

Adam Smith (1723-1790)



Adam Smith

- Biographical details
 - Born Kirkcaldy, Scotland 1723
 - Attended U. of Glasgow at 14
 - Taught by Francis Hutcheson
 - Attended Oxford for 6 years
 - Returned to Scotland 1746
 - Professor at Glasgow 1751
 - *Theory of Moral Sentiments* 1759
 - Tutor to the Duke of Buccleugh 1764
 - European Tour until 1766
 - Returned to Scotland
 - *Wealth of Nations* 1776

Adam Smith and the Scottish Enlightenment

- “Scottish Enlightenment” of the 18th C
- Social science of Francis Hutcheson, Adam Ferguson, Thomas Reid, Dugald Stewart, David Hume, and Adam Smith
- Took inspiration from natural science and Newton
- Naturalist and not a religious approach to human kind

Scottish Social Science

- Uniformity of human nature
- Diversity of culture, but uniform human nature
- Emphasis on social behaviour and on the importance of political, economic and social institutions
- Rejected contract theories of the State
- Conjectural history—Four Stages
- Emphasis on the concept of “spontaneous order”

Scottish Social Science

- Problem of the relationship between self-interest and Sociality
- Issue raised by Mandeville—private vices lead to public benefits
- Hutcheson people are sociable, benevolent and have an innate moral sense
- Virtue yields pleasure
- Utilitarianism—greatest good for the greatest number

David Hume's Social Theory

- Egoism vs benevolence in human nature
- Man is not entirely egoistic
- Values self above others, but does not value others at zero
- Concept of social distance—people value the welfare of others, but less the more distant they are
- This “confined generosity” gives rise to the problem of justice
- Justice is an artificial not a natural virtue

Hume's Social Theory

- Hutcheson vs Hume
- What people find pleasurable they will regard as virtuous
- Moral values and judgments are social constructions
- Hume's skepticism
- Hutcheson, Hume, and Adam Smith
- Smith on sympathy and self love

The “Adam Smith Problem”

- Relationship between TMS and WoN
- TMS seems to stress “sympathy” and moral feeling and social relationships
- WoN stresses economic motives (self interest) and market activity
- Is there a contradiction?
- TMS is about the ability to make moral judgments
- People have a moral sense based on “sympathy” or empathy

The “Adam Smith Problem”

- WoN is about economic activity which is guided by “self-love”
- Self-love is not a narrow egoism
- Self-love does involve a desire to improve one’s material condition, but worldly success also requires that others think well of you
- The best way to gain the esteem of others is to behave in ways worthy of esteem
- Self love, for Smith, is not equivalent to prodigality or vice

The “Adam Smith Problem”

- Smith is rejecting that one should not pursue economic advancement via market activity (the ethical critique of market activity for economic gain)
- Smith is also rejecting the argument that the public good is served by “vice” in the form of greed, vanity, or self-indulgence (Bernard de Mandeville *The Fable of the Bees* 1714)

The Wealth of Nations (1776)

- The title tells the theme of the book—why are some nations wealthy and others not
- First have to define wealth
- Smith defines wealth as the per capita provision of “necessaries and conveniences”
- Per capita real output—not specie or agricultural surplus
- What will determine per capita real output?

Determinants of Per Capita Real Output

- The “skill, dexterity, and judgment” with which labour is applied
- The proportion of the population employed in “productive labour”
- These come down to:
 - the productivity of labour (Book I of the WoN)
 - saving (thrift) and productive investment that leads to capital accumulation over time (Book II of the WoN)

The Division of Labour

- The greatest increases in productivity of labour seem to have been the result of the division of labour
- Example of a pin factory—Smith is talking about *vast* productivity increases
- Division of labour increases productivity by:
 - increasing skill and dexterity
 - saving time
 - the application of machinery invented by workmen or by specialized inventors and machine makers

Origins of the Division of Labour

- “The division of labour, from which so many advantages are derived, is not originally the effect of any human wisdom”
- It is the unintended outcome of a basic human propensity—the propensity to “truck, barter, and exchange”
- Propensity to exchange and self interest will lead to individuals specializing in one activity (and exchanging their output for other things) if they can do better for themselves that way

Specialization and Exchange

- Vast amount of specialization and exchange leads to a complex and interdependent system.
- Example of the simple woolen coat
- System of specialization and exchange based on and organized via self love and not benevolence
- Specialization based on differences in natural abilities or on training; training being the most important source of different abilities

Specialization and its Limits

- The division of labour is limited by the extent of the market
- Division of labour is taken further in large towns than in small villages
- Importance of transportation and of trade for the extension of the division of labour

