Did Adam Smith Retard the Development of Economic Analysis?

A Critique of Murray Rothbard's Interpretation

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In the first volume of a two-volume work, *An Austrian Perspective on the History of Economic Thought* (1995), Murray N. Rothbard attempts to make the case that Adam Smith perverted the development of sound economic analysis by failing to advance valid extant theories of value, money, and income distribution. According to Rothbard, most of those ideas had been developed by the Scholastics but were little known to the English-speaking world until recently "simply because [they] had not been translated into English" from Latin (xi). He believes the ideas were "proto-Austrian," which is why their later discovery naturally has had to fall to the modern Austrian School, which he regards as "the major challenge to the Smith-Ricardo" tradition of modern economics (xiii).

Rothbard develops the specifics of his criticisms of Smith in chapters 16 and 17, where he claims there does not exist in *The Wealth of Nations* any consistent cost or relative-scarcity theory of value, let alone the concept of subjective valuation of objects

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The Independent Review, v.III, n.3, Winter 1999, ISSN 1086-1653, Copyright © 1999, pp. 355–383

by individuals. For Smith, profits are not payments for entrepreneurship, claims Rothbard, nor is Smith clear on whether rents enter into the determination of prices or prices into the determination of rents. According to Rothbard, Smith also does not recognize the money-supply-and-demand theory of the price level as argued by David Hume; nor does Smith include Hume's familiar price-specie-flow model of international price adjustments. Rothbard also faults Smith for not having been a consistent advocate of laissez-faire policies, alleging that Smith advocated various forms of state intervention in the economy, including the establishment of a government post office, and that he supported rigid usury laws. His overall assessment of Smith's scholarship is that Smith "originated nothing that was true, and whatever he originated was wrong; that [Smith] was a shameless plagiarist, acknowledging little or nothing and stealing large chunks, for example, from Cantillon" (435). Rothbard thus wants to awaken the economics profession to the truth about Smith's scholarship and to identify the Scholastics, Richard Cantillon, A. R. J. Turgot, and the Austrians as the true developers of what is good economics.

Rothbard may well have made a worthwhile contribution to the history of economic thought by drawing more attention to pre-Smithian economic theorists. And, of course, not every one of Smith's arguments in *The Wealth of Nations* is beyond valid criticism. Indeed, David Ricardo, in the preface to his *Principles,* for example, explained that it was to "advert to those passages in the writings of Adam Smith from which he sees reason to differ" (6), particularly with respect to the laws that regulate the "course of rent, profit, and wages" (5), that he was writing. But there is little evidence in Rothbard's book to justify the serious charges he levels against Smith. Rather, most of the claims are misrepresentations of Smith's arguments in *The Wealth of Nations.* Others derive from errors in Rothbard's own analysis. I illustrate these points with direct quotations from *The Wealth of Nations,* to which Rothbard refers but without providing specific pages where his claims may be verified. I also refer to some other sources in which more accurate evaluations of Smith's work may be found. I conclude that it is Rothbard who distorts Smithian scholarship by his arguments, and not Smith who is liable to the charge of having seriously perverted the development of sound economic analysis.

These days, when the study of the history of economic thought is fast disappearing from the curriculum of most economics students, misrepresentations such as Rothbard's appear to warrant the more extensive correction that some reviewers could only hint at (e.g., Lowry 1996). My reexamination of Smith's work also contradicts some concessions made to Rothbard by Paul B. Trescott (1995), including that "Smith's distinction between productive and unproductive labor is appropriately condemned" (319), "Smith helped perpetuate a materialistic fallacy that persisted into recent development theory and toyed too much with the labor theory of value" (320), and "Rothbard rightly notes that Smith failed to identify any useful services provided by landlord and capitalist which would justify their shares of income" (321).[1] My assessment follows the sequence of topics in Rothbard's book, beginning with a restatement of Smith's theory of value.

Smith's Theory of Value

Smith's theory of value is an explanation of the "principles which regulate the exchangeable value of commodities" (Smith, *The Wealth of Nations* [hereafter *WN*], 1: 33), including money, in the marketplace, namely, the principles of supply and demand or relative scarcity. Smith recognized the difficulties associated with ascertaining individual valuations or "value in use" (32) and therefore focused instead on explaining "values in exchange," or relative prices, which are observable. He called the rate of exchange of any commodity for money (cash) its price.

Modern economics pretty much continues along Smith's line of analysis, although designating money as a measure of value. Smith, on the other hand, uses the quantity of labor time as the real measure of value. Thus Smith explains:

> The value of any commodity to the person who possesses it, and who means not to use or consume it himself, but to exchange it for other commodities, is equal to the quantity of labour which it enables him to purchase or command. Labour, therefore, is *the real measure* of the exchangeable value of all commodities. (*WN,* 1: 34, emphasis added)

Again, Smith explains that

> the real value of all different component parts of price is *measured* by the quantity of labor which they can, each of them, purchase or command. Labour *measures* the value not only of that part of price which resolves itself into labour [i.e., wages], but of that which resolves itself into rent, and of that which resolves itself into profit. (56, emphasis added)

Smith has a good reason for choosing labor rather than money as a measure of value, and he is not guilty of the perversion of thought Rothbard (1995, 456–57) attributes to him. He indeed gives a historical account of the use of money as a measure of value (*WN,* 1: 36). However, he explains that the exchange value of a commodity in terms of money (i.e., the price) may rise while its exchange value in terms of other commodities falls or remains unchanged. But labor (exertion or toil) is entailed in the production of all commodities, including money itself. Moreover, labor's exchange value in terms of money (the average wage) also changes in the same direction as the price level. Therefore, Smith argues that it is more reliable to estimate the value

1. Trescott 1998 retains some of these concessions to Rothbard but also points out more of Rothbard's misreading of Smith.

of commodities in terms of the amount of labor for which they will exchange rather than in terms of money or nominal prices. Thus, says Smith:

> At all times and places that is dear which it is difficult to come at, or which it costs much labour to acquire; that is cheap which is to be had easily, or with very little labour. Labour alone, therefore, *never varying in its own value,* is alone the ultimate and real *standard* by which the value of all commodities can at all times and places *be estimated and compared*. It is their real price; money is their nominal price only. (37, emphasis added)

It is instructive that Thomas Robert Malthus, whom Rothbard identifies very closely with Smith's economic analysis (apparently so as to tie Smith with Malthus's population theory and its implications), also recognizes Smith's use of labor as a measure of value in *The Measure of Value* (Malthus [1823] 1957, esp. iii–v; also cited in Hollander [1973, 176 n]. Alfred Marshall [1920, 51–52] and Thomas Sowell [1974, 100–101] are also helpful on this point). However, the problem of defining a common unit of labor by which all values may be measured, a problem noted by Smith (*WN,* 1: 35) himself, led Ricardo, for example, to his unsuccessful search for an alternative, invariable measure of value. Economists, including the Austrians, still have not found one.

Rothbard's charge that Smith argued a labor theory of value and that it took later theorists employing marginal utility analysis—particularly the Austrians (e.g., Rothbard 1995, 450–52, 502)—to explain relative prices by consumers' demand or marginal utility is not new.[2] The charge has been around for a long time (e.g., Böhm-Bawerk [1890] 1970, 73, 269) and has appeared in several economics textbooks. Will Mason (1974) describes it as the "Marxist and (ironically) Austrian misconception that classical value theory made labor the *source,* rather than merely the *regulator,* of value" (567 n. 1, emphasis in original; Mason [1982, 544, 546] repeats the point). A basis for the charge is Smith's explanation that in the absence of any tools or instruments of production, in the "early and rude state of society which precedes both the accumulation of stock [investment funds] and the appropriation of land" (*WN,* 1: 53), goods would exchange for the relative amounts of labor time spent in acquiring them—beaver and deer "among a nation of hunters" in Smith's example. But in explaining the relative prices or exchange values of commodities where labor, land, and capital goods are used, Smith indeed accounts for their relative prices by the commodities' relative costs of production, including wages, rent, interest, and expected profits in the long run, or

2. Rothbard may not have seen Blaug 1972, which minimizes the novelty of the Austrian contribution to value theory in contrast with arguments of the classics, nor Blaug 1985. If he had seen Blaug's discussions, it would have been most helpful to his readers to have shown why Blaug's clarifications are inadequate, especially given Rothbard's efforts to explain that we have been in the dark all along about the worth of Smith's analysis. Such a discussion would have made worthwhile an anonymous reader's claim: "I have seen the Blaug piece and have been persuaded by it; but it does not leave Rothbard without ground to stand upon."

relative scarcity (quantities supplied relative to demand) in the short run (*WN,* 1, chaps. 6, 7).

