notion of stages was a teaching tool. It was a way of bringing out to his students how differing social situations generate different forms of ownership and different modes of regulation. The first three of these four types all revolve around the dominant mode of subsistence and were identified by many other writers. It is Smith's explicit reference to a 'commercial society' that is distinctive and Smith here is a pioneer. The *Wealth of Nations* is the systematic investigation of this society. Although the 'four stages' does not figure prominently in the book the fact that he sees commercial society as a historically distinctive type remains an important backdrop.

In the second of the four stages the leaders are those who own the greatest herds and similarly in the third agricultural stage power lies with the owners of land. Smith is very clear that the power held by the owners is exercised by them to protect their own interests. In his Glasgow lectures he is blunt: government in those stages is not neutral because in practice it is 'a combination of the rich to oppress the poor' (*LJ* 208). This bias, however, does not apply in the age of commerce. In that age, governance is subject to the impersonal rule of law and not the personal (despotic) rule of khans or feudal lords. He also made this point in the 1790 edition of the *Theory of Moral Sentiments*, where he writes that 'in commercial countries' the 'authority of the law is sufficient to protect the meanest [i.e. poorest] man in the state' (*TMS* 223).

The feudal lords were masters of their own local territory. They settled disputes, enforced discipline, and commanded their tenants to fight on their behalf. They could do this because they owned the land on which those they commanded depend for their livelihood. The tenants could only grow and retain for themselves some of the crops if they did the lord's bidding. However, this changed when foreign commerce introduced luxury goods. To obtain what Smith deliberately calls frivolous and useless goods (he mentions diamond buckles) the lords sold off their land or granted long leases. The effect of this was to undermine their power to command and their ability to act as judges because those who had been previously dependent became independent. As Smith vividly depicts this transition, it was 'for the gratification of the most childish, the meanest and the most sordid of all vanities' that these landlords gradually bartered away their whole power and authority (*WN* 419).

Smith calls this change a 'revolution of the greatest importance to the publick happiness' (*WN* 422). But it was not brought about with the deliberate aim to further the public good but was, rather, an example of unintended consequences. Everyone involved was out to get something for themselves. The landlords wanted the buckles for their own enjoyment and the merchants who supplied the buckles did so to make a living from retail and those tenants who stayed on the land (rather than moving into towns to trade) did so because they could then reap for themselves the full benefits of their labours.

This revolution was important because it made possible the 'regular administration of justice'. No longer was there a patchwork of local jurisdictions but the emergence (gradually) of a uniform system of law. The establishment of that uniformity is crucial; without it a commercial society is not possible. The *Wealth of Nations* is a scientific enquiry into the nature and causes (as the full title of the book states) of that society. Yet unlike most present-day economics, Smith's enquiry is sensitive to the fact that the subject of his analysis is a product of history.

The division of labour

For Smith a developed commercial society enjoys a 'universal opulence which extends itself to the lowest ranks of the people' (*WN* 22). It is the breadth of this opulence, by which Smith means not just riches or wealth but purchasing power, that is significant. Other societies have been opulent but this opulence was confined to their upper classes. It is a distinctive mark of commercial societies that the lower ranks are able not only to meet their basic needs but also able to enjoy a better quality of life. In a pointed conclusion to the book's opening chapter, Smith declares the quality of the accommodation of these ranks exceeds that of 'many an African king' (*WN* 24). Moreover, in a commercial society there are sufficient resources to care for the vulnerable—infanticide is no longer a decision imposed by extreme poverty. A central task of the *Wealth of Nations* is to explain this shift, to provide an account of economic growth or development that, in doing so, also accounts for the increase in well-being, or welfare, both socially and individually.

This diffused opulence does not occur in a social vacuum, it is only possible in a 'well-governed society'. The *Wealth of Nations* is not simply a work of economic analysis it is also a work that provides a political philosophy. This twin feature is neatly captured in a phrase from his Glasgow lectures when he tells his students that 'opulence and freedom are the two greatest blessings man can possess' (*LJ* 185).

The root cause of universal opulence is the division of labour. Smith thinks the source of this specialization of tasks is a 'propensity', an inclination or disposition, in human nature to 'truck, barter and exchange' (*WN* 25). He just asserts that humans possess this disposition, although he speculates that it is probably a consequence of the faculties of reason and speech. Earlier in his Glasgow classroom he tied the trucking disposition to the 'natural inclination to persuade' (*LJ* 352) which in the *Moral Sentiments* he labelled one of the strongest of human desires. As a further testimony to the connections across Smith's work, in the *Considerations* he had located the origin of language in the utterances of savages as they attempted 'to make their mutual wants intelligible to each other' (*CL* 203).

Because the division of labour is a propensity of human nature then it is true of everyone. It cannot, it follows, be an exclusive feature of commercial society. It exists throughout the four stages. With implicit reference to the first stage, Smith gives the example of a skilled bowmaker who discovers that by exchanging high-quality bows for the meat from deer slain by more adept hunters, he can obtain more venison than from trying to kill his own beast. This division is rudimentary because before the age of commerce there is little scope for extensive exchange. Why that is true of the earliest stages and untrue of the fourth stage hinges on the security generated by the rule of law, the definitive characteristic of a well-governed society.

Smith illustrates how an extensive division of labour produces opulence with the famous example of pin-making, a 'very trifling manufacture' as he calls it (*WN* 14). The example was often used and chosen by Smith precisely because it was familiar. He calculates that through the division of labour ten individuals could make 48,000 pins a day—equivalent to 4,800 each. But if each individual performed all the tasks required (drawing, straightening, cutting, pointing the wire, and so on) then less than twenty would have been manufactured. He gives three reasons for this: increased dexterity that comes from reducing each individual's task to 'one simple operation'; time-saving that stems from not having to transfer from one task to the next; and inventing better ways of executing the task prompted by the concentration on one task (*WN* 17). There is a downside to this specialization that Smith returns to later in his book.

The division of labour in this illustrative way increases the 'productive powers of labour' and is the engine of economic growth. But this is not an independent process. Its extensiveness, the key to its provision of opulence (a multitude of cheap pins), is dependent on the size of the market. When the population is small and scattered the scope for an extensive market is small. In these circumstances there is no incentive to specialize so as to produce a surplus to exchange for the surplus of another specialist; the propensity to exchange will remain largely dormant. Smith uses the Highlands of Scotland to illustrate how individuals are there forced to perform for themselves many tasks, 'every farmer' must be his own 'butcher, baker and brewer' (*WN* 31).

