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History of Economic Thought

IV. Adam Smith

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Before Adam Smith

1. Richard Cantillon
2. The Physiocrats
3. A. R. J. Turgot
4. The Italian Economists

The Scottish Enlightenment and Adam Smith

5. The Scottish Enlightenment
6. Adam Smith



1. Richard Cantillon

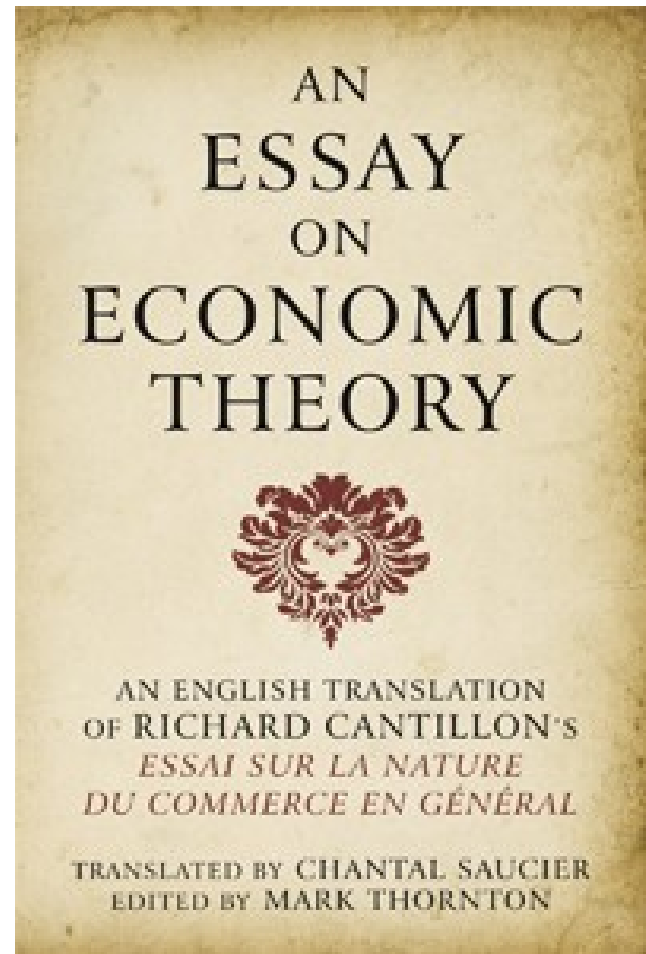


- C. 1680-1734
- Irish, family exiled after Cromwell's invasion of Ireland
- Banker in Paris, first working for cousin, then independently
- Became fabulously wealthy during the Mississippi Bubble 1717-20 – and got out in time
- Lived in various European cities afterwards
- Died mysteriously in London



The *Essai sur la nature du commerce en général*

- Written c. 1730, widely circulated in manuscript, published 1755
- General treatise on economics – unlike mercantilists
- Purely descriptive – unlike the scholastics, natural law philosophers
- Highly influential in his day, fell into oblivion after Smith





Price and Subjective Value

- The price of a thing is determined by demand and the stock of the good – i.e., relative scarcity

Objective Costs and Production

- “Objective” measure of cost: determines which areas of business are profitable, which are not
- Equilibrium: cost of production = selling prices of all goods
- Equilibrium achieved by labourers, entrepreneurs moving between lines of production



Land and Labour

- Land is the “matter” of production, earns rent
- Labour provides the “form” of production, earns wages

Entrepreneurs

- Distinction between salaried labour and entrepreneurs crucial:
 - Salaried people earn fixed, contractual wage
 - Entrepreneurs earn uncertain returns
- The entrepreneur faces uncertainty:
 - Fixed costs (contractual payments to workers and others)
 - Uncertain selling prices for final product
- The profits he earn result from his prudence, foresight
- Losses from his lack of prudence and erroneous judgement



The Theory of Wages and Population

- In the long run, wages depend on the supply of labour, i.e., on population size
- Equilibrium will be subsistence wages – but with compensating differentials
 - To attract people to jobs that require more training
 - To provide funds to train the next generation in the job
- Population growth determined by economic and cultural factors
- Increase in demand for land-intensive products lead to decline in demand for labour, lower wages, eventually lower population
- Increase in demand for labour-intensive products lead to increase in demand for labour, higher wages, eventually higher population



