

Capitalism

How Adam Smith would fix capitalism

Often misread as a prophet of laissez-faire, the father of modern economics would have radical remedies for the 21st century

Jesse Norman JUNE 21, 2018

Capitalism in flames, [populism and nationalism](#) on the march across Europe, a US president bent on demolishing [free trade](#), a British shadow chancellor calling openly for the overthrow of capitalism itself . . . the 21st century is not going to script.

The market system from which global prosperity has emerged over two centuries is now under attack from all sides, its basic legitimacy assailed from the right by critics of unfair competition and crony capitalism, from the left by campaigners against inequality and “market fundamentalism”.

More than any other, the Scottish political economist and philosopher Adam Smith stands at the centre of this ideological battlefield, while around him clash competing views of economics, markets and societies.

For many on the right of politics, the author of *The Wealth of Nations* is a founding figure of the modern era: the greatest of all economists; an eloquent advocate of laissez-faire, free markets, the “invisible hand” and the liberty of the individual; and the staunch enemy of state intervention in a world released from the utopian delusions of communism.

For many on the left, Smith is something very different: the true source and origin of “market fundamentalism”, homo economicus and the efficient market hypothesis; the prime mover of a materialist ideology that is sweeping the world and corrupting real sources of human value; an apologist for wealth and inequality and human selfishness — and a misogynist to boot.



A portrait of Adam Smith by John Kay (1790) © Getty

Which, then, is the real Adam Smith? In fact, both these views are hopeless caricatures. Smith was not an advocate of laissez-faire; the phrase “invisible hand” occurs just once in *The Wealth of Nations*; and he did not oppose all state interventions in markets. Indeed, he positively advocates a range of them, from specific forms of taxation to regulation of the banks.

He did not think selfishness was a virtue, and he was not a misogynist; far from originating the idea of “market fundamentalism”, he would have opposed it; and homo economicus and the efficient market hypothesis are later ideas that badly distort Smith’s own views. Industrial capitalism itself, as the combination of freely trading markets and autonomous corporations, is a 19th-century phenomenon, and only emerged two generations after his death.

The real Adam Smith is a vastly wiser and more subtle thinker. He forces us to discard the usual simplistic slogans and tired clichés. But more than this: he still has a vast amount to teach us, not

merely about economics and markets and trade, but about the deepest issues of inequality, culture and human society facing us today. Far from attacking Smith, we must turn to him again. For we cannot understand, or address, the problems of the modern world without him.



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One thing is clear: Smith is by far the most influential economist who has ever lived. Virtually every great economist of the past two centuries has invoked his name. Every major modern branch of economics, from the so-called neoclassical mainstream to the Austrian and Marxist schools and the more recent offshoots of institutional, developmental and behavioural economics, traces its roots back to Smith.

Meanwhile politicians, academics and pub bores around the world have found the authority of *The Wealth of Nations* and the simplicity of its core ideas an irresistible combination, and routinely draw on them to dignify and adorn their own beliefs or arguments, however dubious they may be.

The result has been to obscure Smith's ideas, and to breed myths without number. For Smith is so intellectually fertile, so multi-faceted and so quotable that he offers constant temptations to over-interpretation or outright theft. Indeed, he can be read as anticipating an astonishing range of contemporary events.

One such is the rise of celebrity politics, from the interaction of modern technology with the human disposition to admire the rich and the powerful, and the human capacity for mutual sympathy, both ideas Smith discusses in his less well-known but no less brilliant first book, *The Theory of*

