

7. Turgot's paper was applauded in Bentham's notable *Defence of Usury*, and was reprinted along with Bentham's essay in its French and Spanish translations in the late 1820s.
8. As Turgot puts it: 'a capital is the equivalent of a rent equal to a fixed portion of that capital and conversely, an annual rent represents a capital equal to the amount of that rent repeated a certain number of times, according as the interest is at a higher or lower rate'.
9. While the Hume-Turgot model is highly useful in isolating and clarifying distinctions between the price level and interest, and in highlighting the impact of a change in the quantity of money, it is still a retrogression from the sophisticated process analysis of Cantillon.
10. The paper, written for the seminar of Karl Knies in Heidelberg, was presented to the Austrian F.A. von Hayek by Böhm-Bawerk's widow in 1922–23. See P.D. Groenewegen (ed.) *The Economics of A.R.J. Turgot* (The Hague: Martinus Nijhoff, 1977), pp. xxix–xxx. For Böhm's dismissal of Turgot, see Eugen von Böhm-Bawerk, *Capital and Interest* (South Holland, Ill.: Libertarian Press, 1959), I, pp. 39–45. For the American Austrian Frank Fetter's defence of Turgot as against Böhm, see Frank A. Fetter, *Capital, Interest, and Rent: Essays in the Theory of Distribution*, ed. by M. Rothbard (Kansas City: Sheed Andrews and McMeel, 1977), pp. 24–6. For more on the treatment of Turgot's theory of interest by economists, see Groenewegen 'A Reinterpretation of Turgot's Theory of Capital and Interest', *Economic Journal*, 81 (June 1971), pp. 327–8, 333, 339–40. For Schumpeter on Böhm's mistreatment of Turgot, see J.A. Schumpeter, *History of Economic Analysis* (New York, Oxford University Press, 1954), p. 332n. On the Marshall–Wicksell–Cassel controversy over Böhm-Bawerk's treatment of Turgot's theory of interest, see Peter D. Groenewegen, 'Turgot's Place in the History of Economic Thought: A Bicentenary Estimate', *History of Political Economy*, 15 (Winter 1983), pp. 611–15.
11. Schumpeter, op. cit., note 10, pp. 249, 325.
12. 'Einaudi on Galiani', in H.W. Spirogl (ed.), *The Development of Economic Thought* (New York: John Wiley & Sons, 1952), pp. 77–8.
13. Indeed publicly self-professed Machiavellianism or amorality is almost always self-contradictory, since it will hardly serve Machiavellian ends.
14. See Joseph Rossi, *The Abbé Galiani in France* (New York: Publications of the Institute of French Studies, 1930), pp. 47–8.
15. Oswald St Clair, *A Key to Ricardo* (New York: A.M. Kelley, 1965), p. 293.
16. My translation. See Emil Kauder, 'Genesis of the Marginal Utility theory', *Economic Journal* (Sept. 1953), p. 647.
17. T. Hutchison, *Before Adam Smith: The Emergence of Political Economy, 1662–1776* (Oxford: Basil Blackwell, 1988), p. 326.
18. Hutchison, op. cit., note 17, p. 327.
19. Henry Dunning Macleod, *A Dictionary of Political Economy* (London, 1863), I, pp. 534–5.



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## 15 The Scottish Enlightenment

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The temptation is to entitle this chapter: ‘The forerunners of Adam Smith’, himself a leading product of the Scottish Enlightenment. The problem, however, is that Smith, in most aspects of economics, was a retrogression and deterioration, rather than an advance, from his notable predecessors.

By the later seventeenth and during the eighteenth century, the once mighty Oxford and Cambridge Universities, previously in the forefront of thought and scholarship, had deteriorated to being merely the playground of wealthy young men. Instead, for over a century, the intellectual leadership of Great Britain devolved on the two great universities of Scotland: the University of Glasgow and particularly the University of Edinburgh.

### **15.1 The founder: Gershom Carmichael**

The founder of the tradition of academic economics in Scotland was Gershom Carmichael (c.1672–1729). Carmichael’s father was a Presbyterian minister, who was exiled for heresy by the Scottish, Presbyterian-run government. Born in England, Carmichael graduated from Edinburgh University. He then became ‘regent’ at St Andrews and Glasgow Universities, where courses were taught by ‘regents’ who were essentially young graduate students. After that, Carmichael was Presbyterian minister at Fife. When the regenting system was abolished in 1727, Carmichael was named the first professor of moral philosophy at Glasgow, where he died two years later.

