

# Sic et Non: Three Remarks of Adam Smith to Economics of Governance

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## Abstract

The work of Adam Smith is often interpreted as a justification of the natural order of economy, an apology which harmonizes individual and public interests. In addition to the concern for the economic system, Smith's books comprise valuable passages in which the role of the state is explored within its both negative and positive implications. Generally, the corpus of his work includes three problem areas of fundamental importance for public economics. The first of these fields consists in the presentation of the tendency toward reciprocity as a significant trait of human behaviour. The second main topic constitutes a definition of the role of the State in economy, and it is based not only on the strictly economic assumption that the State ought to finance activities not profitable for a private person, but also on numerous exceptions. The third central issue then concerns the opportunism of individuals in its various forms. As the outlined topics are crucial for public economics, a further insight into Adam Smith's ways of approaching them may be rewarding.

**Keywords:** public economics, Adam Smith, reciprocity, opportunism, government, public policies

## 1. Introduction

One of the hitherto neglected sources of public economics consists in texts which, within the wider field of the history of economic thought, analyze the role of the State and non-governmental organizations. This limitation, or the scarcity of application of such texts, has not been caused by a lack of interest in the given problem on the part of economists throughout past centuries; in this respect, we should rather notice that economic thought encompassing the domain of today's public economics may be described as well-developed and awaiting more systematic treatment. Thus, the real cause of the presented situation probably lies in the fact that the mainstream of public economics has been established mostly upon the theoretical basis of Samuelson's theories, which were formulated for the democratic system (Note 1), in so far that the historical approach is deliberately banished from within boundaries of the field concerned. Nevertheless, it holds true mainly for the public sector that even entirely new institutions are formed upon the ruins of the old ones, from which they adopt certain principles or elements; this is also why the application of models where the analysis begins "in the green field" and without considering the inherited institutional structure may appear to be of only negligible benefit. Conversely, utilization of the historical method may be considered as an aspect beneficial for the effort to capture the above-mentioned relationship, because the presence of the public sector can be understood in full only when duly connected with the past. This opinion has gained major importance in evolutionary economics and path dependence theory. It is therefore important to investigate into how the questions set before current economists were tackled by their precursors. And, as the origins of economics as a scientific or scholarly discipline are often identified with the first publication of Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*, it may be a vital step to find out whether this work could also mark the beginning of public economics as an individual subject.

Adam Smith began his academic career by delivering lectures in rhetorics and belles lettres, and it was only at the age of twenty-nine that he adopted a rather more systematic approach to economics - mainly thanks to his professorship of Moral Philosophy at the Glasgow, where the subjects of theology and ethics were complemented with general elements of administration, government, and economy (See Raphael, 1985) for more details). Smith's work is usually interpreted as a justification of the natural order of economy, an apology bringing the self-interest of individuals into harmony with the public interest (Note 2). However, in addition to

the concern for the economic system, the work comprises many valuable passages which notice both the negative and the positive implications of the role of the State in economy. Smith also addresses particular aspects related to economic provision of culture, churches, education, social services, and other fields which, today, are altogether subsumed under the public sector.

Smith's work contains three problem areas of fundamental importance for public economics. The first of these fields consists in the presentation of the tendency towards reciprocity as a trait of human behaviour that can be applied to join together the seemingly inconsistent works of *The Theory of Moral Sentiments* and *An Inquiry into the Nature and Causes of the Wealth of Nations*. The various forms of reciprocity also show that exchange may assume a lot of different shapes and that market exchange is merely one of the many embodiments.

The second problem area to be discussed lies in the definition of the role of the State in economy. Even though Smith begins here by promoting strictly economic assumptions (the State ought to finance activities which are not profitable for a private person), in the main text he admits of numerous exceptions. Thus, Smith's argumentation against government intervention in economy is, much rather than a matter of *principle*, a question of *strategy* in which preference is given to the market at certain times and to the government or non-governmental institutions at other times - always with respect to positive consequences (For a more concrete description see, e.g., Muller, 1993, p. 140). The choice of concrete areas of State intervention in social and market exchanges, as well as Smith's substantiation of these actions, constitutes a very significant aspect for public economics. Also, Smith assigns different means of financing to those activities of the government that he considers important. The invisible hand of the market, therefore, is in Smith's work supported at certain moments by the visible hand of the state, albeit the forms of such support may differ markedly.

From these elements then stems the third outstanding topic within Adam Smith's reflections on economy and private interests. More concretely, the philosopher was well aware that economic order left to its own devices may cause a serious conflict between the private and the public interests (Viner, 1927, p. 217). In spite of advocating the expediency of self-interest, Smith perfectly knew its limitations and discriminated between a self-interest leading to the common benefit and a self-interest realised at the expense of others. As further sections of this text will show, not even *The Wealth of Nations* as such is a book of a single principle: It rather constitutes Smith's moderate defence of a system which, despite not embodying the ideal state of the world, is the only known structure that relieves people of the necessity of violence and bondage (Cf. Capek, 2001, p. 5).

## 2. Adam Smith on Reciprocity

The first substantial aspect traceable in the work of Adam Smith is the emphasis placed on reciprocity as a crucial motive of human behaviour. Smith's work was created at a turn of epochs, and his concept of the purpose of human behaviour corresponds to this fact.

Since Antiquity, behaviour was perceived as acting in conformity with the order of being: "It was determined by the imaginary world of religious / philosophical or mythological conceptions and images, values and symbols, which man believed in and respected. With the formation of modern society, the situation changes in that posing the question of the meaning of behaviour in the ethical or the religious / philosophical sense is substituted by searching for - within the bounds of possibility - the most effective and sensible manner of problem solving.

This searching is no more intuitive but rationalised and conscious. The idea of the world created and controlled by God was superseded with the image of the world as a perfectly adjusted machine or an effectively functioning system" (Mucha, 2000, pp. 7-8).

