

## STUDY UNIT 2: ADAM SMITH

### STUDY OUTCOMES

When studying this unit, you should aim at gaining knowledge and understanding of the following:

- The main tenets of the Enlightenment worldview.
- How both the Theory of Moral Sentiments and the Wealth of Nations suggest different ways of reconciling individual freedom with the achievement of the common good.
- How the division of labour enhances productivity and ultimately leads to mechanisation and industrialisation.
- How the size of the market limits the division of labour.
- The meaning of Smith's concept of self-interest and how that concept may be differentiated from pure selfishness or greed.
- Why in modern capitalism competition is less likely to guide private interests towards the common good than in Smith's time.
- The two main reasons why, according to Smith, state interference is likely to be ineffective in furthering the common good.
- The forms of state interference which Smith, nonetheless, advocates.
- Smith's argument in favour of free international trade.
- Smith's distinction between value in use and value in exchange.
- The meaning of the water-diamond paradox, why it caused Smith to focus on value in exchange and ignore value in use (utility).
- The distinction between relative price and absolute nominal price, and the role it plays in Smith's labour theory of exchange value.
- The distinction between short-term market price and long-term natural price, and the role it plays in Smith's labour theory of exchange value.
- The sense in which Smith's labour theory of exchange value is applicable to an "early and rude state of society".
- How, according to Smith (and Hume), the general price level is determined by the quantity of money in circulation.
- The wages-fund theory, and why it is more applicable to an agricultural society than to a modern industrial society.
- On what grounds Smith disagreed with the low wage doctrine of the mercantilists, and the "iron law of wages" of later classical authors.
- Smith's determinants of the wage structure in a free society.
- Smith's view of profit as the reward for risk-taking.
- How the classical authors in general insufficiently distinguished between profit and interest.
- Why profit rates, according to Smith, tend to be lower in rapidly advancing nations than in poor stagnating nations, which can be more than offset by the lower wages paid in poor nations.
- After having studied Ricardo: how Smith's theory of rent is similar to Ricardo's.
- How Smith's anti-bullionist stance caused him to underestimate the contribution of money to wealth creation.
- The grounds on which Smith opposed the rising national debt of his day.
- The virtuous circle implicit in Smith's ideas, according to which increased productivity and wealth creation leads to even greater increases in productivity and wealth creation.
- Smith's distinction between productive and unproductive labour

## Adam Smith (1723–1790)

An influential Scottish economist who objected to the stifling **mercantilist** systems that were in place during the late eighteenth century. In response, Smith wrote the seminal *Wealth of Nations* (1776), a dissertation criticising mercantilism and describing the many merits of a free trade system.

### Tenets of the Enlightenment Worldview:

Several key influences on Smith's thinking

#### 1. **Period of Enlightenment**

- General Intellectual Climate
- Intellectual Movement built on 2 pillars
  - People's reasoning Ability
  - Concept of Natural Order

*Scientific revolution associated with Newton established order and harmony characterise the physical universe*

- Through systematic reasoning people discover physical laws and those that govern society
- Enlightenment Thinkers:
  - Optimists: Believe that human thought and energy could produce unlimited progress

#### 2. **Influence of Physiocrats > Quesnay & Targot**

- Against Mercantilism
- Propose removal of trade barriers
- From them he drew
- Theme of wealth: Consumable goods annually reproduced by labour of society
- Minimal interference in economy from government
- Circular process of production and distribution

#### 3. **Influence of Francis Hutcheson**

- Instructor @ Glasgow College
  - People will discover themselves what is ethically good - the will of God - by discovering actions that serve the good of humankind

#### 4. **David Hume**

- Letters and conversations contributed to intellectual development & economic ideas

Fundamental principles of Enlightenment:

- **Reason:** Truth could be discovered through reason or logical thinking
- **Nature:** That what was natural was also good and reasonable
- **Happiness:** Rejected the medieval idea that people should find joy in the hereafter and urged people to find well-being here on earth
- **Progress:** Society and humankind could improve
- **Liberty:** People had the right to freedom -like freedom of speech and religion- and that these freedoms should be guaranteed by people's governments. They also believed that government should be for people, not the other way around. John Locke wrote, "Man is born free, and everywhere he is in chains."

