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## THE LIBERAL WORLD OF A CLASSIC AND SOCIAL WELFARE

*“He, who has left us knowledge we shall employ even after his death, he never dies”*

Ibn-Iasir, an Arab historian

This article is dedicated to the 230<sup>th</sup> anniversary of the publishing of Adam Smith's work "The Wealth of Nations" (9 March, 1776). The subject of our study is the liberal world of Smith and social welfare. We highlight his contribution as a founder of the "homo economicus" model, which asserts that self-interest underlies economic activity.

Special attention is given to the benefits in micro- and macroeconomic aspect from free foreign trade, the negative effects of monopolistic trade companies and the understanding of the cosmopolitan nature of capital, substantiated by Smith.

We specify the place he earmarks for the state in economy. The subject of our study are also Smith's early ideas of the external factors /externals/, the restructuring of natural monopolies and the state as a bad proprietor.

Arguing against several authors, who ascribe in a far-fetched manner the idea of optimal distribution of resources to the neoclassic economists, we uphold the understanding that rudiments of this idea are available as early as Smith and there are grounds that he can be deservedly ranked among the forerunners of institutionalism. The new reading of Smith's works is not only an assessment of his merits and his personality, but it is also an explanation of the present, and a look into the future.

JEL: B12; B31

According to C. Colton contemporaries judge the person rather than his merits, and the offspring appreciates merits rather than the person. As M. Blaug pointed out, we should not present A. Smith as the founder of political economy. There are strong grounds for this honor to be awarded to Cantillon, Quesnay and Turgot.<sup>1</sup> T. Buholtz on his part adds that Smith did not invent the market, nor did he invent economics, but he taught the world that there is market and economics. Judging from the somewhat far-fetched evaluation of Yan McGrail in "The Wealth of Nations" there was nothing "new" when the book was published in 1776. However, Smith has created the system of political economy, and he has written the first comprehensive work laying out the theoretical fundamentals of the general theory of economics and has outlined its boundaries.<sup>2</sup>

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<sup>1</sup> Блауг, М. Экономическая мысль в ретроспективе (пер. с англ.). М., Дело ЛТД, 1994, р. 53.

<sup>2</sup> Classical economics is often wrongly referred to. This in fact is theoretical economy within moral philosophy, but already emancipated from theology.

By analogy with the above-mentioned we can assert that A. Smith is not the founder of liberalism as a school in economic thought. Its substantiation is the result of the intellectual effort of a host of philosophers and economists prior to and following Adam Smith, such as J. Locke, T. Hobbes, D. Hume, Piko dela Mirandola, Ch. Montesquieu, I. Kant, Wilhelm von Humboldt, John Stuart Mill, J. Bentham, B. Constant, A. Tocqueville, R. Cobden D. Brait and others. It was Lao Dzi, a Chinese philosopher who lived in 4<sup>th</sup> century B.C., founder of Daoism, which preached a simple and natural way of life and nonintervention in the natural course of events. On its part the physiocratic school has given grounds for the idea of “natural order and law” and has pointed out the mechanism ensuring “natural order” – free competition based on the principle of “laissez faire, laissez passer”. Smith is not the founder of the liberal economic doctrine. He was the first one, though, to translate the abstract principles of the whole theory of production and distribution of economic wealth into the language of “the obvious and simple system of natural freedom”. In the most outstanding economic work of 18<sup>th</sup> century – “The Wealth of Nations” he mercilessly criticizes the commercial system and policy; he upholds abolishment of the existing semi feudal constraints in industry and domestic trade as well as of the constraints in the free purchase and sale of labor; he stands for the freedom of trading land (i.e., free movement of the factors of production), for free foreign trade, for freedom of access to and breaking away from various branches, for limited state intervention in economy, against the usage of the taxation system for influencing demand and supply; he stigmatizes monopolistic colonial trade, etc.

I

The ideas, developed by the French enlighteners, on freedom of the individual and the manifest of their interest, on the aspiration for personal profit, etc. are applied by Adam Smith in political economy, and thus he becomes the founder of the model of “homo economicus”. According to this model self-interest underlies man’s economic activity. The motives of this economic activity are subordinated to self-benefit, to the endeavor for maximizing benefits and minimizing the expenditure for their achievement. “We expect our lunch, as Smith put it, not owing to the benevolence of the butcher, brewer or baker, but to their jealous attitude to their own interests. We do not address their humanity, but *their egoism* and we never talk about our needs, but about *their benefits*.”<sup>3</sup> (my italic, L. K.)

Pursuing self-interest individuals “constantly need the cooperation and corroboration of a number of people “, “the help of their fellow men, and they would in vain be expecting it to come out of their benevolence”. The way of accomplishing one’s self-interest is involving other people’s egoism in one’s benefit. And the opportunity “that they be shown that it is beneficial for them to do for him (her whatever he) she wants

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<sup>3</sup> Смит, А. Богатството на народите. Изследване на неговата природа и причини. Партиздат, Sofia, 1983, p. 16.

from them. Everyone who is offering another one whatever deal is making the following offer: give me what I need, and you will have what you need".<sup>4</sup>

Meeting the needs and pursuing self-interests is only possible based on mutual favors through "contract, exchange and purchase". In "The Theory of Moral Sentiments" Smith writes that "society, similar to the relationships between various traders on the strength of mutual benefit, without whatever love or attachment can survive without anybody feeling obliged or grateful to anybody owing to the profitable exchange of quality services".<sup>5</sup> People provide services through the exchange of "one item against another". Receiving services or "surpluses from the labor of other people" the individual needs is accomplished through the offering on his/her part of goods "which he/she possesses and which he/she does not intent to utilize himself". In economic activity there is no place for altruism, for readiness to sacrifice one's own interests in favor of others.<sup>6</sup> The consumption of "essentials, the comforts and entertainments of human life", created by the labor of others ("only a small part of them one provides by one's own labor") is accomplished through exchange, through the quantity of "essentials and life conveniences", which are alienated in return through "sacrificing the labor and effort for the generation and acquisition of every item".<sup>7</sup>

