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HistEcon

**Smith Summary**

So far:



Things to Emphasize:

1. Stunning Achievement
2. Harmony
3. Smith’s Explanation for Growth: Div of L and tightly connect reward to performance (principal/agent)

<https://freakonomics.com/podcast/why-does-the-most-monotonous-job-in-the-world-pay-1-million/>

“Human society, when we contemplate it in a certain abstract and philosophical light, appears like a great, immense machine, whose regular and harmonious movements produce a thousand agreeable effects.” Smith, *TMS*

Chicago Smith versus Kirkcaldy Smith and Smith’s Policy Conclusions

Two examples that Smith is NOT a modern, free-market economist:

1. Smith highly critical of stock markets (joint-stock companies)

2007 Frontline documentary about newspapers and journalism, *News War*

<http://www.pbs.org/wgbh/pages/frontline/newswar/>

5-minute clip from above: <https://vimeo.com/econexcel/latimesstock>

1. Smith on usury and interest rates

[Book II, Ch.4, Of Stock Lent at Interest](http://www.econlib.org/library/Smith/smWN9.html#B.II,%20Ch.4,%20Of%20Stock%20Lent%20at%20Interest) (<https://tiny.cc/smithinterest>)

II.4.13 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.

II.4.14 In countries where interest is permitted, the law, in order to prevent the extortion of usury, generally fixes the highest rate which can be taken without incurring a penalty. This rate ought always to be somewhat above the lowest market price, or the price which is commonly paid for the use of money by those who can give the most undoubted security. If this legal rate should be fixed below the lowest market rate, the effects of this fixation must be nearly the same as those of a total prohibition of interest. The creditor will not lend his money for less than the use of it is worth, and the debtor must pay him for the risk which he runs by accepting the full value of that use. 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. In a country, such as Great Britain, where money is lent to government at three per cent. and to private people upon a good security at four and four and a half, the present legal rate, five per cent, is perhaps as proper as any.

II.4.15 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. Sober people, who will give for the use of money no more than a part of what they are likely to make by the use of it, would not venture into the competition. A great part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it. Where the legal rate of interest, on the contrary, is fixed but a very little above the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors. The person who lends money gets nearly as much interest from the former as he dares to take from the latter, and his money is much safer in the hands of the one set of people than in those of the other. A great part of the capital of the country is thus thrown into the hands in which it is most likely to be employed with advantage.

William Easterly argues Smith should be seen as the founder of Development Economics in “Progress by consent: Adam Smith as development economist”  (Review of Austrian Economics, published online September 10, Recommendations for Further Reading 213 2019, <https://link.springer.com/article/10.1007/s11138-019-00478-5>).

Abstract

Adam Smith is not sufficiently recognized as a founder of development economics. Smith challenged the longstanding assumption that inferior development outcomes reflected inferior groups, and that superior groups should coerce inferior groups to make development happen. Smith made clear that the positive-sum benefits of markets required respecting the right to consent of all individuals, from whatever group. These ideas led Smith to be a fierce critic of European conquest, enslavement, and colonialism of non-Europeans. The loss of Smith’s insights led to a split in later intellectual history of pro-market and anti-colonial ideas. The importance of the right to consent is still insufficiently appreciated in economic development debates today.

On Smith’s Wide Coverage of the Globe:

“There is a curious notion in development economics that the field emerged out of nowhere right after World War II. I used to share that view . . . It took me embarrassingly long to acknowledge some obvious ancient history of development thinking, and some other development economists are apparently taking even longer. As long ago as 1776, Adam Smith wrote a book called the Wealth of Nations. It turns out, after many hours of careful reading, that the book is indeed about the Wealth of Nations. Far from ignoring the wider world, Smith cited 164 different historical or contemporary place names or names of ethnic groups. . . . The omissions . . . are rare and reflect information availability. Only Australia and New Zealand are left out altogether. Specific place names in Africa are limited to some places on the coast, but there are very important discussions of the African continent as a whole. The rest of the world is well covered . . . Smith has abundant coverage of future Third World places such as Peru, Mexico, Chile, Egypt, India, Africa, Central Asia, and China. Smith’s First World success stories are England, lowland Scotland, British North America, and Holland. The future Second World is also covered in discussions of Russia and Eastern Europe. . . . Smith used his widespread examples to test his preferred hypothesis to explain development.”