Economics, or political economy, was taught as a subset of a course in moral philosophy, and thus the analysis of trade and the economy was embedded in a groundwork and treatment of natural law. In many ways, the eighteenth century Scottish professors followed the post-medieval and late Spanish scholastic method of including economic analysis as one segment of an integrated tome covering ethics, natural law, jurisprudence, ontology, and theology as well as economics proper.

The term, ‘Protestant scholastic’ has been coined for such writers as John Locke, and indeed the phrase is a coherent one, since one does not have to be Catholic to use the rational scholastic method or arrive at scholastic conclusions. A fascinating example of this was perhaps the first Protestant scholastic, the Dutch jurist Hugo Grotius (1583–1645). Grotius, who studied law at the University of Leyden and later became chief magistrate of Rotterdam, was an eminent natural law theorist who brought the concepts of natural law and natural rights to the Protestant countries of northern Europe. In his outstanding work, which made him the founder of international law, *De jure belli ac pacis (On the Law of War and Peace)* (1625), Grotius clearly pushed natural law to its logical and rationalist conclusion: even if God did not exist, natural law would still be eternal and absolute; such law is discoverable by unaided human reason; and even God could not negate – even if He wanted to – such natural law insights as  $2 + 2 = 4$ . Natural law required the rights of

property to be secure in order to enjoy social cooperation, and under Grotius's influence, the idea of the rights of property became expanded to the economic sphere. In a prefiguration of eighteenth century natural law–natural rights theory, Grotius believed in the harmony of human interaction based on free action and property rights. Grotius had been able to work in the rationalist and natural law tradition because his mentor Jacobus Arminius had previously broken off from orthodox Calvinism to stress the freedom of will of every individual. On these important matters of social philosophy, the Arminians had what might be called a 'neo-Catholic' position. In politics, Grotius was a leader in the classical liberal, free trade, republican party in Holland, then engaged in their century-long struggle with the monarchist orthodox Calvinists.

Particularly influential on northern European theorists was the late sixteenth century Spanish Jesuit scholastic Francisco Suarez. Suarez and his school heavily influenced two men who are generally considered founders of 'modern' philosophy: the early seventeenth century Frenchman, René Descartes; and the late seventeenth century German, Gottfried Leibniz. Suarez's *Disputationes Metaphysicae (Metaphysical Disputations)* was his most influential work, published in Salamanca in 1597. Particularly important was the second edition, published in Mainz, Germany in 1600, which became the leading philosophy textbook in most European universities, both Catholic and Protestant, for over a century. Leibniz, indeed, referred to the *Disputationes* as the *philosophia recepta* (the 'received philosophy').

Suarez's work was heavily influential in Protestant central Europe, Bohemia, Germany and Holland. The university of Leyden, a leading academic centre in Holland during the seventeenth century, was a particular focus of Suarezian dominance. And it was at Leyden that Hugo Grotius pursued his studies.

Though Gershom Carmichael, who inaugurated the teaching of economics in Scotland, launched the tradition of reading and studying Grotius – a tradition that was followed by Adam Smith in the eighteenth century line of Scottish intellectual descent – more directly important for Carmichael was Grotius's best-known follower, Samuel, Baron von Pufendorf (1632–94). Pufendorf was born in Saxony, son of a Lutheran pastor. He first studied theology, and then shifted to mathematics, jurisprudence and natural law. Graduating from the University of Jena, Pufendorf went to Leyden, where he published his first work on jurisprudence in 1661. On the basis of this achievement, Karl Ludwig, the elector palatine, created for the young Pufendorf a chair of natural and international law at the University of Heidelberg. In 1672, while teaching at the University of Lund, in Sweden, Pufendorf published his great work *De jure naturae et gentium*: the following year, he produced the *De officio hominis et civis*, a resumé or abstract of his great *De jure*. It turned out, not surprisingly, that the more concise *De officio*

proved more useful as a teaching tool and therefore became the far more directly influential, if inferior product of Pufendorf's pen.

Not only did Professor Gershom Carmichael bring the study of the new natural and international law teachings of Grotius and Pufendorf to British shores, but also he was himself the English translator of *De Officio*. Carmichael published the English translation in 1718, along with extensive notes and a supplementary commentary. This work turned out to be Carmichael's most important achievement, certainly in economics or the social sciences.<sup>1</sup> Six years later, Carmichael published an improved second edition of *De Officio*, and this edition was reprinted in 1769. Carmichael saw to it that his students were steeped in Pufendorf and in his own commentaries.