This example picks up one of the best-known passages in the *Wealth of Nations*,

> 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. (*WN* 27)

I give the butcher money, she gives me sausages. This is not a claim that humans are exclusively motivated by self-love. The whole argument of the *Moral Sentiments* was to reject that claim. The butcher could well act benevolently and give some meat to the beggar but that could only be an occasional gesture because she would not stay in business long if she gave away her products. Nor is it a claim that humans are motivated simply to satisfy their basic needs. As he put it in his lectures, humans work to procure not just food, clothing, and accommodation but also 'conveniences' according to the 'nicety and delicacy' of their taste as well as to become objects of admiration (*LJ* 488). This is part of what makes us human. As the (now) cliché has it, man does not live by bread alone.

When bakery is a separate enterprise from brewing or butchery, when, that is, labour is more specialized, then the more necessary markets become. I will only specialize in bakery if I can reasonably expect others to be specializing in the production of other foodstuffs, so that when I take my bread to market I can, via the medium of money, exchange it for the produce of others. The decision to specialize depends on having confidence in a stable or predictable future. The butcher can rely on the baker for bread; the baker on the butcher for meat.

That reliance or confidence needs to be underwritten. This comes to be a central plank of Smith's account of the role of government as it upholds a system of justice. When the actions of others are not predictable then it is prudent to be independent and self-sufficient and not rely on anyone else. Everyone produces all their own food. But, of course, that option means forgoing the blessing of the opulence—poorer diet in this case—that comes from interdependence (the Highlands were far less prosperous than Glasgow).

Smith illustrates the interdependency of the members of a commercial society with the example of a coarse woollen coat. Even this humble product, he remarks, involves many thousands in its manufacture, from those involved directly to those indirectly, such as the makers of the tools used by the coat manufacturers. So extensive is interdependence that 'everyman thus lives by exchanging or becomes in some measure a merchant'. And when this has happened then this is 'properly a commercial society' (*WN* 37).

From this general basis Smith proceeds to more detailed technical discussions. These it has to be said are not always as clear or as consistent as they might be. He distinguishes, for example, four types of price and different roles played by labour.

Labour, price, and value

The opening sentence of the *Wealth of Nations* proclaims the importance of labour. The 'necessaries and conveniences of life' are obtained through it either directly or indirectly. It is direct when I bake the bread I consume and it is indirect when I buy a loaf, which is to say I purchase the labour of a baker. But interdependency means the baker would have to have bought flour from the labour of a miller and bought an oven from the labour of a manufacturer. The buying and selling of the products of labour requires a market and that requires some mechanism to calculate how much the bread, wheat, and oven should cost. This leads Smith into tricky questions of money, price, and value.

Smith describes money as 'the great wheel of circulation, the great instrument of commerce' (*WN* 291). Beyond the immediate barter of venison for a bow it is necessary to have some standard to enable the butcher, baker, and brewer to trade. He gives a long list of commodities that have acted as a standard—cattle, shells, sugar, and so on. But he says there was convergence on metals because they didn't perish and could be divided. In a commercial society, paper money gradually substitutes for gold and silver—a development that, later in the book, leads Smith into a discussion of banking and credit.

But money is only an instrument, a tool. It is a separate question how much a consumer pays for bread, beef, beer (and ovens). This raises what historically has been one of the most persistent problems in economics—the relation between price and value. Some objects have 'value in use'. Water is an example. Other objects have 'value in exchange'. Diamonds are an example. Smith observes that though water has the greatest use value it has no exchangeable value (you can't get much for it), while the opposite is the case with diamonds (you can get a lot in exchange for them). Though the distinction is important (it is a pivotal feature of Karl Marx's economics, for example) Smith is concerned with the 'principles that regulate the exchangeable value of commodities' (WN 46). Why is the price of a loaf £1 and a pint of beer £2?

Typically he starts with a simple almost intuitive observation and then unfolds a more elaborate analysis. He supposes in the hunter stage that it takes twice the labour to kill a beaver than it does a deer, so one beaver should exchange for two deer. This is their 'exchangeable value' and, in this simple situation, it is calculated by how much labour was expended (or embodied) in production. Labour is the real measure of exchangeable value and this constitutes the 'real price' of a commodity. It is distinct from the 'nominal price' or the sum of money paid (£1 for a loaf). While labour always remains the ultimate determinate, Smith continues to refine his analysis as the situation becomes more complicated than that portrayed by the deer/beaver example. When I buy rather than bake the loaf I am, in effect, 'commanding' the labour of the baker and this incorporates the labour he has, in turn, commanded from the miller and oven manufacturer.

He proceeds to identify three components in labour. It measures not only how much toil or effort is involved in baking but also measures the value of the land that grows the wheat and the cost in manufacturing and distributing the ovens to bake the bread. These three components of labour have their own local going rate and together they establish the bread's 'natural price' (*WN* 72). Across all marketable commodities this price is decided by what is sufficient to pay the rent, the wages, and the profits of 'the stock employed in raising, preparing and bringing' a good to market. They are in contemporary terminology the 'costs of production'.

Smith is now describing not a primitive society of hunters but a developed society where everyone 'in some measure' is a merchant. But even before such a society develops, labour as a unit of measurement is difficult to gauge. Money makes matters easier. The quantity of money (how much to pay) is a simpler measure than quantity (how much) and quality (skill) of labour. However, that simplicity means it is liable to fluctuate. For example, gold or silver can be more or less available, harvests more or less bountiful, workers more or less plentiful, but, more generally, the 'higgling and bargaining of the market' produces a going rate or the 'market price' (*WN* 49).

He illustrates the fluctuation in the market price with the example of a public mourning. In this situation the sudden increase in demand raises the price of black cloth because the quantity available is now in relatively short supply. Smith in this way identifies one of the lynchpins of modern 'neo-classical' economics, that price is set by the relation between supply and demand. But, thanks to these fluctuations, for him, the market price remains analytically distinct from the natural price. They might coincide but the market price can also be above or below the natural price. For this reason Marx called him a representative of 'classical political economy' (indeed, along with David Ricardo, he was 'the best').

