proceeds to concede implicitly Professor Garrison's insight that Smith exhorted us to negative or at least zero time-preference. Citing Smith's *Theory of Moral Sentiments*, West notes that the virtue of frugality 'commands the esteem' of Smith's alter ego, man's innate moral sense, the 'impartial spectator'. Quoting from Smith: 'The spectator does not feel the solicitations of our present appetites. To him the pleasure which we are to enjoy a week hence, or a year hence, is just as interesting as that which we are to enjoy this moment'.[11]

We might note that the lofty refusal to discount future satisfactions in favour of the present, i.e. the rejection of positive time-preference, is all too easy of any 'impartial spectator'. But is the impartial spectator truly human, or is he simply a floating wraith, who does not participate in the human condition and therefore whose insight can be brusquely dismissed?

Adam Smith's Calvinistic scorn of consumption can be seen in his attack on dancing as 'primitive and rude'. As we shall see, in his 'paradox of value' Smith dismissed diamonds in an excessive way as having 'scarce any value in use'. He also puritanically denounced luxury as being biologically harmful, reducing the birth rate of the upper classes: 'Luxury in the fair sex, while it inflames perhaps the passion for enjoyment, seems always to weaken, and frequently to destroy altogether the powers of generation'.

Smith, furthermore, favoured low and criticized high profits, because high profits induce capitalists to engage in excessive consumption. And since large capitalists set an influential example for others in society, it is all the more important for them to keep to the path of thrift and industry. Thus:

> besides all the bad effects to the country in general, which have already been mentioned as necessarily resulting from a high rate of profit; there is one more fatal, perhaps, than all these put together, but which, if we may judge from experience, is inseparably connected with it. The high rate of profit seems everywhere to destroy that parsimony which in other circumstances is natural to the character of the merchant. When profits are high, that sober virtue seems to be superfluous, and expensive luxury to suit better the affluence of his situation.

Because of the influence of the example of the higher orders, Smith adds,

> If his employer is attentive and parsimonious, the workman is very likely to be so too; but if the master is dissolute and disorderly, the servant who shapes his work according to the pattern which his master prescribes to him, will shape his life according to the example which he sets him. Accumulation is thus prevented in the hands of all those who are naturally the most disposed to accumulate.... The capital of the country, instead of increasing, gradually dwindles away....[12]

But if Adam Smith was excessively in favour of capital investment as against consumption, he at least was sound in realizing that capital investment was important in economic development and that saving was the necessary and sufficient condition of such investment. The only way to increase capital, then, is by private savings or thrift. Thus, Smith wrote, 'Whoever saves money, as the phrase is, adds proportionately to the general mass of capital.... The world can augment its capital only in one way, by parsimony'. Savings, and not labour, is the cause of accumulation of capital, and such savings promptly 'puts into motion an additional quantity of industry [labour]'. The saver, then, spends as readily as the spendthrift, except that he does so to increase capital and eventually benefit the consumption of all; hence 'every frugal man is a public benefactor'. All this was a pale shadow of the scintillating and creative work of Turgot, with his emphasis on time, the structure of production, and time-preference. And it was probably cribbed from Turgot to boot. But at least it was sound, and it stamped its imprint indelibly on classical economics. As Schumpeter put it, in discussing what he calls 'the Turgot–Smith theory of saving and investment': 'Turgot, then, must be held responsible for the first serious analysis of these matters, as A. Smith must (at the least) with having it inculcated into the minds of economists'.[13]

Finally, apart from the Marxists, even the abject Smithians of today reject or at least dismiss the Master's productive vs unproductive labour distinction. Characteristically, however, Smith was not even clear and consistent in his fallacies. His presentation in Book I of the *Wealth of Nations* contradicts Book II. In Book I, he properly states that 'Every man is rich or poor according to the degree in which he can afford to enjoy the necessaries, conveniences, and amusements of human life', a phrase almost directly lifted from Cantillon. But in that case, of course, there is no difference in productivity between material objects and immaterial services, all of which contribute to such 'necessaries, conveniences, and amusements', and indeed Smith's discussion of wages proceeds in Book I as if there were no distinction between productive and unproductive work.