- Transport costs and costs of trade influence human geography
- Cities are centres of consumption; bulky and perishable goods will be produced closer to them, longer-lasting goods farther away
- Rent differentials determine the use of land
- Towns and markets developed, as this reduced costs of trade: merchants would have to spend a lot of time going from farm to farm



The “Cantillon Effect”

- Cantillon showed the gradual effects of money creation
- Prices change in a step-by-step process as money enters the economy, depending on where it first came in, leading to redistribution

Money and the Interest Rate

- The Cantillon effect also holds if money enters loan market first:
 - The rate of interest will temporarily decline
- If money goes first to consumption, the market rate of interest might rise
 - Entrepreneurs increase borrowing to expand production in order to meet higher (monetary) demand
- Fundamental difference between specie and bank notes: latter is costless



Foreign Exchange Market

- Developed theory of international monetary equilibrium: what happens when new money enters the economy?
 - Expenditures on imports go up
 - Domestic prices increase, lowering exports and adding to imports
 - Temporary unfavourable balance of payments: money flows out to pay for imports
 - Money supply reduced, prices fall, incomes fall, leading to reversal: exports increase and imports fall

Foreshadows Hume's price-specie flow mechanism



2. The Physiocrats

- First self-conscious school of economic thought, emerged mid-eighteenth century

Francois Quesnay (1694-1774)

- The founder: physician to Madame de Pompadour, Louis XV

Victor Riqueti, marquis de Mirabeau (1715-1789)

- Promoter of Quesnay: they meet July 1757, a school of thought is born



Quesnay's *Tableau*

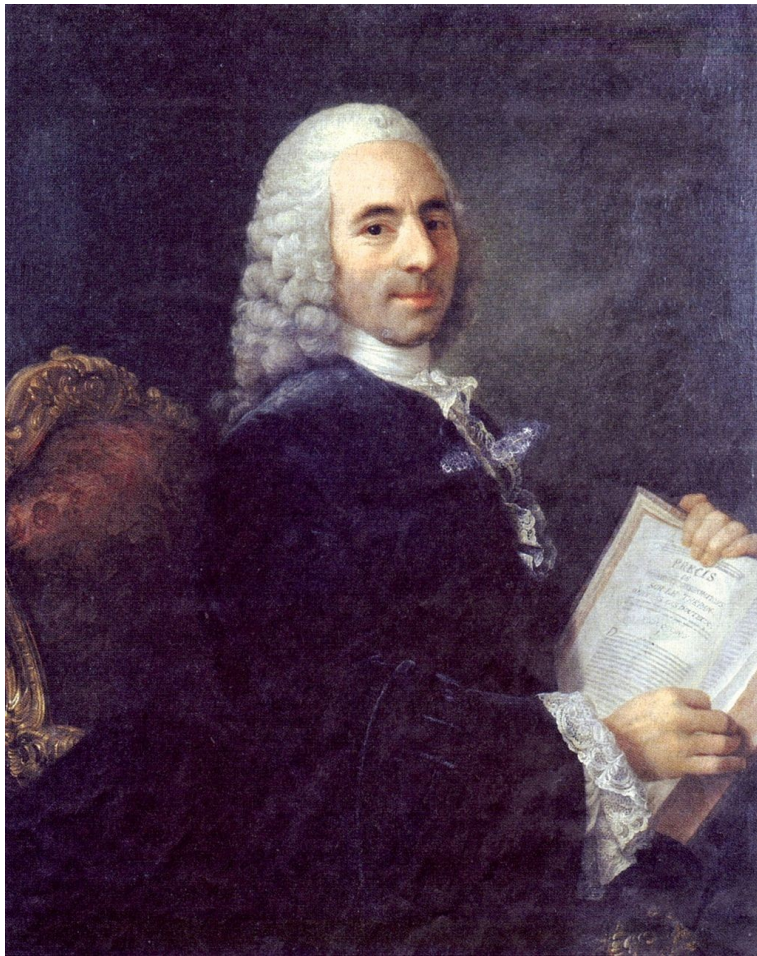
Tableau Économique
Objets à considérer, 1°. Trois sortes de dépenses; 2°. leur source; 3°. leurs avances; 4°. leur distribution; 5°. leurs effets; 6°. leur reproduction; 7°. leurs rapports entr'elles; 8°. leurs rapports avec la population; 9°. avec l'Agriculture; 10°. avec l'industrie; 11°. avec le commerce; 12°. avec la masse des richesses d'une Nation.