According to Smith's analysis, the market price, because it is always subject to fluctuations, does not really explain why bread costs £1 a loaf and beer £2 a pint. The explanation lies in the natural price. Smith uses a revealing metaphor. He says the natural price is that 'to which the prices of all commodities are continually gravitating' (*WN* 75). What is revelatory is the use of the Newtonian image of 'gravity' and Smith's implicit claim that he has scientifically explained the workings of the economy as Newton had done of the universe.

To his own mind he has uncovered the regulatory principles of exchange. If there is a shortfall between demand and supply then it is, where applicable, in the interest of landlords, labourers, and manufacturer to fill the gap by increasing supply. This activity is the gravitational pull and it will operate when the landlords and the others are free from artificial restrictions. As it is now called, this is a process of equilibrium. Smith's achievement is to have shown that the operation of the market has regularities or constantly recurring patterns; it is not a random haphazard series of interactions. This is more than sufficient for neo-classical economists to label him the 'father' of the discipline.

Labour, land, and stock comprise the three components of the natural price. In the form of wages, rent, and profit this provides Smith with a basic three-fold division of sources of income.

Wages

Before land became private property and before stock was accumulated, labourers enjoyed the whole produce of their labour. With the emergence of landlords and stockholders the labourers cannot act independently but must rely for their maintenance on the landlord or later, as society develops, from the manufacturer in the form of wages. Labourers must work on the privately owned land and landlords take their share of the labourers' product as rent. The pin-makers must be provided with the materials to make the pins, as well as wages (money to live on while making the pins). When the pins are sold the manufacturers reclaim their share as profit.

The psychology of the butcher and baker still applies. All three parties—labourers, landlords, and manufacturers—are motivated by their own interests. These, however, do not coincide. Smith observes that the labourers desire to get as much and the 'masters' (landlords, manufacturers) to give as little as possible. In pursuing their side of the contract labourers are disposed of their own accord to join forces or 'combine' in order to raise their wages, while the masters on their side combine to lower them. Smith now adds that the latter can combine more easily than the former, especially since the law prohibits the combination of workers, while permitting that of the masters. This leads Smith to make the forthright comment that 'masters are always and everywhere in a sort of tacit, but constant and uniform combination not to raise the wages above their actual rate' (*WN* 84).

This rate has a necessary floor. The wages paid must at least enable the labourer to subsist and bring up a family. This minimal level is what employers wish to pay. But that aim, Smith judges, reflects a misunderstanding. Many economists of his time, and earlier, took the view that low wages were a necessary incentive but Smith, on the contrary, argued in favour of high wages because, in one of his key phrases, and one he had already used in the *Moral Sentiments*, high wages encourage in the worker the hope of 'bettering his condition' (*WN* 99). The more the labourer is encouraged then the greater the productivity. This explains why wages are highest in times of economic growth. This supports one of Smith's major arguments. The central issue is not the monetary level of wages but their purchasing power: what those wages can buy. The purpose of production is consumption. This self-evident 'maxim', as he calls it, is the most important in the whole book. The wealth of nations lies in the increase of revenue and stock, in the availability and accessibility of more, better, and affordable goods.

Smith the economist is the same man as Smith the moral philosopher, and in the context of wages this is apparent. It is a matter of 'equity' that those who provide for the basic needs of society should themselves be 'tolerably well-fed, cloathed and lodged'. And since, as he said in the *Theory of Moral Sentiments*, prosperity brings joy, then 'no society can be flourishing and happy of which the greater part are poor and miserable' (*WN* 96). A similar moral tone recurs when Smith discusses merchants and manufacturers. They are hypocrites who complain about the effects of high wages but are silent about the bad effects of high profits and the 'pernicious effects of their own gains' (*WN* 115). Furthermore, they are deceitful and, because they always seeking to reduce competition, they are, in effect, conspiring against the public interest.

Profits

Smith has no objection to profits. They accrue from stock, which, when put to use, has the vital role of generating most of a society's useful labour. This role is the subject matter of the whole of Book II. It is a consequence of the division of labour that the pin-maker cannot make pins without the equipment to do so and has to have funds to live on before the pins are sold. The availability of this equipment and the resources to maintain the pin-maker are derived from existing stock. It follows that this stock must have been accumulated in advance. The greater the accumulation then the better the equipment that can be afforded and the higher the incentivizing wages that can earned/paid which leads to greater productivity and thus economic growth and greater national wealth.

Labourers possess little stock of their own and have scant opportunity to accumulate. But if a quantity is built up then stock-holders, after deducting what is needed for immediate personal consumption, and in order to better their condition, will aim to derive a revenue from the residue. They would, Smith says, be 'perfectly crazy' if they didn't (*WN* 285). Smith here introduces the term 'capital' and its accumulation is the key to growth.

Smith distinguishes two types of capital. The stock-holders can, in broad terms, put their residual stock to work in two ways. These are not mutually exclusive. They can manufacture goods and then sell them for a profit, the proceeds of which are usable to purchase more materials, etc., for more manufacture. Smith calls this 'circulating capital' since it involves a series of exchanges (*WN* 279). Or, second, the stock-holder can use the residue to improve land or to buy machinery. This Smith labels 'fixed capital' because once invested there is no further exchange (*WN* 282). The aim of fixed capital, through these means, is to increase the productivity of labour. The relative proportions between these two types of capital will depend on the stockholder's business, so more fixed capital (machinery) is needed for mining coal than for making shoes. But the fixed capital in mining or cobbling cannot of itself raise any revenue without circulating capital to supply and maintain the pumps for the mine or the leather for the shoe-maker as well as the upkeep of the workers.

Capital will only be put to work, and economic growth ensue, if there is 'tolerable security' (*WN* 285). Here is a persistent thread in the *Wealth of Nations*. In the earlier ages when that security is missing individuals will keep what stock they have close at hand. They would be sane not crazy to keep hold of it. The result is no investment which consequently limits the productivity of labour. The effect of this is to entrench an impoverished life in comparison to that enjoyed even by humble labourers in a commercial society. The security afforded to all in that society makes it a safe and sane decision to invest. That security as well as promoting investment also facilitates wider and more intensive markets. A bigger market means more competition and that in its turn also leads to improvement both materially and socially.

This growth in productivity and overall prosperity makes it possible to sustain unproductive labour. Some of this labour is functional, including those whose job it is to maintain security, both internally and externally, and some of it is 'frivolous', including not only musicians but also the professions of the church, law, and medicine. The 'wealth' of nations also encompasses learning and culture.