16.5 The theory of value

Adam Smith's doctrine on value was an unmitigated disaster, and it deepens the mystery in explaining Smith. For in this case, not only was Smith's theory of value a degeneration from his teacher Hutcheson and indeed from centuries of developed economic thought, but it was also a similar degeneration from Smith's own previous unpublished lectures. In Hutcheson and for centuries, from the late scholastics onward, the value and price of a product were determined first by its subjective utility in the minds of the consumers, and second, by the relative scarcity or abundance of the good being evaluated. The more abundant any given good, the lower its value; the scarcer the good, the higher its value. All that this tradition needed to complete its explanation was the marginal principle of the 1870s, a focus on a given unit of the good, the unit actually chosen or not chosen on the market. But the rest of the explanation was in place.

In his lectures, furthermore, Smith had solved the value paradox neatly, in much the same way as had Hutcheson and other economists for centuries. Why is water so useful and yet so cheap, while a frippery like diamonds is so expensive? The difference, said Smith in his lectures, was their relative scarcity: 'It is only on account of the *plenty* of water that it is so cheap as to be got for the lifting, and on account of the scarcity of diamonds...that they are so dear'. Furthermore, with different supply conditions, the value and price of a product would differ drastically. Thus Smith points out in his lectures that a rich merchant lost in the Arabian desert would value water very highly, and so its price would be very high. Similarly, if the quantity of diamonds could 'by industry...be multiplied', the price of diamonds on the market would fall rapidly.

But in the *Wealth of Nations*, for some bizarre reason, all this drops out and falls away. Suddenly, only ten or a dozen years after the lectures, Smith finds himself unable to solve the value paradox. In a famous passage in Book I, Chapter IV of *Wealth*. Smith sharply and hermetically separates and sunders utility from value and price, and never the twain shall meet:

> The word value...has two different meanings, and sometimes expresses the utility of some particular object, and sometimes the power of purchasing other goods which the possession of that object conveys. The one may be called 'value in use': the other, 'value in exchange'. The things which have the greatest value in use have frequently little or no value in exchange; and on contrary, those which have the greatest value in exchange have frequently little or no value in use. Nothing is more useful than water; but it will purchase scarce any thing; scarce any thing can be had in exchange for it. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it.

And that is that. No mention of the solution of the value paradox by stressing relative scarcities. Indeed, 'scarcity'– that concept so fundamental and crucial to economic theory – plays virtually no role in the *Wealth of Nations*. And with scarcity gone as the solution to the value paradox, subjective utility virtually drops out of economics as well as does consumption and consumer demand. Utility can no longer explain value and price, and the two sundered concepts will reappear in later generations as left-wingers and socialists happily prate about the crucial difference between 'production for profit' and 'production for use', the heir of the Smithian emphasis on the alleged gulf between 'value in use' and 'value in exchange'.[14]

And since economic science was reborn after Adam Smith, since all previous economists were cast into limbo by prevailing fashions of thought, the entire tradition of subjective utility – scarcity as determinants of value and price, a tradition dominant since Aristotle and the medieval and Spanish scholastics, a tradition that had continued down through writers in eighteenth century France and Italy – that great tradition gets poured down the Orwellian memory hole by Adam Smith's fateful decision to discard even his own previous concepts. Although Samuel Bailey almost restored it, the great tradition was not to be fully resurrected until its independent rediscovery by the Austrians and other marginalists in the 1870s. Adam Smith has a lot to answer for at the bar of history.

Paul Douglas put it eloquently in a commemorative volume for the Adam Smith sesquicentennial: 'Smith helped to divert the writers of English Classical School into a cul-de-sac from which they did not emerge, in so far as their value theory was concerned, for nearly a century...'.[15] And we can understand the anguish of Professor Emil Kauder when, after lamenting the sinking into oblivion of the great French and Italian economists of the eighteenth century, he wrote:

> Yet it was the tragedy of these writers that they wrote in vain, they were soon forgotten. No scholar appeared to make out of these thoughts the new science of political economy. Instead, the father of our economic science wrote that water has a great utility and a small value. With these few words Adam Smith had made waste and rubbish out of the thinking of 2,000 years. The chance to start in 1776 instead of 1870 with a more correct knowledge of value principles had been missed.[16]

How could Smith have made such a colossal blunder? In effect, he turned away from his almost sole emphasis on explaining market price in the lectures to another concept which for him took on overriding importance: the 'natural price', or what might be called the 'long-run normal' price. This concept, similar to Cantillon's 'intrinsic value' or Hutcheson's 'fundamental value', had appeared in the lectures, but occupied a minor role as it did in the work of these other economists. But suddenly, the 'natural price' and its alleged determinants now became more important, more truly 'real' than the market price of the real world that had always been the prime focus of economists. Value and price theory shifts, because of Adam Smith's unfortunate and drastic change of focus in the *Wealth of Nations*, from prices in the real world to a mystical non-existent price in the never-never land of long-run 'equilibrium'.