DÉPENSES PRODUCTIVES relatives à l'Agriculture, &c.	DÉPENSES DU REVENU, l'Impôt prélevé, se partage aux Dépenses productives et aux Dépenses stériles.	DÉPENSES STÉRILES relatives à l'Industrie, &c.
Avances annuelles pour produire un revenu de 600 ^{ll} sont 600 ^{ll}	Revenu annuel de 600 ^{ll}	Avances annuelles pour les Ouvrages des Dépenses stériles, sont 300 ^{ll}
600 ^{ll} produisent net.....	600 ^{ll}	300 ^{ll}
Productions		Ouvrages, &c.
300 ^{ll} reproduisent net.....	300 ^{ll}	300 ^{ll}
150 ^{ll} reproduisent net.....	150 ^{ll}	150 ^{ll}
75 ^{ll} reproduisent net.....	75 ^{ll}	75 ^{ll}
37.10 ^{ll} reproduisent net.....	37.10 ^{ll}	37.10 ^{ll}
18.15 ^{ll} reproduisent net.....	18.15 ^{ll}	18.15 ^{ll}
9...7...6 ^{ll} reproduisent net.....	9...7...6 ^{ll}	9...7...6 ^{ll}
4.13...9 ^{ll} reproduisent net.....	4.13...9 ^{ll}	4.13...9 ^{ll}
2...6.10 ^{ll} reproduisent net.....	2...6.10 ^{ll}	2...6.10 ^{ll}
1...3...5 ^{ll} reproduisent net.....	1...3...5 ^{ll}	1...3...5 ^{ll}
0.11...8 ^{ll} reproduisent net.....	0.11...8 ^{ll}	0.11...8 ^{ll}
0...5.10 ^{ll} reproduisent net.....	0...5.10 ^{ll}	0...5.10 ^{ll}
0...2.11 ^{ll} reproduisent net.....	0...2.11 ^{ll}	0...2.11 ^{ll}
0...1...5 ^{ll} reproduisent net.....	0...1...5 ^{ll}	0...1...5 ^{ll}
Et c.		

REPRODUIT TOTAL..... 600 ll de revenu; de plus, les frais annuels de 600 ll et les intérêts des avances primitives du Laboureur, de 300 ll. que la terre restitue. Ainsi la reproduction est de 1500 ll compris le revenu de 600 ll qui est la base du calcul, abstraction faite de l'impôt prélevé, et des avances qu'exige sa reproduction annuelle, &c. Voyez l'Explication à la page suivante.



Quesnay and Mirabeau





Physiocracy

- The physiocrats originally called themselves simply “the economists”
- Physiocrats from their principle of physiocracy: the rule of nature

In Locke’s Footsteps

- Right to liberty implies right to property (Quesnay)
- There are natural laws governing social life
- Self-interest the mainspring of human action, leads to harmony if not artificially impeded

Policy

- The physiocrats cast aside all mercantilism
- For total free trade, domestic and internationally



Agriculture is the only productive sector

- Other activity may be useful, but not productive: it does not create matter
 - Perhaps influenced by Fleury and Fénélon?
- Single tax on land

The *Tableau économique*: the first circular flow model

- Depicts flow of expenditures from one class to the next
- Holistic: no mention of prices, price adjustment
- Savings bad: money leaks out, leading to reduction of expenditure

Individualist in their policies, holistic in their economics



3. Turgot and Condillac

- Enlightenment economists
- Not physiocrats
- Overshadowed by Smith



Anne Robert Jacques Turgot, baron de l'Aulne (1727-1781)

- Brilliant but brief career in economics: really a side interest to him
- Wrote several essays, perhaps 150 pages total
- Born in Paris, studied for priesthood, but entered administration instead
- Intendant of Limoges for a decade, minister of commerce 1774-76





Self-made Economist

- A fellow-traveller of the physiocrats – but never part of their school
- First learned economics from his mentor, marquis de Gournay
 - Minister of commerce who advocated for laissez-faire