Rent

In the same way that it is in the interest of an employer to pay wages at the lowest feasible level, so it is in the interest of a landlord to charge as much rent as the tenant can afford. But the cases are not identical. Not all rent takes the form of a reasonable profit from investment in improvement. The difference is that rent can still be derived from unimproved property. With explicit reference to Scotland, Smith gives the example of kelp. This seaweed is useful for making soap and glass but the raw product is not the result of any human industry. Nonetheless the owner of the shore demands a rent from the kelp harvester.

More rent can be charged for fertile than for less fertile land but, where fertility is equal, another factor is relevant. A higher rent can be charged on land that is close to the market town. The explanation for this is that the greater the proximity then the less the transportation costs in taking goods to the market, with the consequence that the income of these tenants is greater, making it feasible for the landlord to raise their rent. That differential would be reduced if transportation costs were also reduced and that would in its turn encourage the cultivation of land further away from the towns. This encouragement is beneficial because it facilitates the emergence of new producers to compete with the more locally based ones. It is because it stimulates this increased competition (always a 'good thing' for Smith) that he judges a developed infrastructure of good roads and canals to be the greatest of all improvements.

Social orders

Wages, profit, and rent as the three sources of income establish within a 'civilized society' three corresponding 'orders of people'—workers, merchants, or manufacturers and rentiers/farmers. Although each is equally a component of society their relationship to the public or general interest differs. This difference matters when it comes to policy-making. Smith finds each order deficient when it comes to good governance.

The interests of those who live by wages are closely bound up with the general social interest, because as society prospers so do they and vice versa. However, their everyday circumstances mean they are relatively uneducated thus making them 'unfit' to inform policy (Smith returns to this deficiency in Book V). The second order—the 'country gentlemen' who live off rent—are the traditional mainstay of the political order and, as Smith acknowledges, because land as a natural resource is a fixed asset then their own interests in maintaining it will not run counter to those of the nation. But they are indolent and incapable of applying themselves to understanding the consequences of any public regulation. This scepticism of the link between landowning and political judgment reflects a remark in his Glasgow jurisprudence lectures that in a 'polished' or commercial society what counts is 'superior mental capacity' (*LJ* 401).

The final order, those whose income derives from profit, are more educated than the first and more intellectually active than the second. However, their interests and the general interest do not coincide, because the rate of profit, unlike wages and rent, does not necessarily harmonize with the prosperity of the country. Indeed, Smith claims the rate is highest in 'countries which are fast going to ruin'. This lack of harmony has bad consequences when it comes to policy-making. Smith proceeds to develop a prolonged critique of the policies typically advocated by merchants.

Chapter 6

Trading and spending

In Book IV of the *Wealth of Nations* Smith identifies two faulty alternatives to his own explanation of the wealth of nations. He criticizes the French economists (the Physiocrats) some of whom he met on his travels as a tutor. Their basic argument was that land is the sole source of wealth and revenue, but Smith, while agreeing with them on the importance of liberty, criticizes them for treating manufacturers and merchants as totally unproductive. However, Smith's chief target is the second alternative. This he calls the 'mercantile system'.

The critique of mercantilist politics

The core objective of the mercantile system was to achieve a favourable balance of trade (measured in bullion). This balance was to be achieved by encouraging a surplus of exports over imports. The latter were subject to high duties on goods that could be produced by domestic industry. By reducing competition, this policy is in the interests of home industry which is the same as saying it is in the interest of domestic manufacturers and merchants. To protect that interest they oppose any law that would threaten their control of the market. According to Smith, so powerful is this interest that it can intimidate the legislature (largely the mentally indolent landowners). This is made easier by the parliamentarians' belief that by accepting the merchants' arguments they gain a reputation for understanding trade as well as by them hoping to curry favour with the increasingly wealthy mercantile order.

Smith has a generally low opinion of politicians. Those who participate 'in the management of publick affairs' do so because of the prestige it gives them. They are not motivated by a commitment to public virtue. Not only are they swayed by outside interests but also they typically take the short view. Their skill he likens to an 'insidious and crafty animal'. He contrasts this opportunistic talent to 'the science of a legislator' that deals with invariable 'general principles' (*WN* 468). He had used this same term at the beginning of Book IV where he identifies 'political economy' as a branch of that science, the purpose of which is two-fold: to enable individuals to live well from their own efforts and to raise revenue. However, it is clear Smith is not advocating that some individual could play the role of 'legislator'. His emphasis is on the 'science' which his book is outlining.

Smith has more faith in the legal system than in politics. The replacement of the arbitrary localized judicial role played by the feudal lords by an independent judiciary is he declares in one of his Glasgow lectures the 'great advantage which modern times have over antient' (*LRBL* 176). He believes this independence makes it very unlikely that justice will be sacrificed to political expediency. This belief rests on two assumptions. He assumes judges are exceptionally able (unlike the bulk of the parliamentarians). He also assumes that, because their emolument is very small, they are motivated by the great honour of their office so that they treat the public admiration that comes with the job as 'part of their reward' (*WN* 123). This view, exemplified also in doctors, poets, and philosophers, incidentally, underlines the fact that Smith did not reduce all motivations to material self-interest.

Smith does not tar all politicians with the same brush. He allows for exceptions. There are in parliament some public-spirited individuals who object to or resist the mercantile lobby. But for their pains they are subject to abuse, insults, and even violence. This, for Smith, is all part of the 'mean and malignant' character of the mercantile system, as its supporters conspire to 'deceive, and even to oppress the publick' (*WN* 267).

These barbs reflect the effects, and are the corollaries, of mercantilism. But Smith's objections run deeper. The very aim of that system is misconceived because it elevates the interests of producers above consumers. Consumers benefit not from mercantile restrictions but from free trade. There are two aspects to Smith's deeper critique. He shows how mercantile policies in practice thwart the wealth of nations and he also demonstrates how in principle its assumptions are faulty and necessarily run counter to what he calls 'natural liberty'. This combination of practical and theoretical aspects reveals the core of his own system.