The mechanism ensuring the pursuing of self-interest is free competition. This is a system, "which lets everybody pursue their interests in their own way in view of the principles of equality, freedom and justice"; a system based on "the wise nature, which rectifies many of the bad consequences of human folly".<sup>8</sup> This system ensures "entire freedom of trade of craftsmen, manufacturers and traders"; "it forces everyone to endeavor to do their job with a certain degree of precision" owing to the rivalry of competitors; it makes "standing out" the aim of self-esteem and encourages greater effort".<sup>9</sup> From the above-mentioned it can be seen that physiocrats' slogan "Laissez-faire, laissez passer" turns into a basic principle of Smith's theory, its leitmotif. This is why he proclaims free movement of the factors of production, free access to various branches and markets and freedom of moving out of them. This presupposes the following conditions:

- *Mobility of labor* as a factor of production; freedom of the choice of profession, place of work and place of residence or "free circulation of labor and

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<sup>4</sup> Смур, А. Op. cit.

<sup>5</sup> Smith, A. The Theory of Moral Sentiments. London, Bohn, 1831, p. 124. Quoted after Лезутко, Р. Споровете за капитализма. 1995, "Asset" and Foundation "Free and Democratic Bulgaria", p. 18.

<sup>6</sup> This proposition is just another expression of the necessity that in the process of exchange used resources be restored, so that the process be extended in the future, which is in the interest of all. One could say that the Smith type of egoism is just a way for the caring of others to acquire a personal meaning, a way to combine private and public interest.

<sup>7</sup> See Smith, A. Op. cit., p. 31.

<sup>8</sup> Ibid., p. 647-648, 659.

<sup>9</sup> Ibid., p. 739.

capital from one branch to another and from one location to another". A condition for this is the abolishment of: "the real violations against natural freedom" such as workshop and corporate constraints; the status of apprenticeship (number of apprentices, years of apprenticeship); the law of permanent residence; the impediments barring "the freedom of exercising a profession by all subjects". The abolishment of these constraining measures would allow those who lost their jobs in a particular branch or place of residence to look for them in other branches or regions without the fear of dismissal or prosecution by the law. To Smith this also means free movement of capital, since depending on the quantity of labor is the quantity of capital, which can be invested in it, and vice versa.

- Since the land is "an asset of a more sustainable and more durable nature" featuring immobility owing to "permanent" residence, Smith stands for the *freedom of land trade*; the restraining of the "foolish practice" to prescribe the ways of cultivating the land in rent contracts; the encouraging of land improvement through longer terms of rent contracts; the abolishment of inheritance laws, which limit fragmentation and impede the inheriting of land by "all children of the family as movable property" and at the same time hinder those who would improve its cultivation and would increase its product; the abolishment of incentives for the various branches and productions; the freedom of trade between the village and the city (between rural economy producing primarily raw materials and manufacturing production generating processed products); the distribution of royal land among the people through tendering, because people would manage them better and more effectively, and preserving only for the "crown" the land intended for entertainment and glory (parks, gardens, recreation spots); the abolishing of the normative determination of the prices of bread and food stuffs, since competition is due to regulate them "much better than any prices established by law".<sup>10</sup>

- *Freedom of foreign trade activity*, of export and import trade between various states. Smith proclaims the abolishing of internal duties where they still exist; the living through "the corporate spirit" and the abolishing of workshop and corporate constraints; temperate duties and excises on a limited number of goods only, the aim of their charging being the interests of the fix (budgetary expenditures), and not the impact on economic activity.

Smith uncovers the mechanism of spontaneous coordination and regulation of the individuals' behavior and the automatic achievement of market equilibrium as a result of competitive market forces. "The quantity of every article delivered on the market, he writes, is *naturally* (my italic) adjusted to the actual demand. All who are offering their land, labor or capital in order to take a particular article to the market are interested in that its quantity should never exceed the actual demand, and all the other people are interested in that it never diminishes below this demand."<sup>11</sup> The natural adjustment of the quantity of the article offered on the

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<sup>10</sup> *Smith, A. Op. cit.*, p. 145.

<sup>11</sup> *Ibid.*, p. 59.

market is in an amount, not less or more than the one that is sufficient to meet actual demand. Provided at a given point supply exceeds actual demand, some of the component parts of the price – rent, salary or profit, will have to be paid redeemed below their natural price. The owners of the production factors, led by their self-interest, will eliminate from the production part of the land, labor or capital. Production and supply will fall, as a result of which the salary /or profit, or rent/ will start increasing to their natural rate and the price will reach its natural level. Eventually, “the quantity of the article taken to the market will soon be sufficient only to meet actual demand”.<sup>12</sup>

In case the offering of a given article at a particular point of time is insufficient to cover the actual demand, some of the identified component parts of its price (salary, profit, rent) will increase beyond their natural rate. This will lead to applying more labor, capital and land for its production, supply will grow, the component parts of the price will fall to their natural rate, the price – to its natural level and the disrupted equilibrium will be restored. It turns out that the regulation of the individuals` behavior is only seemingly archaic. In fact it is governed by definite laws effective not only for natural matter, but for social and economic ones as well. This is also the way of forming the natural prices of goods as a result of free competition. According to Smith “the natural price or the price under free competition...is the lowest price, which can be obtained”<sup>13</sup> and at which those possessing articles are ready to sell long-term (“in somewhat considerable period of time”).