## Theory of Moral Sentiment & Wealth of Nations:

### **Moral Sentiments**

Moral forces that restrain selfishness and bind people together in workable society. Sympathy overcomes selfishness and interest us in fortune of others and make their happiness necessary to us. This is true even though one does not derive anything from someone else happiness except the pleasure of seeing it. Grief and joy arouse similar emotions in ourselves.

By placing one in another persons's position our imagination can evoke sympathy for a situation of which the other person is unaware. If someone go mad they are insensible of any misery. Anguish that stems from observing them comes from our own powers of reason and judgement. This is sympathy.

Smith differentiate between unsocial and social passion.

- Unsocial: hatred & resentment

Divide sympathy between person who feel them and person who is the object of them as the interest of the 2 individuals are contradictory

- Social: generosity, humanity, kindness, compassion, mutual friendship and esteem

Sympathy with person who feels passions coincides exactly with their concern for person who is object of them. Always have strongest sympathy for benevolent passions as they appear agreeable to us.

People identify more with joy than sorrow and therefore we parade our riches and hide our poverty. Toil and bustle of world undertaken to gratify our vanity and not to supply necessities. We want to be noticed with sympathy and approval. The rich glory in their riches because they get the attention of the world and the poor are ashamed of their poverty which leaves them in obscurity.

Smith states that people can only exist in society where they are exposed to mutual injuries and need one another's assistance. When the necessary assistance is reciprocally offered out of love, gratitude, friendship and esteem the society flourish and is happy. If mutual love and affection are absent the society will continue to exist because of utility even though it might be less happy and agreeable. It cannot exist among those who wants to hurt and injure each other. Therefore a system of justice is required.

Smith then consider the problem of our own selfishness and how it can be curbed and controlled.

Our morals prescribe rules of conduct that restrain our actions of selfishness. Rules can be seen as commands and laws of deity. If we violate God's rules we will be punished by torments of inward shame and self condemnation. If we obey God's wishes we will be rewarded with tranquility of mind, contentment and self satisfaction. Therefore God promote our happiness.

Smith states that the rich tend to save and reinvest and therefore consume little more than the workers. They unintentionally share the produce of improvements with the poor.

**Relevance Today:** *Society without people caring for one another will not be very nice but will survive. However a society without law and order will destroy itself.*

## Wealth of Nations

Assumes existence of a just society and show how the individual is guided and limited by economic forces.

## Division of labour

Smith states that the greatest improvements in the productive power of labour lie in the division of labour.

Labour specialisation occurs in two forms.

- Product Specialisation > bake bread, brew beer, make pins
- Operation Specialisation > specialise in parts of production to produce product

When Smith refers to labour specialisation he mainly refers to operations specialisation.

Even in the production of very simple products, division of labour always increases productivity exponentially. (Example of pin factory)

Smith offers three reasons for this increase in productivity.

- Division of labour creates specialised knowledge of a particular trade or task  
This, in turn, makes the labourers engaged in this task more dexterous, and therefore more productive.
- Division of labor saves the labourer time  
In focusing on one task, rather than passing from one task to another, a process that requires him to use different tools and materials, he is able to maximise his time, thus increasing productivity.
- Technological innovation that ultimately makes that task easier  
The amount of time spent by labourers on an isolated task leads to innovation in the methods and tools employed in the task.

Therefore, increased division of the labour involved in the production of a particular product leads to increased productivity.

By increasing productivity, the division of labour also increases the opulence of a particular society, increasing the standard of living even of the most poor.

Division of labour also means that many people are involved in the production of each and every manufactured product. This is a testament to the interconnectedness not only of the labourers employed in manufacturing, but of all the branches of commerce.