Division of Labour, Money and Exchange Values

- Division of labour and frequent exchange activity leads to the development of money
- Precious metals often used as they are limited in supply, durable, portable, divisible and can be stamped for fineness and weight
- Exchange involves exchange values
- Use values and exchange values
- Use values and the water/diamond paradox

Real and Nominal Price

- Nominal prices are money prices
- The “real price” of anything is defined in terms of labour and is “the toil and trouble” of acquiring it
- Difficult to express real prices as labour varies in its hardship and skill level
- It is therefore usual to express exchange values in nominal terms
- Variation in money prices may not reflect changes in real prices
- Value of money may vary—money not an invariable measure
- Labour is a universal and accurate measure of value
- Labour Commanded theory of real values

The Component Parts of Price

- If goods are produced with only a single type of labour and with no capital or private property in land—exchange values will be determined by relative quantities of labour
- If it takes “twice the labour to kill a beaver than a deer” then 1 beaver will exchange for 2 deer
- If labour is all paid the same wage than that translates into relative prices being determined by relative labour costs

The Component Parts of Price

- Relative prices determined by relative costs of production which in this simple case are composed entirely of labour costs
- The price paid goes entirely to wages
- What if capital is used in production?
- The price paid has to compensate both labour (wages) and capital (profits)
- If there is private property in land the price charged will also have to cover the rent charged for its use

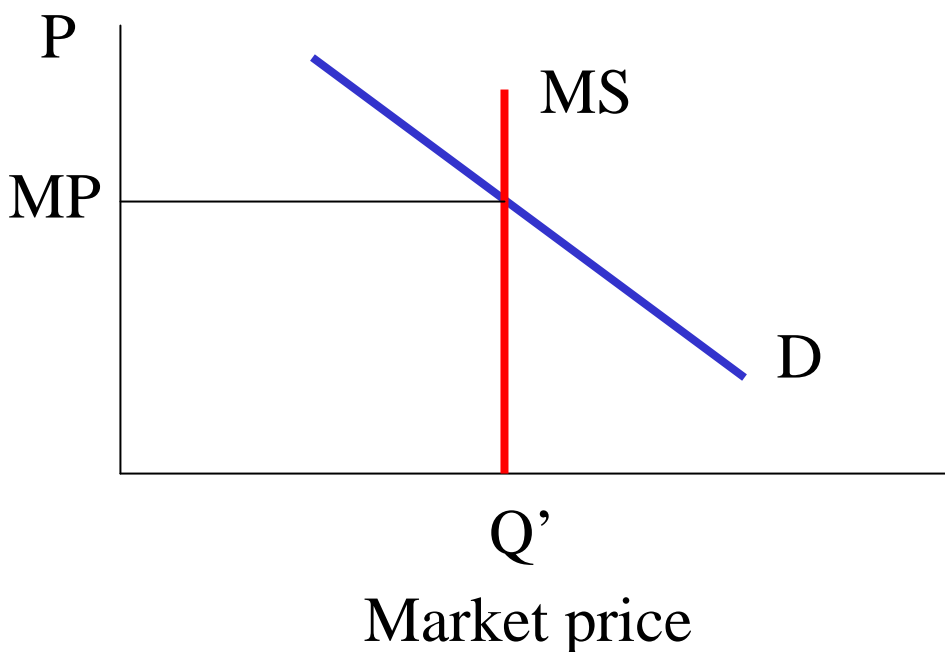
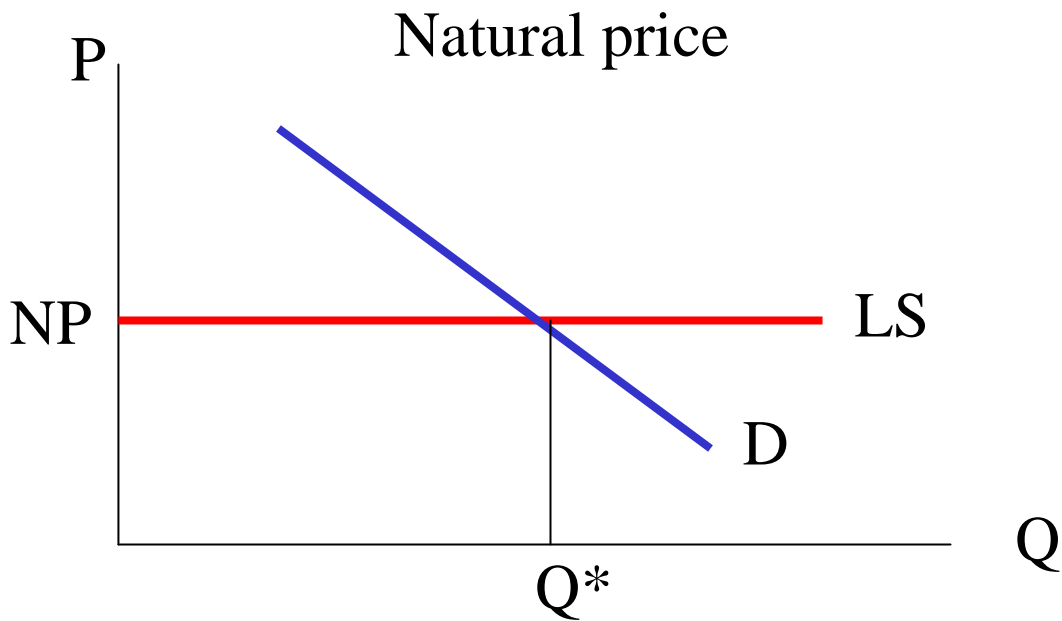
Cost of Production and Price