During this “considerable time” market prices are rarely below the natural ones, but monopolistic formations are able to fix them beyond the latter for a long period of time. Monopolistic prices are to Smith the highest possible to be attained, “which can be squeezed from buyers or which they are supposed to pay for”.<sup>14</sup> Entirely in the spirit of modern understanding of natural and artificial monopolies, Smith reveals also the reasons for “the considerable increase of market prices against natural ones”. This is for him “random circumstances” or “natural causes” generating natural monopolies and “special instructions of the government”, which create artificial monopolies.

As a factor for the creation of natural monopolies along with random circumstances he identifies the trade secret or the considerable increase of the market price of a given article beyond the natural one by those “ who employ their capital for supplying the market with this article”. However, most often conditions arise from secrets in manufacturing, which are the result of “the inventions” of the producers of goods and they allow for the creation of cheaper articles (for example, “a painter, who invented a method of obtaining a particular color with materials, which are twice as cheap as those normally used...”).<sup>15</sup> “The benefits of the

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<sup>12</sup> *Smith, A. Op. cit.*, p. 60.

<sup>13</sup> *Ibid.*, p. 64.

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*, p. 62.

invention” breed a temporary monopoly, which allow for “the realization of a higher income through the higher price”, paid by the consumers for “his labor kept secret”. Smith calls this monopoly “temporary monopoly over the new machine of the inventor”. If we try to give a modern touch to the above-mentioned, this means decreasing average and threshold expenditures of the company-natural monopolist and the obtaining of an innovation rent, an additional profit of the pioneers who accomplished the innovation. However, this monopoly is of a temporary nature, it exists until “production secrets” become well-known and lose their commercial value. Production secrets based on knowledge are sensitive to the factor of time. Knowledge becomes outdated and can be reproduced or replaced by other knowledge. This elasticity (in view of time) of knowledge-based production secrets did not escape Smith’s attention. ‘We must confess, he writes, that similar secrets are rarely kept for long and extraordinary profit can last a short period of time following their revealing.’<sup>16</sup>

Smith links “natural causes” to “natural products” thriving on specific “soils and location”, the entire production of which “may turn out to insufficient to meet the actual demand”. These products are sold at higher prices and allow for the receiving of a rent at the amount of “over its natural rate”, for example, “the exclusive and valuable products of some vineyards in France having particularly favorable soil and location”.

The same effect leading to a continuous and durable deviation from the rate of profit, salary or rent from their natural level is exercised as well by artificial; monopolies granted to given persons or firms as “exclusive privileges of corporations, the statute of apprenticeship and all laws limiting the competitors to a smaller number in a certain branch...”,<sup>17</sup> rather than in the conditions of free competition. The rise of market price as a result of the effect of natural monopolies lasts “as long as there is the effect of the government instructions breeding them”.<sup>18</sup>

The ideas developed in Chapter 7 of Part 1 of “The Wealth of Nations” on natural and market price of articles clearly reveal the “conductor” of the self-interests of individuals in the conditions of “the obvious and simple system of natural freedom” – “*the invisible hand of the market*”. Pursuing their own benefit and security in their economic activity individuals are oriented to the so-called by Smith “invisible hand”. This great and most often quoted metaphor in economic literature in fact envisages the automatic equilibrium mechanism under “natural course and freedom” of economic activity. The natural course can be attained only by abolishing “the hundreds of boring impediments by which the insanity of human laws impedes human activity” and “the irrational restrictions hindering the freedom of competition. Demand, supply, prices, the leveling of the rate of profit (rent or

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<sup>16</sup> Smith, A. Op. cit., p. 63.

<sup>17</sup> Ibid., p. 64.

<sup>18</sup> Ibid.

salary) to their natural value as the result of competition, ensure the optimum welfare at “the lowest prices”. The lowest prices for consumers are a consequence as well of the including in them “the lowest normal profits possible” as the result of “the greatest competition possible” between producers-sellers.

“The ardent, consistent and continuous efforts of every man to improve his lot”, accompanying man from birth to death determine the motives and incentives for his economic activity. They make him govern his production activity so that “its product should: have the highest value, increase his own private profit from the various applications of capital, cooperate directly or indirectly for the increase of the actual rent from the land, increase the actual wealth of the landowner, his ability to buy labor or the product of labor of other people”.<sup>19</sup> The individual owes everything to his being a self-made man and so does society as a sum of the interests of its individuals.

The private self-interest of the individual is in concert with the interests of society, and his individual goals coincide with the social ones. Individual efforts on maintaining the production process and “the creation of products with the highest value” are at the same time an activity which to the greatest possible extent increases the annual income of society. In this case Smith as a typical representative of classicism treats society the way Hume does – as “a combination of individuals”. In a similar way he presents the annual income of society as a sum of “the highest maximum value” created by economic agents. Guided by an invisible hand in the pursuit of his own benefit, “the individual facilitates a goal, which was not intended by him at all. *Pursuing his own interest he often corroborates for social interest more efficiently than he intends actually to facilitate this goal.* (my italic, L.K.). I have never seen doing much good those who proclaim that they are trading for the common welfare. In fact this is just a pretence...”<sup>20</sup> In search of the most beneficial application of their capital and labor individuals are led by their own benefit, and not the social one, of which goal not every one is completely aware. But “the assessment of his own benefit naturally or necessarily leads him to prefer that application of capital, which is most beneficial for society”.<sup>21</sup> The economic benefits from the production and consumption of more goods both in individual and in social aspect prevail when individuals are led by their own interests, and not by the pursuit of altruistic common goals.