**Mercantilists:** How exchange of goods could add to nations well-being

**Physiocrats:** Focus on agricultural output

**Smith:** Increase output by dividing labour

## Division of labour > enhance productivity > mechanisation & industrialisation:

Labour specialisation creates possibilities for mechanisation and, as such, paves the way for industrialisation. Labour (operation) specialisation facilitates mechanisation, because it divides up the production process into a large number of repetitive, standardised productive handlings, which makes it possible for machines to take over these repetitive handlings. The enormous productivity gains from industrialisation and mechanisation, which Smith only partly anticipated, can thus indirectly be attributed to Smithian labour specialisation too.

The scope for labour specialisation, and thus for industrialisation too, is limited by the size of the market.

## Harmony of interest & limited Government:

Participants in the economy tend to pursue their own personal interests.

Consumers look for lowest price for good, given its quality.

Workers try to find highest pay, given nonage aspects of the job.

There is a natural order in the seemingly economic chaos. There is an invisible hand that channels self-interested behaviour in such a way that the social good emerges.

**Invisible hand:** *A term used by Adam Smith to describe his belief that individuals seeking their economic self-interest actually benefit society more than they would if they tried to benefit society directly.*

Key to understanding the invisible hand is competition. Action of each producer who attempts to garner profit is restrained by the other producers also attempting to make money. Competition drives down prices and by doing so reduces profit for the seller. Initially when there is only one seller, the huge profits attract new competitors which increase supply and reduce profit.

Employers compete with one another for best workers, workers compete for best jobs and consumers compete for the right to consume products.

Resources get allocated to their highest valued uses > economic efficiency prevails.

Business persons save and invest (out of self-interest), capital accumulates and economy grows.

Therefore the pursuit of self-interest, restrained by competition, tends to produce Smith's social good: Maximum Output & Economic Growth.

This harmony implies that Government intrusion is unneeded and undesirable. According to Smith, governments are wasteful, corrupt, inefficient and the granters of monopoly privileges to the detriment of society as a whole.

His distrust of the government is further reflected in his references to his own government which was at the time thought of as one of the honest and efficient ones in the world. He extended his belief in the harmony of interest and laissez-faire to international trade. He directly attacked mercantilism and argued that the government should not interfere in international trade.

Nations like individuals, should specialise in producing goods in which they have an advantage and trade for goods which the other nations have an advantage. If a foreign country can supply us with commodity cheaper than what we can make it, it is better to buy it.

Foreign trade can also promote division of labour by overcoming narrowness of home market.

Exports remove surplus products for which there is no demand and bring back products for which there is a demand. He condemned subsidies on exports.

Limited role for government:

- Protect society from foreign attack
- Establish administration of justice
- Erect and maintain public works & institutions that private entrepreneurs cannot undertake profitably

Smith recommends taxation to fund the government activities.

Maxims for good taxes:

- Taxes should be proportional to the revenue
- Taxes should be predictable and uniform
- Taxes should be levied at time and in manner most convenient to contributor
- Taxes should be collected at minimum cost to government

Government intervention through coercive laws does not further the common good for two main reasons.

- People know their own interest better than government officials do
- Government officials tend to waste public resources

## Size of the market & division of labour:

The size of the market limits the scope for labour specialisation, because increased specialisation, whether in product or in productive operation, always involves dividing up the market into smaller sub-markets – one for each specialised product or productive operation.

In short: the division of labour implies a division of the market too. As a result, only when the market is initially large enough can its division into these sub-markets keep these sub-markets large enough for a specialist to make a living. That is why the growth of a market, say of the population of a town, leads to the establishment of more specialised shops in that town. When a town is really small, only a single general store can make a living there. As the town grows, however, a specialised bakery, butchery and clothing shop may be able to establish themselves, offering better quality, a wider selection and better prices than the general store previously could. That general store, therefore, goes out of business unless it specialises itself. As the town grows even further, there may even be space for a watch-maker, a tobacco shop and a dentist. And so the process goes on.