Free trade

According to Smith mercantilist policy seeks to 'force' trade into a particular direction (*WN* 506). His use of the word 'force' here helps to sharpen the contrast to his own policy of 'free' trade. The outcome of this forced attempt is worse than if the trade had been left to find its own way. The whole idea of a 'balance' of trade, to be achieved by artificially diverting industry away from its own course, is 'absurd' (*WN* 458). To illustrate this absurdity Smith gives a local example. With the help of artificial devices, like greenhouses, good wine, he says, can be produced in Scotland. But the production of Scottish wine would require so much capital that, compared to importing wine from France, it would be expensive. As a result, it would, he judges, be unreasonable to prohibit the import of cheaper claret.

This deliberately contrived example, dramatizes three fundamental Smithian principles. The natural advantages of one country in producing some commodities (wine in France) make it wasteful to offset them in another (subsidize Scottish vineyards). The free trade in wine benefits the Scottish consumer, who pays less for his or her tipple; the subsidies would only benefit the owners of Scottish vineyards. Second, no regulation, like imposing bounties or subsidies, can increase the quantity of industry in a society beyond what its capital can sustain; it can only direct it. But, third, this will be a misdirection.

If a good is only produced because it is subsidized it means the producer would otherwise not engage in its production, since no profit would be earned. This entrenches inefficiency to the overall detriment of the economy. If there were no subsidies then a producer would not waste her capital in Scottish grape production but use it in an area where she can expect a reasonable return on the investment (say whisky). That expectation will be fulfilled if the good now produced has a market, that is, consumers who want whisky.

There is, though, no guarantee that a producer will be successful. This is because that same expectation would be shared by other producers who would use their capital to enter that same market and compete for the consumers' custom by also producing whisky (the same applies for wine production in France). In this way, thanks to free trade and competition, Scottish and French customers will be the ultimate beneficiaries, enjoying both cheaper wine and cheaper whisky. Not only will the drinks be cheaper but they will also be of better quality. In addition there will be more choice since the producers will compete to offer a drink that will 'give them an edge' in the market-place—*vin ordinaire* or *premier cru* of various vintages; blend or malt of varying age.

Smith supplies many other non-contrived examples, with particular attention paid to corn. He devotes one of his 'digressions' of almost twenty pages to it. In his treatment of this issue Smith was contributing to an intense contemporary debate and his 'take' caused much controversy both at the time and later. He used this topic to reinforce his argument about free trade and demonstrate that regulation was misplaced.

Left to his own judgment and in pursuit of his own interest, the corn dealer would set the price as high as the quantity of corn allows. When there is a shortage a high price will be charged. Contrary to the view that this is exploitative, Smith maintains this is to everyone's benefit. The high price will discourage over-consumption and encourage 'thrift and good management'. In that way adequate supply will be maintained. If the dealer sets the price too low then the supply will run out. In that case, not only will the dealer lose income (nothing left to sell) but also at the end of the season 'the hardships of a dearth [and] the dreadful horrors of famine' will be experienced.

Smith is well aware that those circumstances generate social unrest and that this has often prompted government intervention to oversee the distribution. He claims, on the contrary, that his argument by allowing the dealers to follow their own interests by adjusting their prices is the 'only effective' way to prevent 'the miseries of famine'. More pointedly, he declares that it is the 'violence of government' by attempting 'by improper means' to ease dearth that has caused famine. In short, the discrete decisions of individuals (in this case the price-setting by corn merchants) is a superior method of distributing goods, than some centralized and opportunistic political decision; a conclusion that goes a long way to explaining Smith's subsequent status as the flag-bearer of those who argue for the superiority of market economies to centrally planned ones.

In the case of corn the interests of the merchant and consumer align. Underlying this alignment, and the practical advantages of free trade, is a fundamental general principle. This principle is natural liberty.

Natural liberty

The term 'natural liberty' is not novel; it was an important component in political theorizing from the 16th century onwards. Smith, however, gives it a distinctive application. According to Smith's definition, the 'system of natural liberty' is when

> 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.

It follows from this, and in stark contrast to mercantilist practice, that government is completely discharged from 'a duty … of superintending the industry of private people and of directing it towards the employments most suitable to the interest of society' (*WN* 687).

The doctrine of relieving the government from economic superintendence is frequently labelled 'laissez-faire' but although the term was current Smith never uses it. This restriction of the role of government avoids a further fault in mercantilism. Its policy of artificially steering the economy assumes humans (governments) possess enough wisdom or knowledge to ascertain what, and how much, direction is in fact in the interests of society. But for Smith they are deluding themselves. Nobody (and especially not governments) is that wise or knowledgeable.

Smith's confidence that government's role can be safely restricted lies in his conviction that everyone seeks to better their own condition. Given freedom and security this natural urge to self-identified betterment is, he claims, so powerful that, in spite of the extravagance of government and foolish restrictions, it is able to generate social wealth and prosperity. It prompts people to save and build up capital. This 'private frugality', either directly or indirectly by extending interest-bearing credit, increases productive labour, and stimulates economic growth and thus overall national wealth. In another flight of rhetoric Smith underlines the key role played by that urge by describing it as a desire that never leaves us from the womb to the grave. There is, he goes on, scarcely any time when individuals are so satisfied with their lot that they do not wish some improvement. They typically see increasing their 'fortune' as the means to this improvement. This is not reprehensible. In the *Moral Sentiments* he had noted that frugality was esteemed even when it was directed at the personal 'acquisition of fortune' (*TMS* 190).

In less rhetorical vein, individuals are continually exerting themselves to find the best outlet for their resources (capital). Free of external direction or artificial interventions, people will make their own decisions about their own interests. It is a basic Smithian principle that the law should trust folk to take care of their own interests. It is against the backdrop of that principle that Smith's one reference to the 'invisible hand' in the *Wealth of Nations* occurs. This reference is rather 'tucked away'; given its subsequent fame/notoriety, it certainly lacks textual prominence. Like the corn-dealer, each owner of capital seeks his or her own gain but, 'as in many other cases is led by an invisible hand to promote an end which was no part of his intention' (*WN* 456). This unintended end is the public interest (the steady supply of corn). Smith reiterates his distrust of politicians by observing that he has never known much good to stem from deliberately seeking to pursue the public interest.

However, not all operations of the invisible hand produce a benign outcome, like availability of corn. In his usual circumspect way, Smith even hedges this explicit evocation of the invisible hand with qualifications. He says carefully that it is not 'always the worse for the society' that the public interest is 'frequently' the unintended outcome of individuals pursuing their own interests. Between the lines, this pursuit of self-interest can be to the detriment of society and will not always redound to society's benefit.