The above-mentioned gives us grounds to conclude that in compliance with Smith’s understanding, the morally stigmatized passion for improving one’s own condition and enrichment is virtuous from a social perspective. The passion for riches which breeds skepticism as regards human nature generates at the same time optimistic results for society. The conducting of activities by every economic agent, ensuing from his self-interest has the aftermath of increasing social welfare.

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<sup>19</sup> *Smith, A.* Op. cit., p. 250.

<sup>20</sup> *Ibid.*, p. 437.

<sup>21</sup> *Ibid.*, p. 435.

The pursuit of personal benefit does not contradict social interest, but on the contrary, personal benefit and social interest work in one direction, and in harmony, the meeting of self-interest being just a “cunning” (effective) mechanism for the realization of the social one.

It can be seen from the above-mentioned that individual interests in Smith’s system are induced as primary. They are crucial compared with the collective and social interests (those of the company, city, association, social group, state). At the same time individual interests are just the root cause, the locomotive of development, since through realizing them, individuals meet social needs as well.

## II

Foreign trade must also be carried out freely and naturally, without pressure and violence. Being carried out naturally and regularly, this trade is “always beneficial”. Smith asserts that every country which has opened its ports for trade with all nations instead of going bankrupt because of free trade, it “gets rich proportionally to the degree of its openness”. He sees the benefits mainly in:

- Increase of the exchange value of “the annual product of the land and labor” of the country or increase of the annual income of its citizens;

- Economizing scarce resources. The purchase of a given article from abroad cheaper than we produce it ourselves leads to economizing public labor. The acquisition of articles “just against a part of the own production labor” in activities, where there are absolute advantages (whether it be natural or acquired advantages) would allow for the trading countries to save resources through specialization, which resources would be able to be distributed more rationally into activities where they have absolute advantages. Thus, national, as well as world wealth would grow without increasing the labor for its generation;

- Getting rich under the most beneficial conditions for the consumption of goods we are not capable of producing ourselves. Smith asserts the natural assumption that import articles are paid by the export of own articles. The population of the country gets the opportunity to acquire the greatest import possible against the export of a part of its own productive labor. Goods are obtained which are not produced, but are demanded in the country against the smallest export possible, against “only a part of the price of articles, which the applied productive labor of equal capital would prepare in the country.”<sup>22</sup>

- “The opening of wider markets” for goods, which “fosters the improvement of production forces”. The discovering of America by the European countries Smith associates with the simultaneous “discovering of a new and endless market for all articles of Europe”, contributing to the deepening and division of labor (“improvement of crafts”). This is unthinkable concerning “the narrow framework of the old trade” of limited national market, which is not able “to devour the greater part of articles”. As a result there is growth of the productive force of labour,

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<sup>22</sup> *Smith, A. Op. cit., p. 438 - 439.*



generated produce, “actual incomes” and “actual wealth” of the population.<sup>23</sup> The impacts are made manifest in dynamics – free trade generates extending the scales of the market, deepening the division of labor, increasing the productive force of labor, growth of the generated produce, the incomes and wealth;

- Fuller meeting of the needs “through the export of goods, which are not demanded in the country” and their exchange against such that are demanded, but not produced or whose production is more expensive.

Smith not only uncovers the benefits of the foreign trade based on absolute advantages, he also stigmatizes the various constraints on the freedom of foreign trade – duties, import bans, export incentives in the form of export bonuses, pay back duties, trade contracts, founding of colonies, etc... Such constraints he qualifies as nuisance, unreasonable, useless, harmful and absurd. He is a staunch opponent of the imposed monopolistic trade by the capitals of the colonies. The harms or negative effects of monopolistic trade companies are outlined by him in several directions:

*First*, in the generated deficit of capital in the national economy. The national funds which governed only part of the trade with a given colony, following the introducing of monopoly “have to govern it all, to deliver not only part of the articles, but all articles”. This displaces national capital from its application in more profitable activities and hinders the rational distribution of resources. Such thought do not correspond entirely to the stance of some historians of economic thought, who assert that the classics postulate “the quantitative non-growth of land and the quantitative increase of labor”, and reduce the task of economic analysis to revealing how the variable factor – “the quantity and quality of labor force” affects the rate of growth of aggregate product. The neo-classicist economists following the year 1870 have postulated a certain predetermination of all factors of production and reduce the nature of the economic issue to the search for the conditions, under which “the given productive services would be distributed with the optimal result among the competitive directions of utilization”.<sup>24</sup>

This assertion can be conditionally divided into two parts – on the predetermination of the factors of production, and on the nature of the main economic issue. The first part of the assertion on the fixation (“predetermination”) of the factors of production is true both of classical and non-classical economists, but the second one is not quite accurate as concerns classicists. Its refutation is not only Smith’s thought quoted above on the deficit of funds in national economy and its impact on the rational distribution of resources, but also the exposition in Chapters 7 and 10 of Book 1 of “The Wealth of Nations”. When discussing the issue of natural and market prices of goods in Chapter 7 Smith asserts that free competition through leveling prices to production expenditures facilitates “articles to be sold at exactly how much they cost”. Thus competition optimizes distribution of resources within the branch. This is so because, if as the result of demand and supply, the freely formed price does not

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<sup>23</sup> *Smith, A. Op. cit.*, p. 429 – 430.

<sup>24</sup> See *Блауг, М. Op. cit.*, p. 276.

correspond to the actual demand, some of its component parts (rent, salary, profit) are remunerated above or below the natural price. This on its part leads to ruling out or increasing of the factors of land, labor and capital in production and optimizes their distribution inside the given branch.

