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Adam Smith and the Market
Mechanism: Seemingly Unrelated
Contemporaries

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Adam Smith and the Market Mechanism:
Seemingly Unrelated Contemporaries

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ABSTRACT

It is argued that Adam Smith's use of Price Theory in Book I of the Wealth of Nations was no advance on what was known in 1776.

Furthermore, Smith introduced some innovations, such as the dichotomy between goods and factor pricing, that had harmful long-run consequences.

JEL classification: 031, History of Economic Thought

ADAM SMITH AND THE MARKET MECHANISM:
SEEMINGLY UNRELATED CONTEMPORARIES

I. One of the sharpest critics of the Wealth of Nations, Joseph Schumpeter, felt forced to concede the merits of Adam Smith's Price Theory¹

The rudimentary equilibrium theory of Chapter 7, by far the best piece of economic theory turned out by A. Smith, in fact points towards Say and, through the latter's work, to Walras. The purely theoretical developments of the nineteenth century consist to a considerable degree in improvements upon it.

Schumpeter's judgement has been widely accepted, all the more readily because of Schumpeter's little-disguised aversion to Smith. No one, however, appears to have asked how far such a characterization serves to indicate Smith's contribution. It may well be true that Chapter 7 is the best analytical effort of Smith and that it was very influential in the century to follow. But was it an improvement over what was available in the latter half of the eighteenth century?

In 1901, Hannah Sewall had already provided an accurate forecast of what was to be established by subsequent research.²

So much was done [in the seventeenth and eighteenth centuries] that there is scarcely any proposition of importance in the modern discussion of value which was not either stated or suggested by the writers of this first period of economic science, and which had not been discussed before Adam Smith made political economy a world study.

In discussing Adam Smith's contributions to the theory of value Paul Douglas expressed some embarrassment at the sesquicentennial of the Wealth of Nations in 1926.³

The contributions of Adam Smith to the theory of value and of distribution were not great, and in

commemorating the publication of Wealth of Nations
it might seem to be the path of wisdom to pass
these topics by in discreet silence

How is it that within twenty-five years this judgment would be quite reversed, by Schumpeter, and subsequently by other scholars?

To avoid misunderstanding, it should be emphasized that I am not concerned with the labor theory of value or the measure of value, a topic satisfactorily discussed in the above essay by Douglas. Or with Adam Smith's curious rules for the allocation of capital, an issue which Smith's latest editors have considered one of the weakest points of the Wealth of Nations: Nor with the roles of self-interest, the Invisible Hand or the beneficence of laissez-faire, where detailed studies by Myers and Hamowy exist: Nor even with Adam Smith's much publicized criticism of the Mercantilists on Foreign Trade; it was explicitly stated by such "typical" Mercantilists as Malachy Postlethwayt that Foreign Trade was to be considered a political problem and it is therefore not very meaningful to compare Smith and his predecessors on this issue.⁴

Until quite recently, Adam Smith's Price Theory drew praise largely because it was seen as the starting point of meaningful economic analysis. Alec Macfie notes this fact and regrets the emphasis on Adam Smith's analytics that it has encouraged.⁵

One aspect of the great man, probably that which suits later conditions, is chosen, much of the rest probably rejected. The section of Smith's work which was so chosen and developed till it became supreme was the first two books of the Wealth of Nations. The theory of static equilibrium there so carefully sketched has grown into an analytic system and method which has for long dominated English-speaking universities, and our universities

today control our theory as never before in modern times. It is a paradox of history that the analytics of Book I, in which Smith took his own line, should have eclipsed the philosophic and historical methods in which he so revelled and which showed his Scots character.

What Macfie, in common with most other scholars, fails to do is to note whether and how far Adam Smith's analytics in Books I and II of the Wealth of Nations were in fact advances on contemporary opinion.

In recent years the merits of Adam Smith's analysis of the market have been most forcefully (and independently) argued by Marian Bowley and by Samuel Hollander.⁶ It is notable that neither scholar gives careful attention to the eighteenth century pamphlet literature. Hollander's chapter has no direct references (presumably he considers the references given in an earlier chapter to suffice) while Bowley provides direct comparison only with the Scholastics and with Cantillon. Even if such a comparison were accurately done it would be most unfair to the rich pamphlet literature arising since 1660. One needs to go no further than J. R. McCulloch's Selected Tracts to find that considerable awareness of the workings of self-interest in the market is shown by Daniel Defoe in Giving Alms no Charity or by the anonymous author of An Apology for Pawnbroking.⁷ It will be shown below that our interpretation of what Adam Smith actually said does not differ from Bowley or Hollander on many occasions; that our evaluations nonetheless differ is perhaps largely attributable to the context within which we place Smith. In section 3 several of Smith's pretty applications are considered and an explanation offered for Smith's success in providing such nice illustrations of market phenomenon.

The failure to grasp the sophistication of eighteenth-century Microeconomics is perhaps the greatest defect in the existing literature. Jacob Viner dropped a significant hint when he wrote that⁸

On every detail, taken by itself, Smith appears to have had predecessors in plenty. On a few details was Smith as penetrating as the best of his predecessors.

The extent to which Smith failed to climb to the level of his predecessors is an issue deserving more careful consideration. It is not claimed that the eighteenth century understanding of the market was complete--only that Smith had nothing to add to what already existed. He never went ahead, and frequently stayed behind, the best views of his predecessors.