Of course, Marxists, who find the labor theory of value important for their cause, namely, waging war on private property, go on to assert that the emergence of private ownership of land and capital (funds as well as capital goods) prevents all of labor's product from being paid to laborers. But that misuse of Smith's argument should be seen for what it is and not confused with Smith's relative cost theory of exchange values.

Rothbard also accuses Smith of inconsistency in his theory of value by alleging a conflict between the supposed labor theory and the cost of production theory (1995, 453). But there is no conflict if there is no labor theory of value. And no such theory may justifiably be read into Smith's argument outside the context of the "early and rude state of society" for which Smith originally stated his relative-labor-cost theory.

Rothbard attributes a worse transgression to Smith by claiming that he abandoned the role of relative scarcity as well as utility in the explanation of exchange values, despite having previously made that argument in his own *Lectures.* "Smith sharply and hermetically separates and sunders utility from value and price, never the twain shall meet," claims Rothbard (449). His basis for this charge is the so-called "paradox of value" (447), which in fact does not exist in Smith's text, carefully interpreted.

In setting the stage for his explanation of the relative prices of water and diamonds, Smith contrasts the low exchange value (price) of water with the high exchange value of diamonds notwithstanding the higher relative utility (value in use) of water: "The things which have the greatest value in use have frequently little or no value in exchange.... Nothing is more useful than water: but it will scarce purchase anything; scarce anything can be had in exchange for it" (*WN,* 1: 32–33). Before giving his account of this puzzle, Smith also "earnestly entreats both the attention and patience of the reader" to follow his explanation, and prophetically anticipates that "after taking the utmost pains that [he could] to be perspicuous, some obscurity may still appear to remain upon a subject in its own nature extremely abstracted" (33). Rothbard's misrepresentations of Smith on the theory of value, it turns out, amply validate Smith's fears.

What may be obscure in Smith's explanation is what he means by the "usefulness" of water in contrast with that of diamonds. However, interpret the word to mean usefulness in the sustenance of life, as Smith does in the very next chapter, and there is hardly any paradox in his explanation. Also note the focus of Smith's inquiry from the very first page of *The Wealth of Nations* on the supplies of the "necessaries and conveniences of life which [a nation] annually consumes." Further, in book 2, Smith distinguishes between "commodities which are indispensably necessary for the support of life" and luxuries (*WN,* 2: 399). Thus, water is needed in support of life; diamonds are not. Hence, "A diamond, on the contrary, has scarce any value in use;

but a very great quantity of other goods may frequently be had in exchange for it" (*WN,* 1: 33). In subsequent pages Smith goes on to account for the relative exchange values of water and diamonds by their relative scarcity.

Furthermore, with respect to the role of scarcity, Rothbard's assertions are easily contradicted by the evidence. He says Smith makes "no mention of the solution of the value paradox by stressing relative scarcities. Indeed, 'scarcity'—that concept so fundamental and crucial to economic theory—plays virtually no role in *The Wealth of Nations*" (449). But in volume 1 (e.g., 96, 180, and 191–92) of *The Wealth of Nations,* one finds Smith employing the concept of scarcity, utility, and demand to explain relative prices (of labor, land, and precious metals). Smith also conducts a hypothetical experiment in explaining the possible higher exchange value (price) of gold over diamonds thus:

> Increase the *scarcity* of gold to a certain degree, and the smallest bit of it may become more precious than a diamond, and exchange for a greater quantity of other goods. The *demand* for those metals arises partly from their *utility,* and partly from their beauty.... The merit of their beauty is greatly enhanced by their *scarcity*.... These *qualities of utility, beauty, and scarcity,* are the *original foundation of the high price of these metals,* or of the great quantity of other goods which they can every-where be exchanged. (*WN,* 1:191–92, emphasis added)

Rothbard also serves his readers poorly by citing previous critiques of Smith's value theory, especially those of Paul Douglas (1928) and Emil Kauder (1953), who also argued that Smith allowed little role for the utility and scarcity of goods in determining their relative values or prices, without noting in the same chapter that such views already have been criticized in the literature. Thus, although Samuel Hollander (1973, 133–36), for example, effectively refutes the arguments of Douglas and Kauder, there is hardly a hint of that refutation in Rothbard's text (see also Hollander 1987, 60–72). Rather, Rothbard cites Hollander (1973) only in a bibliographical essay in which he curtly dismisses Hollander as someone who "absurdly attempts to torture Smith into the mould of a thoroughly consistent, formalistic proto-Walrasian modern general equilibrium theorist" (530). Thus, Rothbard's claims about Smith's theory of value, including the water-and-diamond example, arise either from a failure to understand Smith's explanation or from a refusal to appreciate previous corrections of the charge against Smith.

Rothbard makes other false charges while discussing Smith's value theory. One is that "Smith, unlike the later Austrian School, did not demonstrate logically and step by step how industrious and thrifty people accumulate capital out of savings" (456). This claim may well reflect the difficulties many Austrians, including Böhm-Bawerk (1890, 6, 39) and Hayek (1936), have in recognizing Smith's and other classical and early neoclassical economists' use of "capital" to mean funds or savings. But Smith should be the last person vulnerable to Rothbard's charge, inasmuch as he explained that

> Capitals are increased by parsimony.... Whatever a person saves from his revenue he adds to his capital, and either employs it himself in maintaining an additional number of productive hands, or enables some other person to do so, by lending it to him for an interest, that is, for a share of the profits. As the capital of an individual can be increased only by what he saves from his annual revenue or his annual gains, so the capital of society, which is the same with that of all the individuals who compose it, can be increased only in the same manner. (*WN,* 1: 358–59.)

In fact, Rothbard's own earlier quotation on page 448 of Smith's argument that "whoever saves money, as the phrase is, adds proportionately to the general mass of capital.... The world can augment its capital only in one way, by parsimony," and Rothbard's own view that "Adam Smith was sound in realizing that capital investment was important in economic development and that saving was the necessary and sufficient condition for such investment" (447–48) contradict what he later says about Smith on page 456. Of course, Smith would not claim that saving is a necessary *and sufficient* condition for investment and economic growth but would correctly add that prospects for profitable investment of savings ("capital") on the part of entrepreneurs must exist before such investment will occur.

Another of Rothbard's false claims is that Smith is responsible for the "dropping out of the concept of the entrepreneur from British classical thought, never to be resurrected until some of the continental thinkers and especially the Austrians" (451) revived it. Yet Rothbard credits Smith with pointing out that "the capitalist (the 'undertaker') *reaps profits in return for the risk,* and for interest on the investment for maintaining the workers until the product is sold—so that the capitalist earns profit for important functions" (455, emphasis added). Recognize the risk-taking activities of the "capitalist" as entrepreneurial, and the inconsistency of Rothbard's argument as well as Trescott's endorsement of it (1995, 321) becomes clear. (See also *WN,* 1: 124–30.)

Rothbard claims that the "virtually exclusive classical and neoclassical absorption in the unreal 'long-run,' to the neglect and detriment of analyzing real-world prices and economic activity, shunted economic thought on to a long, fallacious and even tragic detour, from which it has not yet fully recovered" (451). This claim fails to comport with Smith's analysis of price adjustments in the short run, which is based on supply and demand (e.g., *WN,* 1: 63–65), or with Marshall's explanation of the role of time in affecting prices in the marketplace (1920, 92–94, 274–75, 289–91, 302–15, 353–54).