- Everything paid for a good can be decomposed into a return to a factor of production
- Does this imply that prices are determined by cost of production?
- Smith seems to suggest this cost of production theory
- This would imply that normal factor returns are determined first
- Problem of rent—is rent price determining or price determined
- Are corn prices high because rents are high or are rents high because corn prices are high?

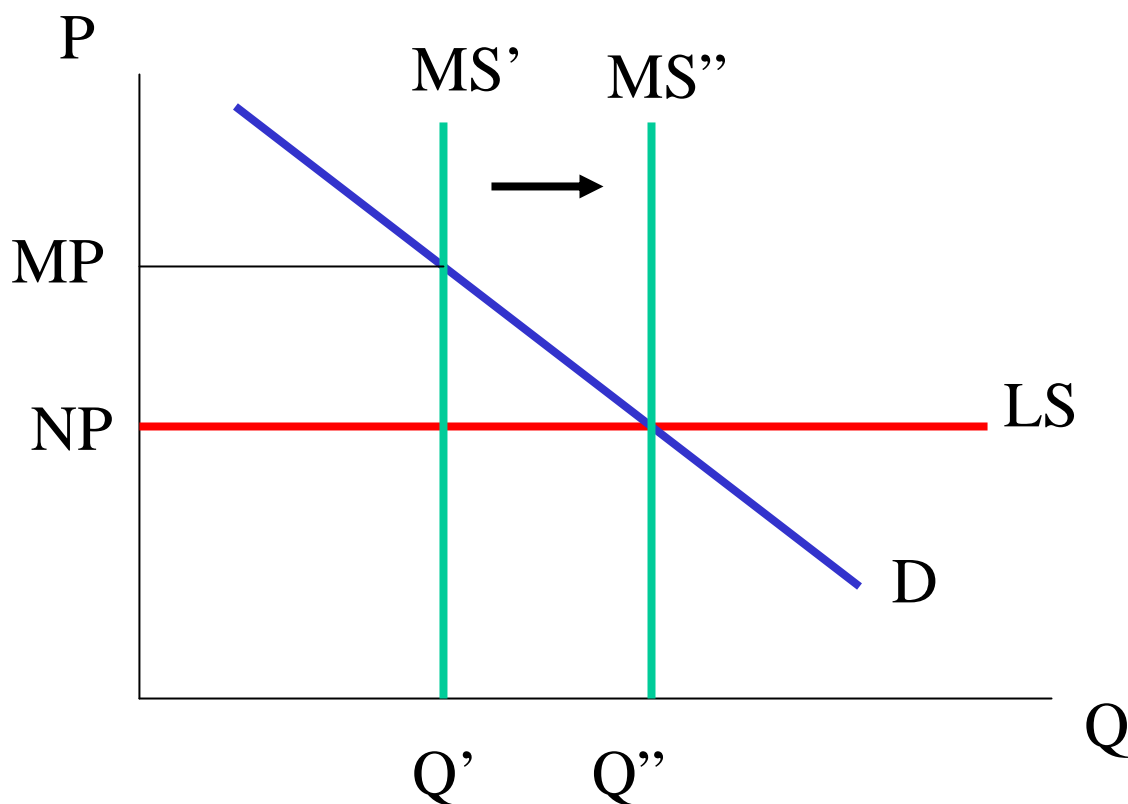
Natural and Market Prices

- “Natural” price just covers wages, profits and rent at their ordinary or “natural” rates
- Market price depends on demand and supply and may differ from natural price in the short term
- Smith’s concept of demand is demand at the natural price: “effectual demand”
- Supply: given in the short (market) period but is infinitely elastic at the natural price in the long term

Natural and Market Price



Adjustment to Natural Price



If effective demand $>$ MS then $MP > NP$.
Some or all factors will be earning more than natural returns and this will attract more resources into the market, shifting the MS curve until $P=NP$ and supply equals the effective demand