One important methodological point, which guides the criticism of this essay, needs to be cleared at the outset. Trite though it may sound, theorists must theorize and be judged for their theories. To provide us with a wonderful array of anecdotes, stories and facts as well as a fund of insightful observations is no doubt a contribution--but it is not theorizing. It is up to the theorist to tell us the essence of the matter--the crux of his theoretical insight--and it is illegitimate for modern scholars to extract such ideas out of other, non-theoretical parts of a book. The enormous size of the Wealth of Nations has encouraged an unfortunate methodology whereby the explicitly theoretical portions are given equal weight with observations and historical facts. Scholars range at will and show us that the theory explicitly proposed is not fully representative of Adam Smith's "general" view.⁹ This procedure forgets that it was Smith's responsibility to do his own theorizing.

II. The famous beginning of the Wealth of Nations concerns the division of labor. It is well known that Smith held the division of labor to be the prime reason for increases in productivity, and hence, for economic growth. Whether such a view is true or not, it has no bearing on this paper because the division of labor is a technological feature and its adoption is something internal to a firm, while we are concerned primarily with markets and prices. Hence the nature of the division of labor is not something to be directly explained by "economics" (as we understand it) but the extent to which the division of labor is practiced leads us directly to the market.¹⁰

Since the division of labor is regulated by the extent of the market the first requirement for a deeper understanding of economic prosperity lies in describing the working of the market. This is attempted by Adam Smith in Chapter VII of Book I entitled, "Of the Natural and Market Price of Commodities." As the title indicates, Smith distinguishes between "Natural" and "Market" Price and the former is clearly the more fundamental of the two. What then determines Natural Price?

Smith begins by telling us that in every society, at any given time, there exists an ordinary or average rate of wages, profits and rent which are determined by circumstances which have little to do with the price of individual commodities. These average rates for each factor of production Smith calls the natural rate and defines the natural price as the sum of the natural rates of wages, profits and rents. This price is distinguished from the market price, which is merely another name for whatever price reigns in the market at any time.¹¹

The actual price at which any commodity is sold is called its market price. It may either be above, or below, or exactly the same with its natural price.

Those individuals who are willing to pay the natural price of a commodity have a special role to play. Their demand constitutes what is called the "effectual demand" and market price is said to arise out of the interplay of the actual supply and the desires of the effectual demanders.

The market price of every particular commodity is regulated by the proportion between the quantity which is actually brought to market, and the demand of those who are willing to pay the natural price of the commodity.

The explicit theoretical construct thus consists of juxtaposing a point supply and a point demand.¹² This is an awkward way of formulating the market pricing process, especially since Smith's subsequent description makes it clear that in cases of excess supply new buyers enter the market and in cases of deficient supply some effectual demanders have to "leave" the market.

If, however, we gloss over the location of equilibrium, i.e., the natural price, and ask instead how Smith describes what happens when we are not in equilibrium, the treatment is excellent.¹³

When the quantity of any commodity which is brought to market falls short of the effectual demand, all those who are willing to pay the whole value of the rent, wages, and profit, which must be paid in order to bring it thither, cannot be supplied with the quantity which they want. Rather than want it altogether, some of them will be willing to give more. A competition will immediately begin among them, and the market price will rise more or less above the natural price, according as either the greatness of the deficiency, or the wealth and wanton luxury of the competitors, happen to animate more or less the eagerness of the competition.

Smith then treats of the opposite case, i.e., when supply exceeds effectual demand and shows just as clearly that an excess supply will cause price to fall and lead to a restriction in supply. The general tenor of Smith's argument regarding adjustments of price is quite modern and leads to the conclusion that¹⁴

The natural price, therefore, is, as it were, the central price, to which the prices of all commodities are continually gravitating.

Given the centrality of natural prices in Smith's schema, what we need is an adequate theory of natural prices. Since natural price is defined as the sum of natural wages, profits and rents, this requires an explanation of the natural rates of wages, profits and rents.

However Smith's statement of the most important features determining the natural rates does not seem to have any role for microeconomics.¹⁵

There is in every society or neighbourhood an ordinary or average rate both of wages and profit in every different employment of labour and stock. This rate is naturally regulated, as I shall show hereafter, partly by the general circumstances of the society, their riches or poverty, their advancing, stationary, or declining condition; and partly by the particular nature of each employment.

There is likewise in every society or neighbourhood an ordinary or average rate of rent, which is regulated too, as I shall show hereafter, partly by the general circumstances of the society or neighbourhood in which the land is situated, and partly by the natural or improved fertility of the land.

These ordinary or average rates may be called the natural rates of wages, profit, and rent, at the time and place in which they commonly prevail.

When the price of any commodity is neither more nor less than what is sufficient to pay the rent of the land, the wages of the labour, and the profits of the stock employed in raising, preparing, and bringing it to market, according to their natural rates,

the commodity is then sold for what may be called its natural price.

So the natural rates are set, first, by the macroeconomic health of the economy and secondly, by various technical and sociological features of different employments. Smith has provided us with a dichotomy between factor pricing and goods pricing. If it could be sustained, this would be an important contribution.