Self-interest the prime mover of economic life

- Individual interest always coincides with the general interest
- All exchange mutually advantageous
 - Freedom for domestic and foreign trade follows

Politics

- Exceptions for special interests harmful
- They turn political economy into a war of reciprocal oppression
- Therefore, commercial freedom must be universal



Subjective Utility

- Value is conferred on goods by the individual
 - He chooses between things, ranks goods on a scale
- The subjective utility of a good diminishes as its supply increases
 - Diminishing utility
 - Solves “value paradox”: since water is abundant, it is not considered very valuable

Exchange

- In an exchange, each person receives greater value than he gives up
- But the idea of equality of exchange persists: equal value will exchange for equal



Sources of Productivity

- Only agriculture productive
- Division of labour and trade greatly increases productivity

The Law of Diminishing Returns

- Double the input (advances of capital) will not lead to double the product
- After a point, all further advances useless
- There is a maximum point of returns: adding more beyond this will yield less and less
- Worked out in great detail, only graphical presentation missing



Original Capital Theory

- Capital comes from saving, consuming less than one earns
- Saving first in form of money
- Then invested in production
- Capitalists save and advance money to labourers while they work

Role of Time

- Production takes time: capitalists have to wait
- Labourers give up part of the product to benefit from capital
- Therefore, the capitalists earn a discount on the final product
- They also earn profits from uncertainty – like Cantillon



Equilibrium Returns

- Return on capital invested and interest on money will tend to be equal
- Capital owners will balance returns from different channels

Interest and Usury Laws

- Interest rates set by supply and demand
 - Many reasons to borrow
 - Two reasons to lend: security of capital and interest
- Turgot hard critic of usury laws: the contract is freely made, therefore mutually beneficial
- Money can always be invested, there are always opportunity costs to loans
- The physical quantity of loan not important but its present utility to borrower and lender

Capitalization

- The present value of land is the sum of rents discounted to the present



Turgot on Money

- Money is not a token, it is itself a commodity, a form of wealth
- Development and extension of monetary economy of crucial importance
 - Scope for commerce, capital accumulation greatly extended
 - Large sums of capital needed to develop production structure
 - Division of labour depends on monetary exchange
- There is no necessary connection between the quantity and value of money and the rate of interest
- Turgot overshadowed by Smith, but had large influence



Minister of commerce 1774-76

- Promised great effects from freeing trade
- Oversold it: too optimistic on short run gains
- Louis XVI then caved to pressure from other ministers

But is the problem overstated?

- Example of Cardinal Fleury 1723-43: moderately laissez-faire
- Gournay another example
- Real economic advance in France before the Revolution
- The real problem: the loss of faith in the *ancien régime*, partly from real and perceived failures of reform



Etienne Bonnot de Condillac (1715-1780)



- Famous sensationalist philosopher
- Educated at theological seminary in Paris, wrote philosophical works in 1740s and 50s
- Travelled to Italy 1758, tutor to the son of the Duke of Parma
- Learned economics from Italian economists
- Back in Paris after a decade, stimulated by free trade agitation



Subjective Value Theory

- Source of value: utility to individuals
- Utility increases with scarcity, decreases with abundance

Value, Exchange and Cost

- Exchange arises because the value of two goods exchanged is the reverse for the two individuals
- There is no “equal value” in exchange, each receives more than he gives up
- Cost is dependent on value, not the other way around
- Analysis of money, international money flows following Cantillon

Completely overshadowed by Smith



4. Italian Economists

- Ferdinando Galiani
- Antonio Genovesi



Ferdinando Galiani (1728-1787)

- Neapolitan
- Major work *Della Moneta* published when only 23, in 1751
- Develops utility-scarcity theory of the value of goods and money
- Value not intrinsic, a relation between possession of one good and another in the human mind
- Quantity demanded is inverse to price, utility diminishes as supply increases
- Interest equalizes present and future money
- Providence orders the world so self-interest leads to social harmony
 - A process guided by a “supreme hand”



Antonio Genovesi (1712-69)

- Also Neapolitan, born in Salerno
- Priest, professor at Naples, first moral philosophy, then economics and commerce
- Notable teacher
- *Lezione de economia civile* (1765)
- Moderately free trade
- Emphasized the essential double inequality of value in all exchanges
- In exchange, the superfluous is given up for the necessary
 - Key phrase in later liberal tradition!