Smith's interpretation is positioned somewhere between these two approaches. There appear the principles of hedonistic morality, and behaviour is supposed to secure the maximum personal benefit of man as an independent autonomous subject; however, Smith still does not believe that an individual is bound in his or her decision-making solely by reason. While it is true that both the works (*The Theory of Moral Sentiments* and *An Inquiry into the Nature and Causes of the Wealth of Nations*) are in their introductory passages built upon the personality of an individual, they also contain parts where older institutions or tradition are referred to and man is restrained in various manners. Thus, Smith remains dependent in his texts on ideas, images, or symbols of the past. In his concept, society retains its coherence, with the older institutions based on the principle of duties and related benefits and compensations still functioning within it. "How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it." (Smith, A., 2000, p. 3).

In all the institutions, reciprocal services (and the activation of elements of egoism on the one hand and altruism on the other) are taken into account. Nevertheless, as Smith well knew, these differing interests never entirely

convene in the mind of an individual. A certain degree of harmony may occur only when private interests are in agreement with interests of other people, namely when such institutional framework is formed that regulates the tension between egoism and altruism.

Adam Smith attempted to capture this framework in both of his most renowned books, or *The Theory of Moral Sentiments* and *An Inquiry into the Nature and Causes of the Wealth of Nations*. Through quick reading, the reader may assume the impression that the works are based upon two diametrically opposed aspects of human character: self-interest and affection for others. Therefore, the books are seemingly inconsistent with each other, and the reader may ask the question of how this inconsistency, which was defined by representatives of the German Historical School as the *Adam Smith problem*, is to be understood. (Note 3)

Initially, it is necessary to say that Smith himself clearly did not consider the works inconsistent, because he produced and published them together. *The Theory of Moral Sentiments* (1759), despite being the older of the two books, was published for the sixth time in a substantially enlarged form only several weeks before Smith's death in July 1790, a few months after the fifth publication of *An Inquiry into the Nature and Causes of the Wealth of Nations*. New sections of the book were, above all, oriented towards theories of political justice. Thus, we may assume that there exists one common basis for both the works, namely a basis which unifies non-cooperative self-interest on the one hand and considerate sympathy with charity on the other. And this structure, this unifying system, may consist in either the dual concept of justice or the dual approach to exchange; both of these criteria have their own logic and sense.

The first (and older) system of balancing egoism and altruism in economic thought is the effort to achieve justice (Note 4). When Smith defines his stance toward mercantilists, he turns back to scholastics, whom he knew well, and to their dual concept of justice adopted from Aristotle.

He directly quotes two kinds of justice – commutative and distributive, of which the former became Smith's basis for *An Inquiry into the Nature and Causes of the Wealth of Nations* and constitutes justice within exchange. (Smith, A., 2000, p. 399). The latter type, or distributive justice, is applied to examine charity and utilization of private ownership not to one's own benefit, but for noble purposes, and is developed mainly in *The Theory of Moral Sentiments*. If this interpretation of the two works by Smith is further pursued, we may perceive the Scottish philosopher as being not a precursor of modern economics, but rather the most vivid symbol of the scholarship of his time or the last offshoot of the Middle Ages, whose efforts materialised in a sort of *Summa oeconomica*. (Note 5)

The search for balance between egoism and altruism can be also realised through the second (and newer) system, which consists in reciprocity (Note 6). Vernon Smith assumes that the work of Adam Smith encompasses only one axiom of human behaviour, namely the universal gravitation towards exchange; this axiom, however, comes through in two different ways (Smith, V. L., 1998).

The first type of exchange expresses impersonal, market exchanging, where “the propensity to truck, barter, and exchange one thing for another “is realised (Smith, A., 2007, p. 9). Yet the group of exchangeable elements may also include donations, help, expressions of affection, and “generosity, humanity, kindness, compassion, mutual friendship and esteem” (Smith, A., 2000, p. 52), thus constituting the second and older system of exchange that is based on the principles of economy of the gift and still finds its application in many modern institutions.

The above-discussed propensity to exchange, as a fundamental axiom of human behaviour, therefore may (according to Adam Smith) manifest itself in both the impersonal market exchange between two individuals maximizing their benefit and the social exchange realised by two cooperating individuals or small groups. In this sense, the apparent contradiction between *An Inquiry into the Nature and Causes of the Wealth of Nations* and *The Theory of Moral Sentiments* can be settled through a reference to the dual form of exchange between people, where each of the two types of exchange plays its own significant role in society. Non-cooperative behaviour maximises the gain stemming from exchange and creates the basis for specialization and growth of wealth (Note 7). Cooperative behaviour in personal exchange is based upon reciprocity of the gift, small favours, help, and maximises the gain from social exchange by such means as the maintenance of friendly relations or the formation of an institutional framework facilitating effective cooperation between members of society. The fact that humans are cooperative and non-cooperative at the same time has been experimentally verified. Thus, it is pointless to join Schumpeter in order to analyze the Adam Smith problem, because the problem of inconsistency between the two views of man was created artificially; even though cultural forms of reciprocity are varied, there exists only one principle.

### 3. Adam Smith on the Visible Hand of the State

Adam Smith is often presented as a supporter of free market and opponent of direct government intervention in economy. Yet this description (albeit true) is not true in its entirety, because Smith's works contain a multitude of references where the role of the State is characterised as indispensable. The reason for this dichotomy does not rest in inconsistency but rather in the fact that the philosopher expressed his attitudes to the government policy of his time and illustrated its shortcomings as related to the regulation of wages, prices, and customs tariffs. Importantly, Smith did not reject the question of *what the government is supposed to do*; rather than that, he complemented it with the problem of *what the government is not supposed to do*. Thus, Smith's censure of state intervention must be perceived in context of the time. Within the period, confidence of the British in their government was exceptionally weak, mainly because power lay in the hands of an aristocratic clique "corrupt, cynical, ..., who clung to the traditional mercantilism not so much because of a strong faith that it met the problems of a growing trade struggling to burst its fetters, but because they did not know anything else to do" (Viner, 1927, p. 221). Albeit Smith had a good reason not to find positive words in relation to the then British administration, he recognised and appreciated the effort of foreign governments:

"The orderly, vigilant, and parsimonious administration of such aristocracies as those of Venice and Amsterdam, is extremely proper, it appears from experience, for the management of a mercantile project of this kind. But whether such a government as that of England - which, whatever may be its virtues, has never been famous for good economy; ... - could be safely trusted with the management of such a project, must at least be good deal more doubtful" (Smith, A. 2007, p. 490).