Carmichael was the first teacher in Scotland to expound Locke, Leibniz and Descartes, as well as Grotius and Pufendorf. A knowledgeable observer has called Gershom Carmichael 'the true founder of the Scottish school of philosophy'. A contemporary noted that he was 'of very great reputation, and was exceedingly valued both at home and abroad'. So much so, in fact, that another observer noted that 'on Mr Carmichael's death, all the English students have left the University and, indeed, it's very thin this winter, and his name and reputation brought many to it'. Thus Carmichael led the way in the emerging custom of bright English students deserting Oxbridge and going up to a Scottish university for intellectual attainment.

On Carmichael's commentary on the *De Officio*, the testimony of Carmichael's most distinguished student, Francis Hutcheson, is telling: '...Pufendorf's smaller work, *De Officio Hominis et Civis*, which that worthy and ingenious man, the late Professor Gershom Carmichael of Glasgow, by far the best commentator on that book, has so supplied and corrected that the notes are of much more value than the text'.

Samuel von Pufendorf, like the eighteenth century French and Spanish scholastics, was a pre-Austrian subjective utility–scarcity theorist. That is, he believed that the value of goods on the market was determined by their common valuation placed on them by the consumers, and that the more abundant the supply the lower the value. Thus, Pufendorf:

Of common value the foundation is that aptitude of the good or service by which it helps directly or indirectly to meet human needs... Yet there are some things most *useful* for human life upon which no definite value is set... The necessity of the good or its great usefulness are so far from always being the first determinant that we can observe men putting a very low value on what is indispensable to human life. This is because nature... gives us a plentiful supply of such goods. In fact a high value proceeds from *scarcity*....

In his notes to Pufendorf, Carmichael adds some valuable and not so valuable insights. He stresses the subjective nature of utility, pointing out that

the usefulness of a good, which is essential to its value, may be either real or imagined. Unfortunately, he also muddied the waters by adding to scarcity as a determinant of value, ‘the difficulty of acquiring’ goods – an obvious ‘real cost’ attempt to measure the value of goods by the effort put into their production.

### **15.2 Francis Hutcheson: teacher of Adam Smith**

Carmichael’s most prominent student and follower was his successor at the chair of moral philosophy at Glasgow, Francis Hutcheson (1694–1746). Hutcheson, too, was the son of a Presbyterian minister of Ulster Scottish (or ‘Scots–Irish’) stock, who was born in Ireland. Educated in Glasgow and then Dublin, Hutcheson succeeded to the moral philosophy chair at Glasgow in 1730, upon the demise of Carmichael, where he taught until his death 16 years later. Hutcheson brought to Scottish philosophy a solid belief in natural rights and in the beneficence of nature. Hence Hutcheson brought to Scottish thought the basic classical liberal world-view.

Francis Hutcheson was a stimulating and dynamic lecturer, who introduced the style of pacing up and down in front of his class. The ‘never-to-be-forgotten Dr. Hutcheson’, as Adam Smith referred to him in a letter half a century later, was the first Glasgow professor to teach in English instead of Latin, and also the first to become friend, guardian, and even banker to his students. His lectures on philosophy, politics, law, ethics and political economy drew students from all over Britain, the most famous of whom was Adam Smith, who studied under him from 1737 to 1740. Hutcheson’s major work, the *System of Moral Philosophy* (1755), was published by his son after his death.<sup>2</sup>

Hutcheson’s treatment of value in his *System* is virtually identical to that of Pufendorf. Again, utility and scarcity are the determinants of value. Beginning with the statement, ‘when there is no *demand*, there is no price’, Hutcheson also points out that some highly useful things, such as air and water, have little or no value because of the bountiful supply furnished by nature. An increasingly scarce supply will raise the value or price of a good; a more abundant supply will lower them. Furthermore, Hutcheson perceptively defines ‘use’ highly subjectively, not simply as a good which naturally yields pleasure, but as ‘*any* tendency to give any satisfaction, by prevailing custom or fancy’.

Unfortunately, however, Hutcheson also took the Carmichael confusion about real costs and escalated it. For Hutcheson not only brought in the ‘difficulty of labour’ as a determinant, he also made it even *more* determining ‘where the demand for two sorts of goods is equal’.