But this alleged natural price is neither more real than nor equally real as the current market price. It is, in fact, not real at all. Only the market price is the real price. At best, the long-run price is useful in providing a vital clue to the direction of price and production changes in the real world. But the long-run price is never reached, and never can be reached, for it keeps shifting as underlying supply and demand forces continually change. The long-run normal price is important but only for explaining the directional tendencies and the underlying architectonic structure of this economy, and also for analysis of how uncertainty affects real-world income and economic activity. The virtually exclusive classical and neoclassical absorption in the unreal 'long-run', to the neglect and detriment of analysing real-world prices and economic activity, shunted economic thought on to a long, fallacious and even tragic detour, from which it has not yet fully recovered.

Another terrible loss inflicted on economic thought by Adam Smith was his dropping out of the concept of the entrepreneur, so important to the contributions of Cantillon and Turgot. The entrepreneur disappeared from British classical thought, never to be resurrected until some of the continental thinkers and especially the Austrians. But the point is that there is no room for the entrepreneur, if the focus is to be on the unchanging, certain world of long-run equilibrium.

Before the *Wealth of Nations*, economists had always concentrated on the market price, and had seen readily that it was determined by the forces of supply and demand, and hence of utility and scarcity. Indeed, while David Hume knew nothing of utility and spoke of labour as the source of value, he was far sounder on value theory than his close friend Adam Smith. On receiving a copy of the newly published *Wealth of Nations*, Hume, on his deathbed, was able to write to his friend on one important criticism: 'I cannot think that the rent of farms make any part of the price of produce, but that the price is determined altogether by the quantity and the demand'. In short, compared to Smith, Hume was in the continental tradition and almost proto-Austrian.

But if Smith stressed the long run, what is supposed to determine the non-real concept of a 'natural' or 'long-run normal' price? Following up unfortunate hints of his eighteenth century predecessors, Smith concluded that the natural price is equal to and determined by costs of production, a concept that had only occupied a fitful and subordinate place in economic thought since the medieval scholastics.

Not that the long-run normal price, or as we now call it the 'equilibrium' price, is nonsense. The equilibrium price is the long-run tendency of the market price. As Adam Smith indeed saw, if the market price is higher than the long-run equilibrium, then extra gains will be made and resources will flow into this particular industry, until the market price falls to reach equilibrium. Conversely, if the market price is lower than equilibrium, the resulting losses will drive resources out of the industry until the price rises to reach equilibrium. The equilibrium concept is highly useful in pointing to the direction in which the market will move. But equilibrium will only be *reached* in reality if the 'data' of the market are magically frozen: that is, if the values, resources, and technological knowledge on the market continue to remain precisely the same. In that case, equilibrium would be reached after a certain span of time. But since these data are always changing in the real world, equilibrium is never attained.

'Cost of production' is defined by Adam Smith as total expenses paid to factors of production, that is, wages, profits and rent. More specifically, in what was to become the famous classical triad, Smith reasoned that there were three types of factors of production: labour, land and capital. Labour receives wages, land earns rent, and capital earns 'profits' – actually long-run rather than short-run rates of return, or what might be called the 'natural' rate of interest. In equilibrium, which Smith seems to have believed was more real and hence far more important than the actual market price, the wage rate equals the 'average' or the 'natural' rate: and the other returns similarly equal the 'natural' rent and the long-run average rate of profit.

There is one striking fallacy in his analysis of cost that Adam Smith shared, though in an aggravated fashion, with earlier writers. Whereas market price is changeable and ephemeral, 'cost' is somehow determined objectively and exogenously, i.e. from outside the world of market economic activity. But cost is not intrinsic or given; on the contrary, it itself is determined, as the Austrians were later to point out, by the value foregone in using resources in production. This value, in turn, is determined by the subjective valuations that consumers place on those products. In brief, rather than cost in some 'fundamental' sense determining value, cost at any and all times is *itself* determined by the subjective value, or expected value, that consumers place on the various products. So that, even if we might say that prices will equal cost of production in long-run equilibrium, there is no reason to assume that such costs *determine* long-run price; on the contrary, expected consumer valuation determines what the value of costs will be on the market. Cost is strictly dependent on utility, in the short and long runs, and never the other way around.