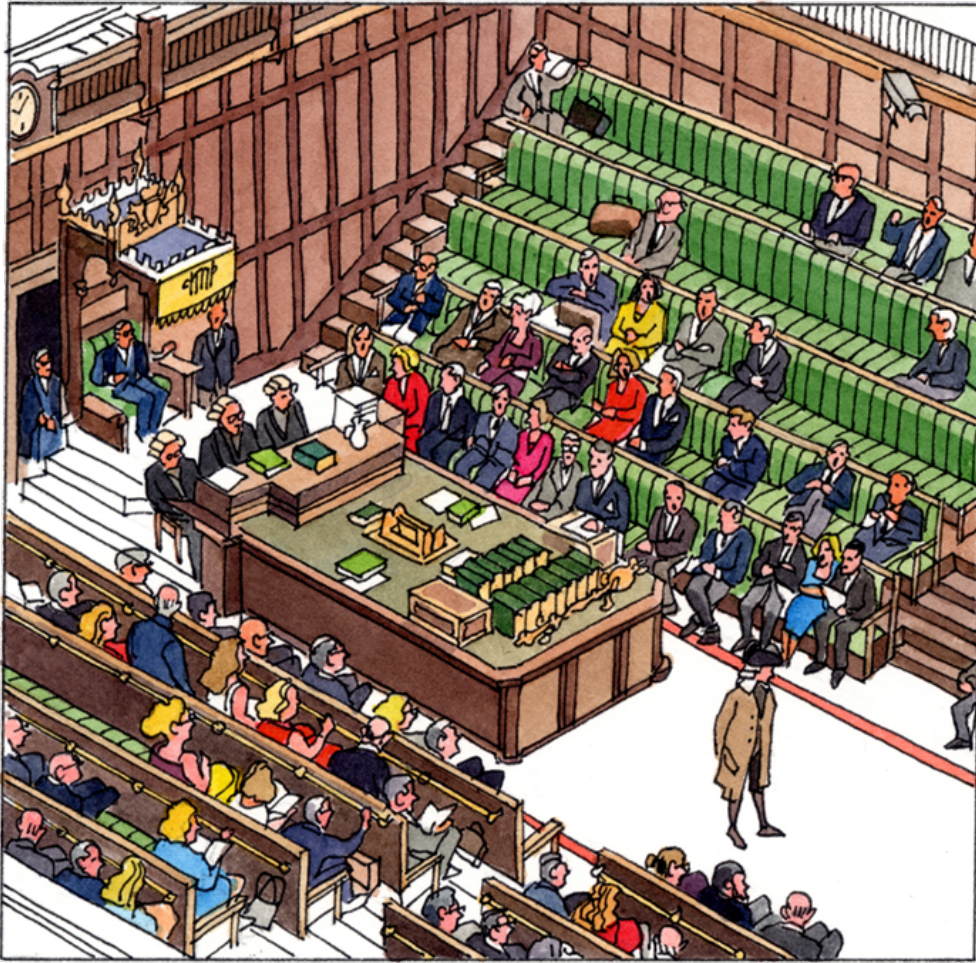
Moral Sentiments.

Another is the logic or otherwise of Britain's departure from the European Union. After all, during the war of independence, Smith argued in relation to the American colonies that Britain faced a clear choice: either to separate entirely from them, or to form an imperial union, in which case sovereignty, and in due course the seat of government itself, would end up slowly being transferred to America.

It is no small irony that Smith himself detested controversy. A man of gentle and retiring disposition, he led a life of academic uneventfulness. Born in Kirkcaldy, Fife, in 1723, he went to study first at the university of Glasgow, and then in 1740 at Balliol College, Oxford — which he much disliked. One can understand why, since Balliol at that time was High Church, Tory, factional, costly and Scotophobic; and Smith was Presbyterian, Whiggish, sociable, impecunious and a Scot. It was not a happy combination.

Smith left Oxford in 1746, and after a period at home returned to Glasgow as a professor. In 1764 he embarked on an extended tour of France as tutor to the young Duke of Buccleuch, before finally taking a position as a Commissioner of Customs for Scotland. Over 40 years he published *The Theory of Moral Sentiments* (1759) and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), and very little else.

As to his private views, we know very little. In politics he was broadly Whiggish in his belief in the virtues of constitutional monarchy, religious toleration and personal freedom. But he remained remarkably close-lipped about his own political views throughout his life. He was famously absent-minded, once being so engrossed in conversation that he fell into a tanner's pit. He never married, and he had no children. As far as we know, there were no secret loves, no hidden vices, no undergraduate pranks, no adult peccadilloes: when it comes to juicy personal detail, Smith's life is a featureless Sahara.



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But if Smith's life was uneventful, the times he lived in were not; indeed, they were tumultuous. The Union between England and Scotland forged in 1707 was, then as now, a bitterly contested affair. But it proved to be a foundation of modern Scottish nationhood, and it set in motion a transformation that made Scotland one of the tiger economies of the 19th century.

Union opened the way for Scotland to leave feudalism behind and become what Smith calls a "commercial society", based not on personal subordination but on markets and trade. But that process was by no means preordained. After all, in their quest to reclaim power for the Stuart monarchy, which had been dispossessed in 1688, the Jacobites repeatedly rebelled. In their last and greatest revolt, under Bonnie Prince Charlie in 1745, the Jacobites came within 120 miles of London and might have taken the city had they not been tricked by false English intelligence. If they had succeeded, then — who knows? — the entire political and religious settlement of Britain might have changed.

However, Scotland's 18th-century transformation was not merely economic; it was cultural and intellectual as well, and it took the country from the edge to the centre of European thought. What is now known as the Scottish Enlightenment included a dazzling array of thinkers in philosophy, the natural sciences, law, history, and literature as well as political economy, social psychology and ethics — a generation comparable to Dr Johnson, Edmund Burke, Joshua Reynolds, David Garrick, Oliver Goldsmith and Edward Gibbon south of the border.