Steven Landsburg, *Price Theory and Applications*, 2004 (6th ed.), pp. 286-288.

The Problem of the Social Planner[[1]](#footnote-1)

Try the following experiment: Ask your friends to name the two ways to get a chicken to lay more eggs. Few will know. The two ways to get a chicken to lay more eggs are to feed it more or to provide it with more heat from blowers that are usually powered by natura1 gas.[[2]](#footnote-2) In chicken farming, natural gas and chicken feed are close substitutes.

Imagine a chicken farm next door to a steel mill. In a typical week each consumes 100 cubic feet of natural gas. The steel mill has no economical alternative production process, and it would have to curtail its operation significantly if natural gas became unavailable. The chicken farmer, at an additional cost of a few cents per day, could switch off the blowers and use more chicken feed.

One day it transpires that only 100 cubic feet of natural gas per week will be available in the future. A benevolent economic planner, seeking only to benefit society, must decide how to allocate this natural gas. Perhaps he observes that the steel mill and the chicken farmer have historically used natural gas in equal quantities, and on this basis he decides that their “needs" for natural gas arc roughly equal. He assigns 50 cubic feet per week to the steel mill and 50 cubic feet to the chickens.

As a result, there is a substantial cutback in steel output, to society's detriment. If all 100 cubic feet had been assigned to the steel mill, production would have continued about as before, with the chicken farmer having slightly higher costs and perhaps cutting egg production by a small amount. Why does this benevolent planner not recognize his mistake? Because he—like the friends you were invited to poll on this question, and almost everybody else except for chicken farmers and the readers of this book—has never remotely suspected that chicken feed can be substituted for natural gas. Why doesn't the chicken farmer tell him? If he did, he would lose his natural gas allocation and his costs would go up-only slightly, to be sure, but the incentive is still to keep mum.

An alternative social arrangement is to abolish the planner and to allocate the gas via the price system. Now when natural gas becomes more scarce, the price gets bid up. This has two effects on the chicken farmer: He acquires the information that the available natural gas is more valuable to someone else than it is to him, and he acquires an incentive to react accordingly. He puts in an order for some chicken feed.[[3]](#footnote-3)

*The Use of Knowledge in Society*

In 1945, Friedrich A, Hayek (later a Nobel Prize winner) addressed the American Economic Association on the occasion of his retirement as its president. The title of his address was “The Use of Knowledge in Society." In it he called attention to the social role of prices as carriers of information, allowing the specialized knowledge of each individual to be fully incorporated in decisions concerning resource allocation. He contrasted this knowledge with so-called scientific knowledge and found it unjustly underrated by comparison:

A little reflection will show that there is beyond question a body of very important but unorganized knowledge which cannot possibly be called scientific in the sense of knowledge of general rules: *the knowledge of the particular circumstances of time and place.* It is with respect to this that practically every individual has some advantage over all others in that he possesses unique information of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or are made with his active cooperation. We need to remember only how much we have to learn in any occupation after our theoretical training, how big a part of our working life we spend learning particular jobs, and how valuable an asset in all walks of life is knowledge of people, of local conditions, and special circumstances. To know of and put to use a machine not fully employed or somebody's skill which could be better utilized, or to be aware of a surplus stock which can be drawn upon during an interruption of supplies, is socially quite as useful as the knowledge of better alternative techniques. [Emphasis added.][[4]](#footnote-4)