Another grave problem with all cost-of-production theory is that it necessarily abandons any attempt to explain the pricing of goods and services that have no cost because they are not produced, goods that are simply *there*, or were produced in the past but are unique and not reproducible, such as art works, jewellery, archaeological discoveries, etc. Similarly, immaterial consumer services such as the prices of entertainment, concerts, physicians, domestic servants, etc., can scarcely be accounted for by costs embodied in a product. In all these cases, only subjective demand can explain the pricing or the fluctuations in those prices.

But this analysis scarcely exhausts Smith's sins in discussing the central concept in economics – the theory of value. For side by side with the standard cost-of-production analysis as equalling wages + rents + profits, another, new, and far more bizarre theory was set forth. In this alternative view, the relevant cost of production that determines equilibrium price is simply the quantity of labour embodied in its production. It was, indeed, Adam Smith who was almost solely responsible for the injection into economics of the labour theory of value.[17] And hence it was Smith who may plausibly be held responsible for the emergence and the momentous consequences of Marxism.

Side by side and unintegrated with Smith's cost-of-production theory of the natural price lay his new quantity-of-labour-pain theory. Thus:

> The real price of every thing, what every thing really costs to the man who wants to acquire it, is the toil and trouble of acquiring it. What every thing is really worth to the man who has acquired it, and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself, and which it can impose upon other people. What is bought with money or with goods is purchased by labour, as much as what we acquire by the toil of our own body... They contain the value of a certain quantity of labour which we exchange for what is supposed at the time to contain the value of an equal quantity.

Thus goods exchange on the market for equal quantities which they 'contain' of labour hours, at least in their 'real', long-run prices.

Immediately, Smith recognized that he faced a profound difficulty. If labour quantity is the source and measure of all value, how can the mere quantity of labour hours be equated to the quantity of labour pain or labour toil? Surely they are not automatically equal. As Smith himself admitted, in addition to labour time, 'the different degrees of hardship endured or ingenuity exercised must likewise be taken into account'. Yet such equating is 'not easy', for indeed 'there may be more labour in an hour's hard work than in two hours easy business: or in an hour's application to a trade which it cost ten years labour to learn, than in a month's industry at an ordinary and obvious employment'.

How does this crucial equating take place? According to Smith, 'by the higgling and bargaining of the market' bringing them into a 'rough sort of equality'. Yet here Smith fell into an iron trap of circular reasoning. For, like Ricardo and Marx after him, he attempted to explain prices and values by the quantity of labour, and then appealed to the settling of values on the market to determine what the 'quantity of labour' is, by weighting it by differences in the degree of labour hardship and toil.[18]

Smith tried to escape such circularity by his egalitarian assumption – still held in orthodox neoclassical economics – that all labourers are equal, and that hence wages, at least in the natural long run, will all be equal, or rather will be equal for equal quantities of labour toil among all the workers. According to Smith, competition on the market will tend to equate wages per unit of sacrifice or labour toil. As Douglas put it, 'Smith believed he had established the fact that equal units of labor in the sense of disutility were at any one time compensated for by equal amounts of money wages'.

Thus, Smith opined in an eighteenth century egalitarian way that 'The difference between the most dissimilar characters, between a philosopher and a common street porter, seems to arise, not so much from nature as from habit, custom and education'. There are no unique individuals and irreducible differences between people; in this reductionist view now active again in the twentieth century, the mind of a human being is merely a *tabula rasa* on which external environment fills in the content. Hence, according to Smith, skilled labour earns more than unskilled merely to compensate for years of apprenticeship and training when earnings were much lower: so that their labour hours and toil and hence wages would be equalized over a lifetime. Wages in occupations which are active in only part of the year should be higher to compensate for the fewer days of work – so that annualized incomes would be equal. Other things being equal, furthermore, workers in unpleasant or dangerous occupations would receive higher wages to compensate them for the higher labour sacrifice, while prestigious occupations would receive lower wages since their sacrifice or unpleasantness is lower.

While all these distinctions make some sense and have to be taken into account in any theory of wages, they founder on the *a priori* assumption that every person's mind is a uniform *tabula rasa*. Once enter the realistic assumption of innate differences in talent, and the egalitarian levelling of wage rates to equal units of sacrifice (assuming of course that the latter could be measured) falls to the ground.