Foreshadowing Adam Smith’s famous analysis, Francis Hutcheson stressed the importance of an advancing division of labour in economic growth.

Liberty on the market involves reciprocal aid through mutually beneficial exchange, a prime example of the beneficence of nature. The division of labour is a key to the preservation of human life, and Hutcheson shows the enormous advantages of specialization, skill, and exchange over the puny productivity of an isolated Crusoe. Extended division of labour also connotes a more extensive communication of knowledge, and permits greater use of machinery in production.

In his analysis of money, Hutcheson set forth an analysis of which commodities are likely to be chosen as money on the market that used to be standard in money and banking texts until governments destroyed the gold standard in the early 1930s. Money, Hutcheson pointed out, is a commodity generally accepted in a particular country, that becomes used as a general medium of exchange, and as a common standard of value and measure for economic calculation. Commodities which are chosen as money on the market are those with the most money-ish qualities: already generally desirable and acceptable in exchange; divisible into small quantities without losing their *pro rata* share of value; durable for long periods of time; and portable, for which quality they must have a high value per unit weight. Generally, he pointed out, silver and gold have been the two commodities that have been chosen as by far the most suitable as money, with coins becoming the most popular form precisely for being divisible and easily carrying a warrant of purity.

Debasement of coins increases their supply proportionately and raises prices of goods in terms of the money unit. As in the case of all other goods, an increase in the supply of gold or silver, Hutcheson pointed out, lowers their value in terms of other goods, i.e., increases their prices in terms of specie.

Hutcheson's most impressive achievement was his sharp rebuttal of the satiric Bernard de Mandeville (1670–1733), whose enormously popular *Fable of the Bees, or, Private Vices, Public Benefits* was published in 1714, and expanded and reprinted in several editions over the next 15 years.<sup>3</sup> In a pre-physiocratic, proto-Keynesian piece of mischief, the *Fable* maintained that the vice of luxury, no matter how deplorable, performs the important economic function of maintaining the prosperity of the economy. Many historians, especially F.A. von Hayek, have held Mandeville to be a forerunner of Smithian *laissez-faire*, since Smith held that individual self-interest is harmonized with the interests of all through the operation of competition and the free market. But the intent and the analysis are very different, for Mandeville stressed the alleged paradox of 'private vice, public benefits', and the 'benefit' was to come through the pre-Keynesian mechanism of consumption spending. Mandeville, furthermore, did not in any sense draw *laissez-faire* conclusions from this analysis; on the contrary, in a *Letter to Dion* (1732)

published shortly before his death, Mandeville insisted that not the free market but the ‘wisdom’ and ‘dexterous management of a skilful politician’ are needed to transform private vices into public gain.

Mandeville’s work, furthermore, was virtually the living embodiment of what the nineteenth century French *laissez-faire* economist Frédéric Bastiat would call the ‘broken window fallacy’. Mandeville not only defended the importance of luxury but also of fraud, as providing work for lawyers, and theft, for having the virtue of employing locksmiths. And then there was Mandeville’s classically imbecilic defence, in his *Fable of the Bees*, of the Great Fire of London:

The Fire of London was a great Calamity, but if the Carpenters, Bricklayers, Smiths, and all, not only that are employed in Building but likewise those that made and dealt in the same Manufactures and other Merchandizes that were Burnt, and other Trades again that got by them when they were in full Employed, were to Vote against those who lost by the Fire; the Rejoicings would equal if not exceed the Complaints.<sup>4</sup>

‘Keynesianism’ gone mad; or rather, carried to its consistent conclusion.

Mandeville’s defence of the ‘vice’ of luxury was enough to outrage both the rational economist and the Presbyterian in Francis Hutcheson. In rebuttal, in a prefiguration of Say’s law, he pointed out that ‘income not spent in one way will be spent in another and if not wasted in luxury will be devoted to useful prudent purposes’. Luxurious spending, then, is scarcely necessary for economic prosperity. In fact, he went on, it is the thrifty and the industrious who provide prosperity by supplying goods to the public. Declared Hutcheson: the ‘good arising to the public is in no way owing to the luxurious, intemperate or proud but to the industrious, who must supply all customers’. Ridiculing Mandeville, the ordinarily sober Hutcheson riposted: ‘Who needs to be surprised that luxury or pride are made necessary to public good, when even theft and robbery are supposed by the same author [Mandeville] to be subservient to it, by employing locksmiths?’ The money saved by not spending on luxury (or locks) would be profitably employed elsewhere, unless all other wants had been totally saturated, that is, ‘unless all men be already so well provided with all sorts of convenient utensils...that nothing can be added...’.