Failures to Adjust

- Can PM be kept above PN?
- What might prevent MS from shifting out if $PM > PN$?
- Trade Secrets
- Monopoly
- Scarcity of a particular soil
- Restraints on labour mobility

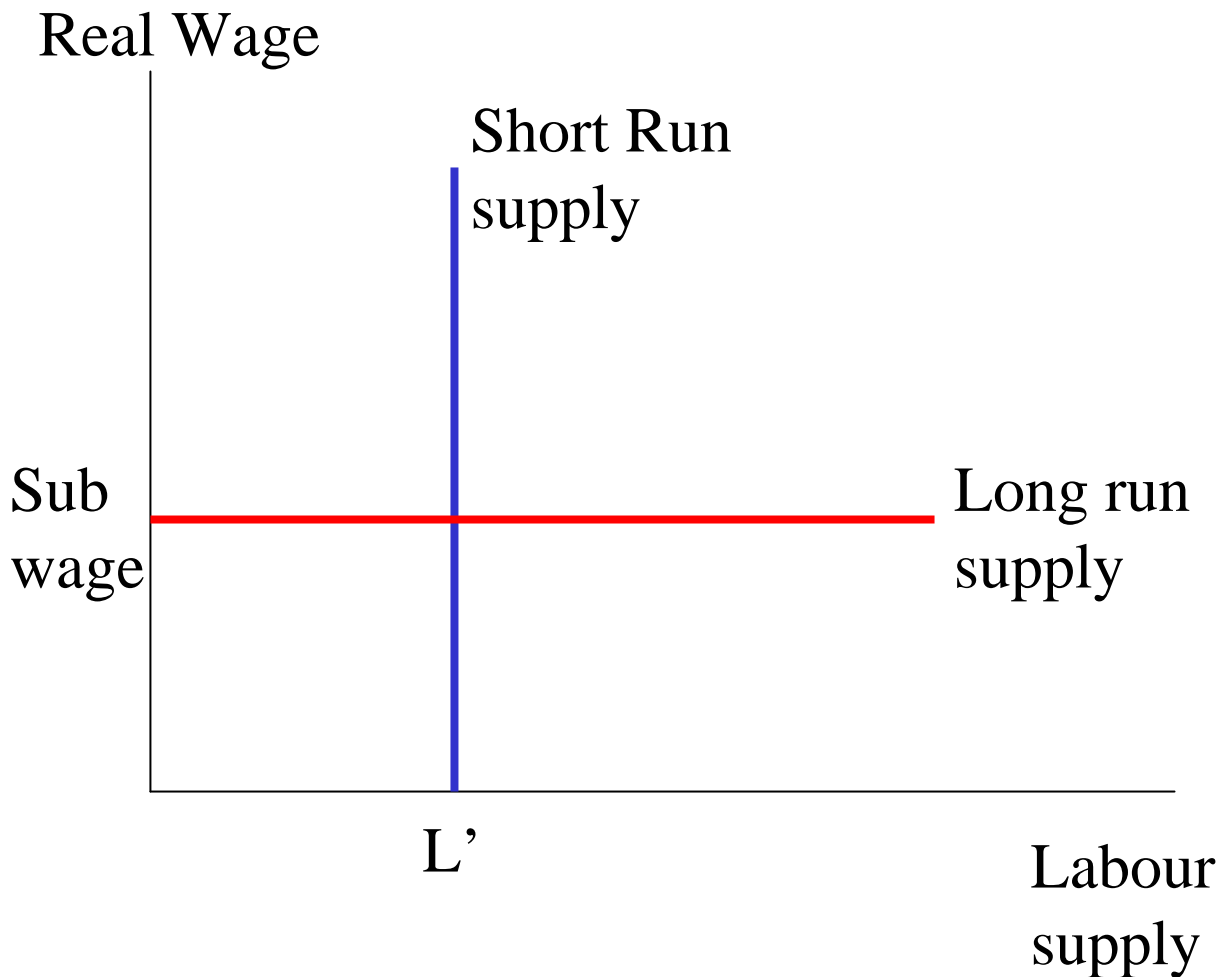
Wages

- Determination of the “common wages of labour”
- Bargaining and contract
- Bargaining power on the side of the masters in a dispute due to combination laws and greater resources
- Masters want to reduce wages
- Constraints on lowering wages
 - subsistence requirements
 - competition and demand for labour

Labour Supply

- Short run labour supply is fixed by the given population
- In the long run population will grow if wages $>$ subsistence minimum and fall if wages $<$ subsistence minimum
- Population mechanism works primarily through infant mortality rates
- Subsistence wage is the minimum required to maintain existing population size