Labour specialisation in itself increases the size of the market: by being more productive and lowering the cost of production and thus the price of goods, more people can afford these goods, which in itself enlarges the market for these goods. This effect is, however, never quite so strong that the size of the market never limits the possibilities for labour specialisation.

Given that the size of the market limits labour specialisation and industrialisation, any measure which increases the size of the market aids the scope for labour specialisation and thus for greater prosperity in general.

Three ways in which markets can expand spring to mind.

- Improvements in transport & communication technology increase the size of markets.

Ability of potential demanders and suppliers to communicate with each other and transport goods (and money) to each other defines a market. As transport and communication keep on getting faster and cheaper, the market which any given producer with access to that technology can reach keeps on growing too, to the point where the whole world has now just about become one huge market for everyone.

On the downside, if transport and communication deteriorate through increased cost, slowness, unsafety or other forms of unreliability, the effects on the achievable degree of productivity through reduced specialisation and industrialisation will be equally significant. In some ways, modern industrialised economies have thus become more vulnerable.

If the road, railway, air traffic and communication infrastructure deteriorate, farmers could no longer reliably and cheaply get their crops to their market, information about available qualities and prices could no longer be spread among potential market participants quickly and cheaply, producers could no longer reach their market except for those who live in close proximity to their factory, and so on.

When markets shrink in this way, possibilities for labour specialisation decrease and productivity falls.

**Relevance today:** it is imperative that we take good care of our transport and communications infrastructure.

- Markets can grow by removing restrictions on international trade.

Smith's advocacy of free international trade is based on precisely this point. Smith thereby takes it for granted that countries always have some area in which to develop a competitive advantage vis-à-vis other countries. If this is not the case, a country will not necessarily benefit by free trade.

The free trade argument then points out that a country, when exposed to the winds of competition, will eventually develop competitive strength in some area.

The current trade policy of the South African government is roughly based on this very idea: the economy is gradually exposed to international competition by reducing its legacy of import protection and export subsidisation (partly because international trade agreements force the government to do so), in the hope that the South African economy will react to this greater competition by eventually developing its own strengths.

There are signs that this is indeed happening, although some sectors, like the textile industry, have been seriously hurt by foreign competition, especially from China.

- The market for an individual firm can also expand by reducing the number of competing firms. Such a reduction is often a more or less spontaneous by-product of the process of advancing mechanisation: the firms which are quickest to apply the latest, most efficient machinery are typically also the ones which can produce at the lowest cost. By offering the goods at a lower price, they obtain a larger share of the market often at the expense of a multitude of smaller, less progressive operators, who are then forced out of business. That is partly why oligopoly rather than perfect competition is the typical market form in the modern industrialised world, in spite of the fact that markets have kept on growing due to the falling cost and increasing efficiency of transport and communication. Highly mechanised firms can only exist by virtue of large scale production, which means that, for a given size of the total market, there may only be space for a handful of firms – if we wish firms to produce at the lowest possible price. It seems that the loss of competition in markets is, to some extent, the inevitable downside of the economies of scale and the higher standard of living made possible by mechanisation and mass production.

Smith assigns an important role to competition as the invisible hand which spontaneously guides individual interests towards the common good. In Smith's day, however, industrialisation had not progressed very far in Britain. There were hardly any big factories. Most production was still handicraft production performed by artisans in small family enterprises organised as unincorporated proprietorships or partnerships. Under these circumstances, there was indeed a good chance that competition was vigorous in most markets. Modern capitalism with its far advanced industrialisation dominated by corporate firms may have had huge advantages in terms of raised productivity, but it has not been conducive to competitive markets. Most markets in modern capitalism are oligopolistic rather than perfectly competitive. Hence Smith's invisible hand has a much reduced chance of success in modern capitalism than in Smith's own day.