As a general proposition, Hutcheson called for liberty and the natural right of property. As he put it in his *System*:

each one has a natural right to exert his powers, according to his own judgment and inclination, for those purposes, in all such industry, labour or amusements as are not harmful to others in their persons or goods, while no more public interest necessarily require his labours...This right we call *natural liberty*.

An unexceptionable statement, except for the ominous vagueness in the concept of public interest that ‘requires’ a man’s labour.

Hutcheson’s devotion to *laissez-faire*, however, was limited and guarded. Thus, in his *Introduction to Moral Philosophy*, he opines that ‘the populace often needs also to be taught, and engaged by laws, into the best methods of managing their own affairs and exercising their mechanic arts...’ In international trade, for example, Hutcheson was mired in old-fashioned mercantilism, advocating state regulation to insure a ‘favourable balance of trade’, and high protective tariffs as well as government subsidies of shipping, to develop industry.

Hutcheson’s devotion to natural rights was weakened still further by his being the first to adumbrate the chimerical and disastrous formula of utilitarianism: ‘the greatest happiness for the greatest number’, possibly after having acquired it or its equivalent from Gershom Carmichael.

The specific influences of Hutcheson on Adam Smith will be detailed further below; suffice it to say here that the order of topics of Hutcheson’s lectures, as published in the *System* and as heard by young Smith at the University of Glasgow, is almost the same as the order of chapters in the *Wealth of Nations*.

### **15.3 The Scottish Enlightenment and Presbyterianism**

The Enlightenment was a general movement in European thought in the eighteenth century that stressed the power of human reason to discern truth. Generally, it was dedicated to natural law and natural rights, although in the later years of the century it began to shade off into utilitarianism. While scholasticism was compatible with an emphasis on natural law and natural rights, it was generally discarded and reviled as ignorant ‘superstition’, along with revealed religion. In religion, therefore, Enlightenment thinkers tended to discard Christianity, attack the Christian Church, and adopt scepticism, deism, or even atheism.

In this atmosphere corrosive of Christian faith and values, it is remarkable that the Scottish Enlightenment was linked very closely with the Presbyterian Church. How did this happen? How did a Scottish kirk which in the sixteenth century under the *aegis* of John Knox, had been fiery and militant, become softened into a church that welcomed the Enlightenment, i.e. natural law, reason, and latitudinarian if not sceptical Christianity?

The answer is that in the two centuries since John Knox the hard-nosed Calvinist faith had weakened in Scotland. In particular, after 1752, a powerful group of moderate Presbyterian clergy was able to take over and dominate the Church of Scotland, the established Church which, since the union of Scotland and England in 1707, had been established by the British Crown even though it was Presbyterian rather than Anglican, as was the Church of England.<sup>5</sup> Bitterly opposed to the moderates were the evangelical party, that

is, clergy true to the basic Calvinist faith. The well-connected and highly educated moderates, strong in the lowland areas of Edinburgh and Glasgow, and on the east coast up to Aberdeen, were able to form the dominant power elite in the Church of Scotland after the 1750s, even though they represented a minority of the local kirks.

The moderates, embodying a soft and latitudinarian theological outlook, were intimately connected with the Edinburgh and Glasgow intellectuals who constituted the Scottish Enlightenment. Most of their tactics were planned in meetings in Edinburgh taverns. The dominant figure among the moderates was the Rev. William Robertson (1721–93), an incessant talker and indefatigable organizer who led the moderates since their formation in 1752, and who became the moderator, or head, of the general assembly of the Church of Scotland from 1766 to 1780. In 1762, furthermore, Robertson became the principal of the University of Edinburgh, and it was his leadership and administration that vaulted Edinburgh into the front ranks of European universities. Robertson was also the founder and leading light of various learned societies, which brought together weekly, for papers, discussion, and socializing, the leading figures of the Scottish Enlightenment, including university professors, lawyers, and the major figures of the moderate clergy.