The next step is to specify each of the natural rates that serve to constitute the natural price. Chapter VIII of Book I attempts to determine the natural rate of wages. A careful reading of this chapter, however, shows that, amidst a great many digressions, all that is established is the existence of a lower bound on real wages; this lower bound is set by the condition that workers should be enabled to reproduce themselves. In a rather terse version of the Malthusian argument Smith points out that if wages do not permit reproduction, labor supply will fall and force wages to rise while if wages are more than adequate for reproduction, labor supply will increase and cause wages to fall.¹⁶

It is in this manner that the demand for men, like that for any other commodity, necessarily regulates the production of men; quickens it when it goes on too slowly, and stops it when it advances too fast.

It will be noted that this mechanism must take at least a dozen years, since a new generation has to be raised, and nothing specific is said about the rate of wages in the interim.

Smith lays emphasis upon the fact that wages rise, not in countries which are rich, but in countries which are growing richer.

The increased demand for labor in such growing economies always succeeds in keeping ahead of the reproductive cycle and so wages can keep on rising. This is most spectacularly seen in North America, the fastest growing part of the world.¹⁷

Labor is there [American colonies] so well rewarded that a numerous family of children, instead of being a burden, is a source of opulence and prosperity to the parents. The labor of each child, before it can leave the house, is computed to be a hundred pounds clear gain to them.

This observation is certainly accurate, but it leaves Smith's analytical structure incomplete. Both Europe and North America are stated to be growing economies, the former much more slowly than the former. In neither continent can wages be at their natural level. At what level then are they set?

The same difficulty faces us in the next chapter on profits. Once again we have several digressions, some of which are highly interesting, but one looks in vain for a clear-cut paragraph which will tell us what the natural rate of profit is at any given time and place. Instead, what we are told is that the natural rate of profit declines as a country becomes richer. While wages rise as a country continues along its course of growth, profits do just the opposite. The argument is based on an analogy between the trade for a single commodity with the trade of the entire economy.¹⁸

When the stocks of many rich merchants are turned into the same trade, their mutual competition naturally tends to lower its profit; and when there is a like increase of stock in all the different trades carried on in the same society, the same competition must produce the same effect in them all.

This explanation is expanded a little later, where the increased competition of traders is attributed to the gradually increasing difficulty of finding "a profitable method of employing any new capital." Once again we are provided with some interesting observations, but no help in determining natural profits. Without an explanation for its two principal components, wages and profits, the analytical structure of market price is left hanging in mid-air. Mark Blaug's comment is entirely appropriate.¹⁹

A cost-of-production theory of the value of a commodity is obviously empty and meaningless if it does not include some explanation of how the prices of productive services are determined. But Adam Smith had no consistent theory of wages and rents and no theory of profit or pure interest at all. To say that the normal price of an article is the price that just covers money costs is to explain prices by prices. In this sense, Adam Smith had no theory of value whatever.

There is a pause in the continuity of the argument while Smith deals with the causes of the inequalities in wages and profits across various occupations. In Chapter XI of Book I Smith turns to the rent of land. In earlier chapters Smith occasionally refers to average rents and speaks of rents as though rent is another component of price, on all fours with wages and profit. This loose language is shed in the first half of this chapter and we have an excellent exposition of rent, which left Malthus and Ricardo little to improve upon.²⁰

Rent, it is to be observed, therefore, enters into the composition of the price of commodities in a different way from wages and profit. High or low wages and profit, are the causes of high or low price; high or low rent is the effect of it. It is because high or low wages and profit must be paid, in order to bring a particular commodity to market, that its price is high or low. But it is because

its price is high or low; a great deal more, or very little more, that it affords a high rent, or a low rent, or no rent at all.

After such a clear exposition of the price mechanism one is surprised to find a quite different story told later in the chapter. A different set of principles, it appears, governs the rents of coal mines.²¹

The most fertile coal mine regulates the price of coals at all the other mines in its neighbourhood. Both the proprietor and the undertaker of the work find, the one that he can get a greater rent, the other that he can get a greater profit, by somewhat underselling all their neighbours. Their neighbours are soon obliged to sell at the same price, though they cannot so well afford it, and though it always diminishes, and sometimes takes away altogether both their rent and their profit. Some works are abandoned altogether; others can afford no rent, and can be wrought only by the proprietor.

Immediately after this extraordinary passage Smith correctly notes that the cost of production at that mine which pays no rent must be a good indicator of the lowest price at which the commodity be sold!

That Smith was unclear in his own mind as to the role of rent may be seen by turning to his treatment of rent in an earlier chapter. When supply is deficient, we are told, some component of natural price must be above its natural level. So far so good. Smith, however, chooses rent as an example of a return that can exceed its natural rate.²² Not only does this contradict Smith's own observation that rents are less affected by fluctuations of market prices than wages or profits, it also disguises the more plausible sequence whereby high profits are earned on the limited supply, the high profits thereafter leading to a greater cultivation of lands and eventually to higher

rents. A little later, Smith points out that natural causes may keep the market price above the natural price for long periods of time. To illustrate this, Smith refers to commodities such as special French wines which require land of such singular quality that the entire supply of such land is inadequate to meet the "effectual demand."²³

Some natural productions require such a singularity of soil and situation, that all the land in a great country, which is fit for producing them, may not be sufficient to supply the effectual demand. The whole quantity brought to market, therefore, may be disposed of to those who are willing to give more than what is sufficient to pay the rent of the land which produced them, together with the wages of the labour, and the profits of the stock which were employed in preparing and bringing them to market, according to their natural rates. Such commodities may continue for the whole centuries together to be sold at this high price.