The special knowledge of the chicken farmer is a sort of knowledge of the particular circumstances of time and place. But Hayek is referring here to knowledge even much more specialized (and inaccessible to the planner) than that: the knowledge of the foreman that a leak in a certain machine can be plugged with chewing gum; the knowledge of a manager that one of the file clerks has a knack for plumbing repairs; the knowledge of a shipper that a particular tramp steamer is half-full. No planner can have access to this knowledge:

The sort of knowledge with which I have been concerned is knowledge of the kind which by its nature cannot enter into statistics and therefore cannot be conveyed to any central authority in statistical form. The statistics which such a central authority would have to use would have to be arrived at precisely by abstracting from minor differences between the things, by lumping together, as resources of one kind, items which differ as regards location, quality, and other particulars, in a way which may be very significant for the specific decision.[[5]](#footnote-5)

Suppose that you and your friends discover a new science fiction writer whose works you all rush out to buy. It may not occur to you that this requires more linseed plants to be grown in Asia, but it does, because the oil from those plants is used to make the ink to print the books that the stores now want to restock. The Asian linseed farmer is no more aware of the change in your reading habits than you are of your need for his services, but he nevertheless responds by increasing his output. Your increased demand for books causes a rise in the price of linseed and informs the farmer that someone, somewhere, wants more linseed for some reason.

A competing economics textbook begins its first chapter by observing that “the rest of us people" (together with nature) "dominate your life and prevent you from having all you want.” [[6]](#footnote-6) However, the authors warn:

Do not suppose that if we were less greedy, more would be within your grasp. For greed impels us to produce more, not only for ourselves, but, miraculously, more for you too.

What the authors have in mind is that other people's greed enables you to offer them incentives to act as you want. It is because the carpenter is “greedy" that you can hire him to build your house.[[7]](#footnote-7) In fact, we can say more. While greedy neighbors are more likely than apathetic neighbors to respond to your desires, you might imagine that the best possibility is a third one that the authors did not consider: What if the rest of the world were neither greedy nor apathetic, bur actively altruistic, attempting to cater to all of your wishes? While such a world would have obvious advantages, it would also have a less obvious disadvantage: In the absence of a price system, you would be severely limited in your ability to communicate your desires. The farmer in Asia, wanting only to make your life more pleasant, has no criterion by which to choose between producing more linseed or more of some other crop. You have no way of informing him, because you don't realize that a yen for science fiction creates a need for more linseed oil—or, if you do realize this, then you don't realize that you also need more glycerin, to make the glue with which the books are bound.

Your need for the selfishness of others stems not just from the fact that it motivates them to respond to your desires—altruism on their part would serve that purpose even better. It also stems from your need to *communicate* those desires. Students—and others who have not previously encountered the idea—generally find it quite surprising that a major role of prices in society is to fulfill this need.

1. From *Science,* letter to editor by R. Dorfman, 1976. [↑](#footnote-ref-1)
2. Chickens use calories from feed to produce both eggs and body warmth. A chicken in a heated henhouse can divert more calories to egg production. [↑](#footnote-ref-2)
3. Economist, financial planner, and chicken expert Dan Gressell reports that when natural gas prices were controlled in the 1970s, chicken farmers routinely consumed large and socially inefficient quantities of natural gas. When the controls were lifted and prices rose, farmers switched to chicken feed. [↑](#footnote-ref-3)
4. A. Hayek, "The Use of Knowledge in Society,” *American Economic Review* 35 (September 1945): 519-530. [↑](#footnote-ref-4)
5. Ibid. [↑](#footnote-ref-5)
6. A. Alchian and W. Allen, *Exchange and Production: Theory In Use* (Belmont. CA: Wadsworth, 1969). [↑](#footnote-ref-6)
7. Adam Smith put this very well. In *Tbe Wealth of Nation,* he said, “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. We address ourselves not to their humanity but to their self-love.” [↑](#footnote-ref-7)