Both moral sentiments & wealth of nations reconcile the individual with social interest through the principle of the invisible hand, or natural harmony, and the principle of natural liberty of the individual, or the right to justice.

In moral sentiments sympathy and benevolence restrain selfishness; in Wealth of nations competition channels economic self-interest toward the social good.

### Self-Interest:

**Self-interest** is the driving force behind free-enterprise capitalism:

*“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.”*

This self-interest is supposed to be kept in check by competition. If your butcher charges unreasonably high prices for his meat, competition gives you the opportunity to go to another butcher. Butchers are thus forced, by the threat of losing customers to competing butchers, to be reasonable in the pricing of their meat. That is how their self-interest is kept in check by competition and how the “invisible hand” of competition, analogous to Newton's law of gravity in a system of natural harmony, automatically guides self-interest towards the common good.

Competition (understood as the availability of alternative suppliers or demanders) as a protection against social victimisation is a particular incidence of a more general principle. That general principle can formally be stated as follows: disassociation provides the best protection against possible harm resulting from association. For example, if I join an association like a trade union, a business agreement, a business partnership, a church or a sports club, but my associates turn out to be unpleasant, unreliable or even positively harmful and dangerous, I protect myself from any further harm by simply disassociating myself from them: leave that trade unions, business agreement, business partnership, church or sports club and join another. It is for that reason that

both the freedom of association (the freedom to cooperate with others for mutual benefit) and the freedom of disassociation (the freedom to terminate that cooperation with others when it is perceived to be no longer beneficial) are necessary to balance the potential benefit and the potential harm of human cooperation. When the freedom to disassociate from others is absent, I get locked into association with them (no exit). People gain power over me, which creates scope for abuse. Such is also the power of monopoly, that is, the lack of competition (no exit). While Smith's argument thus presented contains important truths, it is open to a number of misunderstandings. We will spend some time expelling some of these misunderstandings, which are still widespread in our day.

Many people mistakenly regard Smith's idea of self-interest as equivalent to **selfishness**, in the morally objectionable sense of being only and exclusively concerned with one's own interests at the expense, if necessary, of the interest of others. There is, however, a subtle but important difference between Smith's self-interest and plain selfishness.

Smith's self-interest refers to the desire to meet one's own needs – earn one's own income and pay for one's own food, clothes and housing. Clearly, that kind of self-interest is entirely moral, even if only minimally so. While morality challenges people to go a step further and also be concerned about the needs of others, people must at least look after themselves. Otherwise, that step further would not even be possible; only people who have already looked after their own needs can afford to be concerned about the needs of others. Self-interest as the desire to meet one's own needs is thus not inherently immoral, selfish or greedy.

It becomes immoral, selfish and greedy only when done at the exclusion of a concern for the interests of others, that is, when it is pushed so far that it squeezes out any generosity or any desire to see others get a fair deal too, which is not at all what Smith had in mind. Smith did not exclude the possibility that his "butcher, brewer or baker", even while being self-interested, are also keen to give their clients a fair deal or to spend part of their fairly earned income on contributing towards the needs of others. While generosity and fair play are not inherent in Smith's concept of self-interest, they are not excluded by it.

Therefore, Smith's idea that self-interested people can serve the common good should not be interpreted as a justification for selfishness: "why should I worry about being selfish if my selfishness serves the common good?" Although this interpretation was not intended by Smith, he is partly to blame for it. The problem lies in Smith's proposition that the invisible hand of competition operates like an impersonal natural law and that the mechanism is, therefore, automatic and inevitable. But contrary to harmony in the material world of physics, harmony in the world of human affairs is never automatic or inevitable, for which there are a number of reasons. First, markets are far from always sufficiently competitive to constrain rampant self-interest and guide it towards honesty and decency in business dealings. Second, even if markets were highly competitive, people are still in need of some degree of moral restraint and benevolence if their behaviour is to be in the interest of all, as Smith himself argued in his Theory of Moral Sentiments. In essence: competition cannot completely replace the role of moral self-restraint.