As it is, Smith ran into considerable difficulty in explaining why prestigious occupations, far from earning low wages in the real world, actually earn higher wages than the average. When discussing the high-income physician or attorney, for example, he lamely fell back on the implication that they were positions of great trust, and therefore presumably faced onerous and painful responsibilities to their clients and were compensated thereby. His other attempt to rationalize the high incomes of attorneys was to make the dubious assumption that the *average* income in such occupations was *lower* than in others, since a flood of people are attracted by the glittering prizes of very high incomes accruing to the few top people in the profession.

Adam Smith, in addition, muddied the waters still further by putting forward, side by side with the labour-cost theory of value, the very different 'labour-command' theory. The labour-command theory states that the value of a good is determined not by the quantity of labour units contained in it (the labour theory of value), but by the amount of labour that can be purchased by the good. Thus: 'The value of any commodity to the person who possesses it...is equal to the quantity of labour which it enables him to purchase or command'.

If, in the real world, the price of every commodity precisely equalled the amount of labour units 'contained' in its production, then the two quantities – the labour cost and the labour command of a good – would indeed be identical. But if rents and profits (i.e. interest) are included in cost, then the price, or relative purchasing power, of each good would not be equal to the labour cost. Labour cost and labour command for each good would differ.

In his typically purblind way, Adam Smith did not perceive the contradiction between these two labour theories in a world where rent and profits exist (as indeed he did not seem to see the difference between the labour and the cost-of-production theories of value). Ricardo was to see the problem and struggle with it in vain, while Marx tried to resolve it by his theory of 'surplus value' going to the non-workers in the form of rent and profits, a theory that foundered on Marx's attempt to reconcile two contradictory propositions: the labour-cost (or quantity of labour) theory of value, and the acknowledged tendency toward an equalization of profit rates on the market. For, as we shall see further in the treatment of Marx (Chapters 9–13 in Volume II), the 'surplus value' of profits out of labour should be greater in labour-intensive than in capital-intensive industries, and yet profits tend to equalize everywhere. Paul Douglas properly and with rare insight noted that Marx was, in this matter, simply a Smithian–Ricardian trying to work out the theory of his masters:

> Marx has been berated by two generations of orthodox economists for his value theory. The most charitable of the critics have called him a fool and the most severe have called him a knave for what they deem to be transparent contradictions of his theory. Curiously enough these very critics generally commend Ricardo and Adam Smith very highly. Yet the sober facts are that Marx saw more clearly than any English economist the differences between the labor-cost and the labor-command theories and tried more earnestly than anyone else to solve the contradictions which the adoption of a labor-cost theory inevitably entailed. He failed, of course: but with him Ricardo and Smith failed as well... The failure was a failure not of one man but of a philosophy of value, and the roots of the ultimate contradiction made manifest, in the third volume of *Das Kapital*, lie imbedded in the first volume of the *Wealth of Nations*.[19]

Adam Smith also gave hostage to the later emergence of socialism by his repeatedly stated view that rent and profit are deductions from the produce of labour. In the primitive world, he opined, 'the whole produce of labour belongs to the labourer'. But as soon as 'stock' (capital) is accumulated, some will employ industrious people in order to make a profit by the sale of the materials. Smith indicates that the capitalist (the 'undertaker') reaps profits in return for the risk, and for interest on the investment for maintaining the workers until the product is sold – so that the capitalist earns profit for important functions. He adds, however, that 'In this state of things the whole produce of labour does not always belong to the labourer. He must in most cases share it with the owner of the stock who employs him'. By using such phrases, and by not making clear why labourers might be happy to pay capitalists for their services, Smith left the door open for later socialists who would call for restructuring institutions so as to enable workers to capture their 'whole product'. This hostage to socialism was aggravated by the fact that Smith, unlike the later Austrian School, did not demonstrate logically and step by step how industrious and thrifty people accumulate capital out of savings. He was content simply to begin with the alleged reality of a minority of wealthy capitalists in society, a reality which later socialists were of course not ready to endorse.

Smith was even less kindly to the role of landlords, where he recognized no economic function whatever that they might perform. In pungent passages, he writes that 'As soon as the land of any country has all become private property, the landlords like to reap where they never sowed and demand a rent even for its natural produce'. And again: 'as soon as the land becomes private property, the landlord demands a share of almost all the produce which the labourer can either raise or collect from it'. There is no hint of recognition here that the landlord performs the vital function of allocating the land to its most productive use. Instead, these passages were to become understandable red meat for socialists and for Henry Georgists in calls for the nationalizing of land.