While it is obvious from the text above that Smith clearly took a stance against mercantilist activities of the State (Note 8), we should also note that he found ample room for different types of state involvement in economy. This approach is already implied by, for instance, Smith's definition of political economy: "Political economy, considered as a branch of the science of a statesman or legislator, proposes two distinct objects: first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the State or commonwealth with a revenue sufficient for the public services. It proposes to enrich both the people and the sovereign. (Smith, A. 2007, p. 325)". Within this concept, the hold of power has its own economic dimension, and it is necessary that those who rule should bring their interests into harmony with the interests of those who are governed. Thus, in conjunction with other Smith's remarks scattered throughout the text of the *Wealth of Nations*, we may conjecture that even though the philosopher sharply objected to concrete mercantilist interventions realised by the state in economy, he reserved considerable room for other actions performed by public administration on the basis of either the principles of power, economic convenience, and justice, or the common benefit.

The exercise of power was also accompanied by certain necessary expenses which, for Smith, possessed both an economic and a moral dimension; interestingly, such classification is obvious from Smith's referring to these costs simultaneously as "necessary expenses" and duty of the sovereign" (Note 9). The group of justified expenses of the government (or duties of the monarch) comprised three types of service: *Defence, justice*, and those *public institutions and works* "...which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain" (Smith, A., 2007, p. 473). Thus, the expenses in question include those that are connected with the hold of power as well as those ascribed through rational calculation to the State. Within the latter group, two main concepts incorporated by Smith capture the reader's interest: Institutions (infrastructure in particular) facilitating the practice of trade within society, and institutions providing education to people of all ages. At this point, Smith continues the older tradition of scholastics, whose conclusions in the least were very close to his own (Note 10). It is definitely possible to say that neither the duties of the sovereign nor the purpose of the taxation system had undergone major alterations since the 15th to 18th centuries, and public budget as conceived by Smith possesses only and exclusively the allocative role. (Note 11)

The chapter dedicated to taxes is, at its beginning, introduced by four principles, the commonly known 'canons of taxation', whose basic idea then finds application as the evaluation criterion for the following individual forms of taxation. The emphasis placed by Smith on this part of the book, together with the accurate formulation of arguments, expresses the feeling of the time; in the second half of the 18th century, the taxation problem was a politically explosive topic because in any monarchy the modification of taxes was rather hard to expound and the related discontent within society could not show itself during elections.

In this context, it was virtually no accident that both the French and the American revolutions broke out in

response to taxation.

After defining the needs to be satisfied by means of public budget, Smith begins to allocate suitable resources to the connected expenses. He searches to find the answer to the question of “which of those expenses ought to be defrayed by the general contribution of the whole society, and which of them, by that of some particular part only, or of some particular members of it” (Smith, A. 2007, p. 7.). In addition to the substantiated selective taxation, Smith also promotes the idea of progressive taxation, which in fact is no surprising moment given Smith’s sharp criticism aimed at the upper strata of society of the time. In the chapter containing the problem of *tax upon house-rents*, the philosopher asserts that such a tax would be most burdensome for people of property and that this type of inequality probably does not involve much injustice: “It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion” (Smith, A. 2007, p. 547). In the case of road and bridge toll, Smith proposes to raise the toll amount upon *carriages of luxury, coaches, post-chaises* and other related means of transport, mainly for the reason that “the indolence and vanity of the rich is made to contribute, in a very easy manner, to the relief of the poor, by rendering cheaper the transportation of heavy goods to all the different parts of the country” (Smith, A., 2007, p. 471-472).

According to Smith, the keeping and maintenance of traffic infrastructure can be defrayed through usage toll, with the actual collection entrusted to private persons (for canal usage), clerks or officers (in the case of roads), and special administrators. In spite of the fact that, in Smith’s time, the system was newly introduced and thus confronted with a substantial number of complaints, the philosopher advocated the view that the administration of road toll should be left in the hands of clerks or special officers because “a high road, though entirely neglected, does not become altogether impassable, though a canal does. ... The proprietors of the tolls upon a high road, therefore, might neglect altogether the repair of the road, and yet continue to levy very nearly the same tolls” (Smith, A., 2007, p. 472). In order for the toll system to perform its function, it is advisable to establish supervisory and accounting authorities whose main duty consists in monitoring the overall management of the system and reducing the toll by an amount necessary at the moment to support the realization of works needed (Note 12). However, the toll should not be transferred to and left under the authority of central government, since it might easily happen that the revenue is not utilized for the maintenance of roads but changes into an indirect tax instead. Public facilities having a local character (such as municipal pavement and street lights) ought to be kept from local revenue. (Note 13)

Also, Adam Smith knew and respected the principle of selective taxation as a type of social controlling; nevertheless - from the perspective of tax collection purposes - he did not consider this principle primary (Viner, 1927, p. 230). Furthermore, however, we should notice that Smith accepted the policy leading towards curbing the consumption of spirits by means of higher taxes and that he proposed a reduction of tax (implying the simultaneous reduction of price) levied on “the wholesome and invigorating liquors of beer and ale might be considerably reduced in their price. The people might thus be in part relieved from one of the burdens of which they at present complain the most” (Smith, A., 2007, p. 580).

Therefore, it seems that even though Smith initially intended to define the role of the State strictly on the basis of economic profitability, the outstanding feature of his further comments on suitable actions of the government consists in the abandonment of the profit unattainability

attitude in favour of argumentation based on the principles of *greater public good*. For example, Smith thus supported governmental participation in the process of educating people of all ages, mainly because in this manner they would be taught diligence and could become better citizens and military servicemen enjoying more happiness of health in their bodies and souls. In this sense he also discusses health: “...in the same manner as it would deserve its most serious attention to prevent a leprosy, or any other loathsome and offensive disease, though neither mortal nor dangerous, from spreading itself among them; though, perhaps, no other public good might result from such attention, besides the prevention of so great a public evil” (Smith, A., 2007, p. 509). The cure he recommends against *intoxication with fanaticism and superstition* consists in science as well as the necessity to take an examination in “the higher and more difficult sciences”; this obligation to undergo an exam should be applied to anyone wishing to obtain the permission to practise a free profession or hold an official function requiring responsibility or providing substantial income. For the same reason, in connection with the above-discussed *cure*, Smith also recommends subsidizing culture and securing the “frequency and gaiety of public diversions”. Furthermore, he says that “the state, by encouraging, that is, by giving entire liberty to all those who, from their own interest, would attempt, without scandal or indecency, to amuse and divert the people by painting, poetry, music, dancing; by all sorts of dramatic representations and exhibitions; would easily dissipate, in the greater part of them, that melancholy and gloomy humour which is almost always the nurse of

popular superstition and enthusiasm” (Smith, A., 2007, p. 515).

