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LET US UNDERSTAND ADAM SMITH

BY
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I. INTRODUCTION

Without exception, economists are guilty of methodological hubris, although members of this group are clearly less guilty than their inclusive disciplinary peers. But we may all learn from the postmodernists by making some effort to situate ourselves imaginatively in time and place alongside those whose works we now critically examine. My own great professor, Frank Knight, led us astray when he advised us to study earlier economists to learn from their mistakes, somehow with the implication that we, as modern ''scientists,'' had indeed discovered some absolutes. George Stigler, with whom I seldom agreed, was more prescient when he told us that, with Adam Smith, it was always best to proceed on the presumption that it was Smith, rather than we, who had things right.

Neoclassical economists, especially, made the critical mistake of looking at the whole production-exchange-consumption nexus through their own window, to use Nietzsche's wonderful metaphor, their own closed-end logical structure, which is admittedly appealing aesthetically. They have remained blind to those elements of Smith's analysis that do not readily fit into their putative explanatory models of economic reality. The aim of the neoclassical economists, for more than a century, was never to ''understand'' Adam Smith, whose empirical generalizations were both temporally and spatially grounded and were not specifically advanced as universally valid propositions. Smith was, indeed, the father of our science, but, as we know, he did not think of himself, contra Hobbes, as an intellectual revolutionary.

In this discourse, I shall offer my own ''understanding'' of Smith's vision of economic interaction. In so doing, I make no claim to demonstration or proof by exegesis. Along with so many others, I, too, exploit ''Adam Smith,'' metaphorically, by imputing to him a vision that, for me, becomes both scientifically coherent and normatively satisfying.

I shall organize the discussion in three parts, each one of which develops a separate element of the comprehensive Smithean vision. Twentieth-century neoclassical interpretation, and especially up until the final decades, can be classified to fall almost wholly within the first of the three Smithean thematic structures, to the relative

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neglect of the second and third. The second, and central, element in the inclusive Smithean understanding has been variously treated, but for the most part in a deviant strand of analysis, and has not even now been convincingly incorporated into the corpus of received doctrine. The third element in Smith's argument has been almost wholly neglected, and when noted, often attributed to elementary confusion.

II. SMITH VERSUS THE MERCANTILISTS: THE FIRST SOCIALIST CALCULATION DEBATE

When ''socialist calculation debate'' is mentioned to modern economists, they immediately think of the conflicting arguments between Mises, Hayek, and fellow Austrians, on the one hand, and Dickinson, Lange, Lerner and their fellow travelers on the other—debates that extended from the 1920s through the 1940s. The issue here was whether or not central-planning boards, through bureaucratically administered rules, could duplicate or approximate the results that describe the idealized market economy. Affirmation here would allow the inference that collectivization could improve on the less-than-ideal existing and observed market arrangements. As surprising as it may now seem, when I was a graduate student in the late 1940s, yes, even at Chicago, the generalized opinion was that Lange and his cohorts had carried the day.

This debate was, however, only the second of a series, so to speak. Adam Smith and his classical-economist peers can be interpreted as having engaged in a similar debate with the mercantilists. Although not equipped with the tools that allowed the logical closure that described neoclassical analysis, Adam Smith was variously advancing the theme that an economy organized in accordance with natural liberty would generate more value than that which might be produced through a maze of sometimes conflicting bureaucratic direction. In so doing, Adam Smith was also implying that the emergent results of the separate but related pursuits of participants were indeed properly defined as the ''wealth'' of a nation. In sum, Adam Smith argued that markets work; resources are shifted to their most productive uses if persons are only granted liberties of entry and exit, with the presumed natural motivation for self-betterment, and made possible through the working of the interlinked set of voluntary exchanges.

Interestingly enough, and particularly for those from any history of ideas perspective, Adam Smith and his peers swept the field in that early great debate, even if they were perforce operating with a less than complete set of tools—a set that necessarily required filling out by the neoclassical theory of distribution a century later.

At this point, temptations are strong to launch off into a summary judgment as to why the classical victory was so short-lived, and why the Marxian-inspired challenge, which ultimately proved to be so weak scientifically, exerted and continues to exert such public and political appeal. I shall forego such temptations and concentrate on Smith's role in that first great debate.