Smith once described the great philosopher-statesman Burke as "the only man, who, without communication, thought on economic subjects exactly as he did". But Smith's closest friend and deepest influence was David Hume, and he and Hume — by any measure one of the greatest

philosophers of all time — were at the heart of this remarkable Scottish intellectual transformation. They were an unusual pair. Hume, the older man by 12 years, was worldly, open, witty, full of small talk, banter and piercing *aperçus*, a lover of whist, a gourmand and a flirt; Smith by contrast was reserved, private, considered and often rather austere in his public manner, although he could unwind in private.

Hume's ironic wit and humour make him a biographer's dream. After his *History of England* proved to be a tremendous critical and popular success, his publisher entreated him for another volume, only to receive the memorable rebuff: "I have four reasons for not writing: I am too old, too fat, too lazy and too rich."

When at a last dinner before Hume's death in 1776, Smith complained of the cruelty of the world in taking him from them, Hume said: "No, no. Here am I, who have written on all sorts of subjects calculated to excite hostility, moral, political, and religious, and yet I have no enemies; except, indeed, all the Whigs, all the Tories, and all the Christians." There are many other such stories.

Hume's thoroughgoing philosophical scepticism had earned him a notorious reputation as an atheist, so much so that he was turned down for academic positions at both Glasgow and Edinburgh universities, to their everlasting later embarrassment. But after Hume's death, Smith published a warm and loving encomium, which concluded: "Upon the whole, I have always considered him, both in his lifetime and since his death, as approaching as nearly to the idea of a perfectly wise and virtuous man, as perhaps the nature of human frailty will permit." It was a handsome tribute — to his friend, and to the truth.

But it is for his ideas that Adam Smith will be remembered, and it is through his ideas and their impact that Smith lives and breathes today.

At the heart of his thought is a — perhaps the — great Enlightenment project. This is to set out what Hume had described as a "science of man": to give a unified and general account, just as Newton had done with cosmology, of human life in all its major aspects, derived from a few basic propositions but reaching out to cover philosophy, religion, political economy, jurisprudence and the arts as well as the sciences, even language itself.

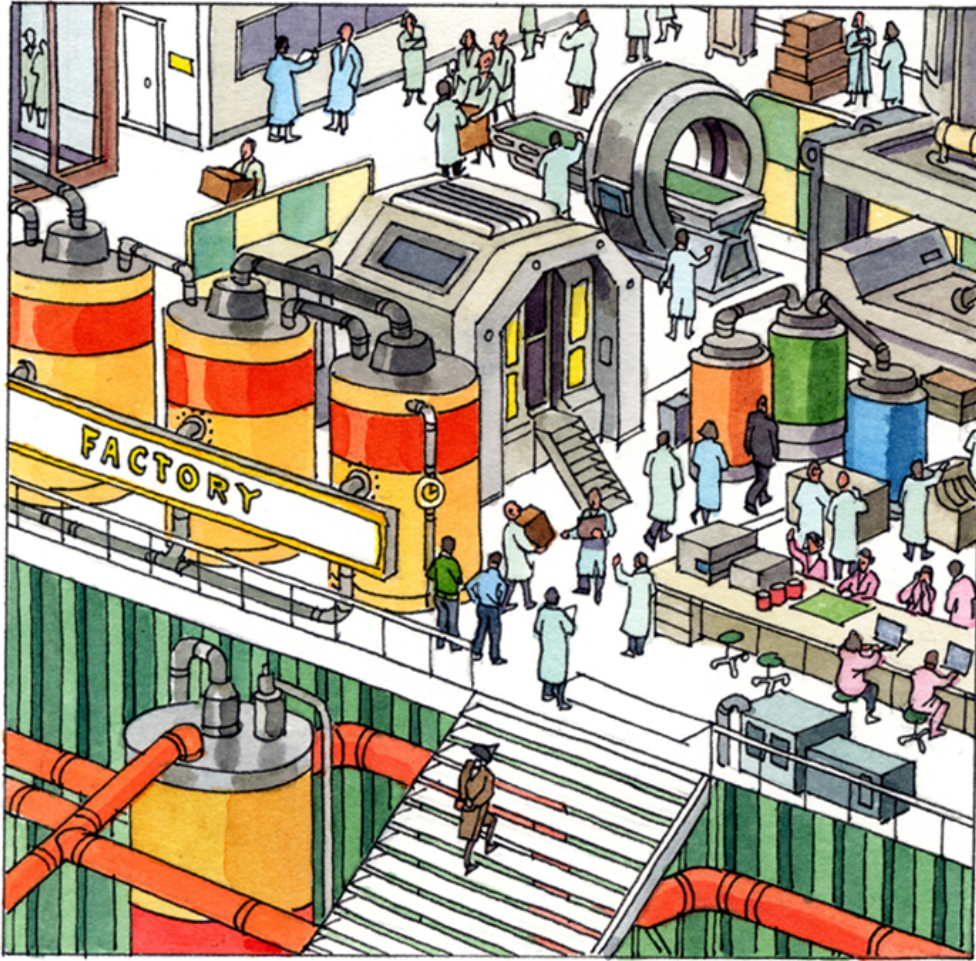
Crucially, this science of man was to be based on observation and experience, and not on natural law, divine inspiration or religious dogma.