As we shall see further below, Smith's labour theory of value did inspire a number of English socialists before Marx, generally named 'Ricardian' but actually 'Smithian' socialists, who decided that if labour produced the whole product, and rent and profit are deductions from labour's produce, then the entire value of the product should rightfully go to its creators, the labourers. Douglas justly concluded that

> It is then from the Whiggish pages of the *Wealth of Nations* that the doctrines of the English Socialists as well as the theoretical exposition of Karl Marx, spring. The history of social thought furnishes many instances where theories elaborated by one writer have been taken over by others to justify social doctrines antagonistic to those to which the promulgator of the theory gave adherence. But had the gift of prevision been granted to those men, few would have been more startled than Adam Smith in seeing himself as the theoretical founder of the doctrines of nineteenth-century socialism.[20]

Modern writers have tried to salvage the unsalvageable labour theory of value of Adam Smith by asserting that, in a sense he did not really mean what he was saying but was instead seeking to find an invariable standard by which he could measure value and wealth over time. But, to the extent that this search was true, Smith simply added another fallacy on top of all the others. For since value is subjective to each individual, there *is no* invariant measure or yardstick of value, and any attempts to discover them can at best distort the enterprise of economic theory and send it off chasing an impossible chimera. At worst, the entire structure of economic theory is permeated with fallacy and error. Professors Robertson and Taylor, indeed, go so far as to call the admitted failure of Adam Smith a grand and noble failure, and one which they assert to be far more inspiring in its essential bankruptcy than if Adam Smith had continued in the subjective value tradition of his forbears. In a bizarre passage, Robertson and Taylor acknowledge the correctness of Professor Kauder's anguished critique of Smith as leading economic theory into a century-long blind alley. But they still laud Smith for his very failure:

> If a true explanation is given here of the reasons for Adam Smith turning from 'scarcity and utility' to a labour theory of value, did he not, in fact, do more for the progress of economics by a grand failure in an impossible but fundamental task, than he would have done, had he been content to add a seventh rung or even to strengthen some of the existing steps in the rickety ladder of subjective-value theory such as, according to Dr. Kauder, it appeared in 1776?[21]

Is it hopelessly banal to counter that truth is always superior to fundamental error in advancing a scientific discipline?

There is a more fundamental and convincing reason for Adam Smith's throwing over centuries of sound economic analysis, his abandonment of utility and scarcity, and his turn to the erroneous and pernicious labour theory of value. This is the same reason that Smith dwelled on the fallacious doctrine of productive versus unproductive labour. It is the explanation stressed by Emil Kauder, and partially by Paul Douglas: Adam Smith's dour Calvinism. It is Calvinism that scorns man's consumption and pleasure, and stresses the importance of labour virtually for its own sake. It is the dour Calvinist who made the extravagant statement that diamonds had 'scarce any value in use'. And perhaps it is also the dour Calvinist who scorned, in the words of Robertson and Taylor, real-world 'market values which depended on monetary whims and fashions on the market', and turned his attention instead to the long-run price where such fripperies played no part, and the grim eternal verities of labour toil seemingly played the decisive economic role. Surely this is a far more realistic view of Adam Smith than the Quixotic romantic in quest of the impossible dream of an invariable measure of value. And while Smith's most famous follower, David Ricardo, was not a Calvinist, his leading immediate disciple, Dugald Stewart, was a Scottish Presbyterian, and the leading Ricardians – John R. McCulloch and James Mill – were both Scottish and educated in Dugald Stewart's University of Edinburgh. The Calvinist connection continued to dominate British – and hence classical – economics.

16.6 The theory of distribution

Adam Smith's theory of distribution was fully as disastrous as his theory of value. Though he was aware of the functions performed by the capitalist, his only venture in explaining the rate of long-run profit was to opine that the greater the 'amount of stock' the lower the rate of profit. He arrived at this highly dubious conclusion from his perfectly valid observation that capitalists tend to move out of low-profit and into high-profit industries, their competition tending to equalize the rates of profit throughout the economy. But more production, lowering selling price and raising costs in a particular industry, is scarcely the same causal claim as more capital throughout the economy lowering profit rates. Indeed, the rate of interest, or long-run rate of profit, is related, not to the quantity of accumulated capital, but to the amount of annual saving, and moreover falling profit rates are not *caused* by increasing saving. On the contrary, as the Austrians would point out, *both* are the results of lower rates of time-preference in the society. It is perfectly possible for a highly capitalized economy to experience rising rates of time-preference, which in turn would bring about higher rates of interest.