In order to show that a system of natural liberty would, indeed, generate more value than politically directed orders, Adam Smith found it necessary to develop an independent theory of the working of an economy. And so was ''economics'' born.

There is no explicit normative content in the simple conjectural history model in which the relative prices of deer and beaver are determined. And if we have fully

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mastered the logic of that simple construction, we already possess a good grasp of general equilibrium, and without the overlay of mathematical trapping. Should we then wonder why, when he taught the ''History of Thought'' course at the University of Chicago, Frank Knight spent so much time on Adam Smith and the deer and the beaver? Or why, for that matter, when it came my turn to teach the course one year at Virginia, I should have even overextended the Knightian emphasis? Or, for all my peers who learned Chicago price theory during those mid-century decades, why we, somewhat arrogantly perhaps, took the simple deer-beaver logic, as amended by Henry Simons's imaginative rent problems so as to include neoclassical distribution theory, as the basis upon which the complex embroidery of formal constructions must rest?

Robbins (1932) finally had given us a summary description of what our science was alleged to be all about. Adam Smith, as supplemented, gave us the framework within which we, as economists, went about our work in explaining how resources do indeed get allocated among alternative uses. (Recall the story told by Milton Friedman, who had been invited to China very soon after the decision was made to move toward a market-like organization of the economy. Milton was asked to give, and gave, a week-long intensive course in economics to the very brightest of Chinese bureaucrats. On the final day, one of the best of these students raised his hand and said ''But, Professor Friedman, who allocates the resources?'')

Returning to my theme, the point here is that the second great socialist calculation debate could only have taken place within the mutual acknowledgment of the neoclassical logical structure that finds many of its origins in Adam Smith. Participants in this latter debate accepted that idealized markets work. Adam Smith's early victory over the mercantilists was embodied in the early twentieth-century conventional wisdom. Smith's vision here remains in what we teach today, even if it is presented in altogether different, and unnecessarily complex language.

III. THE SOURCES OF ECONOMIC PROGRESS

We sometimes forget that Adam Smith did not think of himself as an economist, and so limited to familiar subject matter disciplinary boundaries. He was, instead, a moral philosopher, whose intellectual curiosity extended to the origins of the explanatory structure being applied. Why did the system of natural liberty generate maximal value? What were the ultimate sources? Why was trade mutually beneficial to traders?

As you know, he identified the common answer to these questions as the ''division of labor,'' which we may translate more inclusively as ''specialization.'' That which persons value, whatever this might be, can be increased in quantity through the process of production and subsequent exchange, as contrasted with production for exclusive own usage. Persons gain from trade, one with another, because they can produce disproportionately more value when they specialize. Smith's famous and familiar example of the pin factory soon became a universally known element of our economic understanding.

We may draw two inferences from the pin factory example, one that is clarifying, the other of which is confusing. Note, first, that the enhanced value stems from

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specialization, as such, and not from any postulated initial differences among the persons who participate in the production process. The potential gains do not depend on the presence of rents remaining to be exploited. Second, however, the example has continued to create confusion for economists through its apparent close association between gains from specialization and economies of scale in production—an association that need not be present at all, and which introduces ambiguity in the distinction between economic and engineering relationships in comparisons of inputs and outputs.

To understand Smith's logic here, we must examine why an economic structure based on specialization with trade is generally more productive than that structure based on diversification without trade. Conventional models, either those of team production or economies of scale, will, of course, validate the basic hypothesis. But, even in the absence of either of these familiar constructions, a demonstration that specialization remains, in net, productive of value would extend the generality of Smith's claim.

What continues to be overlooked in the standard treatments is the possible presence of economies of scale in consumption or usage, as measured over the numbers of *persons, users, consumers, purchasers*. This characteristic of the whole nexus must be present to validate Smith's basic theorem that relates specialization to the extent of the market—the theorem that Allyn Young (1928) referenced as one of the most important in economics. If economies of this sort are present, even in the total absence of orthodox economies of scale, the economy operates always in a range of *generalized* increasing returns.