Labour Supply



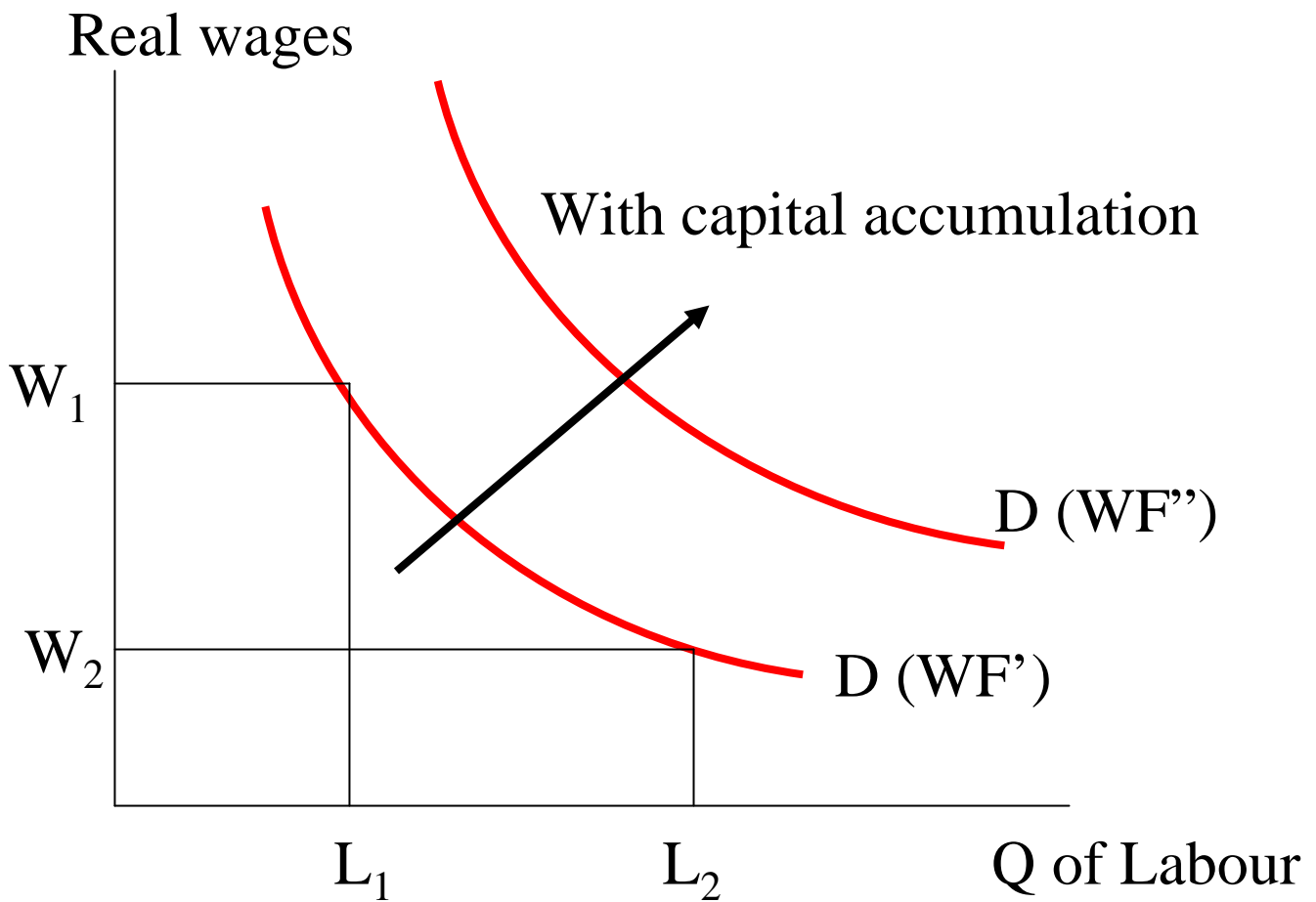
Labour Demand

- Demand for labour depends on the size of the “wage fund”
- Wage fund is the fund available for the support of labour over the production period
- Agricultural model of production—takes a year
- Wage fund a fund of real goods—stocks of food and other wage goods
- Sometimes thought of as a fund of money
- Always thought of as capital—a circulating capital fund