Similarly, by emphasising self-interest as the driving force behind liberal capitalism, Smith does not wish to suggest that liberal capitalism is based on selfishness or even on greed. While liberal capitalism gives people considerable freedom to pursue their own interests according to their own values, it would be a caricature to suggest that its core value is that of the "law of the jungle" where "might is right" and selfishness is given free rein. It would be more correct to argue that a liberal, free-enterprise system is based on the idea that the responsibility to provide for one's own needs lies, first and foremost, with private individuals themselves. Instead of looking to the state or their fellowmen for their means of existence, private individuals have to accept responsibility for their own needs, even if it may still be the duty of a liberal state to create an environment which makes it reasonably possible for people to look after themselves. In addition liberals would also wish the state to provide some minimum safety net for those who fail to make an adequate living for themselves – as Smith himself advocated. And if people are to carry the responsibility to provide for their own needs, they must also be given the freedom to do so, which requires that the means of production be privately owned and that exchange be largely voluntary. Because freedom can be abused (freedoms can always be abused; this is their drawback but not always a good enough reason to abolish them), selfishness, greed and social injury can play a role too – see again

Smith's Moral sentiments. But, says Adam Smith, the scope for such abuse of freedom can be brought back to acceptable proportions when there is sufficient competition (Wealth of Nations) and when there is a sufficiently strong sense of voluntary self-restraint based on moral conviction (Theory of Moral Sentiments).

## **Economic Laws:**

Smith developed several ideas that later economists classify as economic laws.

- Division of labour
- Law of self-interest behaviour
- Law of absolute advantage in international trade
- Value & Price
- Wages, Profit & Rent
- Role of money & Debt
- Economic Development

## **Value**

### **Water-Diamond Paradox:**

Also known as the theory of value which was not solved by Smith.

Two kinds of value:

- Value in Use: Utility of specific object
- Value in Exchange: Purchasing power of goods which possession of object convey

Things that have greatest value in use have often low exchange value and those with greatest exchange value have often little use value. E.g. water vs diamonds.

Even though life cannot exist without **water** and can easily exist without **diamonds**, **diamonds** are, pound for pound, vastly more valuable than **water**.

Nothing more useful than water yet you cannot purchase anything with it (price of water low).

Diamonds have very few uses but can exchange great quantities of goods for it.

Therefore the utility obtained from water is obviously very high, while the utility obtained from diamonds is substantially less.

Value in use - how much pleasure or convenience someone gets out of owning & using a good. It is subjective and difficult to measure objectively.

Value in exchange (market price) - Price which a good would fetch when selling it in the market. It is objective and easy to measure in quantities of money.

Smith directed his attention toward exchange value.

The possession a commodity provides to purchase other goods. Its "natural" price.

### **Primary Society:**

He examined exchange value in the economy in "an early & rude" state. He defined it as one where labour is the only scarce resource. Capital & Land are either nonexistent or free. As the only resource the value of a commodity will be determined by the amount of labour required to produce it. > Labour cost theory.

Value of any commodity to a person who possesses it, if he wish to exchange it for other commodities is equal to quantity of labour that enables him to purchase it.

Labour is the real measure of the exchange value of commodities. > Labour command theory.

In a primitive economy labour is both the source (labour cost theory) and the measure (labour command theory) of exchange value.

### **Advanced Economy:**

Then developed theory of value for advanced economy where capital accumulated and both capital and land commanded a positive price.

In a society where capital and land become important goods will normally be exchanged for other goods, money or labour at a figure high enough to cover wages, rents and profit.

Profits will depend on the whole value of the capital advanced by employer. Real value of commodities can no longer be measured by labour contained in them, but can be measured by the quantity of labour which they can purchase on demand.

Quantity of labour that a good can buy > quantity of labour embodied in its production by total profit and rent.