In another context, Smith is ready to allow government-orchestrated restriction of rights in property, and this attitude is evidenced through his approval of governmental restraint of land buyouts. Such restriction, he believes, paved the way to the blooming of colonies in Northern America: “The colony law, which imposes upon every proprietor the obligation of improving and cultivating, within a limited time, a certain proportion of his lands, and which, in case of failure, declares those neglected lands grantable to any other person; though it has not perhaps been very strictly executed, has, however, had some effect” (Smith, A., 2007, p. 369). In addition, Smith viewed the discussed political measure as offering better support for the development of country areas in general.

Even though Smith remains relatively sceptical as regards entrepreneurial engagement of the government, he considers the conditions under which such governmental activities could be carried out and, using the example of postal service, demonstrates that government enterprise can be most effectively realised through businesses not requiring substantial initial deposit. While the management of such businesses should not be complicated, the related revenue is expected to be certain and instant; in this respect, Smith emphasises the role of postal services and says that “it is, perhaps, the only mercantile project which has been successfully managed by, I believe, every sort of government” (Smith, A., 2007, p. 490).

In addition to this concrete sort of enterprise, the philosopher also recommends that, for both historical and practical reasons, the government should be entrusted with mintage. Throughout history, metals had won their place as the foremost medium of exchange mainly thanks to their durability and divisibility. Despite being initially unmarked, metals came to bear public marking in order to prevent fraudulent alteration by individuals, and mints were established as public authorities certifying with specific marks the quantity and quality of goods in precisely the same manner as *gaging offices for measures, woolen fabric and canvas* did. Thus, through guaranteeing both the quality and the quantity, a public authority became the predecessor of current norms or standards.

After the double-sided and circumferential minting of coins started to be realised, there was obviously no need of lengthy weighing. And at this point Smith, even though he observes that “the avarice and injustice of princes and sovereign states” was a central factor within abusing the confidence of subjects and promoting gradual reduction of metals in coins, does not propose any means to avoid such inflation, which is naturally convenient for debtors but pernicious for creditors. The reason for this attitude most probably consisted in the fact that state-controlled weakening of the worth of coins was a gradual process which, seen through Smith’s eyes, did not endanger the economy to an extent comparable with the malicious role of banknotes and the related high inflation as a phenomenon to be feared.

Smith proposes that the overwhelming light-heartedness connected with paper money issuing should be curbed to prevent excessive rise in the quantity of notes causing the loss of money value, and he maintains this position despite the apparent *sui generis* breach of natural liberty present in such regulatory action. Furthermore, Smith considers governmental intervention appropriate in the event that a banker intends to issue drafts or bills which are to be accepted by his friends: “Such regulations may, no doubt, be considered as in some respect a violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments; of the most free, as well as or the most despotical” (Smith, A., 2007, p. 208). The philosopher also utilizes a parallel to a directive specifying the necessity to build fire-protection walls; even though this regulation too constitutes a violation of natural liberty, it is a necessary measure as it protects other peoples’ safety. (Note 14)

In addition to the above-discussed cases of positive governmental intervention, Adam Smith emphasised favourable impact of moderate regulation on credit markets. Since he was aware that the prohibition of interest on loan could not forestall the “evil of usury“, he supported the concept of legally specified (fluctuating) interest rate. Within this context, Smith says that “the legal rate, it is to be observed, though it ought to be somewhat above, ought not to be much above the lowest market rate”, because then most of the money available for lending would be usurped by “prodigals and projectors, who alone would be willing to give this high interest. “Thereafter, he proceeds as follows: “Where the legal rate of interest...is fixed but a very little above the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors. ... A great part of the capital of the country is thus thrown into the hands in which it is most likely to be employed with advantage”(Smith, A., 2007, p. 229).

The well-known passage where Smith discusses the production of pins to illustrate various merits resulting from the distribution of labour has been quoted by a large number of authors. However, only few texts have incorporated negative consequences of such organization of labour, albeit Smith himself recognised and

described these aspects in other parts of his book. Thus, on the one hand, it definitely holds true that “the greatest improvements in the productive powers of labour, and the greater part of the skill, dexterity, and judgment, with which it is anywhere directed, or applied, seem to have been the effects of the division of labour” (Smith, A., 2007, p. 3), and we may summarize this argument by concluding with Smith that the division of labour, if it can be introduced, brings about a proportional increase in the productive force of labour. By these means, the dexterity of a worker improves thanks to his concentration on one task. But, on the other hand, “in the progress of the division of labour, the employment ..., of the great body of the people, comes to be confined to a few very simple operations; The man whose whole life is spent in performing a few simple operations, ..., has no occasion to exert his understanding, or to exercise his invention, in finding out expedients for removing difficulties which never occur. He naturally loses, therefore, the habit of such exertion, and generally becomes as stupid and ignorant as it is possible for a human creature to become. “The torpor of his mind renders him not only incapable of relishing or bearing a part in any rational conversation, but of conceiving any generous, noble, or tender sentiment, and consequently of forming any just judgment concerning many even of the ordinary duties of private life. Of the great and extensive interests of his country he is altogether incapable of judging.” (Smith, A., 2007, p. 506).

Adam Smith therefore recommends that the government of a civilised and commercially developed society should prevent the onset of similar decay through pursuing the diverse paths of education aimed at the lower social strata. This way, “for a very small expense, the public can facilitate, can encourage and can even impose upon almost the whole body of the people, the necessity of acquiring those most essential parts of education“. The State may make education easier through establishing “in every parish or district a little school, where children maybe taught for a reward so moderate, that even a common labourer may afford it;... The public can encourage the acquisition of those most essential parts of education, by giving small premiums, and little badges of distinction, to the children of the common people who excel in them” (Smith, A., 2007, p. 507-508).