Wage Fund

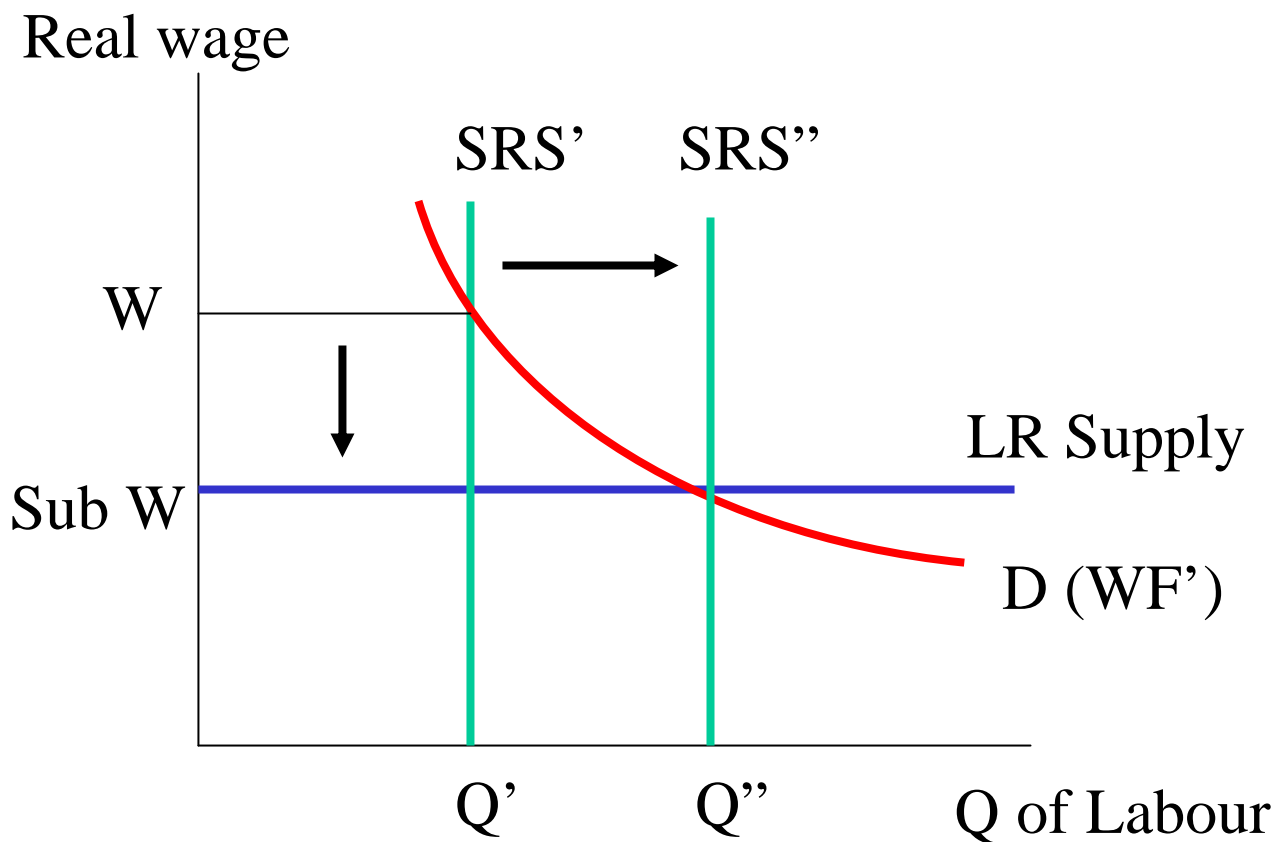
- In money terms the wage fund equals the masters total revenues *less* his own consumption and fixed capital requirements
- Wage fund usually thought of as set and fixed at the beginning of the production period
- If the whole fund is spent on labour then wage rate = wage fund/labour force (unit elastic demand for labour)
- Wage fund can be accumulated over time—thrift and capital accumulation