The duties and role of government

For Smith, government in a commercial society has three duties: protection from external foes, maintenance of public works, and an 'exact administration of justice'. Smith's view of justice in the *Wealth of Nations* is the same as that put forward in the *Moral Sentiments*. It is strict, rule-bound, and indispensable. This duty of government is similarly indispensable. It enforces adherence to the 'laws of justice' (the rule of law) that provide the security that enables individuals to pursue their own goals, to enjoy their natural liberty. This security is absolutely crucial; its presence makes it a safe or sane decision to invest and thus increase industry and stimulate improvement.

It is one of Smith's basic points that a successful economy does not exist in a vacuum but depends on a stable legal framework. This is not an article of faith on his part but one that the historical evidence bears out. The message from Book III was that it took the establishment of a regular administration of justice to enable commerce and manufacture to flourish. If this third duty of government was more extensive than the enforcement of contracts, the payment of debts, and rule-abidingness in general then it would inhibit prosperity. This seemingly limited task is Smith's default position. But he is not dogmatic and he is willing to allow exceptions.

Government can properly take a positive role, even when this appears to infringe natural liberty. Most often these infringements of liberty are for the sake of greater liberty. They remove obstacles and Smith identifies many such cases for action. He attacks the 'absurd' legal practice of primogeniture (the first born exclusively inherits) and entail (inheritance is predetermined —causing Mrs Bennet in *Pride and Prejudice* to hope Elizabeth will marry Mr Collins to whom the Bennet Estate will pass). Both these practices restrict the market in land.

He is more forthright in his opposition to the English poor laws whereby each parish had the responsibility to support their own poor, with the additional authority to eject immigrant paupers. Smith judged that to eject someone who had committed no crime and had chosen where to live was 'an evident violation of natural liberty' (*WN* 157). By penalizing mobility, the effect of this law is to entrench poverty. Accordingly, Smith supported its repeal. The same applies to the statute of apprenticeships and the exclusive privileges of corporations and guilds because they too prevent workers from working where, and on what, they please. The argument here is that the government should withdraw from certain tasks. In effect the legislation should be repealed thus relieving government from the obligation to administer and go beyond its three duties.

Smith also identifies cases where the default can be over-ridden. These interventions generally make some sort of appeal to the 'national interest' and invoke, implicitly, government's first duty, its responsibility for defence. The Act of Navigation 'very properly' gives British shipping a monopoly of their own trade (*WN* 463). This differs from the monopoly granted to joint-stock companies. Here the monopoly is a reward for the risks and expense in establishing new trade with 'remote and barbarous' lands. But this monopoly is time-limited (like copyright). Not only is competition and free trade the way to raise the wealth of nations but these companies have a lamentable record of mismanagement as well as a self-interested desire to retain their monopolistic advantages.

In justifying proper government interventions, Smith gives the example of requiring fire walls to be built. These constructions prevent the spread of a blaze and that prevention is a justified infringement of the natural liberty of builders. In this same passage, Smith argues on the same principle that regulation of the issuing of notes by banks is proper; they should be in large denominations and be immediately payable on demand. In a related vein, he justifies a legal rate of interest in order that capital is put 'visibly' in the hands of those who will make more productive use of it. It can also be appropriate to deviate from the principles of free trade in order to encourage home industry. For example, when a domestically produced good is taxed then it is reasonable that the same good should incur a tax when imported. Smith is clear that this is not a mercantilist policy. It still leaves competition in place, what it does is level the playing field.

Public works, education, and the well-being of workers

In addition to its duty to maintain external and internal security, government's remaining duty is the provision of what he calls 'public works and institutions'. These are activities that although in the general interest are not in the direct interest of specific individuals. This is because profits cannot be earned from the provision of a good or service when the access to it can't be controlled. Smith supplies examples of what are now regarded as classic examples of such goods. Prominent among these are roads, bridges, and navigable canals. In addition to these infrastructural goods, Smith also includes the provision of public promenades, parks, and gardens. Particularly important is his promotion of education as a proper duty of government. His argument here in Book V requires him to revisit the division of labour.

The opulence produced by the division of labour was an unintended consequence but it had other less benign results. These affect those who perform 'a few simple operations'. Smith uses some of his most powerful language to depict these effects. The simplicity of the specific task repetitively undertaken by an operative (the pin-maker), means he has no opportunity to 'exert his understanding or to exercise his invention'. As a consequence he loses the 'habit of exertion' and with that loss becomes 'as stupid and ignorant as it is possible for a human creature to become'. The 'torpor of his mind' renders them unable to indulge in rational conversation and incapable of acting responsibly or prudently when it comes to everyday obligations and commitments. The uniformity of the pin-maker's life also 'corrupts the courage of his mind', that is to say, it instils cowardice, which involves a 'sort of mental mutilation, deformity and wretchedness'. In sum, the opulence induced by the dexterity of the pin-makers and the specificity of their task is bought at the cost of their 'intellectual, social and martial virtues' (*WN* 782).

This is what will happen to the 'labouring poor', who make up the bulk of the population in a 'civilized society'. The very power of Smith's language in these passages serves to prepare the ground for justifiable government intervention. This intervention is a realistic proposition because what will happen to the pin-makers is not, in fact, inevitable. Like the difference between the philosopher and the porter (which was the consequence not the source of the division of labour) it reflects the operation of 'moral causes' not physical necessity. Government can therefore exercise moral causation of its own; it can take some remedial steps. Education is the key remedy.

The remedy focuses on those affected. Smith's proposed remedy draws on Scottish practice, where public funds are used to establish a local parish school. In the schools envisaged by Smith, children will be taught for a fee that 'even a common labourer may afford' (*WN* 785). He is opposed to wholly public funding because that would encourage the teacher to neglect his or her duties. (This was a conclusion drawn from his experience at Oxford University, in contrast to Glasgow where students paid fees with the result that they got a superior education.) The public purse will pay the rest of the teacher's salary.

But Smith's prescriptions go further. He also recommends a curriculum. The essentials should be covered. This means imparting basic literacy plus elementary mathematics, instead of the 'little smattering of Latin' that is sometimes currently taught. Smith thinks this sufficient for the 'common people' who, unlike those of 'rank and fortune', do not have the time and financial resources to live economically independent lives (*WN* 784–5).