Demand does not influence the value of goods.

The cost of production is the only determinant of value in the long run.

- Wages
- Rent
- Profit

Reasonable that assumption that production expand or shrink at constant cost / unit of output.

Competition will drive prices down to cost, including normal profit. An increase in demand will not increase value because cost of producing each unit remain unchanged.

Assume increasing / decreasing costs and the principle becomes untenable. If demand for product increase and the industry expand and produce good at higher cost, the long-run price (value) of the item will rise. If rising output results in reduced cost per unit, the increase in demand will cause the long-run price to fall.

### **“Do Pearls have value because people dive for them, or do people dive for pearls because they have value?”**

Pearls (goods) have value because people need to dive to get them.

That is that the costs of production determines a good's exchange value or relative price.

People pay for things because they value them, they do not value them because they pay for them.

## Market Price

Smith distinguished between the natural (intrinsic) price of a good and its short-run market price. There are average rates of wages, rent and profit in every society. This is called the natural rate of each. When a commodity is sold for its natural price there will be exactly enough revenue to pay for these. The natural price is the long-run price below which an entrepreneur will no longer continue to sell its goods. If desperate they will sell goods for cheaper, but it cannot continue as they can go out of business.

The market price is the actual price at which any commodity is sold. It can be above, below or the same as its natural price. It can be influenced by both the demander (utility) and suppliers valuation (cost of production and reward) of the good.

The market price depends on the deviation of short-run supply and demand and it will tend to fluctuate around the natural price.

- Above the natural price: More goods will come to market depressing the price
- Below the natural price: Some productive factors will be withdrawn, quantity supplied will fall and market price will raise towards natural price

Short-run supply and demand are not fundamental determinants of prices (exchange value) but cause fluctuations in market prices around the natural price (value of commodity).

Smith also distinguished between the real price of a product and its nominal price (money). Here he followed Hume by pointing out that increase in stock of money in society can cause an increase in the nominal price of products and resources.

The real price of a commodity is its command over labour and not its command over money. A doubling of prices will not increase a commodity's command over labour if wages also double.

## Wages

Smith addressed three aspects of wages:

- Aggregate level of wages (WF)
- Growth of wages over time (WF)
- Wage structure

Wage Fund Theory (WF):

WF idea implies that there is a stock of circulating capital out of which present wages are paid. Stock consist of savings & depend on revenue from sales and production. It is fixed in the short run but increase from year to year.

**Average Annual wage = Wages Fund / Number of labourers**

Minimum rate of wages must be that will enable a worker with a family to survive and perpetuate the labour supply. When demand for labour rises the wages will rise above this minimum. Rate of increase of national wealth determines the demand for labour and the wages by influencing the size of the wage fund.

If wealth of country great but stationary, population and labour supply will multiply beyond employment opportunities and wages would fall.

Smith emphasises capital accumulation & economic growth. Applauded rise of wages that accompanied economy growth. Therefore against the low wage doctrine of mercantilism.

High wages increase health and strength of the workers - do their best work as high wages gives them hope for an improved life. *Known as economies of high wages (efficiency wages).*

Bargaining plays role in wage determination.

He assumed a society with perfect liberty, one where everyone is free to choose and change occupation. Theory of equalising differences - compensating wage differentials.

Wage structure vary according to 5 factors:

- Agreeableness of the occupation (More Disagreeable, higher wage)
- Cost of acquiring necessary skills and knowledge (theory of human capital)
- Regularity of employment (less regular, higher wage)
- Level of trust & responsibility (high trust - dr, higher wage)
- Probability or improbability of success (great risk of failure, high wage)

## Profit

Every investment exposed to risk of loss. The lowest rate of profit must be high enough to compensate for such loss and still leave a surplus for the entrepreneur. Gross profit includes compensation for any loss and the surplus.