Not only is it difficult to find an adequate definition of "effectual demand" in such cases but the fact that market price could exceed natural price "for whole centuries together" should give one pause to consider whether the distinction between natural and market prices is even worthwhile in such cases.

The most recent editors of the Wealth of Nations have praised Smith's treatment of the determination of market price.²⁴ "This section of Smith's work is perhaps among the best from a purely analytical point of view, and is quite remarkable for the formality with which the argument unfolds." The subsequent discussion by Campbell and Skinner fails to make clear that Smith's analytical apparatus is based upon a dichotomy between product and factor markets and that its effective use requires us to know the natural rates of wages, profits and rents; that Smith fails to give us any guidance as

to the level of natural wages in any country that is not stationary, of natural profits in any country at all, and provides an account of natural rents in a way that would confuse any careful reader. If, however, we accept that there is such a thing as natural price, to which market price must tend, then the process of adjustment is very clearly described. Those students of the Wealth of Nations who believed they understood the functioning of the market after reading Book I probably had a sufficient understanding of the market mechanism when they began, so that they were able to find their way through Smith's confusion.

III. If Adam Smith's analytics are of little use then perhaps it was his shrewd illustrations that served to educate future generations? There is certainly considerable truth in such a claim. There are many instances in which Adam Smith provides us with convincing illustrations of opportunity cost and of the equalization of returns in different uses. Chapter X of Book I deals with "Wages and Profit in the Different Employments of Labour and Stock." It is a beautiful exercise in tracing, for example, differences in money wages to differences in the prestige of different jobs, or of differences in profits to differences in the risk associated with different activities. Despite some occasional lapses from clarity, it is well-deserving of the praise bestowed upon it by Wakefield in 1843.²⁵

This, one of the most admired and most admirable chapters in the Wealth of Nations, is allowed on all hands to be free from error, and to contain, even now, the only complete account of the subject to which it relates.

Nor is Smith's use of such reasoning limited to this famous chapter. There is a fine development of this theme in the discussion of the relative profitability of tillage versus pasture.²⁶

Corn is an annual crop, butcher's-meat, a crop which requires four or five years to grow. As an acre of land, therefore, will produce a much smaller quantity of the one species of food than of the other, the inferiority of the quantity must be compensated by the superiority of the price. If it was more than compensated, more corn land would be turned into pasture; and if it was not compensated, part of what was in pasture would be brought back into corn.

The same point is also developed later.²⁷

When the price of cattle, for example, rises so high that it is as profitable to cultivate land in order to raise food for them, as in order to raise food for

man, it cannot well go higher. If it did, more corn land would soon be turned into pasture.

And in an extended discussion of the profitability of raising cattle, which is too long to be quoted in its entirety, Smith notes both the problem of joint costs and how it affects the allocation of land.²⁸

Whatever regulations tend to sink the price either of wool or of raw hides below what it naturally would be, must, in an improved and cultivated country, have some tendency to raise the price of butcher's-meat. The price both of the great and small cattle, which are fed on improved and cultivated land, must be sufficient to pay the rent which the landlord, and the profit which the farmer has reason to expect from improved and cultivated land. If it is not, they will soon cease to feed them. Whatever part of this price, therefore, is not paid by the wool and the hide, must be paid by the carcase. The less there is paid for the one, the more must be paid for the other. In what manner this price is to be divided upon the different parts of the beast, is indifferent to the landlords and farmers, provided it is all paid to them.

Even though Adam Smith did not provide any explicit theoretical guidelines that are particularly valuable one cannot fail to ask--what principles did guide Smith in making the perceptive and accurate observations provided above? The views expressed on the Law of Settlements for the poor perhaps gives us a clue. The law itself was believed by Smith to have restricted the mobility of labor and Smith therefore ascribed to the law not only the great differences in the price of labor in contiguous areas but also indignantly exclaimed that²⁹

There is scarce a poor man in England of forty years of age, I will venture to say, who has not in some part of his life felt himself most cruelly oppressed by this ill-contrived law of settlements.

This strong assertion has drawn the critical attention of several of Smith's editors. Campbell and Skinner make a pointed remark regarding Smith's indifference to providing factual details to support his assertion.³⁰

The general principles, the opposition to restrictions damaging to the free allocation of resources, were held so strongly that there seemed no case to answer.

This observation is pregnant with consequences which have not been developed.

If Smith indeed began by assuming that any violation of natural liberty was both morally wrong and economically harmful, how far could such a position take him into analytical economics? First, Smith's procedure needs to consider the absence of competition on only one side of the market. In the case of the Law of Settlements, for example, Smith did not proceed to ask whether masters might not find it profitable to find ways of evading the law. This is just what later critics, such as Sir F. M. Eden, contended.³¹ Secondly, if we assume that a market reaches a stable equilibrium, then the belief in one-sided competition alone suffices to provide several analytical results. For example, in the version of Ricardian Rent Theory espoused by Piero Sraffa, the same final outcome is reached whether only farmers compete (for land) or only landlords compete (for farmers). This one-sided analytical procedure works best when there are constant returns to scale and the assumption of fixed proportions, used on several occasions by Smith, is perhaps a consequence of his analytical method.³²