It is convenient and plausible to think that there is at any time a whole "sea of goods" that remains beyond economic viability, given any size of an existing market nexus. There are goods which persons, as potential consumers-users, evaluate positively, but which cannot be brought into production because the aggregate of such evaluations does not cover opportunity cost, at any level of outputs.

Why and how does the extent of the market matter here? If there is nothing analogous to economies of scale over usage or consumption; that is, if there are no nonrivalrous qualities of a good at all, then a change in the size of the market, via a shift in aggregate demand, is of no relevance. Any and all goods that can be marketed at prices that cover the opportunity costs will be produced and distributed to separate buyers. But if a prospective entrepreneur-producer finds that, beyond these familiar limits, the custom of an increasing number of buyers can be met with less than proportionate increases in opportunity cost, then the aggregate demand over all potential buyers-users becomes determinant in setting the margin of viability. Hence, there is an element of nonrivalry, or Samuelson-like "publicness," over units of product, even if observable units seem to be wholly partitionable, and, therefore, subject to exclusion at relatively low cost (Samuelson 1954).

At a level of common-sense consideration, the necessary condition here seems reasonable enough. The larger is the network of market exchange, the more specialization becomes possible, and, by Smith's relationship, aggregate value is increased. But, as noted, this proposition holds only if specialization, one feature of the organization of supply, is itself dependent on aggregate demand, as measured across all potential buyers. This interdependence between the two sides of the market is not explicitly incorporated in orthodox neoclassical models of market process.

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These models do not, therefore, lend themselves to a full understanding of Adam Smith's identification of the sources of economic growth (which was a second central argument in his structure). Markets work to allocate resources efficiently but, also, private and public choices that act to extend the market, increase the wealth of nations. The extent of the market enters as a relevant policy variable.

After the mid-century Keynesian-macroeconomic digression, neoclassical economists began to place more emphasis on sources of economic growth. Early efforts were focused almost exclusively on investment, as a policy variable, embedded within exogenously developing technological change. There was a continuing failure to recognize that investment itself becomes a source for economic growth only through its effect on the extent of the market.

In the last decades of the century, there was a ''return to increasing returns,'' which Yong Yoon and I used as the title for our edited volume that brought together the contributions, from Adam Smith forward, in this deviant strand of economic theory (Buchanan and Yoon 1994). Some of the models could be represented as extensions of Marshall's conception of external economies in production, particularly as applied to the knowledge and/or information sector of the economy.[1]

Other modern contributions embodied the presumed existence of scale economies in production, with the presence of these economies being reconciled with observed competitive organization through preferences for diversity, which, in turn, generated Chamberlin-like equilibria. Patterns of trade, especially across national boundaries, that seemed inconsistent with economies of scale in production were explained, and a putative ''new'' theory of trade presented.[2]

Only in the work of Xiaokai Yang do we find a modern contribution that may be interpreted as being akin to Adam Smith's understanding (Yang 2001). Yang concentrated attention on the choice margin between own or home production-use of valued end items and the offering of produced items on the market in exchange for generalized purchasing power, which is then, in turn, returned to the market as demand. Note, in particular, that in this construction there need be no increasing returns that is descriptive of the production of any identified good. In this construction, increasing returns characterizes the whole exchange nexus rather than any separately defined production process.

IV. PRODUCTIVE AND UNPRODUCTIVE LABOR

The third component of Adam Smith's understanding of the working of a market economy, constrained only by the presence of the appropriately defined laws and institutions that enforce property and contract and prevent fraud, concerned the composition of demand for end items or final products. A market economy, through the operation of natural liberty, allocates resources among uses and also grows as its extent is increased. But the growth process can itself be affected by the ways in which persons choose to direct their spending patterns. Adam Smith made a distinction

[1]See, especially, the papers by Paul Romer (1987, 1990) and Robert Lucas (1988). For a good nontechnical treatment of this set of papers, see David Warsh (2006).
[2]See, especially, Krugman (1979) and Ethier (1982).

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between outlay directed toward the purchase of value in the form of goods that embody productive labor and that outlay directed toward the purchase of outputs embodying only unproductive labor.