It may appear trivial, but Rothbard's chiding of Smith for describing landlords as those who "like to reap where they never sowed and demand a rent for [land's] natural produce" (*WN,* 1: 56; Rothbard 1995, 456) also shows the error of his criticisms calculated to depict Smith as mostly inconsistent in thought. Says Rothbard, "There is no hint of recognition here that the landlord performs the vital function of allocating the land to its most productive use" (456; see also Trescott 1995, 321). But in the case of agricultural production it is not the landlord who does the allocating as much as the farmer. The farmer, knowing he has to pay rent, devotes the rented land to the most profitable use in order to gain a tidy residual (profit) after paying for seed, additional workers, equipment, and the rent (*WN,* 1: 161). Thus, Smith was correct in his statement. The defense of income accruing to privately owned land and "capital" (savings) need not depend on the mischaracterization of reality Rothbard apparently seeks from Smith.

Among other points one might raise about Rothbard's criticisms of Smith's value theory, one more may suffice to illustrate his mistaken views. Rothbard (e.g., 1995, 457) criticizes Smith for not appreciating that value is a subjective notion for individuals. But it is precisely because Smith recognized that "value" means also "the utility of some particular object" (*WN,* 1: 32) to individuals, and is not subject to objective measurement, that he focused on explaining value in exchange, where differences in individual valuations are resolved into market supply and demand schedules. Rothbard's charge would have been valid if Smith had said that the value of any commodity for all people is equal to its market price, an objective magnitude.

Indeed, Smith (*WN,* 1: 63–65) uses the differences in the valuation of commodities among people and their variation to explain variations of prices in the marketplace. Thus, those who value a product more than they value what they would give up by paying the product's price buy it. Those who value the product less do not. Of course, the valuation an individual places on the last quantity purchased (marginal utility) is equal, or about equal, to the price for all buyers (see, e.g., Marshall 1920, 15–16, 103–9). The same subjective valuation is entailed in the decision to offer anything for sale, namely, that what one receives in exchange at least compensates the seller for what he gives up (*WN,* 1: 34; also see Marshall 1920, 307–15). These notions of subjective valuation are also implicit in the classical usage of the terms "demand price" and "supply price" for individuals.

Smith's Theory of Distribution

The classical economists' theory of distribution follows directly from their theory of value. It explains the rewards to suppliers of factor services in the form of wages for labor, interest on borrowed "capital" (savings), and rent on land. The theory describes profits as the reward for undertaking the risk and management of an enterprise that employs the services of the other factors at their contract fees. Thus, profits are a residual that remains after bearing the costs of wages, interest, rent, and materials needed in production. Higher product prices relative to input costs therefore yield higher profits. However, over the long run, there must be "normal" profits to pay entrepreneurs for their "trouble" or opportunity costs in undertaking an enterprise; otherwise production would cease. Therefore, Smith designates long-run profits as part of the cost of production, and hence a component of equilibrium price.[3]

The expectation of high profits leads entrepreneurs to bid at higher interest rates to borrow "capital" (funds) for investment. Therefore, Smith argues,

> According . . . as the market rate of interest varies in any country, we may be assured that the ordinary profits of stock must vary with it, must sink as it sinks, and rise as it rises. The progress of interest, therefore, may lead us to form some notion of the progress of profit. (*WN,* 1: 99)

From the fundamental principles of supply and demand, Smith also argues that profits would tend to decline in a growing economy as entrepreneurs bid against each other to borrow "capital" at interest and to rent the services of land and labor (e.g., *WN,* 1: 102, 277, 375). However, with declining profits and a smaller accumulation of "capital" or funds to hire labor, wages also would ultimately decline—but not below the level of subsistence, determined on the basis of the minimum standard of living acceptable in a community.

Although the total land surface may be fixed, land of different qualities and for different uses is not. Therefore, Smith applies supply-and-demand analysis to explain the determination of rent, although giving much more emphasis to demand than supply. Thus, land of better quality (or location) obtains more rent than land of lower quality because of its greater demand or the willingness of those who would profit from the use of such land to bid for the right of usage (e.g., *WN,* 1: 164–65). Smith also takes the trouble to explain the circumstances under which some lands do not earn rents (*WN,* 1, chapter 11, parts 2 and 3). However, rents as a share of total income would continue to rise as an economy and its population grow, because the total supply of land is fixed whereas the demand for it increases as farmers undertake to produce more of the means of subsistence.

Elaborating on Smith's explanation of the declining rate of profit, Ricardo explained that it is not the competition of "capitals" per se that causes the rate of profit to fall but rather the rise of (real) wages. Ricardo thus focused his analysis of the path of wages and profits during the growth process and used that insight to argue for free trade in "corn." The resultant reduction in the cost of food would slow the decline of profits and stave off the arrival at the stationary state, Ricardo argued.

3. An anonymous reader has difficulty with this explanation, arguing, "How can Smith have considered profit *both* a residual *and* opportunity costs [*sic*] which in the long run make up part of the cost of production? Maybe Knight has made too much of an impression on me." It is simply by the nature of things that profit rates cannot be contracted before production, hence they must be a residual. However, if the owner of an enterprise did not receive compensation (profits) for his activities, he would stop the production in the long run. But the price that pays all input costs as well as average profits in the long run has to be the equilibrium price. Did Knight teach otherwise?

Rothbard's peculiar reading of Smith's theory of distribution, however, hardly conveys any such logic as I have summarized, and he declares that "Smith's theory of distribution was fully as disastrous as his theory of value" (458). It is tempting to argue that having shown how badly Rothbard read Smith's theory of value, I need not explain his misreading of the theory of distribution. But let us consider some examples.

Rothbard criticizes Smith's interest theory by arguing that "the rate of interest, or long-run rate of profit, is related, not to the quantity of accumulated capital, but to the amount of annual saving, and moreover falling profit rates are not *caused* by increasing saving" (458, emphasis in original). Rothbard here fails to recognize that "capital" in *The Wealth of Nations* means "savings," not capital goods, as many Austrians are wont to interpret that term (see e.g., Böhm-Bawerk 1890, 6, 39; Hayek 1936). In fact, Smith is arguing exactly what Rothbard would like him to. (The refusal of Austrians to recognize the classical usage of the term "capital" to mean savings or funds has been a hindrance to themselves as well as to modern economics; see Ahiakpor 1997b.[4]) Smith did not argue that increased saving causes profits to decline, but rather that the competition of "capitals" to hire other factors of production causes it. Rothbard's subsequent invocation of time preference to explain the path of interest rates therefore has no valid bearing on Smith's argument.

Regarding Rothbard's charge that "the very idea of the entrepreneur as a risk-bearer and forecaster was thrown away" (460) by Adam Smith, the following passages from *The Wealth of Nations* show otherwise: "In exchanging the manufacture either for money, for labour, or for other goods, over and above what may be sufficient to pay the price of the materials, and the wages of the workmen, something must be given for the *profits of the undertaker of the work who hazards his stock in this adventure*" (*WN,* 1: 54, emphasis added); and "Part of profit naturally belongs to the borrower [of "capital" or "stock"], who runs *the risk and takes the trouble* of employing it" (*WN,* 1: 59, emphasis added). These statements are in addition to Smith's association of profits with risk-taking cited earlier (*WN,* 1: 124–30).

Rothbard (459) also repeats a familiar criticism of Smith, namely, that he could not make up his mind about whether rent determines price or vice versa. Rothbard here appears to be referring to Smith's statement about how rent enters differently into the composition of price than wages and profits do, but he appears not to have carefully read the subsequent explanation.[5] Smith wrote:

> Rent, it is to be observed enters into the composition of the price of commodities in a different way from wages and profit. High or low wages and

4. This confusion encouraged Keynes to believe, incorrectly, that the classicals did not have a valid theory of interest-rate determination, because he read them as arguing that the supply and demand for capital goods determine interest rates rather than the price of capital goods themselves. For an elaboration, see Ahiakpor 1990.