It is my belief that Smith thoroughly appreciated--and made his readers appreciate--the fundamental fact that a genuinely competitive market leads to zero-profits. This observation is repeatedly and successfully applied to such fields as the choice of occupations, the preference for pasturage over tillage or the determination of joint prices. It will even suffice to move us towards the "natural price," wherever that might be. If one re-examines Smith's concepts "natural" price, or any of its components, it is evident that the concepts are so defined that, any deviation implies the existence of a profitable venue of activity,--and hence encourages resource movements in a free economy. The fundamental principle was widely known and appreciated as may be seen from the two pamphlets earlier referred to, Defoe's Giving Alms No Charity and An Apology for Pawnbroking. (These examples can be readily multiplied.) The repetition of fundamentals is however the principal tool of good pedagogy. Smith's exposition undoubtedly contributed to the wider understanding of the market mechanism.³³

Apart from the wide extent and deep appreciation for the market visible in the general run of economic pamphleteering it is instructive to contrast Smith with Sir James Steuart. The Common Knowledge of an age is most evident when individuals with the most divergent views employ the same ideas. An examination of Steuart and Smith on the workings of competition clearly shows that Steuart was as knowledgeable as Smith.³⁴ Nor should this surprise us. Steuart was concerned with telling an intelligent statesman how to devise rules which

would move a free economy in desired directions. In modern terminology, Steuart's statesman was a Stackleberg leader and it is elementary that such an agent has to know the reaction functions of the followers--in this case the competitive market.

If then, Adam Smith is to be credited with having provided us with an understanding of the market mechanism, the case must rest not on his theoretical treatment, but rather on the process of adjustment to equilibrium and on the many insightful examples that Smith presented. Given the weakness of Smith's own analytical constructs, in assessing the merits of this achievement, it is necessary to spend only a little space on the theory and application of the price mechanism by Smith's predecessors.

IV. In looking over the literature prior to Adam Smith it is possible to take a European view, as Schumpeter did, and find antecedents for Smith's ideas in the works of the Scholastics and the Natural-Law philosophers. Due to limitations of space, this is the only group to be directly quoted here. Max Beer provided a striking example from the thirteenth century in Richard of Middleton, who formulated a rudimentary two-country, two good model to explain the benefits of trade.³⁵

Let us envisage two countries, A and B, unequally endowed by nature. A produces corn in abundance, but little wine, while country B has an abundance of wine and a deficiency of corn. We know that the market price or the just price of a commodity varies according to its plentifulness or scarcity. The same commodity when plentiful is less appreciated than when it is scarce. In this manner a sextarium of corn in country A will be cheaper than in country B, while conversely a dolium of wine in country A will be dearer than in country B. Now, it is natural for the business of trade and commerce to equalize supply. The merchant, then, buys corn cheap in country A and sells it at the higher market price that is ruling in country B, or he buys wine cheap in country B and sells it at the higher market price that is ruling in country A, so that in reality the consumer is not in the least overcharged, for he pays for each commodity the normal price, the just price, which is ruling in his respective country. The exchanges are equal, yet the merchant earns his profit, and he does so rightfully, for, far from having injured either country, he brought benefit to both. His profit is therefore neither usury nor turpe lucrum. The same rule of equality applies also to the business transactions of individuals in their own country. The commodity which the consumer receives is of more immediate utility to him than the money he gives for it, while to the merchant the money he receives for his commodity is of greater immediate utility than the commodity which he surrenders, so that both draw equal benefits from the exchange. (emphasis added)

The value of scholastic economic thought has subsequently been impressed upon us by Marjorie Grice-Hutchison, Raymond de Roover, Barry Gordon and, most recently, Odd Langholm.³⁶ Here is Azpilcueta on the quantity theory of money. Note the pertinence of the example in sixteenth century Spain (1556), the explicit ceteris paribus clause, as well as the comparative historical method.

other things being equal, in countries where there is a great scarcity of money, all other saleable goods, and even the hands and labour of men, are given for less money than where it is abundant. Thus we see by experience that in France, where money is scarcer than in Spain, bread, wine, cloth and labour are worth much less. And even in Spain, in times when money was scarcer, saleable goods and labour were given for very much less than after the discovery of the Indies, which flooded the country with gold and silver. The reason for this is that money is worth more where and when it is scarce than where and when it is abundant. What some men say, that a scarcity of money bringd down other things, arises from the fact that its excessive rise [in value] makes other things seem lower, just as a short man standing beside a very tall one looks shorter than when he is beside a man of his own height.

Finally, Juan de Lugo writes very clearly in 1642 that price fluctuates because of the subjective desires of the majority in the market:

not because of the intrinsic and substantial perfection of the articles--since mice are more perfect than corn, and yet are worth less--but on account of their utility in respect of human need, and then only on account of estimation; for jewels are much less useful than corn in the house, and yet their price is much higher. And we must take into account not only the estimation of prudent men, but also that of the imprudent, if they are sufficiently numerous in a place. This is why our glass trinkets are in Ethiopia justly exchanged for gold, because they are commonly more esteemed there. And among the Japanese old objects made of

iron and pottery, which are worth nothing to us, fetch a high price because of their antiquity. Communal estimation, even when foolish, raises the natural price of goods, since price is raised by abundance of buyers and money, and lowered by the contrary factors.