5. The Scottish Enlightenment

British Intellectual Life

- Oxford and Cambridge dead – only to make friends for young gentlemen, education of Anglican churchmen
- Scotland the place to be intellectually, Edinburgh and Glasgow Universities

Growing Reading Public

- Increasingly possible to be an independent intellectual
 - David Hume and his *History of England*
 - Edward Gibbon and the *Decline and Fall of the Roman Empire*



Act of Union 1707 – Scotland and England united

- Presbyterian Church established church of Scotland
- The church dominated by lowlands and east coast moderates

Moderate Presbyterians and the Scottish Enlightenment

- Rev. William Robertson (1721-93) leader of the moderates
 - Principal of Edinburgh University 1762
 - Founder of Select Society of Edinburgh 1750
- Institutional and economic support from the church
- Likely intellectual influence also, if only for sentimental reasons – note Smith’s high opinion of “Presbytery”



Moral Philosophy, Natural Law and Economics in Scotland

- Founder: Gershom Carmichael (1672-1729), son of Presbyterian minister exiled for heresy, born in England
- Graduated from Edinburgh, regent at St Andrews and Glasgow
- After Presbyterian minister at Fife, first professor of moral philosophy at Glasgow 1727

The Natural Law Inheritance

- Carmichael translated Pufendorf's compendium, *De Officio Hominis et Civis*, published with extensive commentary 1718
- Follower of Pufendorf on subjective value
- Also muddied the waters: introduced difficulty in acquiring goods as a determinant of value



Francis Hutcheson (1694-1746)

- Son of Ulster Scottish Presbyterian minister, educated in Glasgow and Dublin
- Succeeded Carmichael in his chair, his most prominent student
- Dynamic teacher, in English rather than Latin
- *The System of Moral Philosophy* 1755
- Again, followed Pufendorf on value: no demand, no price
- Very subjective definition of use: any tendency to give satisfaction
- But took up Carmichael's real cost suggestion, expanded it



Commodity Theory of Money

- Money first a commodity generally accepted in a country
- Then comes into use as medium of exchange, standard of value, measure of economic calculation
- Commodities chosen for the monetary role based on their properties:
 - Generally desirable
 - Divisible into small quantities
 - Durable
 - Portable
- Silver and gold are the commodities usually chosen, the form of coins most popular, most convenient for daily use



Division of Labour

- A free market means reciprocal aid through mutual exchange
- Division of labour key to preserve human life
- Against Mandeville: it is not luxury consumption but saving and investment that leads to prosperity

Lingering Mercantilism

- Trade must be regulated to maintain favourable balance of trade
- In practical policies, Hutcheson simply a mercantilist
- Hutcheson had a clear influence on Adam Smith
 - Seen from arrangement of topics, almost the same in Hutcheson and Smith



Famous philosopher

- *A Treatise of Human Nature* published at age 28
- Of great importance in history of philosophy
 - Fact-value dichotomy
 - Skepticism
 - Kant's "dogmatic slumber"

"Amateur" Philosopher

- Earned his living as diplomat, wrote essays, and his famous *History of England*
- His economics spread over his essays, about 100 pages all told



On Trade

- Wrote essays on balance of trade, commerce
- Liberating influence on mercantilist prejudices
- Not a complete free trader

On Money

- Revived quantity theory from Locke
- The price-specie flow mechanism: the quantity theory applied internationally
- Hume not consistent: thought that an increase in the money supply positive, stimulates “spirit of industry”



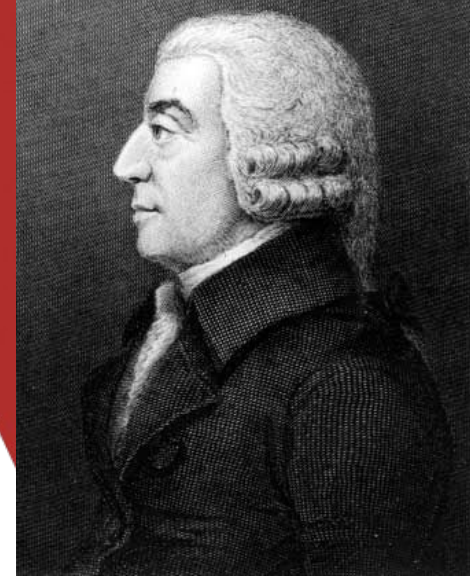
The Price-Specie Flow Mechanism

Money supply increases in one country

- Prices rise in one country, reducing its exports and increasing its imports
- Unfavourable balance develops, money flows out to pay
- Contraction of the domestic money supply the result, fall in prices
- Reversal of unfavourable balance results