5. On this point, Rothbard gives no quotations from Smith; nor does he cite any relevant pages in *The Wealth of Nations.*

> 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, or no more, than what is sufficient to pay those wages and profit, that it affords a high rent, or low rent, or no rent at all. (*WN,* 1: 163)

To an impatient reader, this statement may appear confused. But Smith's subsequent explanation of it entails the argument that when a commodity is so abundant that it is not worth taking to market, no one offers to pay rent to a landlord to acquire or harvest it. Indeed, a landlord may be glad to grant the privilege of harvesting "materials of lodging [when] super-abundant to whoever takes the trouble of asking" (*WN,* 1: 182). Thus, rent derives from the high demand relative to the supply of the produce of land. On the other hand, for one to be willing to offer rent to a landlord, one also wants to be sure that the price to be had for the sale of the commodity covers other "costs," including the reward for undertaking the venture (profit).

Another source of difficulty for some interpreters of Smith is their treatment of his explanation of the "component parts of price" (*WN,* 1, chap. 6) as if he were explaining the determination of prices. But there Smith affirms only that the price received for any product must "resolve itself into" wages, rent, and profits where labor, land, and capital are employed. Indeed, in the same chapter he also mentions those occasions when the price does not resolve itself into rent or profits. For example, if one does not have to pay rent for the use of land, then the price received does not have to resolve itself into rent. Thus, given a careful reading of Smith's chapter "Of the Rent of Land," his arguments make good sense and are not the confusion of thought Rothbard interprets them to be (see also Hollander 1987, 77–80). Furthermore, the chapter is yet another refutation of Rothbard's claim that Smith, along with other classical and neoclassical economists, was not concerned with "analysing real-world prices and economic activity" (451).

The Theory of Money

As in the case of the theory of value, many of Rothbard's criticisms of Smith's treatment of money turn out to be founded on misinterpretations or misrepresentations. Smith's treatment of money, as in classical economics as a whole, is simply an application of the theory of value (Ahiakpor 1997a). Money is the particular commodity or specie (gold or silver) that serves as a medium of exchange, or "the means by which the whole revenue of the society is regularly distributed among all of its members" (*WN,* 1: 306). When private bank notes are issued, they serve as money substitutes and are properly called "paper money." And where bank notes are redeemable in money (specie) on demand, their supply does not add to the total quantity of money or currency (*WN,* 1: 345).

Employing the principle of supply and demand to determine the value of commodities, Smith also argues that the greater the quantity of money (specie or cash) available to be exchanged for other commodities as a whole, the lower will be the value of money, and vice versa (e.g., *WN,* 1: 378). The supply of money may come from domestic production of gold and silver or from revenue acquired through net exports. As others had noted previously, Smith wrote: "When the country exported to a greater value than it imported, a balance became due to it from foreign nations, which was necessarily paid to it in gold and silver, and thereby increased the quantity of those metals in the kingdom" (*WN,* 1: 453). And Smith accepts the proposition as being "solid" (*WN,* 1: 454). Similarly, he declares that "a country that has no mines of its own must undoubtedly draw its gold and silver from foreign countries, in the same manner as one that has no vineyards of its own must draw its wines" (*WN,* 1: 456), that is, from trade. And the supplies of money relative to their demand affect prices in all countries, because "money necessarily runs after goods" (*WN,* 1: 460).

Of course, these arguments follow David Hume's, even as Smith adds his own modifications. For example, Smith criticizes Hume for arguing that the increase of paper money necessarily increases "the money price of commodities" without also noting that such will occur only when paper money is not readily convertible into specie (*WN,* 1: 345–46), and he cites evidence relating to Scotland, England, and France in support of his own argument. Where there are restrictions on the convertibility of bank notes into specie or where the notes are issued by government as legal tender, their value sinks below that of specie from their excessive supply. Then prices denominated in such paper monies will be higher than prices in real (specie) money (e.g., *WN,* 1: 319–22, 347–50). Such paper monies also will exchange with foreign monies at a discount on the currency exchange market.

Modern readers of Smith who do not pay careful attention to his (and other classicals') distinction between money (specie) and paper money, but define money simply as the medium of exchange (such as M1, M2, etc.), might conclude that Smith is incorrect to argue that increases in bank (paper) money do not cause inflation because they cannot add to "the quantity of the whole currency" (*WN,* 1: 345). Or they might read Smith as denying that an increase in the quantity of money relative to the quantity of goods and services will raise prices. But such readings of Smith are incorrect, because in a regime of free convertibility, an increase of paper money that tended to raise prices in terms of that medium but not in terms of specie would cause the public to redeem their deposits in specie and thus would cause a contraction of paper money.

Smith's explanation of an overflow of specie abroad (*WN,* 1: 310–12) upon the issuing of bank notes as a means of lending the deposits of specie follows precisely this

6. That Rothbard bases part of this criticism on Viner (1937, 87) is no good excuse.

principle and is also meant to explain how banking converts money (specie) into "capital" to be employed in trade or manufacturing. Because banks can lend a portion of the public's deposits (specie) with them, "reserving in their different coffers [sufficient amounts] for answering occasional demands" (*WN,* 1: 311), such loans of money could be used as trade capital to import foreign goods instead of being "allowed to lie idle" (311) in bank vaults. Thus Smith's argument in the chapter "Of Money…" must not be construed to deny either the explanation of the value of money (specie) by its supply and demand or Hume's price-specie-flow mechanism. Smith would not otherwise have argued that "there was a very sensible rise in the price of provisions, owing, probably to the badness of the seasons [fall in output relative to the quantity of money], and not to the multiplication of paper money" (*WN,* 1: 345). It is also because of Smith's belief in the linkage of monetary (specie) flows and price-level adjustment across countries that he argues:

> The proportion between the value of gold and silver and that of goods of any other kind, depends in all cases, not upon the nature or quantity of any particular paper money, which may be current in any particular country, but upon the richness or poverty of the mines, which happen at any particular time to supply the great market of the commercial world with those metals. It depends upon the proportion between the quantity of labour [productive effort or cost] which is necessary in order to bring a certain quantity of gold and silver to market, and that which is necessary in order to bring thither a certain quantity of any other sort of goods. (*WN,* 1: 349–50)

Smith also affirms the proposition that increases in the quantity of money per se do not represent increases in savings or "capital" and therefore do not lower the rate of interest permanently. Thus, he argues that "it is utterly impossible that the lowering of the value of silver [following the Spanish discovery of the new world] could have the slightest tendency to lower the rate of interest" (*WN,* 1: 376), precisely because the increase of money increases the price level, lowering the value of the medium in which interest is paid. On this point, Smith also invokes Hume's exposition of the argument, adding that "it is, perhaps unnecessary to say more about it" (376).

Yet, in spite of the preceding evidence, Rothbard alleges that Smith includes "none of the Humean analysis in his *Wealth of Nations*.… Gone is any reference whatever to the causal nexus between the quantity of money, price levels, and balances of trade" (460);[6] that "Smith treats only a world of pure specie money, and assumes that all countries are always in equilibrium" (461); and that Smith believes "there is no need to consider or worry about increases in money supply causing price rises" (501). One wonders what Rothbard makes of Smith's description of the inflationary consequences of "paper currencies of North America" issued not by private banks but by the colonial governments and declared to be "legal tender of payment," and also not redeemable into specie "till several years after it was issued." Indeed, Smith calls such declaration of legal tender "an act of such violent injustice, as has scarce, perhaps, been attempted by the government of any other country which pretended to be free" (*WN,* 1: 347).