In Chapter 10 of Book 1, dedicated to the salary and profit given various applications of labor and capital, Smith asserts that in case of a “natural course” of things the sum of profits or nonprofits from various applications of labor and capital must be quite equal or it must tend to get equal.<sup>25</sup> If in a certain field (meaning branch) profits or nonprofits are more than the rest, this means stepping forth or back of the factors of labor and capital, i.e., the complete freedom of competition facilitates the optimizing of production factors` distribution also among the various branches of economy. Therefore, as early as the classic Smith we come across the earliest understanding of the optimal distribution of resources in the various branches as well as among them, which is ascribed not quite justly only to the neoclassical economists.

*Second*, rise of prices, fall of production and consumption in the country and creation of opportunities for bigger production and consumption of the other countries. The cheap purchases from the colonies, and sales of colonial articles at monopolistic high prices ensures for traders profits “beyond the normal level”. Higher prices attract competitors and facilitate maintaining the profit beyond “the natural level” under free trade. “Raised rate of profit” brings forth one absolute harm, and one relative”. The absolute harm is made manifest in “higher prices and less production and consumption in the country, and the relative one – in the ensured to the other countries bigger production and consumption in comparison with this very country”.<sup>26</sup>

*Third*, disturbing the natural equilibrium among various branches owing to one-sided orientation of trade to a vast market, “to a big channel”, “instead of flowing through a great number of small channels”. One could hardly give a more valuable piece of advice to the governing authorities in Bulgaria prior to, and following 9<sup>th</sup> September, 1944, who made decisions on the one-sided orientation of the prevailing part of foreign trade activity of the country to one market only without taking into account the negatives of eventually losing it.

*Fourth*, fall of the population’s incomes and limiting its capacity for accruing capital. All primary sources of income (salaries, land rents, profits from capital) become less feasible than with free trade.

*Fifth*, reducing the number of circulation of capital “owing to longer distances and specific circumstances in the farther countries of America and West Indies in comparison with the trade with Europe.

*Sixth*, hindering the capital from “maintaining a larger quantity of production labor”, its natural growth owing to the falling total sum of income.

*Seventh*, making more expensive the colonial articles, decreasing their consumption round the world and thus – constraining industrial development not

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<sup>25</sup> See *Smith, A. Op. cit.*, p. 101.

<sup>26</sup> *Ibid.*, p. 585.

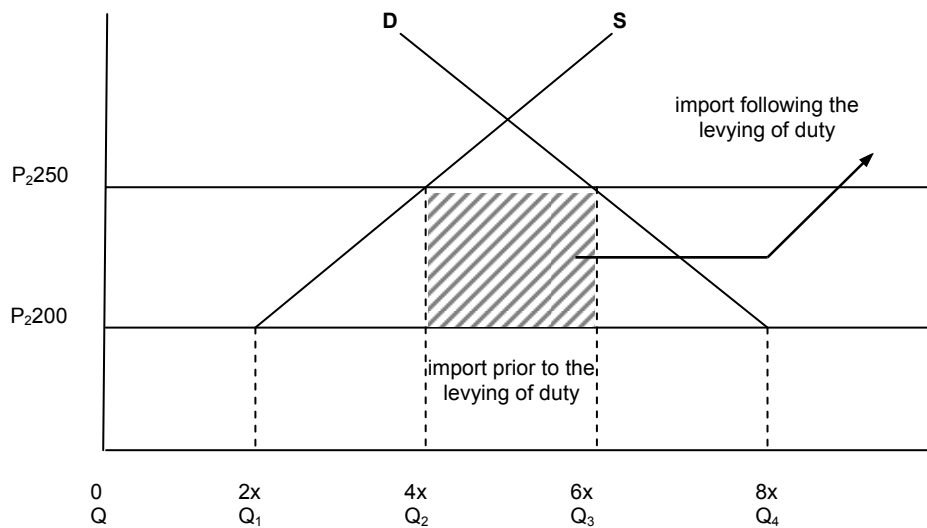
only of colonies, but of all countries which “pay, produce and consume less owing to higher prices”.<sup>27</sup>

Summarizing the above-mentioned, we can capitalize that Smith looks for the negative effects of protectionist trade policy /which is still dominated by mercantile ideology/ in the disruption of rational distribution of resources (“deviating productive labor from profitable to less profitable application”), “decreasing the exchange value of the annual product of the land and labor of the country”, constraining the opportunities for export, shrinking of markets, impeding the deepening of international division of labor, rising of prices, “poorer procurement”, sacrificing the interests of national consumers”, decreasing consumption and production in the country, fall of incomes and barring the opportunities for accumulation, constraining the economic development of the other countries through shrinking the consumption of the products produced by them.

By using modern analytical techniques one can give a graphic expression of Smith’s thoughts on the negative effects of introducing duties and other “constraints on import”, as well as on the incentives for export.” His deliberations on the negative impact of duties and export incentives on prices, internal consumption, national production and import would appear as follows.

Figure

Impact of duties on prices, internal consumption, national production and import



<sup>27</sup> On the aftermath of monopolistic colonial trade see *Smith, A. Op. cit.*, p. 578, 585, 590, 594, 598.