Education brings considerable benefit to the State, which is obvious from the following passage: “In free countries, where the safety of government depends very much upon the favourable judgment which the people may form of its conduct, it must surely be of the highest importance, that they should not be disposed to judge rashly or capriciously concerning it” (Smith, A., 2007, p. 510).

In this connection and at another point of the book, the State is assigned the role of a coercive agent in education; more concretely, the State ought to compel people in possession of medium and top-level wealth to study science and philosophy, in which a compulsory examination should be established. Such obligation to undergo an exam (as already observed above) should be applied to anyone wishing to obtain the permission to practise a free profession or hold an official function requiring responsibility or providing substantial income (Smith, A., 2007, p. 515).

Furthermore, Smith subsumes *culture* under the class of activities to be financed by the State, thus laying the foundations of current cultural policy, which is not conceived as subservient to the monarch but rather as an element being *pro bono publico* of the entire nation (Smith, A., 2007, p. 516). Similar argumentation concerning positive effects of culture, which substantiate public subsidies, can be found in current economic texts too (for example, in Baumol, 2003, pp. 21-22).

#### 4. Adam Smith on Homo Oeconomicus

While the category of interest was not left void before his time (Note 15), Adam Smith became the first thinker to balance it conveniently and make the concept socially acceptable. In Smith’s work, self-interest is duly presented as having multiple (and not always beneficial) forms: On the one hand, there stands out the statement that “it is in the interest of every man to live as much at his ease as he can” (Smith, A., 2007, p. 494), which naturally defines the basis for human diligence, whereas on the other appears the specification and condemnation of unwelcome shapes of self-interest (“avarice and ambition in the rich, in the poor the hatred of labour and the love of present ease and enjoyment, are the passions which prompt to invade property”), namely of aspects which may cause the economic order to function improperly (Smith, A., 2007, p. 462). (Note 16)

In addition to personal opportunism, Smith also recognises negative effects of agreement or deals between individual participants in the market; thus, we can find in Smith the elements of the *collective action* problem. (Note 17)

This concept is connected with activities that require the coaction of effort made by two or more individuals, with the prevailing approach being the conception of collective action as an activity pointing toward the assertion of interests or prosperity of a group; such conception also involves the issue of externalities, public goods, and the related problem of the *free rider*.

Analysis of collective action, albeit only on the inductive and intuitive levels, constituted a significant part of Smith's overall investigation into inefficiency and injustice in the economy he monitored and described; for example, Smith thus observed that people within a single economic sector can meet repeatedly to agree upon the rise of prices against the interest of the public.

Further, Adam Smith argues that while workers unite to reach the highest wage possible, employers join together to keep the same wage low, and after introducing this thesis he proceeds to find out which of the two sides prevails (Smith, A., 2007, p. 44).

As there exist less employers than workers, they may unite more easily and, moreover, *freely*: Unlike workers, employers are not forbidden by law to form unions. Also, property owners may continue disputes for prolonged periods of time and live off the capital for a year or two, whereas workers are able to manage without their wages merely for a week or, at most, a month. Even though the worker is indispensable for his or her employer and vice versa, this relationship of mutual dependence is not balanced. In labour disputes, Smith concludes, the owner always has an advantage (Smith, A., 2007, p. 45). There can be seen one of the reasons why Smith regards the law that instructed employers in several areas of manufacture to pay their labourers in money, not in goods, as "quite just and equitable" (Smith, A., 2007, p. 93). Besides, he closely monitors the aptness with which the interests of the rich are formulated within the prevailing mercantilist doctrine.

Unlike mercantilists, who recommended that wages should be kept low in favour of an active balance of trade, Smith did not regard the preference of base-line wages as appropriate. The trade policy of mercantilism brought about, among other things, the classification of goods into indispensable and luxurious (Note 18); within this context, the former class was meant to ensure the subsistence of workers, while the latter was perceived as harmful owing to its direct (impossibility to export) or indirect (necessity to import) diminishing impact on the quantity of precious metals.

The discussed time was characterised by continuous whinging of higher social strata about the diffusion of luxury in the lowest classes of society (Note 19): According to people enjoying a higher social status, high wages only helped to cultivate idleness and lavish consumption. In the mercantilist outlook, the poor had to stay poor if the economic system was to maintain its viability; Bernard de Mandeville, a typical advocate of this viewpoint, used his *Fable of the Bees* to propose that consumption is beneficial merely with wealthy classes. Moreover, in this connection, he emphasised repeatedly the importance of poverty: "In a free Nation where Slaves are not allow'd of, the surest Wealth consists in a Multitude of laborious Poor" (Mandeville, 1806, p. 179).

In full agreement with the spirit of mercantilism, de Mandeville approved of child labour and opposed the education of children, since the only path to maintaining industriousness in the poor led through keeping them ignorant (Geremek, 1991, p. 233). Smith's attitude, by contrast, is markedly different. Above all, he did not identify the main problem in the rise of wages, which essentially improved the standard of living of the lower classes, and did not assume that only the consumption realised by higher social strata was effectively beneficial for the society. Rather than that, Smith promoted the following view:

"Servants, labourers, and workmen of different kinds, make up the far greater part of every great political society. But what improves the circumstances of the greater part, can never be regarded as any inconveniency to the whole. ... It is but equity, besides, that they who feed, clothe, and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, clothed, and lodged (Smith, A., 2007, p. 52). ... The liberal reward of labour, therefore, as it is the necessary effect, so it is the natural symptom of increasing national wealth. The scanty maintenance of the labouring poor, on the other hand, is the natural symptom that things are at a stand, and their starving condition, that they are going fast backwards" (Smith, A., 2007, p. 48). Adam Smith believed that, in relation to national wealth, high wages are produced by its growth, not by its amount (Smith, A., 2007, p. 46) (Note 20). And another one of his recommendations was also in favour of the less affluent: Basic victuals or essentials of life such as bread, meat, cooking oil, and wine should not be subject to taxation, since any tax thus levied burdens the poor more than the rich. Conversely, the philosopher did not preclude the taxation of luxury goods and considered it appropriate in certain cases.