While the manner of secular writers in the early modern period may have been more attractive, they did not show any considerable advance in economic principles over the best scholastics.³⁷

Be that as it may, the point to be made here concerns not just influence in the sense of glimpsing the mountain peaks reached by the best minds but rather the sort of influence imbibed simply by being part of a common culture. The extremely commercialized nature of British society has been ignored by economists. In this sense, which is most germane to the thesis proposed here, it is readily documented that

(a) Monopoly was carefully defined by the English in the late sixteenth century and its detriment to social welfare clearly observed. Adam Smith's casual hyperbole that "The price of monopoly is upon every occasion the highest which can be got" is a step backwards.³⁸

(b) The paradox of value or the diamonds-water paradox had been both posed and solved by several economists, such as John Law.³⁹

(c) The use of competition as a standing if implicit assumption was widespread and the notion of short-run and long-run clearly emphasized by such famous economists as John Locke.⁴⁰ As for Smith's explicit analytical apparatus, consisting of a point

demand and a point supply, this also shows little advance on John Locke.⁴¹

Unlike a modern price theorist, Locke did not see price as the result of the interaction of two functional relationships which are defined for a given moment in time. Instead, he always describes price as an exchange ratio which is determined by a set of proportions involving the quantity of a good (the stock available) and its vent (a flow).

(d) "Demand and Supply" (in the loose, pre-Marshallian sense) were widely and correctly used--indeed the workings of this mechanism were treated as a truism, e.g., Dudley North says⁴²

as corn, wool & e when they come to market greater quantities than there are buyers to deal for, the price will fall; so if there be more lenders than borrowers, interest will also fall.

As more buyers than sellers raiseth the price of a commodity, so more borrowers than lenders will raise interest.

Note that North takes the mechanism completely for granted for the case of goods and seeks to explain its workings in the case of the interest rate. W. Thweatt has provided many neat examples of the actual use of "Demand" and "Supply" in the late eighteenth century.⁴³

(e) The ahistorical approach used hitherto is exemplified in the way "natural price" is seen as prescient of capitalist society. Adam Smith's use of the word "natural" is somewhat peculiar because Smith appears to focus upon the long-run stationary state which is an odd context because his primary concern is with economic growth. Before Smith the notion of a

short-run equilibrium price around which day-to-day fluctuations would occur was already well established. The New Whole Duty of Man says⁴⁴

So long as you keep within the latitude of lawful gain you may use your skill against another man in driving a bargain: for in an ordinary plenty of commodities there is an ordinary price, which those that deal with them know and understand [emphasis added].

By the 1750's economists such as Joseph Massie and Malachy Postlethwayt were already using the word "natural" to qualify words like "interest" or "price" without being self-conscious.⁴⁵ Richard Cantillon uses "natural" somewhat in Smith's sense, but Cantillon's usage was not general. Since Smith's views on allocation of resources also follow Cantillon closely, this is almost surely Smith's source. It is a pity that Schumpeter did not live to complete his History, since it is hard to reconcile the praise for Smith's analytics (earlier quoted) with the following:⁴⁶

Cantillon paid much attention to the problem of market price as distinguished from normal price--exactly as did A. Smith later on. One feature of his treatment is worth noting because it persisted practically to J. S. Mill. Like all "classics" of the nineteenth century, Ricardo especially, Cantillon never asked the question how market price is related to normal price and precisely how the latter emerges--if indeed it does emerge--from the supply and demand mechanism that produces the former. Taking this relation for granted, he was led to treat market price as a separate phenomenon and to restrict the supply and demand explanation to it. Thus emerged the superficial and, as the later development of the theory of value was to show, misleading formula--normal price is determined by cost, market price is determined by supply and demand.

Thomas Pownall was quite worried by the sharp distinction Smith drew between "market price" and "natural price." Given the highly favorable connotations of "natural," Pownall felt that one could be led to assume that interventions against the "market price" and in favor of the "natural price" might be needed. By the 1820's, T. R. Malthus could only provide a lame justification for Smith's peculiar use of natural price.⁴⁷

- (f) There is no suggestion in the literature prior to Adam Smith that factor prices were somehow different in nature from goods prices. By emphasizing this point Smith served to turn economics into a blind alley for almost a century. Malthus, one of Smith's greatest admirers, realized Smith's deficiency by the time he came to write his Principles and asked why demand and supply could not determine natural price (or the long run cost of production) as well as the market price. Such words fell on the deaf ears of the Ricardians and Ricardo replied defiantly⁴⁸

The author forgets Adam Smith's definition of natural price or he would not say that demand and supply could determine its natural price. Natural price is only another name for cost of production. When any commodity sells for that price which will repay the wages for labour expended on it, will also afford rent, and profit at their then current rate, Adam Smith would say that commodity was at its natural price. Now these charges would remain the same, whether commodities were much or little demanded, whether they sold at a high or low market price.

It was not until the Marginal Revolution that the ill effects of Smith's dichotomy could be left behind.

V. From the time of publication of the Wealth of Nations in 1776 till the middle of the twentieth century, Adam Smith has been viewed primarily as the source of laissez-faire ideas. The benefits of economic freedom can be argued on the basis of three axioms⁴⁹

1. Individuals desire to maximize their wealth.
2. Individuals know better than governments how to maximize their own wealth.
3. National wealth is the sum of individual wealth.

This is an effective argument for Free-Trade and it never really requires an understanding of the microeconomics of demand and supply.