Smith has been, almost universally, accused of making an analytical error in this distinction—an error that is often explained by Smith's failure to understand elementary utility theory. At this point, however, it may be best to heed George Stigler's advice and try to understand the distinction that Adam Smith deemed to be relevant here. The examples of unproductive labor are familiar: menial servants, military personnel, musicians, et al., all of whom may be described, in one way or another, as supplying services directly, as opposed to indirectly, by way of embodiment in material goods. Smith's apparent emphasis on materiality suggests some notion of capital, defined by Knight as "the capacity to satisfy wants stored up in things," as the relevant criterion for the basic distinction. To the extent that the services provided in response to demand are themselves used up in the process of production itself, such services cannot, almost by definition, yield temporally extended spillover or external benefits. Hence, they cannot be "productive" in any sense comparable with those services that are locked into or embodied in material goods that are not immediately used up or destroyed simultaneously with production.

How can the services of, say, a menial servant be, at base, different from the services, say, of a chair, each of which is valued by a purchaser at the time of exchange? Both yield prospective utilities. By its nature, by technological necessity, the chair, as such, cannot be used up in the period of its production, which may be temporally coincident with its initial usage. The chair will remain in being in subsequent periods, as a capacity to yield services in such periods, thereby making subsequent production unnecessary, at least over maintenance outlay. Initial purchase of the chair, and claimancy to ownership, allows a person to have available the services each period and without current purchase of newly produced goods. This procedure allows for a freeing up, or saving, of labor and other inputs required for the initial production.[3] As these now-available inputs produce value, which is then returned to the spending stream, the extent of the market nexus is thereby increased. Specialization that may not have been viable prior to this increase may become sustainable in the wider market. In this fashion, any outlay devoted to the purchase of a good with temporal continuity indirectly increases the extent of the nexus.[4]

Note that, in the formulation suggested, it is possibly helpful to think of any good that yields services over a sequence of periods as embodying a technologically determinate "publicness" in a sense analogous to a Samuelsonion good, with the nonrivalry present as among the separate periods. In the illustration, the chair is nonrivalrous as between its services yielded today and those that it will yield tomorrow, and subsequent periods. In making the initial period choice to purchase the chair, or some other material good, as opposed to purchasing a menial servant, the chooser may discount and effectively capitalize the services anticipated to be provided over subsequent periods, but this fact becomes irrelevant in the context under consideration here. Choices have multi-period consequences, regardless of

[3]I owe this argument to Nimai Mehta. For elaboration, see Mehta (2003).

[4]For treatment of this point in a somewhat different construction, see Buchanan (1994), especially chapter 2.

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what calculations may have motivated them. And Adam Smith's argument was to the effect that choices directed toward the purchase of material goods indirectly increase the extent of the market, whereas choices directed toward the purchase of immaterial services do not.

Smith was not, of course, developing his analysis within the methodological boundaries of modern economists, and he exhibited no qualms about discussing ''preferences for preferences,'' subject matter considered out of bounds by later generations of putative scientists. Adam Smith could be more straightforward; he could say, and did so say in my interpretation, that if the wealth of the nation is defined by the evaluations placed on goods and services by the exercise of liberties in the marketplace, then the distribution of these evaluations must matter.

V. CONCLUSION

As I understand Adam Smith, the analysis that I have sketched out seemed clear, although he did not possess the tools to expound this analysis in any way comparable to modern scientific discourse. I fully acknowledge that, for myself, there remain ambiguities in translating my putative understanding of Adam Smith into the hard logic of modern economics, as the latter is practiced. This problem stems, in part, from my own competence limits in working with the formal models that dominate economists' efforts. As I have noted, I continue to remain frustrated by my own inability to convince my younger colleagues that the models of interaction that I have interpreted to be implicit in Adam Smith's understanding are both interesting and intrinsically important. My plea for them to ''join the ride'' has, for the most part, fallen on deaf ears.

Perhaps, only perhaps, by concentrating carefully on Adam Smith's grand vision, paying heed both to what he actually wrote and to what he must have had in mind, we can, finally, come to a consensus understanding of his inclusive message as well as its current implications.

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