In this context, it is no wonder that, shortly after the publication of his main work, Smith came to be considered a supporter of the poor (and generally remained to be viewed as such well into the 1790s); it was only after 1800 that his image slowly started to gain the characteristics of the free market hero (see Rotschild, 1992, p. 88 for more information on this process). Yet this gradual process could not be easily marked as smooth, because the work spoke for its author. Thus, as late as 1881, Lord Acton was able to make the following (and, in the context of our discussion, very interesting) observation: "...That is the foreign effect of Adam Smith – French Revolution

and Socialism". (Note 21)

Similar evaluation of theories proposed by Smith came from Carl Menger, who (in agreement with earlier proponents of the viewpoint) asserted that Smithian liberalism inevitably leads to socialism. Nevertheless, Menger later moderated his original stance and referred to Smith merely as a supporter of the poor: "There is not a single instance in A. Smith's work in which he represents the interest of the rich and powerful as opposed to the poor and weak" (Menger, C. *Die Social Theorien*, p. 223; cit. from Rotschild, 1992, p. 88).

In spite of the fact that, in *An Inquiry into the Nature and Causes of the Wealth of Nations*, Smith indeed did attack the institutional structure of the then society, his objective was not to achieve destruction of this structure but to replace it with a beneficial degree of market forces' action. According to Smith, freedom will be less cruel to the poor than the policy of oppression or badly informed governments. The price system, Smith observes, developed as a more refined form of organisation of economic life and should be increasingly promoted:

"Where there is an exclusive corporation, it may, perhaps, be proper to regulate the price of the first necessary of life; but, where there is none, the competition will regulate it much better than any assize" (Smith, A., 2007, p. 93). Smith was considered a friend of the poor also thanks to his stance on the import of grain; he advocated liberalising the grain market in order to eliminate hunger and poverty.

### 5. The *Sic et Non* of Adam Smith

While in *The Theory of Moral Sentiments* Smith began with general statements on the nature of the universe that, in his time and by himself, were considered both manifest and revealed truths of the world and the character of man, and from these statements he derived further conclusions through the use of speculation and deduction, in *An Inquiry into the Nature and Causes of the Wealth of Nations* his method was different. Here, Smith proceeded as a direct observer from the concrete to the universal by means of induction. (Note 22)

*The Theory of Moral Sentiments* recorded the development of Smith's system of ethics based on the doctrine of a natural harmonic order led by God, and this general doctrine was, subsequently, applied with strict consistency to economic order.

Thus, *The Wealth of Nations* too includes the opinion that there exists a beneficial order which, left to itself, will bring maximum happiness and prosperity to mankind; however, no reference to divinity is present, and even the invisible hand appears merely at one place in the book (Viner, 1927, p. 207). Besides, the harmony of economic order is not ideal (even though – as alluded to within the text – the cause of this imperfection consists in the failure of morality – Note 23). The outcome of Smith's effort was supposed to materialise in such an institutional structure that would best harmonise the interests of an individual with broader interests of the society. A quotation from a book of Walter Eucken, who provides a nutshell summary of the importance of Smith's work, shows how deep were the roots taken by Smithian principles in mainstream economics:

"The economic policy of *Laissez faire* was founded upon a great idea: Freedom ought to be guaranteed so that a natural, God-granted order could evolve. Spontaneous behaviour allowed the creation of the division of labour, exchange, savings, economies, money, and competition. Economic liberty, then, assumes a double role – it constitutes the basis for a personal, humanly dignified life of an individual and, at the same time, facilitates the realisation of the creative plan from which there follow certain natural laws of economy... [Yet] granted freedom has shown the potential to endanger liberty by enabling possible formation of private power, and though it has also shown its capability of arousing extraordinary effort, such effort may ruin liberty. ...The creation of any economic order should not be left to itself" (Eucken 2004, p.108). This summary provides an accurate definition of Smith's position on the problem. The philosopher certainly was a supporter of the "invisible hand"; however, he advocated it merely as a part of natural order and natural freedom. Also, Smith employs the often repeated adjective "natural" to convey a dual sense: While its positive message is "indispensable" or "inevitable", the related normative meaning can be best expressed with "proper" (Note 24). And this criterion may be applied as the basis for the reading of Smith's books, which contain a consistent and accurate description of both beneficial and harmful behaviour of the State or the individual. This, then, is the point where actually lies, in relation to economic order, the *Sic et non* of the Enlightenment, this is the point where the foundations of public economics are established.

Within the same duality, Smith discussed the beneficial effects of the division of labour in broader connection with the negatives. Thus, while describing how a poor man may grow rich through his own industriousness, whilst defining the action of economic forces that secure gradual increase in everyone's wealth, the philosopher did not hesitate to restrain the rich (through measures such as selective taxation) in order to relieve the poor. Despite opposing trade monopolies, he admitted that they can be purposeful and beneficial on a short-time basis.

(Note 25)

At times, the evil of unbound self-interest (selfishness) was less burdensome to Smith than the evil of an incompetent and corrupt government, whereas at other times it was vice versa: “The capricious ambition of kings and ministers has not, during the present and the preceding century, been more fatal to the repose of Europe, than the impertinent jealousy of merchants and manufacturers. The violence and injustice of the rulers of mankind is an ancient evil, for which, I am afraid, the nature of human affairs can scarce admit of a remedy: but the mean rapacity, the monopolizing spirit, of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind, though it cannot, perhaps, be corrected, may very easily be prevented from disturbing the tranquillity of anybody but themselves” (Smith, A., 2007, p. 318).

In certain passages, based on the assumption that the State is a bad dealer and an inferior manager, Adam Smith discourages the government from entering trade. Yet it is not possible to say that he repudiates economic activities of the State on principle, because other parts of his work include examples of governments (such as those of Venice and Amsterdam) whose efforts were fruitful. Moreover, as emphasised by Viner, Smith was not aware of the good results achieved by German-speaking principalities in the management of public land as well as other activities falling within public administration. Adam Smith always accentuates the positive effect of private and public activities in relation to the common benefit, and with respect to this benefit he differentiates between favourable and unfavourable consequences of both the laissez-faire system and governmental interventionism. Interestingly, the philosopher finds ample room for state intervention, room which could be even larger if the government were *competent, incorrupt and public-serving*. Thus, the last edition of *The Theory of Moral Sentiments* contains a beautiful, enchanting passage on functional public administration:

“In the same manner, if you would implant public virtue in the breast of him who seems heedless of the interest of his country, it will often be to no purpose to tell him, what superior advantages the subjects of a well-governed state enjoy; that they are better lodged, that they are better clothed, that they are better fed. These considerations will commonly make no great impression. You will be more likely to persuade, if you describe the great system of public police which procures these advantages, if you explain the connexions and dependencies of its several parts, their mutual subordination to one another, and their general subserviency to the happiness of the society; ... It is scarce possible that a man should listen to a discourse of this kind, and not feel himself animated to some degree of public spirit” (Smith, A., 2000, p. 267).