An anonymous reader also queries that

> in the lengthy and systematic account of money [in chapter 2 of book 2, Smith] assumes that additions of the money stock cannot cause inflation. If more specie is introduced than the needs of trade require, it will flow abroad and hence will not raise prices. But what if it is more than the importing country requires? Why won't it flow back to where it came from? This is all thoroughly unHumean. And it is not redeemed by remarks at other places in the book that are more in line with Hume's thinking. Again, Rothbard is far from the first to discover a puzzling neglect of Hume's money-price theory in *The Wealth of Nations.*

In the first place, it is the increase of bank notes, not specie, that Smith cites in the chapter as causing the "overflow" of money abroad. Second, it is because pressing both money (specie) and paper money into circulation would cause domestic prices to rise relative to those abroad that importation of foreign goods in exchange for specie ensues. Paper money does not go abroad because, as Smith explains, "at a distance from the banks which issue it, and from the country in which payment of it can be exacted by law, it will not be received in common payments" (*WN,* 1: 311). Thus there is no meaningful sense in which such specie becomes "more than the importing country requires." Foreign exporters would hardly refuse payment for their wares. It is unjustified to insist, as does the reader cited, that the price-specie-flow mechanism is missing in *The Wealth of Nations.*

Another of Rothbard's misinterpretations of Smith is in relation to the latter's praise of fractional-reserve banking. Rothbard (463) quotes Smith's explanation that

> the judicious operations of banking, by substituting paper in the room of a great part of gold and silver, enables the country to convert a great part of this dead stock into stock that produces something to the country.... [Such] operations of banking, by providing, if I may be allowed so violent a metaphor, a sort of wagon-way through the air, enable the country to convert, as it were, a great part of its highways into good pastures and cornfields, and thereby to increase considerably the annual produce of its land and labour. (*WN,* 1: 341)

Rothbard quibbles with Smith's description of gold and silver deposited at banks as "dead stock," arguing that Smith failed to realize that such money "performed the vital function of being a money commodity providing to every member of society an insurance against paper money inflation, *whether launched by government* or banks" (463, emphasis added). Furthermore, he says, "Smith's critique of specie as 'dead stock' stems from his belief that money is not a commodity serving as a medium of exchange" (463). But the correct interpretation of Smith's argument regarding specie deposits being dead stock is that, while sitting in bank vaults, they constitute locked-up savings ("capital") of their depositors. Such savings could be loaned out to investors to increase production through the device of issuing private bank notes. (The modern equivalent is the deposit of cash, which banks lend to borrowers.)

Before offering the explanation of the benefits to society from fractional-reserve banking, Smith also explains its underlying principle, a principle that some Austrian economists, including Rothbard, apparently fail to understand:

> What a bank can with propriety advance to a merchant or undertaker of any kind, is not either the whole capital with which he trades, or even any considerable part of that capital; but that part of it only, which he would otherwise be obliged to keep by him unemployed, and in ready money for answering occasional demands. (*WN,* 1: 317–19, 322–23)

The Austrians, on the other hand, think that fractional-reserve banking is a source of inflation or, worse, a fraudulent scheme. But they are wrong on both counts.

Private banks lend only a fraction of what is deposited with them, thus partly restoring into the expenditure stream the nonconsumed income of savers. Therefore, such lending does not increase expenditure beyond the level of income (output) so as to bid up prices. Note that in the so-called bank-deposit-multiplier process, the extension of a loan by a bank does not lead to further (declining) series of deposits in the banking system unless the subsequent recipients of the loan disbursements redeposit them with banks as nonconsumed income or savings. Moreover, the recipients of loan disbursements must have created new goods or services for which they are paid.[7]

Second, banks promise depositors (savers) only the redemption of such deposits into money (cash) on demand or over some specified period. They do not promise that none of such deposits will be loaned out to borrowers, hence no fraud or deception is involved in fractional-reserve banking. And indeed, few who make deposits with banks are unaware that banks do lend such deposits. What most depositors care about is the ready availability of their funds when they need them. People who do not want any part of their deposits loaned out may pay the banks for the custody of their "savings" (properly called hoarding, e.g., *WN,* 2: 442) in a safety deposit box. Thus, if fractional-reserve banking should be perceived as a fraud, it would be a "victimless crime and therefore not really a crime at all" (Rothbard 1995, 477); this argument is

7. Irving Fisher (1912, esp. 187–91, 202–3) gives credence to the opposite view, arguing that the institution of banking mainly promotes inflation. But Fisher is wrong. He fails to take into account that bank deposits, or his "deposit currency," are the public's savings out of income or financial assets. Ahiakpor 1997c elaborates; see also Ahiakpor 1995, esp. 20, and Kohn 1993, esp. 207, on the dependence of bank lending on the public's deposits (savings). However, the terminological obscurity of the multiplier argument informs the insistence of an anonymous reader that "the extension of a bank loan will set off the multiplier process without any 'saving'; bank deposits are not necessarily (or even usually) savings."

the same as the one Jeremy Bentham employs in defense of usury and which Rothbard (477) quotes with justifiable approval.

My point is that Smith correctly understood the principles of monetary economics far better than Rothbard recognizes, and most of his criticisms of Smith on this topic arise from his own misunderstanding or incomplete reading of *The Wealth of Nations.*

Productive versus Unproductive Labor

Rothbard continues with his misrepresentations of Adam Smith under the topic of "productive" and "unproductive" labor, terms that Smith did not originate. According to Smith, political economy,

> *considered as a branch of the science of a statesman or legislator,* proposes two distinct objects: first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the public services. (*WN,* 1: 449, emphasis added)

Thus, Smith considers it one of his primary roles to identify policies that would enhance the increase of output to secure the necessaries and conveniences of life for "the people." This task is consistent with Smith's assuming the role of an "impartial spectator" (e.g., Garrison 1998, 55; see also Smith [1759] 1982).

An important element in Smith's perception of the factors required for promoting economic growth is increased savings or "capital" accumulation. To this end, Smith adopted the existing language, which describes labor engaged in the production of goods, or the "necessaries and conveniences of life" (*WN,* 1: 2), which acquire higher exchange values in the process, as "productive" and labor that does not raise the sales values of objects on which their time has been spent, especially the work of menial servants, as "unproductive" (e.g., *WN,* 1: 351). Thus, the "labour of the menial servant does not fix or realize itself in any particular subject or vendible commodity. His services generally perish in the very instant of their performance, and seldom leave any trace or value behind them, for which an equal quantity of service could afterwards be procured" (*WN,* 1: 352). Consistent with this test of "productiveness," Smith includes among those whose labor is "unproductive" some of "the most respectable orders in the society," such as the "sovereign with all the officers both of justice and war who serve under him, the whole army and navy, churchmen, lawyers, physicians, men of letters of all kinds; musicians, opera-singers, opera-dancers" (352).

Note that Smith does not deny the usefulness of their services. Indeed, he regards some as among "the noblest and most useful" (*WN,* 1: 352).[8] He classifies them as "unproductive" because they produce "nothing which could afterwards purchase or procure an equal quantity of labour" (352). Even regarding the services of menial servants, Smith holds that "the labour of [such servants] has its value, and deserves its reward as well as that of the [manufacturer]" (*WN,* 1: 351). Therefore, Smith does not have to draw a "distinction between productive and unproductive work" when discussing wage determination by the demand for and supply of labor services in book 1, as Rothbard (1995, 448) demands in order for him to be consistent.

