

Adam Smith

Adam Smith, in 1759, published *The Theory of Moral Sentiments (TMS)*. In this masterwork Smith confronted the seemingly contradictory motives of self-love and sympathy for others. Considering this early work of Smith, helps to clarify the extent that political economy is grounded in moral philosophy.

In 1766 Smith published his *Lectures on Jurisprudence (LJ)*, in which he examines the requisites for the “advancement of riches” in the form of an increasing economic surplus.

Then in 1776, Smith published *The Wealth of Nations (TWN)*. During this time, the English business scene was starting to be dominated by capital employing wage labor. Even with the emerging capitalist development, mercantilist restraints remained onerous. And one can read *TWN* as an attack against the principles and practices of mercantilism.

While Quesnay offered a model of an interdependent economy that produced a surplus and Turgot anticipated many Smithian themes in his *Reflections*, it remains *TWN* that is known as the first major work of classical political economy.

TMS

According to Smith, human happiness and well-being are the concern of moral philosophy. The ancient moral philosophers were aware of such a concern and emphasized man as a member of a family, state, and larger society. The view of moral philosophers contrasts greatly with that of the Middle Ages which considered happiness as inconsistent with virtue. The distinction between vice and virtue was taken up by Mandeville in his *Fable of the Bees*. In Mandeville’s *Fable*, the pursuit of riches is presented as anti-social. Smith, however, took a different stance, suggesting that such self-interested behaviors are tempered by an equally strong desire for the approbation of one’s fellows.

In the quote from Smith’s *TWN*, it would seem that self-interest serves as the prime motivator for human action. However, in *TMS*, Smith stated that sympathy for others co-exists with self-interest. This begs an important question, can the primacy attributed to self-interest be reconciled with individuals who extend sympathy to fellow humans. The answer to *Das Adam Smith Problem* is arrived at through the recognition of our interdependence as social beings—individuals cannot be reduced to an entity that exists independent of their social experience; rather, they are the product of the social environment. Individuals pursue self-interest, but in a manner that is consistent with societal norms and values. Self-interest is constrained by what society has determined to be socially acceptable.

TWN

The theory of the social origin of moral judgments and standards is fundamental to the doctrine of the harmony of individual and national interests that pervades *TWN*. It appears reasonable, therefore, to interpret the doctrine of sympathy as developed in *TMS* as the conceptual antecedent of the doctrine of the natural order set forth in *TWN*.

The natural order presented in *TWN* has at its core individuals who pursue self-interest while simultaneously promoting the welfare of society as if guided by an “invisible hand.” This is not meant to imply that the “invisible hand” is a reference to an efficient allocation achieved via the price mechanism, nor does it imply that Smith believed that the market coordinated conflicting individual actions; rather,

the simultaneous promotion of what's best for society that emerges from the pursuit of self-interest is simply a positive externality.

Within the framework of natural order, resulting from human behavior and for the benefit of society, emerges a division of labor, development of money, growth of savings and investment of capital, and foreign trade.

TWN contains few references to the works of other authors. While Smith was sloppy in his scholarship, he skillfully drew upon important ideas from previous works to create a harmonious whole. While utilizing the concept of the surplus as pioneered by Petty, Smith otherwise rejects the empirical approach of *Political Arithmetic*. Instead, Smith favors the methodological perspective of deductive logic. The reliance on deductive logic to articulate an economy envisioned as being comprised of self-interested individuals whose actions simultaneously promote social well-being would remain very influential on the scholars who came after Smith.

TWN contains five books, the central themes of each are presented on this slide.

Summarizing thoughts

The wealth of a nation is best measured by the ability to satisfy the material well-being of its members. Commodities, not metal, constitutes the wealth of a nation. While this view of wealth parallels the Physiocrats emphasis on the net product, a key difference is immediately clarified in *TWN*. For Smith, the source of wealth is human effort which remains the prime mover of production. The division of labor, the title of chapter 1 in book 1, is responsible for the relatively high standard of living that Smith observed. The division of labor arises from a "propensity to truck, barter, and exchange" and is limited by the extent of the market. Specialization requires an ability to exchange the surplus for other material means of well-being. The interrelationship between individuals engaged in capitalist production and market exchange means that in order to serve one's own interest, they must appeal to the self-interest of others.

Productive and unproductive labor

The Physiocrats made a clear distinction between productive and unproductive labor— those who worked the land were productive. Smith also, unfortunately, attempted to distinguish between productive and unproductive labor; his attempt at distinction, however, created considerable confusion.