There will be an incentive to acquire these basics. Before setting up a trade or attaining membership of a corporation the 'public' will impose an examination, or period of probation, in these essentials. The same requirement will apply before being allowed to enter 'any liberal profession' or 'honourable office of trust or profit' (*WN* 786). Smith clearly sees this public facilitation of education as a precaution, because even a relatively educated populace is less likely to fall prey to superstition or succumb to disruptive demagoguery. This precautionary or prudential role should not be over-sold. Even without these external benefits, Smith still affirms the principle that it is a proper task of government to facilitate the education of the 'inferior ranks' (*WN* 788).

Education is the seemingly obvious remedy for the defective intellectual virtues. More indirectly it also addresses the social virtues since an educated workforce will be less torpid and thus more able to engage with the world around them. The state has another more direct, if still oblique, role to play in fostering the social virtues. It can permit 'publick diversions', such as drama, poetry, music, dancing, and the like. This permission is granted to those who would 'for their own interest' put on these diversions, always provided this was done 'without scandal or indecency' (*WN* 796). These diversions will help offset the 'unsocial morals' and lift the gloom and austerity of the 'little religious sects' to which the workers are prone to turn. Smith extends his endorsement of competition to this arena also. When there is a multitude of small sects they will find it beneficial to tolerate each other and, in this way, any disruptive tendency to zealotry will be reduced.

The solution to the lack of martial virtues is more problematic. This is because Smith rules out the practical viability of a citizen militia. In line with the principles of the division of labour, he thinks a professional standing army superior, especially since modern armaments make individual bravery less significant than discipline. The relative ineffectiveness of a conscripted militia in a commercial society would be compounded by this enforced service running up against the interests and inclinations of the people. But despite his strong language about the loss of martial virtue his remedial recommendations are vague.

He refers to the military exercises that the Greeks and Romans made the citizens perform and how these maintained their 'martial spirit' and intimates that an adaptation of such a system would be a superior remedy than a militia. He suggests that giving 'premiums and badges of distinction' to those who excelled would be an incentive. He had used this same suggestion, using the same terms, in the context of the parish schools to encourage performance. The best guess is that Smith thinks a similar system of government-backed public rewards would encourage participation in activities that would help counteract the decline of the martial spirit. Participants would be nudged not cajoled. Whether this really amounts to the government paying 'serious attention' to the problem that he likens to a contagious disease is questionable.

A professional army and other public servants need to be paid and money has to be found to underwrite the costs of education and other public goods. There are two major ways these expenses can be met—through taxation and through borrowing.

Tax

Smith identifies four 'maxims' of taxation. These have remained benchmarks. Taxes should be proportionate to the amount of revenue acquired. Second, tax should not be arbitrary, how much tax and when it is to be paid must be certain and not at the whim of the tax-gatherer. Third, tax should be convenient for the payer. Finally, the tax should be cost-effective, that is, it should not cost more to collect the tax than will be received, nor should it discourage business or induce smuggling. Smith believed implementing these maxims would not only collect revenue but do so justly.

All tax must be derived from the three different sources of income—wages, rent, and profit. Smith discusses them individually then proceeds to a treatment of taxes that apply to all three sources. Smith devotes least space to wages (income tax was not introduced until 1799 by William Pitt to offset the cost of the Napoleonic wars). Taxes on labour will tend either to increase unemployment or to raise wages, an increase that is ultimately passed on to the consumer. Neither outcome is desirable. In the analysis of taxable rent Smith distinguishes three sources. It can be levied on land, on the produce of the land, and on housing. With respect to the last of these Smith observes that the tax falls mainly on the rich, an inequality that he judges as not 'any thing very unreasonable' (*WN* 842). In blunter terms a little later he makes it clear that it is an 'inequality of the worst kind' if the tax falls more heavily on the poor than the rich (*WN* 846).

The analysis of tax upon profit concentrates on that earned as interest (profit as such is the 'compensation' for the risk and effort in employing stock and not subject to direct taxation). Smith observes that, while a tax on land is necessarily upon a fixed asset, taxable interest lacks that fixity. The stock-holder, he says, is 'properly a citizen of the world' who can always leave the country if the tax on interest is thought to be too burdensome (now known as 'capital flight') (*WN* 848). This difference had long been a major source of political debate though Smith largely side-steps it. Nonetheless with his disparagement of the political talents of landowners, together with his underlying argument for free trade as the foundation of the wealth of nations, it is clear he is no supporter of the inherent superiority of the landed interest.

Smith devotes most space to taxes not levied on the sources of income. Here he distinguishes between 'capitation' or poll taxes and those on consumables, but he concentrates on the latter because the former in practice are arbitrary. Consumption taxes can be levied either on necessities or on luxuries. Smith's treatment of the former is another benchmark, important not only in economics but also in social theory and social policy.

What is 'necessary' is not the same as a bare physical minimum. Smith's definition is:

> by necessaries I understand, not only commodities which are indispensably necessary for the support of life, but whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without. (*WN* 869)

He gives a linen shirt as an example. This garment was unknown to the Greeks and Romans and they nonetheless lived comfortably but today a day-labourer would be 'ashamed' to appear in public without that garment, its absence is indicative of a 'disgraceful' degree of poverty. It is the 'established rules of decency' among the 'lowest ranks of people' that fixes what counts as 'necessary' (*WN* 870). From this it follows that what is experienced as a necessity is socially relative (different in California than in Bangladesh). Luxuries are simply a residual category and are similarly relative. Following Hume and contrary to a long-standing and still current opinion, Smith does not, on principle, condemn luxury as a corruption of virtue.

The policy implication is that consumption taxes should be levied on luxuries not on necessities. These will be paid by both rich and poor. Both, for example, pay a tax for consuming tobacco and alcohol. Such taxes on the poor induce them to be 'sober and industrious' and that is socially beneficial. Their ability to raise a family and instil good conduct is enhanced and this will, in turn, minimize the risk of social disorder. Smith says these taxes act 'as sumptuary laws' (*WN* 872). His wording here is careful because earlier in the book he had scornfully dismissed sumptuary laws. This legislation, which sought deliberately and explicitly to control the expenditure that different social classes could spend on clothes or food, was common to most societies in Europe and elsewhere. Smith denounces it as 'the highest impertinence and presumption' for 'kings and ministers' to restrain the expenses of private people (*WN* 346). Unlike the taxes on tobacco and ale, which are discretionary (you choose to buy a pint), these laws directly infringe natural liberty.