Given the presence of a free international trade the price of a given article is 200 leva per unit, and world market is capable of providing the necessary quantity of articles at this price, owing to which the national price is not different from the world one. Internal consumption is eight thousand units ( $Q_1Q_4$ ) at the price of  $P_1$ . By introducing a duty of 25% internal price rises by 50 lev – from 200 to 250 lev ( $P_2$ ). As a result sales will fall to six thousand units (up to  $Q_3$ ), since owing to the higher price consumers move up the curve of demand. Consumption will fall. Local production will grow by  $Q_1Q_2$  and supply will move up the curve to  $Q_2$ . Import will also fall by two thousand units (from  $Q_1Q_4$  to  $Q_2Q_3$ ). Thus the duty imposed will lead to: shrinking of import, higher price, fall in consumption, redistribution of incomes from consumers to state at the amount of the duty introduced, increase of privileged local production. However, since import falls, the opportunities for import decrease as well because importers will have at their disposal fewer funds for the purchase of local goods. This leads to a fall in local production and in the number of persons employed. Eventually duties do not lead to the increase of local production and employment, but to diminishing production on a world scale and depriving the countries from the benefits of international distribution of labor.

Owing to the impeding and fall of industry and consumption in all countries Smith calls colonial trade monopoly “dead freight burdening the operation of one of the biggest springs setting in motion a great part of the business activity of mankind”.<sup>28</sup> The only benefit, which monopoly brings about is for the monopolists “cashing” their specific privileges, and which is harmful for public interest. The latter are sacrificed in the name of the “petty interests” of a handful of monopolists, and public welfare – in favor of private interest. The principles of justice and equality are violated as concerns citizens. Therefore Smith is a staunch opponent to traders who uphold colonial trade, and of manufacturers who sustain the monopoly of internal market through duties and import bans. This army, hostile to free trade, an army of “grocers” aims at establishing an influence on governments with the purpose of “pushing” laws “guaranteeing the absurdities” of their monopolist status. “The defense of their petty interests “is at the expense of the sacrificed interests of national consumers, the “poorer provision of internal market with higher price goods” and the violation of the principles of justice and equality through the violated interests of the “greater part of the people”. The private interests of this “deplorable lot” of opponents to free trade threaten the government and even scare legislative authorities. At the same time “the boorish nuisance of partial interests” enjoys recognition, popularity and “reputation” among monopolists, while the advocates of free trade defending common welfare are subject to “base insults and ill talk, personal offence, and, at times, even their lives are endangered”.<sup>29</sup>

A dedicated proponent and defender of free trade, Smith allows for two instances of its restriction. One is related to the country’s defense and the other is

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<sup>28</sup> *Smith, A. Op. cit.*, p. 578.

<sup>29</sup> *Ibid.*, p. 453.

a countermeasure for equalizing the conditions of competition when a given article is taxed within the country. Notwithstanding, he does not spare the definition of the counterbalance of taxing foreign good “ as the most stupid way of compensating local productive labor”, and he asserts that the Navigation Act, related to the creation of a powerful shipping industry and the country’s defense, has not facilitated foreign trade and the growth of national wealth.

Smith upholds the understanding of the cosmopolitan nature of capital. He asserts that the latter has no national coloring, “it is not necessarily linked to a given country.”. To him the owner of capital is a citizen of the world. As a non-national subject he abides by the maxim “ibi bene, ibi patria”, i.e., your country is where things are good. When the income from the capital in a given country drops below the level of income, which for an equal capital can be realized in every other country /for example, as a result of a higher taxation/, there will be “leakage” of capital and the owner will transfer it “where he can more easily do business or use his property”.<sup>30</sup> “The easier utilization of property” is in fact linked to the more profitable implementation of capital in one’s endeavor to maximization of profits as the root cause and driving force of each economic activity in general. Thus Smith paves the way of the neoclassical explanation of the migration of capital with threshold productivity of production factors. The effects of capital spillovers for the exporting country he sees in “fall of productive labor in the country”, less employment, fall in industry and agricultural activity, curtailing the incomes (profits, rents and salaries) of the population.

### III

In the self-imposing “clear and simple system of natural freedom”, where the state does not intervene in the private economic activity of individuals Smith allows for state intervention as well, i.e., there is room for the state as well. This shows that he does not go to the extreme in his liberal views and does not entirely rule out the state from his liberal system. The pursuit of self-interest by individuals “based on the principles of equality, freedom and justice”<sup>31</sup> frees the sovereign from the fulfillment of obligations “for which there is not enough human wisdom and knowledge...to govern the industrial activity of private persons and direct it towards the branches, which most completely meet the interests of society”.<sup>32</sup> However this does not release him from the fulfillment of “the three obligations, which are very important, but simple and accessible to human reason”:

*First*, “to protect society from violence and invasion by other independent societies”, i.e., to secure the defense of the country.

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<sup>30</sup> *Smith, A. Op. cit.*, p. 825.

<sup>31</sup> *Ibid.*, p. 647-648.

<sup>32</sup> *Ibid.*, p. 671.

*Second*, “to establish good jurisdiction and law enforcement which relieves society members from injustice or subjugation by their fellowmen”. “The enhancing and flourishing of a state organism is possible under a strictly defined regime – the staunch regime of *perfect freedom and perfect jurisdiction*”<sup>33</sup> (my italic, L.K.). “The obvious and simple system of natural freedom” does not mean anarchy, it must be supplemented by order and law. Law with Smith is not elevated as a cult, in judicial fetishism, but it is a necessary condition /*in quo non*/ for the normal functioning of economy. Non-disturbed manifestation of the “invisible hand” must be attired in judicial norms. According to him freedom, reason and happiness of mankind is possible to thrive only where civil authority is capable of defending them. Like in human organism the hands are two, here as well the one “organ” – the invisible hand is supplemented by the “visible hand” of legislation, which guarantees abiding by the rules. The restraining “visible hand” of legislation is the necessary condition for “the natural course” of things and for “the governing of one’s own affairs in one’s own way”. Legislation must generate security in the population with regard to “the possessing of their own property” and the keeping of the voluntary contract obligations; or legislation must be “relying on the law and state authority for the execution of contracts and the regular effecting of compulsory payback of the debts by those who are capable of paying”,<sup>34</sup> and for the preventing of private use of “the natural freedom by individuals, who endanger the welfare of the whole society”.