Thus, Robertson founded the Select Society of Edinburgh in 1750. Prominent during the 1750s, the Select Society met weekly and included in its ranks such university figures as Robertson, David Hume, Adam Ferguson and Adam Smith, classical liberal lawyers such as Henry Home (Lord Kames) and Alexander Wedderburn (later Lord Chancellor of Great Britain), and such youthful but prominent moderate clergy as Robertson, Alexander ('Jupiter') Carlyle, Robert Wallace, Hugh Blair, John Home and John Jardine. Carlyle was a charismatic figure as well as a heavy drinker, as many moderate clergymen were in that era; Wallace was in charge of Church of Scotland patronage, as well as being royal chaplain. Wallace, in his private papers, favoured illicit sex almost to the point of promiscuity, quickly warning that the activity would have to be kept hidden. Blair, in addition to his duties in the clergy, was professor of rhetoric at the University of Edinburgh. Jardine was a shrewd politician, whose daughter married the son of Lord Kames who in turn was a cousin of David Hume. John Home was a moderate clergymen and secretary to Lord Bute, close friend of David Hume, and a playwright – an activity which in itself was a matter of deep suspicion to the dour, fundamentalist evangelical clergy. Thus, Home wrote a play, *Douglas*, in 1756, which was put on with many top leaders of the moderate Enlightenment acting in the play, including: the Rev. Robertson, Alexander Carlyle, David Hume, Hugh Blair, and the Rev. Adam Ferguson, professor of moral philosophy at the University of Edinburgh.

The lax views of the moderates were under constant attack from the evangelical forces. Particular targets were Lord Kames and especially the

philosopher David Hume, who was almost excommunicated for heresy by the general assembly of the Church of Scotland, but was saved by his powerful moderate friends. Even his moderate university connections, however, could not gain for Hume any post in a Scottish university, so great was the enmity of the Presbyterian evangelicals.

It should be noted that one of the key leaders of the moderate party was none other than Francis Hutcheson. Thus, the Enlightenment intellectuals, philosophers, and economists of eighteenth century Scotland were intimately connected with the fortunes and the institutions of the establishment moderate wing of the Church of Scotland.

Hutcheson, Hume and Smith, then, while scarcely orthodox Calvinists, were dedicated Presbyterians according to their own lights, and hence their rationalism and theological laxity were nevertheless infused from time to time with hard-nosed Presbyterian values.

#### **15.4 David Hume and the theory of money**

David Hume (1711–76), the famous Scottish philosopher, was a close friend of Adam Smith, who was named Smith's executor, an acquaintance of Turgot and the French adherents of *laissez-faire*, and member of the moderate élite of the Scottish Enlightenment. Born in Edinburgh the son of a Scottish lord, Hume studied on the Continent, where he published his epochal philosophical work, *A Treatise of Human Nature* (1739–40), at the age of 28. Hume's *Treatise* was pivotal in its corrosive and destructive scepticism, managing unfairly to discredit the philosophy of natural law, to create an artificial split between fact and value, and therefore to cripple the concept of natural rights on behalf of utilitarianism and indeed to undermine the entire classical realist analysis of cause and effect. There is no figure more important in the unfortunate discrediting of the classical philosophical tradition of natural law realism, a tradition that had lasted from Plato and Aristotle at least through Aquinas and the late scholastics. In a sense, Hume completed the corrosive effect of the seventeenth century French philosopher René Descartes's influential view that only the precisely mathematical and analytic could provide certain knowledge. Hume's sceptical and shaky empiricism was the other side of the Cartesian coin.

While highly influential in later decades, Hume's *Treatise* was ignored in his own day, and after writing it he turned to brief essays on political and economic topics, and eventually to his then famous multi-volume *History of England*, which he presented from a Tory point of view.

Barred from academia for his scepticism and alleged irreligion, Hume joined the diplomatic corps, and served as secretary to Lord Hertford, the British ambassador to France. In 1765, Hume became the British chargé d'affaires in Paris, and two years later rose to the post of under-secretary of state. Finally, in 1769, Hume retired to Edinburgh.

Hume's contribution to economics is fragmentary, and consists of approximately 100 pages of essays in his *Political Discourses* (1752). The essays are distinguished for their lucid and even sparkling style, a style that shone in comparison to his learned but plodding contemporaries.