Smith saw correctly that increasing capital means an increase in the demand for labour and therefore higher wages, so that an advancing society necessarily means a secular increase in wage rates. Unfortunately, Smith's mechanistic view of the profit rate as being inversely proportional to the total amount of capital led him to believe that wages and profits are always moving inversely to the other – an adumbration of an allegedly inherent class struggle which Ricardo would do much to aggravate.

Moreover, if the supply of labour increases to absorb the increase in demand, wage rates will then fall. At this point, Adam Smith provided the Malthusian hook, for, as we shall see further, the Rev. Malthus was a devoted follower of Adam Smith. Smith, indeed, was picking up a theme common in the eighteenth century: that the population of a species tends to press on the means of its subsistence. As Smith put it: 'Every species of animals naturally multiplies in proportion to the means of its subsistence'. So that Smith saw the secular trend of the economy as capital increasing, wages rising, and the rise in wages calling forth an increase in population:

> The liberal reward of labour, by enabling them to provide better for their children, and consequently to bring up their number, naturally tends to widen and extend those limits [the means of subsistence]... If this demand [for labour] is continually increasing, the reward of labour must necessarily encourage in such a manner the marriage and multiplications of labourers as may enable them to supply that continually increasing demand by a continually increasing population.

In this way, wages tend to settle at the minimum subsistence level for the existing population. A fall in wages below subsistence will forcibly reduce the population and hence the supply of labour, raising wages to the subsistence rate; and if wages should rise above subsistence, the 'excessive multiplication' of workers 'would soon lower it to this necessary rate'.

One of the many problems of this 'Malthusian' approach is that it assumes that human beings will not be able to act on their own to limit population growth in order to preserve a newly achieved standard of living.[22]

In addition to Smith's erroneous Malthusian view that long-run wage rates are at the means of subsistence, he also introduced into economics the unfortunate fallacy that wages, at least in the shorter run, are determined by the relative 'bargaining power' of employers and workers. It was a simple leap from that position to the view that employers have greater bargaining power than workers, thus setting the stage for later pro-union propagandists claiming erroneously that unions can raise overall wage rates throughout the economy.

In his view of rent, Smith characteristically held several unintegrated views running side by side. On the one hand, as we have seen, rent is demanded by landlords who 'reap where they have never sowed'. Why are they able to collect such a rent? Because, now that land has become private property, the labourer 'must pay for the licence' to cultivate the land and 'must give to the landlord a portion of what his labour either collects or produces'. Smith concludes that 'the rent of land therefore...is naturally a monopoly price', since he regards private property in land in the same category as monopolization. Surely, socialist and Henry Georgite calls for land nationalization found here their fundamental inspiration. Smith also sensibly points out that rent will vary according to superior fertility and location of the land. Furthermore, as we have indicated, he attributes rent to the 'powers of nature', which supposedly earns an extra return in agriculture as compared to other occupations.

Smith is also inconsistent on whether land rent is included in cost. At various points he includes land rent in cost and therefore as an alleged determinant of long-run price. On the other hand, he also asserts that high or low rents are the effect of high or low product prices and that since the supply of land is fixed, the full incidence of taxes upon rent will fall on land rather than being shifted. All these inconsistencies can be cleared up if we regard all costs as determined by expected future selling prices, and individual costs to be the opportunity foregone to contribute to expected productive revenue elsewhere. More specifically, while costs do not determine price directly, they do limit supply, and in this sense every expenditure, whether on rent or elsewhere, is definitely a part of cost.

But as we have seen, the greatest of the many defects in Smith's theory was his totally discarding Cantillon's and Turgot's brilliant analysis of the entrepreneur. It was as if these great eighteenth century Frenchmen had never written. Smith's analysis rested solely on the capitalist investing 'stock' and on his labour of management and inspection; the very idea of the entrepreneur as a risk-bearer and forecaster was thrown away and, again, classical economics was launched into another lengthy blind alley. If, of course, one persists in fixing one's vision on the never-never land of long-run equilibrium, where all profits are low and equal and there are no losses, there is no point in talking about entrepreneurship at all.