Smith's two great published works, *The Theory of Moral Sentiments* and *The Wealth of Nations*, are at first glance very different. The first is about moral psychology, the second about political economy; the first was long ignored, the second is probably the most influential and widely quoted work of social science ever written; and neither is read today even by the vast majority of those who quote them.

But far from being at odds with each other, as some have thought, the two works can be brought together, alongside Smith's unpublished writings, to provide a unified, incomplete but still astonishingly fertile and modern account of human behaviour.

For Smith, the crucial linking idea is that of the continuous exchange that occurs in all human interaction. This may be the exchange of goods and services in markets. But it can also be the exchange of meanings in language and in other forms of communication. And it can be the exchange of regard or esteem that in Smith's view underlies the formation of moral and social norms in society.

Each of these ideas is of extraordinary importance in its own right, but together they reveal a very different picture to the caricatures.



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First, we need to recognise that *The Wealth of Nations* is a work of genius not merely because it sets out many of the central intellectual tools of political economy — the division of labour, the idea of market equilibrium, the effects of incentives on behaviour, the benefits of free trade, Smith's four maxims of taxation, to list just a few — but because Smith is the first person to put markets at the centre of economics itself. Smith is thus the hinge of our economic modernity, just as Burke, with his theory of political parties and representative government, is the hinge of our political modernity.

But, second, markets for Smith are very different to those of economists today. They are not the disembodied mathematical constructs of modern economics and policymaking, and his view of individuals is not that of a desiccated economic atomism. Rather — recalling his insights about language and ethics — markets are living institutions embedded in specific cultures and mediated by social norms and trust. They shape and are shaped by their participants, in a dynamic and evolving way. They often have common features, but they are as different from one another as individual humans are: markets for land and labour and capital, asset markets from product markets and all the innumerable rest of them.

Yes, markets typically generate economic value, and they are unmatched in their ability to allocate goods and services and encourage innovation and technological improvement. But, third, what matters is not the largely empty rhetoric of “free markets”, but the reality of effective competition. And effective competition requires mechanisms that force companies to internalise their own costs

and not push them on to others, that bear down on crony capitalism, rent extraction, “insider” vs “outsider” asymmetries of information and power, and political lobbying.

Fourth, markets constitute a socially constructed and evolving order that exists and must exist not by divine right but because it serves the public good. It follows from this that the modern doctrine of market failure, which derives from academic models assuming perfect competition, needs to be expanded and supplemented. The truth is that outside academic models there are few if any genuinely free markets, and the imagined benefits of perfect markets disappear once any imperfections are allowed. Instead, policymakers need to start by asking two much simpler questions: What is this specific market for? How is it actually working?

Fifth, for the same reason, both individual markets and the market order itself rely on the state. While political intervention can destroy market functioning, it can also enable it. But markets are not inviolable, and they derive their reason for being not from any supposed sanctity of capitalism itself, but from their place within modern commercial society. Ultimately, especially within democracies, it falls to the state to underwrite that legitimacy. And if the preservation of the freedoms, trust and order that make up modern commercial society requires the periodic reform of capitalism, then reform it we must.

Recommended

This is a complex and nuanced message, as befits our ever more complex world. It is threatening enough to current orthodoxies that many on all sides,

libertarian and socialist, will resist it. Properly understood, however, these Smithian ideas remain absolutely fundamental to any attempt to defend, reform or renew the market system. Whether it is the banks, the Big Four accounting firms, the electricity markets, executive pay or the increasing dominance of electronic platforms, 21st-century capitalism offers plenty of targets to a modern Smithian reformer of energy and intent.

But more than this: we live in a time when politics across Europe and the US is being hollowed out by populist ideologies of left and right. Yet the historic alternatives, of war over trade, of religious autocracy, authoritarian communism and nationalism over democracy, or indeed of empty economic materialism over the benefits of commercial society, are not to be contemplated. Smith shows us a way forward — a new narrative through which we can start to reconstruct the centre ground.

Jesse Norman is the Conservative MP for Hereford and South Herefordshire, and the author of a biography of Edmund Burke. His book ‘Adam Smith: What He Thought, and Why it Matters’ is published next month by Allen Lane

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