

## Lecture 4: Adam Smith

Adam Smith's background is delineated in the text, he was very well oriented in the scientific developments of his time, he had travelled abroad and had been in contact with both Quesnay and Turgot, and he was a great admirer of Voltaire. His early work, *The Theory of Moral Sentiments*, is also mentioned. It is a book about ethics but the boundaries between different disciplines was not fixed there are parts which shed light on Adam Smith's economic thinking. In particular, Smith considers *morality* to be founded on the suppression of self-interest in relation to the common good. Notice the quotation in V&G p.105, mentioning the considerations of an *impartial spectator*, this resembles much later considerations by Rawls (to which we shall come later).

Smith sees human activity as fundamentally social, and he is inspired by the natural science, considering social aspects of behavior to be governed by a counterpart of the gravity known from physics, depending on mass and on (squared) distance: we care more for people close to us and much less for people far away. The idea of transplanting physical gravity laws to economics have been revitalized several times, for example by Walter Isard in the 1950s in the context of regional science (Isard 1956). The very recent field with the name *Econophysics* has a somewhat different birth history, inspired by the practice of physical research rather than by its results.

The work which (rightly) made Adam Smith immortal is of course *Wealth of Nations*. It consists of five books,

Book I: *On the Causes of Improvement in the productive Powers of Labour, and of the Order according to which its Produce is naturally distributed among the different Ranks of People*. Here we find Smith's theory of prices, its three components wages, prices and profit, and the notion of *natural rates*. Here we find his famous example of division of labour, the pin factory.

Book II: *Of the Nature, Accumulation, and Employment of Stock* deals with capital and development, here the distinction between productive and unproductive labour is introduced, and Smith here ranks the different types of investment as agriculture, manufacture, domestic trade and foreign trade.

Book III: *Of the different Progress of Opulence in different Nations*, is about economic history and the natural order of things, which according to Smith has been inverted in many European states of his time.

Book IV: *Of Systems of political Oeconomy* treats economic policy, and Smith advocates a *laissez-faire* policy where the state involves itself as little as possible. It is here

that the famous “invisible hand” is discussed.

Book V: *Of the Revenue of the Sovereign or Commonwealth*. Here Smith discusses public finance and insists on cheap government, limiting the role of the state to defence, justice and public works.

In our contemporary tradition we would read the book as divided into microeconomics (price or value theory), macroeconomics (income distribution, growth, international trade), and public economics. These subdivisions are however of much more recent date, and the authors of that time would typically take a more comprehensive view on economic questions. Nevertheless, following the textbook tradition, we deal with the ideas separately beginning with the price and value theory. We go a little more in detail than V&G, see Lecture Note 4, where we also comment on what Smith wrote on economic growth and on international trade.

**We read:** V&G, chapter 11.