Bullionism self-defeating

- Free market equilibrates international money flows, balance of payments



6. Adam Smith (1723-90)

- From Kirkcaldy near Edinburgh, raised by mother, studied under Hutcheson, MA with distinction 1740
- Sent to Balliol College, Oxford, to become Anglican minister. Returned after six years an ardent Presbyterian
- Sponsored by Lord Kames to give lectures in natural law and liberty 1748 in Edinburgh, 1750 chair in logic, 1752 ascended to Hutcheson's old chair, remained there for 12 years
- *Theory of Moral Sentiments* 1759
- Tutor to Duke of Buccleuch 1764, 3 years in France
- Returned to Kirkcaldy to work on his major work: *An Enquiry into the Nature and Causes of the Wealth of Nations* (1776)



The Problem

- The large gap between the early, Smith of the lectures and the *Theory of Moral Sentiments* and the later Smith of *Wealth of Nations*
- Formulated by German scholars in the nineteenth century

Other Curiosities

- Why did he so completely overshadow earlier economists?
- Why little mention of the industrial revolution happening all around him?

Possible Answers

- Smith aimed at fundamental, scientific work in economics, hence the focus on long run equilibrium states (or “natural price”) instead of actual market prices
- Smith also thorough, lots of data: the best of the Baconian/Pettyite tradition married to natural law? (And Smith didn’t make up his data)
- *Wealth of Nations* massive when compared to Cantillon’s *Essai*



The Main-Spring of Human Action

- Human action motivated by self-interest
- Means that men in economic affairs look to their advantage
- Not only virtue! See *Theory of Moral Sentiments*

Influences

- Bernard Mandeville, *Fable of the Bees*
 - Private vice, public benefit
- From Pufendorf, the continental natural law tradition



The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often incumbers its operations. (bk 4, ch. 4)

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. (bk 1, ch. 2)



Exchange and Division of Labour

- The starting point of economics for Adam Smith
- Originator of term division of labour

Origins of the Division of Labour

- Based on an instinct to “truck, barter and exchange”
 - The cause, not the consequences of differences between men
 - Possible influence from Locke
- Encouraged by self-interest
 - As persons realize the advantages to be gained



On the Division of Labour

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. It is the necessary, though very slow and gradual, consequence of a certain propensity in human nature which has in view no such extensive utility; the propensity to truck, barter, and exchange one thing for another.

Whether this propensity be one of those original principles in human nature, of which no further account can be given; or whether, as seems more probable, it be the necessary consequence of the faculties of reason and speech, it belongs not to our present subject to enquire. (bk. 1, ch. 2)



Limits to Division of Labour

- The extent of the market
- Some occupations only possible in towns
- Isolated individuals have to do everything themselves

Effects of the Division of Labour

- Leads to differences in talents
- Three sources of increased productivity
 - Increased dexterity
 - Time saving
 - Invention of machinery



Productive and Unproductive Labour

- Productive labour: work on material goods, durable “stock”
- Unproductive labour: work on immaterial goods, services
- Durable consumer goods also unproductive, despite being useful
- Result: productive work is really work that adds to capital stock

Investment and Growth

- only from savings and thrift
- “Every frugal man a public benefactor” as opposed to Mandeville
- Close to Turgot: Schumpeter talks of the “Turgot-Smith theory of investment”



Early Smith, Late Smith

- Early on, completely in Hutcheson's footsteps
- Subjective value
- *Wealth of Nations* different from Smith's earlier work

Value in Use, Value in Exchange

- From physiocrats
- Value in use: usefulness to the individual
- Value in exchange: price, what you pay
- Labour is the measure of exchange value
- Nominal vs. real price ; money price vs. labour price

Hence, the value paradox

- Water is very useful, but has very low exchange value
- Diamonds are practically useless, but has high exchange value



Exchange in Smith's Lectures

The very intention of commerce is to exchange your own commodities for others which which you think will be more convenient for you. When two men trade between themselves it is undoubtedly for the advantage of both... The case is exactly the same betwixt any two nations. The goods which the English merchants want to import from France are certainly more valuable to them than what they give for them.