Hume's most important contribution is his elucidation of monetary theory, in particular his clear exposition of the price-specie-flow mechanism that equilibrates national balances of payments and international price levels. In monetary theory proper, Hume vivifies the Lockean quantity theory of money with a marvellous illustration, highlighting the fact that it doesn't matter what the quantity of money may be in any given country: any quantity, smaller or larger, will suffice to do money's work of facilitating exchange. Hume pointed up this important truth by postulating what would happen if every individual, overnight, should find the stock of money in his possession to have doubled miraculously:

For suppose that, by miracle, every man in Great Britain should have five pounds slipped into his pocket in one night; this would much more than double the whole money that is at present in the kingdom; yet there would not next day, nor for some time, be any more lenders, nor any variation in the interest.

Prices then, following Locke's quantity theory of money, will increase proportionately.

The price-specie-flow mechanism is the quantity theory extrapolated into the case of many countries. The rise in the supply of money in country A will cause its prices to rise; but then the goods of country A are no longer as competitive compared to other countries. Exports will therefore decline, and imports from other countries with cheaper goods will rise. The balance of trade in country A will therefore become unfavourable, and specie will flow out of A in order to pay for the deficit. But this outflow of specie will eventually cause a sharp contraction of the supply of money in country A, a proportional fall in prices, and an end to, indeed a reversal of, the unfavourable balance. As prices in A fall back to previous levels, specie will flow back in until the balance of trade is in balance, and until the price levels in terms of specie are equal in each country. Thus, on the free market, there is a rapidly self-correcting force at work that equilibrates balances of payments and price levels, and prevents an inflation from going very far in any given country.

While Hume's discussion is lucid and engaging, it is a considerable deterioration from that of Richard Cantillon. First, Cantillon did not believe in aggregate proportionality of money and price level changes, instead engaging in a sophisticated micro-process analysis of money going from one person to the next. As a result, money and prices will not rise proportionately even in the eventual new equilibrium state. Second, Cantillon included the 'income effect' of more money in a country, whereas Hume confined himself to the

aggregate price effect. In short, if the money supply in country *A* increases, it will equilibrate not only by prices rising in *A*, but also by the fact that monetary assets and incomes are higher in *A*, and therefore more money will be spent on imports. This income or more precisely, the cash balance, effect will generally work faster than the price effect.

There are more problems with Hume's analysis, problems other than the omission of previously discovered truths. For while Hume conceded that it does not matter for production or prosperity what the level of the money supply may be, he *did* lay great importance on *changes* in that supply. Now it is true that changes *do* have important consequences, some of which Cantillon had already analysed. But the crucial point is that all such changes are disruptive, and distort market activity and the allocation of resources. But David Hume, on the contrary, in a pre-Keynesian fashion, hailed the allegedly vivifying effects of increases in the quantity of money upon prosperity, and called upon the government to make sure that the supply of money is always at least moderately increasing. The two contradictory prescriptions of Hume for the supply of money are actually presented in two successive sentences:

From the whole of this reasoning we may conclude, that it is of no manner of consequence, with regard to the domestic happiness of a state, whether money be in a greater or less quantity. The good policy of the magistrate consists only in keeping it, if possible, still increasing; because, by that means he keeps alive a spirit of industry in the nation...

Hume goes on, in proto-Keynesian fashion, to claim that the invigorating effect of increasing the supply of money occurs because employment of labour and other resources increases long before prices begin to rise. But Hume stops (as Keynes did) just as the problem becomes interesting: for then, it must be asked, why were resources underemployed before, and what is there about an increase in the money supply that might add to their employment? As W.H. Hutt was to point out in the 1930s, deeper reflection would show that the only possible reason for unwanted unemployment of resources is if the resource-owner demands too high a price (or wage) for its use. And more money could only reduce such unemployment when selling prices rise before wages or the price of resources, so that workers or other resource-owners are fooled into working for a lower *real* though not lower money wage.