It is quite unfortunate that, in recent years, economists have tried to claim that Smith was not only a vigorous advocate of Free Trade but also an economic theorist of some merit. The strong claim that Smith was prescient about modern capitalism not only founders on Smith's treatment of contemporary facts, it also makes one wonder how such quaint rules for the allocation of capital could be espoused by an appreciator of capitalism or why he would support the legal regulation of interest rates, after having provided very good grounds for leaving them free.⁵⁰

It has been argued in this paper that even the weaker claim that Adam Smith synthesized and improved contemporary understanding of the market is dubious. Lord Keynes was generally appreciative of the "Macroeconomics" of Mercantilism but he seriously misled his readers when, with reference to the basic tools of Economics, he wrote that

before Adam Smith this apparatus of thought scarcely existed.⁵¹

That Smith doubted the mutually beneficial nature of the worker-capitalist relation, as is clearly noted in the earlier cited essay by Douglas, is surely suggestive. More serious charges from the analytical point of view can also be made. Smith failed to appreciate the role of utility and demand and confused issues on the measure of value. He introduced a new concept of "natural" price, one that was less useful than that used by his contemporaries, and he thrust upon his readers the dichotomy between goods markets and factor markets. For nearly two centuries Adam Smith was praised for his doctrine of economic freedom and for having pointed to labor as the primary source of value.⁵² This praise had at least the merit of being well-grounded in the text of the Wealth of Nations. It is high time that the modern revision, which views Adam Smith as also being an analytical economist, be questioned.

Notes

¹J. Schumpeter, History of Economic Analysis (London 1954), 188-89. Criticisms of various aspects of the Wealth of Nations abound, e.g., E. Cannan, Theories of Production and Distribution (London, 1893) or Paul Douglas, "Smith's Theory of Value and Distribution," in Adam Smith 1776-1926 (Chicago 1927). The examination of Schumpeter's praise for Smith's treatment of markets and prices however appears to be new.

²Hannah Sewall, The Theory of Value before Adam Smith [1901] (reprinted Kelley, New Nork, 1968), 124.

³"Smith's Theory of Value and Distribution" in Adam Smith 1776-1926 (Chicago: 1928), 77.

⁴R. H. Campbell and A. S. Skinner, eds., An Inquiry Into the Nature and Causes of the Wealth of Nations (Oxford University Press, 1976), 32. M. L. Myers, The Soul of Modern Economic Man (University of Chicago, 1983). R. Hamowy, The Scottish Enlightenment and the Theory of Spontaneous Order (Carbondale, Southern Illinois University, 1987). A brief but penetrating critique of Adam Smith as a supporter of free individual choice is made by Roger W. Garrison, "West's 'Cantillon and Adam Smith:' A Comment," Journal of Libertarian Studies (Fall 1985), VII, 2, 287-294.

⁵A. Macfie, The Individual in Society (Allen and Unwin, London, 1967), 20-21.

⁶M. Bowley, Studies in the History of Economic Theory before 1870 (MacMillan, London, 1973). S. Hollander, The Economics of Adam Smith (University of Toronto, 1978).

⁷J. R. McCulloch, ed., Select Tracts (London Privately printed, 1856). As to the weak spots visible in the earlier authors, let it be noted that Smith also made some peculiar assumptions about economic behavior, such as the independence of the volume of savings and the rate of return to savings (Bowley 193, Hollander 169).

⁸J. Viner, "Adam Smith and Laisser-Faire," in Adam Smith 1776-1926 (Chicago, 1928). I have discussed the strength of eighteenth-century Microeconomics in "Smith, Steuart and Mercantilism: Comment," Southern Economic Journal (January 1986), and developed the theme further in "The Financial Pamphleteers of the Eighteenth Century," forthcoming in Perspectives on the History of Economic Thought, ed. D. A. Walker.

⁹While Samuel Hollander is not the only scholar to adopt such a liberal method, Hollander's treatment of Adam Smith on utility and demand as well as Smith's rules for the allocation of capital come

particularly to mind. An excellent chronological account of the growth of Economics in the seventeenth and eighteenth century is to be found in T. W. Hutchison, Before Adam Smith (Basil Blackwell, Oxford, 1968). For some aspects not covered by Hutchison, see S. Todd Lowry, "Lord Mansfield and the Law Merchant: Law and Economics in the Eighteenth Century," Journal of Economic Issues (1973), 605-622.

¹⁰ I have covered the historical background in "Adam Smith and the Division of Labour: A Historical View," Scottish Journal of Political Economy (August 1986), 292-297.

¹¹ WN, I, 73.

¹² Ibid, 73.

¹³ Ibid, 73-74.

¹⁴ Ibid, 75.

¹⁵ Ibid, 72. If one is not careful, a reading of widely used texts such as Mark Blaug, Economic Theory in Retrospect (Cambridge, 1985), 4th ed., p. 42, can easily mislead.

¹⁶ Ibid, 98.

¹⁷ Ibid, 88.

¹⁸ Ibid, 105.

¹⁹ Ibid, 352-53. Blaug, op. cit., 39. See Cannan (1893) on this point.

²⁰ Ibid, 162.