Focus is on the long-run, *natural price*

First Theory

- Exchange value determined by cost of production
- Equal to total expenses on wages, rent, and profits
- Costs treated as given

Second Theory

- Cost (exchange value) determined by the quantity of labour, or labour pain expended
- Goods exchange for equal quantities of labour hours embodied in them
- Market bargaining brings prices into agreement with labour quantities

Third Theory

- The value of a good determined by how much labour it can command
- How much labour it can purchase
- Clear contradiction to second theory, if we allow for rent and profit
- Some socialist economists simply tried to work out the problem



The Classical Triad

- Land earns rent
- Labour wages
- Stock (capital) profits
 - No entrepreneur: everything comes down to investing stock, managing labour

Rent and Profit

- Often seen as simply deductions from product of labour
- The determination of rate of profit is not clear
 - But the greater the amount of stock, the lower the rate
- Increasing amount of stock means an increasing demand for labour
 - Therefore economic growth means a secular increase in wage rates



Short Run

- Determined by bargaining between employers and labourers

Long Run

- equilibrium development of Cantillon's theory
- Natural price is subsistence wage
 - If wages rise, population increases, until wages fall again to new subsistence level
 - If wages fall below subsistence, population shrinks, driving up wages to subsistence level
- Increasing capital accumulation the only hope? Problem taken up by Malthus

Common 18th Century Them

- the population of a species tends to press on the means of subsistence of the species



- No clear rent theory
- Rent to land at one point portrayed as simply a monopoly price and the landowner a monopolist
- At other points rent is due to the superior location, fertility of land
- Or to the productive powers of land
- Condemnation of landlords: they reap where they do not sow!
- Perhaps Smith influenced by vestiges of *ancien régime*, “feudal” privileges?



Early Smith, late Smith

- Follows Hume in his lectures
- No price-specie flow mechanism in *Wealth of Nations*

Money and Circulation

- Every country will have just enough specie to “circulate trade”
 - Surplus specie will overflow channels of commerce, seek employment abroad
 - Perhaps another instance of too narrow a focus on long-run equilibrium?
- Value of money determined by labour
 - money the embodiment of the labour cost that went into it



Emergence of Money

- Exchange hampered under barter
- Therefore prudent men began keeping commodities for exchange
- Examples: cattle, salt, tobacco, cod

Metallic Money

- Gold and silver preferred for their qualities
- Divisible, durable, valuable, transportable
- Stamping and coinage introduced to certify purity, weight
- Therefore the coins originally simply expressed the weight



- Smith's contemporaries very skeptical or hostile to banking, bank notes – e.g., David Hume
- Smith much more positive, if still careful
- Bank notes are like a “highway in the sky”: the stock bound up in specie can be productively invested if people use bank notes instead of coins
- Issue of bank notes will be regulated by market mechanism, so bank notes always equivalent to specie: an over-issue will flow back to the banks in exchange for specie
- A case of national pride: Scotland the home of modern banking, established in the early eighteenth century



Patron Saint of Free Markets?

- *Wealth of Nations* a thorough critique of mercantilism
- But Smith supported some classic mercantilist policies:
 - Navigation acts
 - Taxes on imports of manufactures
 - Taxes on export of raw wool

Concern for the Martial Spirit

- Policies needed to cultivate the martial spirit, remedy bad influence of division of labour
- Navigation acts
- National education

Memories of Bonnie Prince Charlie '45, concern over future Jacobite rebellions?



Advocate of Usury Laws

- Legal maximum rate of 5 percent

The Goal

- Freeze out marginal borrowers
- Speculators
- Prodigal consumers
- Capital instead channeled to prime borrowers, who could use it productively



4 canons of taxation “of evident justice and utility”

- That the tax be proportionate to income
- That the payment of the tax be made as convenient as possible to the payer
- That the costs of collection be kept to a minimum
- That the tax be certain rather than arbitrary

First Canon

- Progressive income taxation

Last Three Canons

- Arguably simply reduces to minimize costs of taxation