To Smith trade and industry can rarely thrive in a country where there is not a certain degree of trust in the justice of the government. He imposes this not only on despotic governments, but the most democratic (the freest) ones as well. It is in compliance with the individual as well as with the public interest. “The strict, just and impartial jurisdiction” according to him is beneficial for all – for individuals as well as for the entire society, because “...it provides for everyone the fruits of their labor and thus encourages most efficiently every type of productive labor”.<sup>35</sup>

The significance Smith imposes on the judicial regulation of economic activity; the supplementing of market’s “invisible hand” with the “visible hand” of strict and fair jurisdiction; the highlighting of the role of judicial and public institutions (church, educational institutions, etc.) as well as the issues, not mentioned here, but developed in “The Wealth of Nations” on the significance of social norms in the behavior of economic agents (the ideas that no society thrives in case a considerable part of its population is poor); the growing incentives for labor (“hardworking”) as a result of higher remuneration; the search of ways of increasing the productivity of labor owing to increased

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<sup>33</sup> *Smith, A.* Op. cit., p. 658.

<sup>34</sup> *Ibid.*, p. 890.

<sup>35</sup> *Ibid.*, p. 596.

production expenditure as a result of higher salaries; the allowing of government intervention in economy (although it is reduced to a minimum), etc., all this shows that he paid the necessary heed as well to the institutional environment for the functioning of economy. All this gives sufficient grounds that Smith be considered as not only one of the forerunners of classicism, but that he has a deserved place among the forerunners of *institutionalism as well*.

*Third*, “the obligation to create and maintain certain public facilities and public institutions, whose creation and maintenance can never be in the interest of a private person or a small number of private persons, because the profit from them could never restore the expenditures of the private person or the small number of private persons.”<sup>36</sup>

The realms of state intervention are linked by Smith to “the common welfare of the whole society”; the provision of public goods such as national defense, police protection, legislative framework (which ensures the freedom of competition and entrepreneurship); activities and services, which do not “arouse” the hunger of private capital – the building of production and public infrastructure (the construction and maintenance of roads, bridges, navigation channels, ports, warehouses educational institutions, organizational and institutional forms, which monitor the complying with “the rules of the game” by economic agents, etc.).

With regard to the accomplishment of “public affairs” Smith alludes on the so-called external factors as well. He links their manifestation, first, with covering the expenses on “lighting and paving the streets of London” from the total revenues of the state through the collection of taxes from the citizens “without their benefiting from that” and, second, with the misuses of management and spending the revenues of the state. As an example of this second direction he points out “the construction of a splendid road in the wilderness, because it leads to the villa of the governor’s villa in the province”, or “the construction of a huge bridge over a river in a location where nobody goes through:, but the bridge “beautifies the view from the windows of a neighboring castle”.<sup>37</sup> This is why Smiths asserts that part of the expenses on public affairs, for example, construction and maintenance of roads, bridges, navigation channels, ports, etc..., must be covered by charges of those using them. The expenses on similar charges are incomparably smaller than the benefits of their utilization, owing to which Smith concludes that “...it is hardly possible ...to invent a more equitable way of maintaining such facilities”.<sup>38</sup>

“The involving” of self-interest in service of the social one on public activities Smith also seeks in the proposed methods of payment to judges, teachers, priests, clerks, and university lecturers. Expenses on jurisdiction must

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<sup>36</sup> *Smith, A. Op. cit.*, p. 596.

<sup>37</sup> *Ibid.*, p. 706.

<sup>38</sup> *Ibid.*

be covered by court fees and stamp-duties on legal procedure documents; teachers` salaries – by “temperate fees”, bearable to the common people, and partly by the state, which additionally renders scholarships (“small awards and honors”) to “the children of simple people who acquired knowledge with honors”. At schools remuneration must be linked to “reputation in the profession” and the earnestness of teachers, and there must be a combination of interests and obligations. Only given free competition and rivalry among competitors each one would do their job diligently and consistently, and not fulfill their duties “indifferently and slovenly”. As an example Smith points out the fiercely criticized by him university education, where “pseudo lectures” are given and a number of Oxford professors “for many years have not even pretended to be giving lectures”.<sup>39</sup> In order that competitiveness be consolidated in university education, he proposes that the beneficiaries of various scholarships from charity foundations have options regarding universities, mobility in training at different universities, students’ choice of lecturers, etc.

The above-mentioned thoughts on secondary school and university education seem not to be developed in “The Wealth of Nations” by Smith, but in the personal statement of Milton and Rose Friedman in “The Freedom of Choice”. According to Friedman at the state schools of poor central municipalities of USA the quality of training is very low, discipline – poor, the atmosphere – more appropriate for a prison than for an educational institution. At state higher schools low tuitions attract low quality students, and the handout received through funding by the state budget has a negative effect on students and lecturers as well as on administrators. Students do not receive from education “the full value of fees contributed”, lecturers are not evaluated by the quality of teaching, and administrators rise in their career owing to their abilities to raise funds from legislative bodies. Thus decisions are sought in funding higher education through tied credits and a voucher system, as well as in the introduction (in the name of the freedom of choice) of the voucher system in primary and secondary education as well.<sup>40</sup>

Smith’s ideas, developed in Chapter I of Book V of “The Wealth of Nations” on fostering self-interest and providing a part of public goods through state entrepreneurship fully correspond with exerted efforts for restructuring natural state monopolies under contemporary conditions (in sectors such as power engineering, rail way transport, gas supply, post office and telecommunications, water companies, etc.) in the way of privatization, demising to concession, various management contracts, services, etc.