Yet "unproductive" people consume a part of the material produce of the land and labor of the country. In a sense, spending money on "productive" labor is part of the "investment" of "capital" that is likely to increase the volume of "necessaries and conveniences of life," whereas spending money on menial servants is consumption that is not likely to increase riches. Says Smith, "A man grows rich by employing a multitude of manufacturers: he grows poor, by employing a multitude of servants" (*WN,* 1: 351). This statement may be treated as deriving from observation or as an empirically testable hypothesis. Smith himself discusses the historical development of several European countries, including that of Britain, in terms of the distribution of the annual produce between those who engage in "productive" and "unproductive" labor to illustrate the point. His argument need not be viewed as a reflection of his "Calvinistic scorn of consumption," as Rothbard (447) alleges. In fact, Smith takes the trouble to point out that the type of consumption he argues would produce more "productive" employment may be looked down upon as being associated with more selfish goals, whereas the one he views as employing "unproductive" hands may reflect "a more generous and liberal spirit" (*WN,* 1: 370). Thus he declares:

> All that I mean is, that the one sort of expence, as it always occasions some accumulation of valuable commodities [as well as little ornaments of dress and furniture, jewels, trinkets, and gewgaws], as it is more favourable to private frugality, and, consequently, to the increase of the public capital, and as it maintains productive, rather than unproductive hands, conduces more than the other to the growth of public opulence. (*WN,* 1: 371)

Rothbard's assertion that Smith had a "bias in favour of material objects [which amounts to] a bias in favour of investment in capital goods" (444) and a bias against consumption goods is also incorrect. So is Trescott's endorsement of the charge (1995, 320). Smith's concern related to the shares of output consumed by different groups. His focus on consumption explains his otherwise puzzling argument that "what is annually saved is as regularly consumed as what is annually spent, and nearly in the same time too; but it is consumed by a different type of people" (*WN,* 1: 359). The correct meaning of this claim is that invested savings goes to employ "productive"

8. The claim that Smith equated "unproductive" with "useless" (e.g., Garrison 1998, 54) is therefore incorrect.

laborers who then consume their income. Smith also was not being inconsistent when he declared that "consumption is the sole end and purpose of all production.... The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it" (*WN,* 2: 179). Thus, it is incorrect to interpret Smith's urging that more "capital" (savings) be accumulated to finance investment or to increase the consumption of "productive" hands to mean that he was urging mainly the production of "capital goods," the only meaning some Austrians insist on attributing to the term "capital."

Rothbard also accuses Smith of having been led by his "Presbyterian conscience to value the expenditure of labour *per se,* for its own sake, and to balk at free market time-preference between consumption and saving" (444–45). But there is little basis for the charge. It is one thing to recognize the free exercise of time preference, which may lead some people to consume immediately everything they produce or to borrow in order to consume beyond their income. It is quite another to play the role of an advisor who points out that to increase their wealth and future consumption people need to save some of their income for investment—precisely the role Smith assumed.

Smith's arguments employing the designation of labor in different types of activities as "productive" or "unproductive" and emphasizing the need to increase savings to give more employment to "productive" labor also do not accord with Rothbard's interpretation that he "exhorted us to negative or at least zero time preference" (447). Savers demand interest compensation for their abstinence, or the waiting required in order to lend their nonconsumed income or "capital," precisely because they do not have zero or negative time preference: "The stock which is lent at interest is always considered as capital by the lender" (*WN,* 1: 372). And Smith did not advocate zero interest on savings.

Economists long ago discarded the physiocratic designation of labor as "productive" or "unproductive," but policy prescription for efficient economic development still accords with its spirit, partly because economic development experience across the world is consistent with it. Thus, it is urged that development policy pay attention first to agriculture, before attending to manufacturing and services that do not create resalable products. With the exception of oil-rich countries, governments that have attempted to achieve the development of manufacturing and such service industries before the development of agriculture have produced few successes. Ingrid Rima (1978, 79) draws the correct policy conclusions from Smith's argument. Although Rothbard (446) quotes her assessment, he fails to appreciate it. Blaug (1985, 55), Hollander (1973, 147), and Marshall (1920, 56–57) also give more accurate interpretations of Smith's use of "productive" versus "unproductive" labor than Rothbard does. Furthermore, modern efforts to limit the size of government bureaucracies, reduce expenditure on the military, and curtail public support of the arts by taxation, so that more income will be left for savings and private investment, all accord with Smith's discussion of the need to increase the share of "productive" labor in economies in order to promote greater growth. Thus, the chapter on "productive" and "unproductive" labor in *The Wealth of Nations* really is an excellent guide to economic development policy, not the damnable tract that Rothbard and some others have taken it to be.

On Taxation

Rothbard's view of Smith's extensive writing on taxation in *The Wealth of Nations* is that it "was a confused mixture of the banal and the fallacious" (Rothbard 1995, 470). He is most critical of Smith for having argued that "tax be proportional to incomes" (470). Rothbard's own preference is that "all persons should pay an equal tax, that is, a tax *equal in absolute numbers*" (471, emphasis added), which implies that people should pay taxes in inverse proportion to their income. Rothbard arrives at his alternative proposal from his declared failure to see the logic of Smith's argument that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in the proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state" (*WN,* 2: 350).[9]

Smith earlier (*WN,* 2: 208–9) argues that among the legitimate duties of the state are the provision of national defense and the administration of justice, and also that the establishment of civil government is necessary to protect private property (*WN,* 2: 232). According to Smith, the validity of whose argument few would deny,

> It is only under the shelter of the civil magistrate that the owner of the valuable property, which is acquired by the labour of many years, or perhaps of successive generations, can sleep a single night in security. He is at all times surrounded by unknown enemies, whom, though he never provoked, he can never appease, and from whose injustice he can be protected only by the powerful arm of the civil magistrate continually held up to chastise it. (*WN,* 2: 232)

Thus, there is much coherence to Smith's argument, which an incomplete reading may not reveal. The wealthy have far more to lose from the breakdown of law and order than the middle class or the poor. Rothbard also argues that "surely the wealthy [can] far more afford to pay for private provision of" such protection (470–71). Clearly, there would be no need for private provision of security if the state were performing fully one of its duties, as Smith identifies it. However, if one took the stance that the state has no business whatsoever to perform, indeed that it ought not to exist, as in the "anarcho-libertarian" utopia, one may argue as Rothbard does. But such an argument should properly be perceived as an expression of a preference for an alternative state of society

9. Hayek's (1960, 315–16) defense of proportional taxation closely follows Smith's argument. I thank Chuck Baird for drawing my attention to Hayek's argument.

rather than a demonstration of the confusion or banality of Smith's argument for proportional taxation. Moreover, it is disingenuous of Rothbard to impute the redistributive policies of modern welfare states, which generally engage in progressive rather than proportional taxation, to Smith's arguments for equitable and efficient forms of taxation (470). Rothbard also ignores the impracticality of his proposal that taxation be inversely proportional to incomes. How much revenue would accrue from such a scheme, and what functions could a state effectively perform out of such revenue? Never mind that scarcely any civil society could survive by adopting such a tax regime.

On the Myth of Laissez-Faire

If one applied the standard of modern libertarianism, including the call to privatize literally everything in sight, Adam Smith would not qualify as an advocate of laissez-faire. He was willing to recommend legislation to enhance the public welfare where the transaction costs of individual contracting may prevent the attainment of such, as in the case of extending limited-liability protection to companies engaged in "public works." However, consistent with Rothbard's efforts to portray Smith differently than he is generally regarded, Rothbard attributes several policy positions to Smith that on careful reading turn out to be inaccurate. One is that "Smith advocated forms of government intervention in the economy" (466), including regulation of "bank paper," government coinage, the post office, and registration of mortgages, among several others. Rothbard does not cite the pages where the evidence may be found. But when one reads about the post office, for example, it becomes clear that his use of the phrase "advocated government intervention" is misleading. The same applies to other activities Smith discusses in the chapter "Of the Expense of Public Works and Public Institutions."

There Smith mentions the "post-office, another institution [which] over and above defraying its own expense, affords in almost all countries a very considerable revenue to the sovereign" (*WN,* 2: 246), as among the institutions through which the revenues required to meet the expenditure of the state may be acquired, besides income and other forms of taxation. He observes that the institution of the post office already exists in many countries, and he describes the post office as "properly a mercantile project, perhaps the only mercantile project which has been successfully managed by, I believe, every sort of government" (*WN,* 2: 342–43). Smith does not advocate the granting of a monopoly to a state-run post office, as now exists in many countries and which properly attracts the censure or condemnation of people advocating free-market policies. (For an extensive and more informative assessment of Smith's arguments on the role of the state in "public works" than Rothbard presents, see West 1990, 85–102.)