²¹ Ibid, 184. The coal cartels of 1771 may well have provoked this section of the *Wealth of Nations*. H. Levy, Monopoly and Competition (London; MacMillan, 1911), Ch. 6. Smith's difficulty with composition is well-known. As a result, it appears that when he came across new and interesting facts he simply tacked them on, without being overly concerned about consistency. Mountifort Longfield's appropriate comment was, (*Economic Writings*, 262)

Adam Smith appears not to have possessed much taste or capacity for long or subtle trains of reasoning. The "*Wealth of Nations*" is written with very little attention to system, and this circumstance has probably tended to increase its utility. It prevented any error from infecting the entire work.

²² Ibid, 75.

²³Ibid, 78.

²⁴Campbell and Skinner, Introduction (1976), 25.

²⁵Wakefield (1843), I, 328.

²⁶WN, I, 165.

²⁷Ibid, 237.

²⁸Ibid, 251.

²⁹Ibid, 157.

³⁰op. cit., Introduction 54. If the consequences of this view-point are consistently followed out they show that many of Adam Smith's "facts" are traceable to authors who shared his views on natural liberty and on other occasions they are actually claims of "what should be" if the system of natural liberty were true. Samuel Hollander has argued that Ricardo did not deviate from Smith's method of "strong" theory. On the above reading, Hollander is entirely correct and Ricardo is distinguished only by his abrupt directness. S. Hollander, The Economics of David Ricardo (Toronto 1979).

³¹F. M. Eden, The State of the Poor, ed., A. G. L. Rogers (London, Routledge, 1928), 53. Eden was followed by David Buchanan in his edition of the Wealth of Nations (Edinburgh, 1814), I, 235-236.

³²P.A. Samuelson, "A Modern Treatment of the Ricardian Economy . . .," Quarterly Journal of Economics (February and May 1959).

³³Schumpeter's remarks on Smith's expositional powers are worth rereading, History, op. cit., 185-86. A simple but striking example of the appreciation of competition is given by the pamphleteer of 1712 who defends high duties thus: "Whoever lives a few years will probably see many more undertakers of these works, who, by striving to undermine one another, will always keep prices low," quoted by Levy, op. cit., 97.

³⁴See Rashid (1986). Although it is not so explicitly stated, this point can also be read out of Andrew Skinner's Analytical Introduction to Sir James Steuart, An Inquiry into the Principles of Political Economy (London, Oliver & Boyd, 1966). I have also profited from an unpublished M. Phil thesis of A. Karayiannis, "Sir James Steuart (1713-1780), On Methodology, Political Economy, Value and Distribution" (University of Dundee, 1988).

³⁵Quoted in M. Beer, Early British Economics (London 1938), 42.

³⁶R. de Roover, Business, Banking and Economic Thought in Late Medieval and Early Modern Europe, ed. V. Kinshner (1974); B. J. Gordon,

Economic Thought before Adam Smith Hesiod to Lessius (1975); M. Grice-Hutchison, Early Economic Thought in Spain (1975); O. Langholm, "Economic Freedom in Scholastic Thought," History of Political Economy (Spring, 1982), 260-283. The quotes are from Grice-Hutchison, op. cit., pp. 104, 101.

³⁷ Thus Pufendorf, whom Adam Smith knew well, wrote that the "natural price" was that set "by the common judgment and estimate of men, together with the consent of the parties," Sewall, op. cit., 41.

³⁸ Indeed it seems to reproduce the very wording of the Malynes-Misselden period of the early 1600's, Levy, op. cit., 65.

³⁹ Douglas, (1926), op. cit. The footnotes provided by Campbell and Skinner in their edition of the Wealth of Nations should suffice for this point, op. cit., 44-46.

⁴⁰ This point was clear to the Physiocrats but has been inadequately drawn out by modern commentators, e.g., Karen Vaughn, John Locke (Chicago, 1980).

⁴¹ Vaughn, op. cit., 27.

⁴² D. North, Discourses Upon Trade (London 1691), 5.

⁴³ W. Thweatt, "Origins of the Phrase Supply and Demand," Scottish Journal of Political Economy (1983).

⁴⁴ Quoted by H. W. Robertson, Aspects of the Rise of Economic Individualism (London 1933).

⁴⁵ A careful reading of such seventeenth century writers as Sir Josiah Child and Charles Davenant shows that they used the phrase "intrinsic" value in similar fashion. The Cantillon-Smith usage, on the other hand, appears to follow Sir William Petty. This, in turn, probably grew from the belief in an objective "intrinsic" value, noted by Sewall, op. cit., 51.

⁴⁶ Schumpeter, op. cit., 220.

⁴⁷ A Letter to Adam Smith . . . (London 1776). T. R. Malthus, Principles of Political Economy (London, 1836), 2nd ed., 78-79.

⁴⁸ Notes on Malthus in D. Ricardo, Collected Works, ed. P. Sraffa (London 1951-1967), 46.

⁴⁹ This is most clearly argued by Wesley Mitchell, Types of Economic Theory (New York, Kelley, 1967), I, 61-64.

⁵⁰ C. Kindleberger, "Adam Smith and the Industrial Revolution," in The Market and the State, ed., T. Wilson and A. S. Skinner (Oxford,

1967), 1-25. There is a tradition that Jeremy Bentham converted Adam Smith on the interest rate issue but this has not been confirmed.

⁵¹Introduction to H. Henderson, Supply and Demand (Cambridge 1922).

⁵²S. Rashid, "Adam Smith's version of the History of Economics and its Influence in the Eighteenth and Nineteenth Centuries," Quarterly Review of Economics and Business (Autumn 1987).

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