Certainly it is no accident that *An Inquiry into the Nature and Causes of the Wealth of Nations* comprises hundreds of pages proposing an analysis of various functions of the State. Smith addressed the topics of public spending and income, taxation, regulation, state-controlled businesses, public debt and monetary policy, or partial governmental policies from defence to culture and education. Therefore, it is by no means improper to call Adam Smith the first representative of public economics; if we leaf through current textbooks in this field, we find a selection of problems which is, more or less, the same as the list of Smith’s topics given here. And there is yet another aspect that makes the work of Adam Smith attractive: The apology for free trade was undertaken by an academician, a man who never earned his living through or became actively involved in trade, in order to bring more good to more people. This was an attitude which stood in sharp contrast with that adopted at the time by mercantilist tradesmen, businessmen, merchants and practitioners, who merely followed their own narrowly defined interests.

And if Smith assumed the role of a scholar to defend the benefits of trade functioning, in his everyday active life he pursued intensive work for society – as a university professor, a counsellor to heads of government, or a customs commissioner, which was a position he applied for in the autumn of his life to practise dutifully all the related tasks. For if we have not found so far any relation between *The Theory of Moral Sentiments* and *An Inquiry into the Nature and Causes of the Wealth of Nations*, we may turn to Smith’s life to discover it.

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## Notes

Note 1. See Samuelson, 1954. A very convincing critique of the theory of public goods, which are at times quoted as a prominent example of market failure, was presented by Hampl, 2001; this author also shows the category of externalities as a boundary problem of economics. Samuelson's approach is described as inherently democratic in Svoboda, 2008.

Note 2. The notion of "the invisible hand", albeit often discussed and once mentioned already in *The Theory of Moral Sentiments* (p. 188; hereafter referred to as TM), is indicated in the later work *An Inquiry into the Nature and Causes of the Wealth of Nations* (hereafter referred to as WN) merely as a rather marginal problem and can be traced only at one point, namely in the chapter concerning restrictions placed on the importation of goods. By comparison, Smith discusses the problem of natural order or natural liberty on a much more intensive basis.

Note 3. Yet we can find a simpler explanation that is rooted in the prevailing thought of the time. Within their main intent, both the works anticipate the later Kantian realm of nature, where we encounter valid laws of nature, and the realm of liberty, which is built upon rationally substantiated moral laws. Thus, the disputed intersection is possible and realises itself within a human being.

Note 4. The preoccupation with justice had its own logic in the same manner as the current search for balance.

Today, the State is considered the guarantor of property rights albeit these rights in fact preceded state structures and are incorporated into parallel legal systems developed to seek justice. And if the exercise of property rights, together with the related transactions, existed before the State and was included in the domain of execution and administration of justice, it is only logical that justice constituted the basis for the economic thought of the Scholastics.

Note 5. It is obvious from inventories that Adam Smith's library included works by Hugo Grotius and Samuel von Pufendorf (the related connection between Smith and scholasticism was described in Roover (1955), p. 188). Moreover, as shown by the Glasgow college curriculum, 18th century university instruction did not comprise mercantilism, whereas economic principles were taught respecting the medieval manner, namely in conjunction with legal and ethical problems and observing the continuity of scholastic thought. In Glasgow, this system was inherited from the medieval university and, as such, survived for an unexpectedly long period of time. The concept of economics as a discipline dedicated to the search for justice therefore constitutes a significant source of economic thought and can not be left aside in future research.

Note 6. Both negative and positive reciprocity as traits of behaviour can be identified in chimpanzees, our next of kin. Positive reciprocity as a voluntary social exchange apparently originated in the nuclear family, where the close relationships enabled the genes to survive even under weak reciprocity conditions because kinship alone facilitated the recognition and easier punishment of the free rider (see Smith, V.L., 1998, p. 5; in this context, the motto of the family as the basis of the State seems to possess a meaning deeper than usually thought). The family reciprocity model subsequently expanded to subsume an increasingly wider cluster of people, and this expansion was apparently related to the growing importance of negative reciprocity, which strengthened the respect for the system of rights and obligations and whose purpose consisted in deterring free riders (Ibidem, p. 4).

Note 7. When agents maximise their profits against the maximising action of others, they also maximise the total benefit from exchange. As noted by V.L. Smith, the non-cooperative equilibrium principle was proposed by A. Cournot already in 1838; today, however, the principle is termed Nash equilibrium.

Note 8. Importantly, Smith opposed the *practice* of mercantilism, not the theory, and this situation stemmed mainly from the fact that a real and coherent concept did virtually not exist within the doctrine in question. Most mercantilists were tradesmen lacking university education, with mercantilism never being anything more than a sum of partial advice through which the actual authors intended to influence the prevailing economic policy and, as a rule, make it work in favour of their private interests (see Roover, 1955, p. 177).

Note 9. By accentuating the phrase of *necessary expenses*, Smith espoused considerate and – in the very sense of the expression – *economical* functioning of the State, namely such functioning that is currently referred to through the misrepresentative term of the *minimal state*. And whenever the philosopher advocated financing through the public budget, he did so with respect to effectivity and the benefit of individuals or the government as an element representing the entire society.