Rothbard also distorts Smith's discussion regarding legal interest rates by accusing Smith of perhaps his "most flagrant violation of *laissez-faire* [for] his strong advocacy of rigid usury laws," based on "his predilection . . . for hostility to free market time-preferences between consumption and saving" (467). Note that the concept of usury pertains to the moral objection to the charging of high or excessive interest rates—"the taking of a greater interest than it is usual for men to give and take" (Bentham 1962, 4). Usury laws are thus meant to protect borrowers from "exploitation" by lenders or the borrowers (prodigals) themselves from self-ruin through borrowing at "exorbitant" rates. But, in the chapter to which Rothbard refers, Smith actually talks about the consequences of fixing interest rates below, at, or significantly above the rates determined in the market for borrowers "who can give the most undoubted security" (*WN,* 1: 379), after first having explained the harmful consequences of interest-rate prohibition under usury laws (*WN,* 1: 378):

> In some countries the interest of money has been prohibited by law. But as something can every-where be made by the use of money, something ought every-where to be paid for the use of it. This regulation, instead of preventing, has been found from experience to increase the evil of usury; the debtor being obliged to pay, not only for the use of the money, but for the risk which his creditor runs by accepting a compensation for that use. He is obliged, if one may say so, to insure his creditor from the penalties of usury.

Smith then goes on to explain that, in countries where the law permits the charging of interest, the "rate ought always to be *somewhat above the lowest market price*" (*WN,* 1: 379, emphasis added). Otherwise, if the rate is fixed below

> the lowest market rate, the effects of this fixation must be nearly the same as those of a total prohibition of interest.... If it is fixed precisely *at the lowest market price,* it ruins with honest people, who respect the laws of their country, the credit of all those who cannot give the very best security, and obliges them to have recourse to exorbitant usurers.... Where the legal rate of money is fixed but a *very little above* the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors [who are more willing to borrow at higher interest rates]. (*WN,* 1: 379, emphasis added)

The preceding arguments by Smith may not appear to express sufficiently his disapproval of interest prohibition or its fixing by government. Smith's defense of the legitimacy of interest payments (e.g., *WN,* 1: 59, 108) and his explanation of the futility of legally limiting interest below "the ordinary market rate" (*WN,* 1: 102, 380) all seem to matter little to his critics who, perhaps taking their cue from Jeremy Bentham, can point to his having stated that

> the legal rate, it is to be observed, though it ought to be somewhat above, ought not to be much above the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as *eight or ten per*

> *cent,* the greater part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest. (*WN,* 1: 379, emphasis added)

That specification of a rate at or below 10 percent seems to have qualified him as a supporter of "usury laws"; it is the same statement on which Bentham (1962, 20–29) based his charge and his criticism of Smith for having done so. The statement also has left some of Smith's defenders attempting to explain why he favored usury laws. Such defenses have included the claim that he aimed to promote agricultural development instead of foreign trade (e.g., Levy 1987). But such defenses only perpetuate a misunderstanding, because Smith was not seeking to protect any borrowers from high interest rates or to deprive prodigals of opportunities for self-ruin. He was merely explaining the economic consequences of setting the rate above that of "ordinary business profit" rates at the time.

Smith reckoned that in his time the market rate of interest ranged between 4 and 5 percent, which the legal rate had followed downward. Bentham also noted that the legal rate had fallen from 10 percent "at the time of Henry VIII to 8, then to 6, and lastly to 5, where it stands at present." Furthermore, interest payments are a deduction from profits, hence the rate of interest tends to be about half the rate of profits in ordinary business (*WN,* 1: 109), a point Bentham (1962, 6) also asserts: "Ordinary business profit of trade upon the whole capital employed in a man's trade is at least equal to double interest; say 10 per cent." Thus, if the legal rate of interest were raised much above what most ordinary business profits could accommodate, it would depress economic activity, particularly the most "profitable and advantageous" kind (*WN,* 1: 379). Sparing borrowers from being exploited by lenders, the usual motivation for usury laws, was not Smith's intent in making his proposition, although the end result may appear to be the same.

Smith's linking of interest rates to capital scarcity and rates of profit, by virtue of which he deserves exoneration from Bentham's charge of having favored usury laws, is also reflected in the following passage:

> The diminution of the capital stock of the society, or the funds destined for the maintenance of industry, however, as it lowers the wages of labour, so it raises the profits of stock, and consequently the interest of money . . . profits, therefore, being augmented at both ends [fall of wages and rise in the price of goods], can well afford a large interest. The great fortunes so suddenly and so easily acquired in Bengal and the other British settlements in the East Indies, may satisfy us that, as the wages of labour are very low, so the profits of stock are very high in those ruined countries. The interest of money is proportionably so. In Bengal, money is frequently lent to the farmers at forty, fifty, and sixty per cent. As the profits which can afford such an interest must eat up almost the whole rent of the land-

> lord, so such enormous usury [high interest] must in its turn eat up a greater part of those profits. (*WN,* 1: 105)

Rothbard tells the story of Bentham's having criticized Smith for being inconsistent "in his own free market views by upholding usury laws," commenting that Smith's only response was to send Bentham a copy of *The Wealth of Nations,* Smith being "virtually on his deathbed" (477). If the story is true, Smith properly may have been asking Bentham to read the book again to see that he was not advocating usury laws. Indeed, Bentham's criticism (1962, 20–29) takes the position that Smith, by his prescription of 8 or 10 percent interest at a time when the legal rate was 5 percent, was seeking to prevent prodigals and projectors from finding loans. But if Smith's suggestion had been implemented, it would have raised the legal rate and thus not have deprived such borrowers any more than previously; in fact, it would have increased their chances of finding loans. Furthermore, most of Bentham's criticism centers on making the point that (*a*) very little lending of "capital" goes to prodigals and projectors, and (*b*) projectors are those who engage in innovation, leading the improvement of life in all growing economies. Of course, Smith does not disagree with these points, and Bentham quotes Smith's own words to affirm them, although he does so in an attempt to demonstrate Smith's inconsistency. However, because Smith was not seeking to deprive projectors of loanable funds but only predicting where the bulk of the community's "capital" would go if the legal rate were set much above double the "ordinary rate of profit," Bentham's criticism appears to have been misconceived. Moreover, it is undeniable that most new ventures don't succeed in the marketplace, which explains why venture capitalists or buyers of "junk bonds" demand high interest rates when lending for such projects. Smith's fears of harmful economic consequences if most of the community's "capital" went to such projects are thus not unreasonable or deserving of the scorn Bentham heaps on them.

My point is that Smith has a consistent argument about the consequences of fixing interest rates at different levels, an argument that need not be turned into an advocacy of usury laws. "Acquiescence with" such laws (West 1990, 5) may be a more accurate phrase. One may also indict Smith for being inconsistent with his own views of natural liberty in specifying which level of interest rate may be fixed by law (West 1997), besides noting his failure to carefully examine the operational difficulties that would have to be surmounted for a government to determine accurately the average gross rate of profits and set the legal rate of interest accordingly. Perhaps Smith was ill advised to have made the recommendation, but to describe him as one who advocated *rigid* usury laws, as Rothbard does, seems a misleading characterization of what he wrote. Smith was not concerned to deter usury, as that term was commonly understood (see also, e.g., Mill 1965, 3: 922–23; Marshall 1920, 485–86, 612 n, on the meaning of usury).

Notice, too, that Bentham was the developer of the doctrine of utilitarianism, with which several forms of state intervention have been defended on the grounds that they promote "the greatest happiness for the greatest number." Yet Rothbard's book contains little hint of this aspect of Bentham's work (but see West 1990; Ekelund and Hébert 1990). The point is that considering which legislation might promote the public welfare was a common endeavor of many philosophers in the classical period, and Smith argued in favor of individual liberty more than many others.