- First, Smith excluded services from the national product and thus considered labor employed in service as unproductive.
- Second, revenues above the cost of production in manufacturing were treated by Smith as part of the surplus, blurring the difference between profit and interest. This is problematic because profit and interest are functional returns for two distinct activities. Profit is the entrepreneurial reward for assuming risk and managing production while interest is the reward for lenders increased risk and reduced liquidity.
- The final point arises from Smith's special treatment assigned to the productive power of land which created confusion on the nature of rent. Like Keynes said centuries later, "the difficulty lies, not in the new ideas, but in escaping from the old ones..."

Theory of value and exchange

On the origin and use of money, Smith believed that much like the division of labor, money emerges from the individualistic pursuit of self-interest.

In attempting to understand the nature of the wealth of nations, Smith established that labor is the source of wealth and the division of labor remains the chief means to enhancing it. Smith then confronts the question of the worth of a commodity. In so doing, Smith distinguishes a commodities *value in use* and *value in exchange*. Ultimately, Smith concludes that value in exchange is unrelated to value in use.

There are several problems with Smith's analysis.

1. In order for a commodity to command other commodities in exchange, it must have value in use; if not, why would a user give up other commodities or money in exchange for that commodity.
2. Smith failed to realize the significance of the relative scarcity of the commodity at the margin. It is misleading to compare a single diamond to the total supply of water. This paradox was ultimately resolved when it was later realized that the comparison needs to focus on exchange ratios of individual units.

The final two statements seen here raise a question, is it labor cost or labor commanded that Smith accepted as determining value. In "that early and rude state of society" the labor theory of value holds and labor cost is equal to labor commanded; there is no landlord, nor capitalist to claim a share of the product— the entire product belongs to labor. However, once land has been appropriated and capital accumulated, the equivalency no longer holds.

Once society has advanced production to the point of creating a surplus and when there exists groups who have competing claims on that surplus, conflict over distribution is likely to arise. Another key feature of the advance beyond the early and rude state, is that the production of commodities requires the use of previously produced commodities.

Ignoring rent for the sake of simplicity, Smith posited that in the advanced state, natural prices are determined by adding up the different components— wages + profits. The natural price, which acts as a center of gravitation around which market prices will fluctuate, is determined exclusively by costs on the supply side, an approach that would continue until the marginal revolution at the end of the 19th century.

Theory of distribution

The classical theory of distribution explains wages, profits, and rents as the incomes of "the three great social classes." This approach contrasts greatly with the contemporary approach that treats labor and capital as factors of production that receive a functional return according to their contribution.

Wages

Smith's treatment of the determination of wages is rather difficult to pin down. At times he suggests, as seen in the first quote, a bargaining theory of wage determination.

Even though employers maintain the advantage in the interaction between labor and capital, Smith did believe that subsistence determined the floor below which wages could not fall. To understand the

determination of the wage relative to that subsistence, Smith introduced the concept of a wage fund which dates to the Physiocrats. The wage fund is a stock that has been previously accumulated and is available to sustain labor as they engage in production. The total sum of wages is constrained by the size of the wage fund.

Profits, interest, and rent

The rate of profit is inversely related to the wage rate. The capitalist have first right to the product, their relative share is determined by the rate of profit. The wage fund and the wages flowing from that fund are thus a residual.

Smith, like Turgot, opposed the prohibition of usury. Interest was considered by Smith and previous thinkers as a payment for use of borrowed funds and regarded as a part of profit. At this time, most business owners furnished all or most of the required capital, thus their entire income was treated as profit.

Rent was treated as a differential return. The movement of wages and profits will cause prices to move in the same direction. High or low rent, however, does not affect prices, but rather it is the effect of high or low prices. If the land is used in the production of commodity in high demand, the monopolist landlord can charge higher rent.

Concluding thoughts

One of Smith's most noted contributions was that the economic system is driven by self-interested social beings subjected to the forces of competition. From this insight, Smith argued that rate of a return will equalize across its uses. If taken further this line of reasoning leads to a significant conclusion: if perfect competition exists, the area of conflict between private and social interests is greatly reduced.

Even given Smith's emphasis on economic liberty, he recognized that there remains a significant role for government intervention.

The harmony of social interests that pervades *TWN* exists side-by-side with the potential for social conflict. The labor theory of value combined with the existence of a surplus lays the foundation for dichotomy of class interests. The potential for conflict is exacerbated when Smith treats profits and rents as a deduction from the product of labor as opposed to his treatment of wages and profits as components of the price.