Furthermore, why should idle resources, as Hume implicitly postulates, reappear after the effects of new money have been fully digested in the economy in the form of higher prices? The answer can only be that after the price increases are accomplished and a new equilibrium attained, wages and other resource prices have caught up and the 'money illusion' has evapo-

rated. Real resource prices return to being excessively high for the full employment of resources.<sup>6</sup>

Hume's inner contradictions on the quantity of money and inflation permeate his meagre writings on economics. On the one hand, continuing inflation over the centuries is depicted as bringing about economic growth; on the other, Hume sternly favoured ultra-hard money in relation to the banking system. Thus Hume delivered a hard-hitting attack on the unproductive and inflationary nature of the very existence of fractional-reserve banking. He wrote of

those institutions of banks, funds, and paper credit, with which we are in the kingdom so much infatuated. These render paper equivalent to money, circulate it throughout the whole state, make it supply the place of gold and silver, raise proportionately the price of labour and commodities, and by that means either banish a great part of those precious metals, or prevent their further increase. What can be more short-sighted than our reasoning on this head? We fancy, because an individual would be much richer, were his stock of money doubled, that the same good effect would follow were the money of every one increased; not considering, that this would raise as much the price of every commodity, and reduce every man, in time, to the same condition as before.

Elsewhere Hume noted that inconveniences result from the increase of genuine money (specie), but at least they are 'compensated by the advantages which we reap from the possession of these precious metals', including bargaining power in negotiations with other nations. But, he added, 'there appears no reason for increasing that inconvenience by a counterfeit money, which foreigners will not accept of in any payment, and which any great disorder in the state will reduce to nothing'. To 'endeavour to increase' paper credit 'artificially', then, merely increases money 'beyond its natural proportion to labour and commodities', thereby increasing their prices.

Hume concluded his penetrating analysis with an ultra-hard money policy proposal – 100 per cent specie-reserve banking: 'it must be allowed, that no bank could be more advantageous, than such alone as locked up all the money it received, and never augmented the circulating coin...' Hume added that this was the practice of the famous 100 per cent specie-reserve Bank of Amsterdam.

Another important flaw in Hume's analysis of money was his propensity, picked up and magnified by Smith, Ricardo and the classical school, for leaping from one long-run equilibrium state to another, without bothering about the dynamic process through time by which the real world actually moves from one state to another. It is this brusque neglect (or 'comparative statics') that leads Hume to omit the Cantillonian analysis of micro-changes in cash balances and income, and that causes him to neglect income effects in the price-specie-flow mechanism of international monetary adjustment.<sup>7</sup> Ironi-

cally, by doing so, and thereby neglecting the ‘distribution effects’ of changing assets and incomes during the process, Hume – as well as countless other economists following him – distorts what happens in equilibrium itself. For they then cannot see that the new equilibrium will be very different from the old. Thus, when the money supply changes, there will not be an equiproportionate increase in all prices across the board.

Professor Salerno puts the point very well:

...there is some truth to Keynes’ statement that...‘Hume began the practice amongst economists of stressing the importance of the equilibrium position as compared with the ever-shifting transition towards it’. For, in reading Hume, one gets an unmistakable whiff, if not the full flavor, of the notion that it is in the states of long-run equilibrium that the economy actually resides most of the time. The transition between these states, Hume conceives as proceeding rapidly and terminating before another change in the economic data can intervene and propel the economy toward a new equilibrium. This notion at times leads Hume to truncate a full step-by-step analysis of a given change in the data, thus slighting or skipping over altogether its short-run effects in order to focus upon a comparative-static analysis of its ultimate consequences.<sup>8</sup>

In reality, as the Austrians have emphasized, the situation is precisely the reverse of the Hume–British classical assumptions. Rather than the long-run equilibrium state being the fundamental reality, it never exists at all. Long-run equilibrium provides the tendency towards which the market is ever moving, but is never reached because the underlying data of supply and demand – and therefore the ultimate equilibrium point – are always changing. Hence a full step-by-step analysis of a given change in the data is precisely what is needed to explain the process of successive short-run states which tend towards but never reach equilibrium. In the real world, the ‘long run’ is not equilibrium at all, but a series of such short-run states, which will keep changing direction as underlying data are altered.

A final problem with Hume’s monetary views is that, in contrast to the French *laissez-faire* school, he believed that money need not be a useful marketable commodity but was a mere convention. Writing to Abbé André Morellet (1727–1819), a disciple of Gournay and lifelong friend of Turgot, Hume opines that money functions as such because of the belief that others would accept it. Very true: but this does not mean that money originated as a mere convention. And Hume acknowledges that money should be made of materials ‘which have intrinsic value’, for ‘otherwise it would be multiplied without end, and would sink to nothing’.

Hume’s thoughts on interest are illuminating, if only in contrast to the profundity and brilliance of Turgot’s exposition 20 years later. Since money’s impact is ultimately on prices only, Hume shows that interest can only be a phenomenon of real capital rather than of money. He discusses the relation