The political implications of this omission were also not lost on nineteenth century socialists. For if there is no role for entrepreneurial profits in a market economy, then any existing profits must be 'exploitative', far more so than the low, uniform rate existing in long-run equilibrium.

The perceptive Scottish historian of economics, Alexander Gray, wrote of Smith's theory of wages that he presented several theories 'not wholly consistent with each other, [which] lie together in somewhat uneasy juxtaposition'. Gray then slyly added that it is a 'tribute to the greatness of Smith that all schools of thought may trace to him their origin and inspiration'. Other words for such inchoate confusion, for what Gray referred to aptly as a 'vast chaos', come more readily to mind.

16.7 The theory of money

We have seen that David Hume's famous elucidation of the price-specie-flow mechanism in international monetary relations, though attractively written, was itself a deterioration from the pioneering and highly sophisticated analysis of Richard Cantillon. It was, however, better than nothing. Yet, as Jacob Viner put it, 'One of the mysteries of the history of economic thought' is that Adam Smith, though a close friend of Hume for many years, included none of the Humean analysis in his *Wealth of Nations*.[23] Instead, Smith propounded the primitive and erroneous view that every country will have as much specie as it allegedly needs to circulate trade, the surplus overflowing 'channels of circulation...to seek that profitable employment which it cannot find at home'. Gone is any reference whatever to the causal nexus between the quantity of money, price levels, and balances of trade. The mystery deepens when we realize that *The Wealth of Nations* is a grave deterioration even from Smith's own Lectures of over a dozen years earlier. For in those Lectures, unpublished in Smith's own day, we find a clear presentation and summary of the Humean analysis.

Thus, in his Lectures Smith had written that Hume proves

> that when ever money is accumulated beyond the proportion of commodities in any country, the price of goods will necessarily rise; that this country will be undersold in the foreign market, and consequently the money must depart into other nations; but on the contrary whenever the quantity of money falls below the

> proportion of goods, the price of goods diminishes, the country undersells others in foreign markets, and consequently money returns in great plenty. Thus money and goods will keep near about a certain level in every country.[24]

Even Smith's modern admirers despair of his confused and scattered, as well as hopelessly inadequate, theory of money and theory of international monetary relations.[25] Professor Petrella tries to explain Smith's later rejection of Hume's specie-flow-price mechanism as a reaction to Hume's giving hostage to the alleged employment benefits of mercantilistic increases in the quantity of money, benefits which Smith was anxious to deny. Petrella cites in support a sentence critical of Hume following the passage from the Lectures just quoted: 'Mr Hume's reasoning is exceedingly ingenious. He seems, however, to have gone a little into the notion that public opulence consists in money...'. But here Petrella attempts to prove too much, for why couldn't Smith simply continue to adopt the specie-flow-price mechanism and then repeat or elaborate on his criticisms of Hume's position, demonstrating the latter's inconsistency?[26]

It seems clear, in contrast, that the mystery of Smith's abandonment of the price-specie-flow mechanism can be solved if we realize that this particular deterioration in his economic analysis was not unique. Indeed, we have noted a similar fatal deterioration in his value theory from the time of the Lectures to the *Wealth of Nations*. It seems plausible that the cause of the decay, in each case, was the same: Smith's shift of concentration from the real world of market prices to the exclusive vision of long-run 'natural' equilibrium. The shift from the real world of market process to focusing on equilibrium states made Smith impatient with the process analysis that was the hallmark and the merit of the specie-flow approach. Instead, Smith treats only a world of pure specie money, and assumes that all countries are always in equilibrium. Moreover, any departures from worldwide monetary equilibrium are eradicated swiftly, leaving the world in a virtually perpetual equilibrium state.[27]

Smith's focus on the long run, in fact, led him to apply his general labour cost-of-production theory of value to the value of money. The value of money, i.e. the value of the metal commodity gold or silver, then becomes the embodiment of the labour cost of producing it. In that way, Smith attempted to integrate the values of money and other goods by assimilating all of them into a labour-cost theory. Thus, Smith wrote, in *The Wealth of Nations*:

> Gold and silver, however, like every other commodity, vary in their value, are sometimes cheaper and sometimes dearer... The quantity of labour which any particular quantity of them can purchase or command, or the quantity of other goods which it will exchange for, depends always upon the fertility or barrenness of the mines... The discovery of the abundant mines of America reduced, in the sixteenth