Net or clear profit is the surplus alone (net revenue of the business). Countries that advance rapidly in wealth lowers rate of profit among businesses as a result of competition. Low profit rate may offset high wages. Thriving countries may sell goods cheaper than poorer countries who may have lower wages.

Classical economist generally did not treat interest as a separate distributive share - it was simply deducted from profit. Lowest rate of interest must be a bit higher than the losses that can occur through lending. The interest that the borrower can afford to pay is proportional to the net or clear profit only, and rate must generally be lower than the rate of profit in order to induce borrowing.

As profits rise borrowers seek more money and interest rates rises.

As profits fall, interest rates decline.

## Rent

Smith present several theories of rent - none complete or entirely accurate. David Hume criticised Smith's statement that rent of the land enters into the price of the goods produced from the land. He examined the the components of the price of commodities in general. When commodities are sold the revenue received must cover wages, rent and profit.

He also agreed with Hume and Petty's perspective that prices of agricultural products determine the rent that the landlord can charge.

He states that rent is the price paid for use of the land. It is the highest price the tenant can afford to pay after deducting wages, wear and tear of capital, average profits and other expenses of production.

Therefore rent is a surplus or residual.

High product prices yield high rent and Low prices yield low rent.

Smith was on same analytical path that Ricardo later took to develop his differential theory of rent. Ricardo's theory rested on law of diminishing returns which Smith did not apply to agriculture. This is surprising as Petty & Turgot stated the concept earlier. Instead he attempt to explain rent including viewing it as a monopoly return and as an opportunity cost of using the land for one purpose rather than another.

Together Smith's view on wages, profits and rents constitute an attempt to formulate a theory of the functional (factor share) distribution of income. His theory even though incomplete was far superior to the theories presented by the physiocrats.

## Role of Money & Debt:

Deemphasise the importance of money. Money is vital as a means of payment as without it business will need to use a barter system.

Money itself does not add to output / wealth of society. It facilitates the circulation of goods, but the production of the latter is what constitutes the wealth. Even though gold and silver circulating is a valuable part of the capital of the country, they are dead stock as they produce nothing.

Modern economist exclude money from their list of economic resources as money is not productive.

Smith's view on money was in opposition to mercantilism. If money is medium of exchange then paper money will do just as well as gold and silver and require less effort to produce. Gold and silver are like a highway that enables goods to be brought to the market without being productive. As long as paper money was redeemable in gold then a small reserve of metal would be sufficient. Mercantilist argued that consumable commodities are soon destroyed where gold & silver are more durable. Smith asked if one would consider exchange of English hardware for French wines to be disadvantageous. Only require a certain amount to circulate goods, an excess is unnecessary and will be exported. Mercantilist overemphasise gold and Smith ignored the special quality of this metal. It is universally acceptable medium of exchange and can be used for various purposes.

View amongst many contemporary economist was that internally held debt is of little economic consequence because we owe it to ourselves.

Smith was afraid that the heavy taxes needed to pay interest on the debt would induce merchants and manufacturers to invest their capital abroad to the detriment of the home country.

Assuming full employment Smith felt that government debt & interest charges represent resources that might have been used productively by private individuals if government had not diverted them to its own purpose. With corrupt governments far removed from the people such a diversion of resources would not serve society.

Smith further predict that growing debt would in the long run probably ruin all the great nations of Europe.

## Economic Development:

Smith viewed the economy as a whole and emphasised growth and economic development.

Primary factors that promote growth:

- Division of labour
- Accumulation of Capital
- Proper distribution of employment

### **Figure 5.1 & explanation (p87) in textbook**

Proper distribution of employment distinguish between productive labour & unproductive labour

**Productive labour** adds value to the product.

Productive employment stores up labour in a tangible commodity that has market value  
E.g. Artificers, manufacturers, merchants.

**Unproductive labour** does not add value to the product.

It is invested in offering services and does not result in the availability of tangible goods in the marketplace.

E.g. Kings, soldiers, lawyers, doctors, musicians.