Taxation can also be levied to help defray some of the costs of public works. But some discrimination is appropriate. Bridges, for example, can be maintained via tolls. This charge to be paid by users will help ensure the bridge will be built where it is needed. This outcome could not be guaranteed if it was a decision made by public authorities using general tax revenues. Smith refers non-specifically to cases where a bridge or highway has been built in order simply to embellish the view from a neighbouring palace or to gratify the vanity of a minister. Moreover the toll can be proportionate to use. Heavy loads, because they cause more wear and tear on the bridge, should properly pay a higher toll than lighter loads. Similarly regardless of weight, a higher toll can be levied on luxury carriages than on those transporting necessities. As Smith sardonically puts it, 'the indolence and vanity of the rich' in this way contribute to the 'relief of the poor' by making the transportation of goods cheaper (*WN* 725).

When Smith was pulling his book together there was extensive debate on the taxation of the American colonies. Smith contributed to this. He was, though, chided by his contemporaries for delaying the publication of his book in order to participate in the debate and thus making the volume seem to one his correspondents 'too much like a publication for the present moment' (*Corr* 188). That is unfair to the extent that Smith discusses colonies more generally, including those established in the ancient world. This is the occasion for a remark often misattributed to Napoleon. It was Smith who said that to establish an empire to provide for customers is one fit for a nation of shopkeepers but not for a government influenced by shopkeepers.

In response to the American crisis, Smith saw advantages in granting the Americans independence. This would reduce a burden on the British taxpayer. It would also generate goodwill that would facilitate free trade to the advantage of everyone (apart from those merchants benefiting from the status quo). But Smith was under no illusions, he knew full well that his scheme of completely free trade was fated to be a 'Utopia' (*WN* 471). Not only is there no precedent for a nation voluntarily giving up some of its territory but also, here reflecting a recurring theme in his book, because it ran counter to the 'private interests of the governing party' (*WN* 617).

Recognizing this solution to be unrealistic he puts forward some more practical suggestions. The colonies, unless they defray the costs by taxing themselves, should pay to the central government taxes sufficient to cover the expenses of their own administration. They should also make a proportionate contribution to cover central expenses, including those incurred in time of war. To increase the acceptability of this scheme Smith advocates giving the Americans representation in the British parliament. Once again reflecting his unflattering view of politicians, Smith thinks this scheme would gratify the ambition of its leaders.

Debt

Governments can also raise money by borrowing. This presupposes a developed financial system. Money evolved as a more efficient or easier way to exchange different goods. Gold and silver because of their durability came to be widely accepted as the unit of exchange. But as commerce developed so did systems of finance. Paper money emerged out of arrangements between merchants and this in due course led to the establishment of banks. Smith judges this development positively. As he figuratively puts it, paper money converts dead into active stock thus increasing trade and industry.

Paper money is only treated as currency because it is believed to have value. But belief is nothing tangible, it needs to be given some substance or underwritten. Smith therefore counsels that this belief still needs to be secured in gold and silver. In a poetic flight of fancy lifted from Jonathan Swift, one of his favourite authors, commerce is more secure when it rests on 'the solid ground' of gold and silver rather than when it is 'suspended upon the Daedalian wings of paper money' (*WN* 321). In addition, to enable paper money to carry out its beneficial function there has to be confidence in banks as the issuing agents. This confidence can however be lost. This happened, with serious consequences, to the Ayr Bank in Scotland, an event to which Smith explicitly draws attention. The collapse of Lehmann Brothers and RBS in 2008 indicate that this issue has not gone away.

What a banking system facilitates is the issuing of credit—lending money to invest in new capital. But the government itself can borrow. The extent of government debt was contemporaneously a vexed question (Hume, for example, wrote a savage critique). Smith's analysis of government indebtedness provides another case where the unintended consequences of individual action do not work for the best.

Thanks to the security provided by the regular administration of justice, those with capital will have sufficient trust and confidence in the government to extend it credit. Their funds would be safe and they'll get a good deal because the government needing extra money to meet extraordinary expense (usually war) gave a good return. But this set a dangerous precedent.

Because the government can now foresee a source of revenue it doesn't build up reserves. It effectively passes the buck to the next generation to pay the lenders back. However, that generation will adopt the same attitude; and so the debt grows. Smith then proceeds at some length to itemize the various devices by which the debt is funded.

Despite the ingenuity of these devices, bankruptcy, when the revenues are insufficient to pay off the interest, let alone the capital, on past loans, is the ultimate consequence. This, Smith notes, is often 'disguised' by manipulation of the value of the currency. However, this manipulation only aggravates the situation. By undermining the value of money it extends the 'calamity' to more innocent people (*WN* 932–3). He thinks it a vain hope to expect the public debt ever to be paid back. At best it can be reduced by increasing public revenues (such as a more equal land tax, increased excise duties, and a greater contribution from the colonies) and/or reducing public expenditure, such as removing the various distorting subsidies in order to reap the benefits of more productive trade and thus taxable wealth. To this day these options (borrow/increase taxes/reduce expenditure) are how governments have to meet their commitments.

In summary

The *Wealth of Nations* is a justly celebrated book in the history of economics or the study of how an economy works. It combines a comprehensive reach with a systematic analysis. Perhaps above all, the justification for Smith's renown lies in his Newtonian achievement of reducing complexity to simplicity. Economic behaviour and institutions are not random or chaotic but can be systematized and understood as the product of a few principles. In the way that the *Moral Sentiments* gives an account of how humans make moral decisions so the *Wealth of Nations* gives an account of how modern economies work. Both accounts rely on some universal principles identified in a 'science of human nature'.

In the *Wealth of Nations* pride of place among these principles goes to the self-interested hope of everyone to better their own condition. But, equally significantly, that hope embodies the moral principle that everyone is free. Slavery is not only an economically unproductive system it is also 'bad' (*LJ* 453). On the bases of self-interest and freedom Smith built his most characteristic economic doctrines. Free trade is the best way to stimulate economic growth and thus increase the wealth of nations; individuals are the best judges of their own interests; and the outcomes of particular exchanges redound unintentionally to the general benefit. In the last analysis what really counts is that human life is made better as the 'miserable poverty' of the savage nations, as depicted in his Introduction, is left behind, and the twin blessings of opulence and freedom are experienced.

Although Smith's foundational importance is now unquestioned that was not inevitable, his legacy was not straightforward.