Demand for Labour



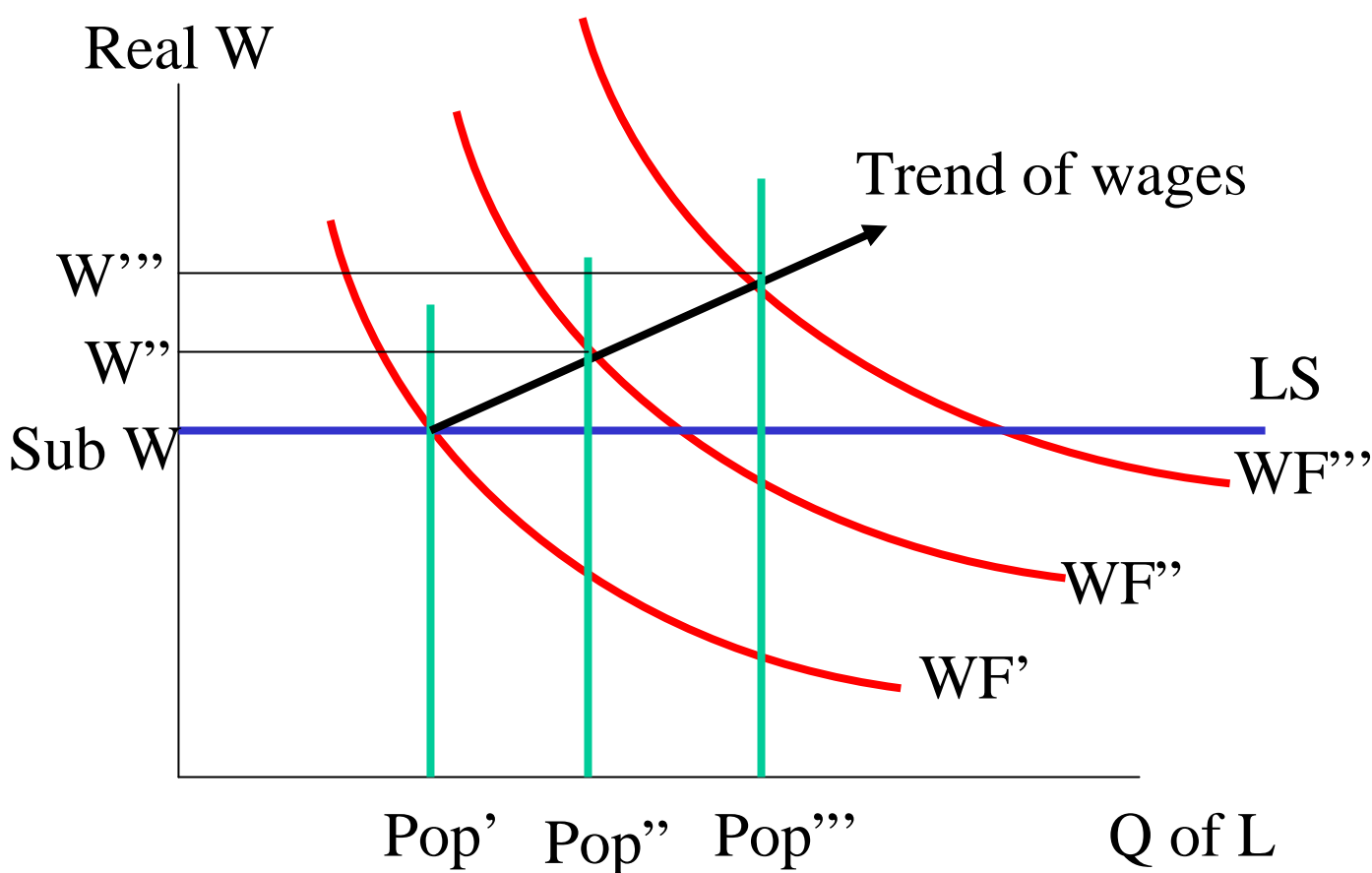
Wage Determination

Demand and Supply of Labour



With a given wage fund, SR market wage rate at W . As $w > Sub W$ population will grow in LR and wage will fall to $Sub W$

Wages in a Progressive State



If capital accumulation proceeds more quickly than population growth, real wages will rise over time. Labour is best off in a progressive State.

Profits

- Profit is the return on capital
- Profit = interest + risk factor
- Profit varies inversely with the real wage rate
- Long run trend of profit with capital accumulation is downward due to:
 - increases in real wages
 - increases in competition in output markets (competition of capitals)

Profits and Wages in Different Employments

- Profits will be equalized in different employments due to mobility of capital except for differentials caused by different risk factors
- Labour mobility will not equalize wages but will equalize “net advantages”
- Wage differentials due to differences in non-wage characteristics of the job

Rent

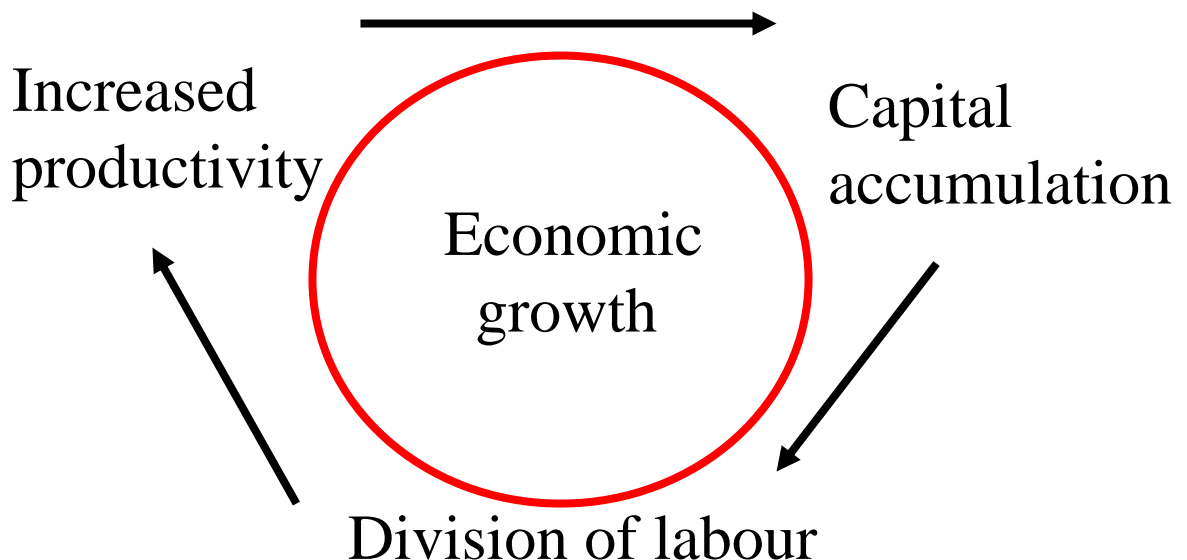
- Rent is a return to the natural scarcity of land
- Rent is price determined—high prices of agricultural goods will cause rents to be high
- With capital accumulation, real wages and population will rise, the demand for food will rise, so rents will also rise