Note 10. The management of infrastructure as an activity traditionally exercised by the State was discussed by various authors throughout centuries and documented, at the latest, in 1494 when Angelus de Clavasio asserted within his work *Summa Angelica* - in relation to tax evasion - that taxes ought to be spent for public benefit including *the care of roads, bridges, or safety of people and objects*. The connection between Smith's thoughts and the older tradition is also obvious from a comparison of his theories with the views presented in a John de Lugo text where, according to the criteria of justice, the Spanish theologian analysed fair distribution of the tax burden as well as the unavoidability of tax collection on the part of the ruler. In the debated sense, the text contains several conditions or theses. The first condition consists in the necessary existence of a just cause; this cause, then, is identical with the common benefit, not the private benefit of the ruler. Further, the requested tax must be proportional to the purpose for which it is levied because there stands the danger that excessive tax burden will be fatal for the State. And, within the third principle, a tax is required to be adequate to the income; if the reason why a tax is collected applies only to a few individuals, the tax burden should analogically affect this group of people first and foremost. However, if the main targeted object of tax is not capable of bearing the entire burden, the others may be required to share: Members of a society together make a whole and ought to help each other (cf. Curran, 1985, p. 114).

Note 11. The purpose of the taxation system radically changed only in the 19th and mainly the 20th centuries; at the time, the redistribution of income started to prevail over the support of legitimate government spending. The redistributive and stabilizing functions of the state budget are nevertheless comparatively new to the entire structure, and they show interesting consequences within research into the development of ethics concerning tax

evasion (see McGee, 2006, p. 243).

Note 12. This controlling mechanism may be interpreted as a precursor of current antitrust offices, whose duty is to ensure that a monopoly position does not cause (to a certain extent) an excessive price increase.

Note 13. The proposition contains traces of the subsidiarity principle, namely a policy which guarantees that decisions are made at a level standing as close as possible to the citizen.

Note 14. This approach undoubtedly stems from scholastics, namely from authors such as Thomas Aquinas. Let us quote here related views of the eminent philosopher and theologian, thus: “ Also. The good of the community surpasses a particular good of the individual. (I Ethic., 2, 8;1094B) Therefore the particular good must give way, that the common good may be maintained.” See *Summa contra gentiles*, art. 146, book III.

Note 15. “Out of ferocity, avarice and ambition, the three vices which run throughout the human race, it [the society] creates the military, merchant and governing classes, and thus the strength, riches and wisdom of commonwealths. Out of these three great vices, which could certainly destroy all mankind on the face of the earth, it makes civil happiness. This axiom proves that there is divine providence and further that it is a divine legislative mind. For out of the passions of men each bent on his private advantage, for the sake of which they would live like wild beasts in the wilderness, it has made the civil orders by which they may live in human society.” Vico, G. *Scienza Nuova* (1725). Cit. as per Hirschmann (1997), p. 17. See also Vico, (1948), p. 56.

Note 16. Cf. Smith, A. (2007), p. 462. At this point we may observe a significant difference between Smith and Mandeville; moreover, Mandeville attracted Smith’s criticism for asserting that it is only vices that yield benefit and that, without them, there would not be any benefit at all (the hive would become extinct). As a matter of fact, Mandeville made two mistakes. Firstly, he considered virtue to be consistent only with utmost asceticism (reasoning through *ingenuous sophistry*, as stated by Smith in *The Theory of Moral Sentiments*, pp. 457-8, and in contradiction with prevailing thought of the period, which is the corresponding expression of the present time). According to Mandeville, vices indiscriminately included such phenomena as the cleanness of someone’s shirt or comfortable habitation. Secondly, Mandeville was unable to imagine the transfers of effective demand; in principle, he eliminated these transfers based on the previously reached (narrow) definition of virtue and the (broad) description of vices. We nevertheless know that if the country we live in is safe, we are not made to spend our means on window grilles and may use the money to beautify our flats or houses. And instead of having to bribe the judge who works impartially, we may acquire (for instance) the ideologically different allegory by Jonathan Swift on the lands of the Houyhnhnms and the Yahoos. Thus, in conclusion, it is possible to say that even virtuous people can create effective demand, and this is where – according to A. Smith – lies the main mistake present in Mandeville’s theory.

Note 17. The term was introduced into economics by Mancur Olson through his book *The Logic of Collective Action* of 1965.

Note 18. Over the centuries, the idea was transferred to current economics courses, which enabled this posthumous remnant of mercantilism to survive – void of evaluative connotations – within the analysis of consumer demand and under conceptual descriptions of goods whose consumption increases more slowly than income and goods whose consumption increases more rapidly than income.

Note 19. At the beginning of the 18<sup>th</sup> century, Daniel Defoe (1660 - 1731), the author of *Robinson Crusoe*, a book much loved by children, wrote: “But there is a general taint of slothfulness upon our poor; there is nothing more frequent than for an Englishman to work till he has got his pocket full of money, and then to go and be idle, or perhaps drunk, till ’tis all gone, and perhaps himself in debt; and ask him in his Cups what he intends, he’ll tell you honestly, he’ll drink as long as it lasts, and then go to work for more“. “...Poverty is caused by the crimes of luxury, sloath, and pride“. See Bremner (1993), p. 57.

Note 20. This view may have been the real origin of the obsession with economic growth (for which economists are often reproached), as within the outlined logic the growth spurs an increase in the demand for labour and, subsequently, in the wages.

Note 21. Lord Acton, Letters to Mary Gladstone; cit. from Rotschild, 1992, p. 88.

Note 22. Viner pointed out that wherever Smith discovered discrepancies between generalisation and data, he diverted from his generalisation and preferred the data. (Viner, 1927, p. 216)

Note 23. When discussing harmony, Smith usually follows the path of describing the general phenomenon which, in spite of bringing generally positive effects, may cause problems in individual cases or within a short-term perspective. The image of harmonic functioning of economic order is described by expressions like “in most

cases...majority...usually...often” (Viner, 1927, pp. 208 – 209). Here, the regular circumspection in money spending can be used as an example: “...because, though the principles of common prudence do not always govern the conduct of every individual, they always influence that of the majority of every class or order“ (Smith, A., 2007, p. 188). And it is with circumspection that Smith talks about the key element of *the Wealth of Nations*, namely the division of labour; according to him, this element constitutes the most significant attribute of economic life and opens the door to welfare. Furthermore, in the given context, Smith says that observing the natural division of labour is usually profitable.

Note 24. See Waterman, 2002 for more details on the dual usage of the word “natural” in the works of Adam Smith.

Note 25. At this point, it is interesting to review Smith’s discursion into the system of the East India Company.

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