Furthermore, Smith's explanation of the consequences of fixing the legal interest rate at various levels does not justify Rothbard's claim that he "virtually embraced the idea of zero time-preference as the ideal" (468), nor does it accord with his claim that Smith had a "predilection . . . for hostility towards free market time-preferences between consumption and saving" (467). The same contradiction applies to Roger Garrison's (1985) interpretation of Smith's discussion of legal interest rates, on which Rothbard apparently relies. As explained before, if people had zero time preference, they would not demand any compensation for lending money, and Smith did not prescribe the payment of zero interest to lenders. A warning against the danger of self-ruin by borrowing for consumption rather than investment does not betray the bias against consumption that Rothbard (1995) and Garrison (1985, 1998) attribute to Smith. Such a warning might well be expected to issue from an acute and "impartial spectator." Indeed, modern credit-card debts and bankruptcies empirically confirm the wisdom of Smith's strictures. As Smith explains, "Bankruptcy is perhaps the greatest and most humiliating calamity which can befal [*sic*] an innocent man" (*WN,* 1: 363). To avoid it, people must act judiciously, being frugal and careful to "accumulate some part of what they acquire, either regularly and annually, or upon some extraordinary occasions" (363). Besides explaining the workings of the marketplace, Smith also took on the role of advising how to promote individual economic welfare and that of the community as a whole. That advice should not be confused with an attempt to impose a moral judgment on others.

Rothbard also believes that Smith's twelve years as a commissioner of Scottish customs, "most important of all" (468), betrays a lack of conviction in free-market principles. He quotes Smith's report of 1785, which showed a fourfold increase of net revenue over the previous seven or eight years, as an indictment, declaring: "Well, happy day! *This* from an alleged champion of *laissez-faire*!?" (469, emphasis in original). But this is hardly proof of Smith's lack of conviction in free markets.

In the first place, Smith's condition for free international trade is that there be no discriminatory restraints or encouragement of imports, such as tariffs or prohibitions, nor of exports, such as bounties or drawbacks (e.g., *WN,* 2: 190–93, 408–11). Thus, free trade does not mean zero tariffs or customs duties. Second, the state, Smith clearly notes, needs revenue to perform its legitimate duties. The evasion of customs duties yields to the evader an advantage over domestic producers of import-competing goods, which by definition violates Smith's stated principles of free trade. Only where there are no taxes on the sale of domestically produced goods would it be consistent to call for zero tariffs on the imported ones. Smith (*WN,* 2: 412) also notes the devices by which some traders seek fraudulently to gain from "bounties and drawbacks" and considers ways to prevent them. The revenue increase Smith gladly reports may have been the result of his success in frustrating the cheats. If so, no violation of free-trade principles occurred. To justly indict Smith on Rothbard's charge would require producing evidence to show that he counseled the introduction of discriminatory tariffs or bounties while serving as a commissioner of customs. Rothbard presents no such evidence.

On the Division of Labor

Rothbard's treatment of Smith with regard to the division of labor appears the least careful of all. Here he tries to make the case that Smith was "a plagiarist of considerable dimensions" (442), but he presents no credible evidence. Plagiarism, of course, is the worst transgression in academia.

In discussing the productivity benefits of specialization with respect to pin manufacturing, Smith says "*I have seen* a small manufactory of this kind" where pin production is "divided into about eighteen distinct operations" and where "ten men only were employed, and where some of them consequently performed two or three distinct operations" (*WN,* 1: 8–9, emphasis added). Rothbard says that "in English pin factories 25 was the more common number of operations" (443), but he does not say that none employed the eighteen operations Smith claims he saw. Rothbard also says that the French tended to employ eighteen operations and that such an arrangement had been described in the *Encyclopedie,* published in 1755. He then concludes that Smith must have copied that description of eighteen operations and represented it as his own observation. One would think that a serious charge, such as plagiarism, deserves a greater semblance of evidence than this conjecture.

Rothbard's argument here is similar to Salim Rashid's (1990), which he cites in chapter endnote 2 (471). But as in the case of Smith's theory of value, Rothbard again does not play fair with the literature. I have previously argued (Ahiakpor 1992) that Rashid did not present convincing evidence to support his charge of plagiarism against Smith, and Rothbard handled my presentation of that argument in his capacity as editor of the *Journal of Libertarian Studies.* Yet readers would not know from Rothbard's book that Rashid (1990, 1992) fails to produce the requisite evidence.

Similarly, Rothbard charges Smith with failing to acknowledge his debt to his "beloved mentor Francis Hutcheson, from whom he derived most of his ideas" (435), a charge also made by Rashid (1990). He is silent on my response, which cited Edwin Cannan's comment that Hutcheson supported mercantilist trade policies, which Smith was arguing against, as well as Cannan's conclusion that "there seems no good reason for attributing to Hutcheson's influence [Smith's] belief in the beneficence of self-interest which permeates *The Wealth of Nations*" (Ahiakpor 1992, 173; *WN,* xlvii) and that it "was not Hutcheson that inspired [Smith's] remark, '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'" (Ahiakpor 1992, 173; *WN,* xlviii). Cannan's view of Smith's acknowledgments, quoted in the same 1992 exchange, is that "few authors are less open than Adam Smith to the reproach of having rifled another man's work" and that Smith "actually quotes by their own name or that of their authors almost one hundred books" (Ahiakpor 1992, 173; *WN,* liii). It does suit Rothbard to quote Cannan when the latter appears to be making comments critical of Smith (e.g., 445, 446).

In discussing the division of labor, Rothbard misrepresents Smith's view on rationality as purposive behavior. He claims that "Smith unfortunately shifts the main focus from mutual benefit [from exchange] to an alleged *irrational* and innate 'propensity to truck, barter and exchange,' as if human beings were lemmings determined by forces external to their own chosen purposes" (442, emphasis added). But Smith actually uses the propensity to truck, barter, and exchange to illustrate how people in pursuit of their own self-interest specialize in doing that which they can do best in order to have a larger means by which to obtain the things they need. Smith also applies the principle of self-love or self-interest to beggars, who he says do not dictate the form of alms they would receive but accept whatever donors can give them and then proceed to exchange those things for what they really need (*WN,* 1: 18–19). Thus, Smith concludes, "As it is by treaty, by barter, and by purchase, that we obtain from one another the greater part of those mutual good offices which we stand in need of, so it is this same trucking disposition which originally gives occasion to the division of labour" (*WN,* 1: 19). He imputes no irrationality to the exchange activities of individuals.

Conclusion

It is clear that Rothbard intends by his harsh comments to diminish Smith's reputation, especially among adherents of free-market principles, and to elevate the reputation of others, particularly the "Austrians." But many of his criticisms appear to stem from his incomplete reading of *The Wealth of Nations* or from his peculiar interpretations of text. The latter arise partly from his attribution of different meaning to certain concepts when reading the text, a misstep not peculiar to Rothbard. Thus, for example, unless one is careful to recognize that modern currency issued by a central bank is the equivalent of specie money in the classical literature, one may find troubling the classical argument that the increase of bank notes—the modern equivalent of which are the checks the public writes on commercial bank accounts—does not cause inflation. The modern association of "capital" with capital goods rather than funds saved out of income, which is the classical (and marketplace) meaning of the term, also has played havoc with readings of the classical literature by Austrians from Bohm-

Bawerk down to Hayek and their modern followers, as well as by Irving Fisher and by Keynes. Rothbard's reading of Smith reflects that problem at several places. Finally, Rothbard's libertarian aversion to government regulation of or participation in an economy leads him to treat with disdain Smith's discussions of government activities that might promote economic growth; and several of Rothbard's strictures under that rubric are unwarranted.

Perhaps Rothbard's sharp attacks on Smith will encourage adherents of free-market principles to examine *The Wealth of Nations* in greater detail for themselves rather than relying on popular extracts or paraphrases. If so, his abusive treatment of Smith may result in a greater appreciation of the arguments laid out in *The Wealth of Nations* than otherwise would have occurred—exactly the opposite of Rothbard's intended effect. One does not have to engage in "relativism" or "ancestor worship" (Blaug 1996, 1) to appreciate the wisdom in most of Smith's arguments, but one must read him with care.

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Acknowledgments: Earlier versions of this article, under a different title, were discussed at the Southern Economic Association Meetings, Atlanta, Georgia, November 21–24, 1997, and at the Western Economic Association International Conference, Seattle, Washington, July 9–13, 1997. I thank Charles Baird, H. Dieter Renning, Gregory R. Woirol, two anonymous referees, and the editor of *The Independent Review* for helpful comments and suggestions without implicating them in any errors.