Wages, Profits and Rents in a Progressive State

- In a progressive state with capital accumulation occurring
 - real wages tend to rise
 - rents tend to rise
 - profits tend to fall
- Interests of each social class
 - labourers—economic growth
 - landlords—economic growth
 - proprietors—to restrict competition
- Ability of each class to influence legislation

Capital Accumulation

- The major constraint on economic growth is capital accumulation
- Capital has to be accumulated before division of labour can take place
- Importance of security of property for capital accumulation
- Smithian growth process:



Capital Accumulation and Productive Labour

- Fixed and circulating capital
- Large part of capital accumulation is in the form of the wage fund and is used to hire labour
- Productive labour produces a return and “replaces a capital”
- Unproductive labour does not produce a return and “consumes a capital”
- Labor used in agriculture, manufacturing or trade is productive
- Labour such as servants, musicians, clerics, soldiers, even teachers are unproductive

Productive and Unproductive Labour

- Smith thought that productive labour had to produce a tangible or storable output
- Unproductive labour produced services which were immediately consumed and could not be accumulated as wealth
- Parsimony and thrift and productive investment
- Problem of prodigality, particularly state prodigality—large and opulent Court, large standing armies, etc.

The Employment of Capital

- Order of productivity in terms of the quantity of productive labour employed by a given capital
 - Agriculture
 - Manufacturing
 - Domestic trade
 - Foreign trade
- Issues of security of capital and rate of turnover of capital

The Natural Order of Investment

- Order of productivity as a description of the natural order of investment
- Mercantilism and Physiocracy as distortions to this natural order—inefficient
- Leads to Smith's discussion of trade and trade policy

Foreign Trade

- Criticism of Mercantilist zero sum game approach to trade
- Extension of idea of division of labour to international arena
- International specialization and trade
- “Vent for surplus” concept
- Efficiency gains from specialization and trade
- Absolute advantage
- Advantage of having wealthy neighbours

Trade Policy

- Smith in favour of free trade
- Exceptions to free trade
 - Defense
 - Import duties where there is a tax on domestic manufacture
 - Retaliation
 - Need to introduce free trade gradually
- Political opposition to free trade from proprietors and merchants

The System of Natural Liberty

- If left to themselves individuals will invest in that line of business that gives the best return, and this will be socially efficient
- The concept of the invisible hand—self interest leading to an unintended social benefit
- Government should not attempt to allocate resources—or superintend the direction of private business
- Role of government to protect persons and property and provide public goods

Role of Government

- National defense
 - Benefits of a standing army
 - Navigation acts
- Justice system
 - Protection of property
 - Payment of Judges
- Public Works
 - Roads, Bridges, Canals
 - Tolls and user charges
- Monopoly trading companies
 - Limited monopoly grant

Role of Government

- Education
 - Primary education
 - Universities and incentives for good teaching
 - Religious instruction
- Taxation
 - Equality
 - Certainty
 - Convenience
 - Economy of collection

A Summing Up

- Smith's great contribution was his overall vision and analytical scheme
- Economic growth
 - Division of labour
 - Capital accumulation: thrift
 - Investment in productive labour
 - The invisible hand
- Growth and the distribution of income
 - Wages, profits, rent
 - Trend of each with growth
 - Problem of rent seeking

A Summing Up

- What might prevent growth
 - Limited markets
 - Monopoly
 - Inefficient Government regulation
 - Prodigality; State prodigality
 - Lack of security of property
- The operation of a “system of natural liberty”
- The functioning of a market system: allocation of resources

Smith and Later Classical Economics

- Smith set the agenda for later Classical Economics
- Major writers: T. R. Malthus, David Ricardo, J. S. Mill
- Many others wrote general works and on specific issues
- Popularizers—Harriet Martineau and Jane Marcet
- Influence of Bentham's Utilitarian Philosophy on Ricardo and the Mills