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<sup>39</sup> *Smith, A.* Op. cit., p. 740.

<sup>40</sup> See *Фридман, М., Р. Фридман.* Свободата на избора. Лична декларация. “Дамян Яков”, Sofia, 1997, p. 232 - 291.



In general, the remuneration of public activity employees must correspond to execution and exerted effort. This principle must not be violated despite the difficulties determining their quantitative value. Remunerations must “correspond as best as possible to the nature of the job” – if they are too low the system will incur losses owing to “the mediocrity and incapability” of employees, and if they are too high – owing to “their idleness and negligence.”<sup>41</sup>

To Smith maintaining the mode of natural freedom, “leaving crafts to themselves is an irrevocable rule of state authority”. To him “there is not a more incompatible combination of that of a trader and a ruler”. Commercial spirit makes the ruler a bad governor, and authoritative spirit on its part also makes a bad trader.<sup>42</sup> Therefore economic activity must be accomplished “in a natural course”, with natural market regulation. It is not necessary for one to govern things which are self-regulated naturally, and to make useless effort and expenses to that end. “The natural endeavor of every man to improve his lot when left to act freely and securely, Smith writes, is *such a powerful principle that it is only him* (my italic, L.K.), without any collaboration, who is not only capable of leading society to wealth and prosperity”,<sup>43</sup> but also of overcoming “the irrelevant” obstacles imposed on him by “the folly of human laws”. The administrative fostering orientation of capital on the part of governments to certain branches in greater amounts than their “natural inflow” under free competition or their deviation as a result of restrictive “extraordinary constraints” in a greater amount than their “outflow” under the natural course of events “...in fact *acts contrary to the main goal, which is sought. It impedes the advance of society to actual wealth and glory, instead of accelerating it, and reduces the actual value of the annual product of its land and labor* /my italic, L.K./, instead of increasing it”.<sup>44</sup> The sovereign /government/ must be released from the obligation to direct and govern private persons` activities to certain branches, but it must leave them to the natural regulation of competitive market forces, because it corresponds to the fullest to the interests of society. It can be seen that Smith asserts the understanding of nonintervention of governments in economy and he views the state as an arbiter and not a participant in economic activity. Moreover, he claims that there is no “human wisdom and knowledge” on the part of the government, so that it cannot govern industrial activity.

Smith’s ideas on the lack of “human wisdom and knowledge” in regulating economic activity are extended and they turn into the principal cognitive thesis in the philosophical conception of the building block of liberal values during XX century – Fr. Von Hayek. To him “knowledge never exists in a concentrated or

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<sup>41</sup> *Smith, A. Op. cit.*, p. 789.

<sup>42</sup> *Ibid.*, p. 795.

<sup>43</sup> *Ibid.*, p. 524.

<sup>44</sup> *Ibid.*, p. 671.

integrated form, but only in the form of dispersed particles of incomplete and often contradictory knowledge possessed by each individual".<sup>45</sup> Individual human knowledge is partial, limited and fallible, it is "known to nobody" in its entirety, and each one knows not much". Individual human knowledge refers not to "the totality of things or events", but to "a certain aspect or piece of reality". Thus there is an endless variety of contradictory facts and opinions, which are continuously developed, changed and enriched. Since "the significant complexity of the social organism does not allow the pretence of all-knowledge",<sup>46</sup> it is not possible for one to compile a complete and objective picture of society and economy. The fact that "the utilization of knowledge is not granted to anybody in its entirety" hinders the attempts for an explanation and rational impact on social processes. Therefore socialists are also "victim of fatal self-assuredness" and "economic central planning is basically unfeasible". People can to a certain degree understand the relationships between phenomena and processes, but they cannot govern them. Hayek links implicit and incomplete knowledge to his conception of "spontaneous order" according to which economy should not develop "according to the conscious plan and intentions" of people oriented to the fulfillment of strictly defined tasks, subordinated to common goals. On the contrary, economy must function on its own, spontaneously and as a result of "unintentional observing of definite traditional and moral practices", abiding only by "the abstract rules of behavior". We must learn "not to manage coarsely" economic activity, but "to shape the mould appropriately", for example, the way the craftsman shapes his article; we must "have the approach of gardeners who cultivate phenomena like plants",<sup>47</sup> creating conditions for their growth. The above-mentioned completely confirms Hayek's conviction, who considers himself a follower of "the Scottish school" thinkers, such as A. Ferguson, A. Smith and David Hume.

In addition, as early as Smith we come across one of the maxims of liberalism in an embryonic form – on the state being a bad owner. Incompatible with natural freedom is not only the combination of trader and ruler, but ruler and owner as well. According to Smith the sale of royal land in every great monarchy in Europe and their turning into private property would lead within several years "to their better cultivation and management". This would generate the growth of their product, of the income and consumption of the people, and, eventually, to the growth of population in the country.<sup>48</sup> What is valid of the

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<sup>45</sup> Хайек, Фр. Индивидуализм и экономический порядок. М., Изд. "Изограф", Изд. "Начала-Фонд", 2001, p. 89.

<sup>46</sup> Ibid., p. 43.

<sup>47</sup> Хайек, Фр. Методологический индивидуализм и задача социальных теоретических наук. – In: Хайек, Фр. Познание, конкуренция и свобода. Антология сочинений М., "Пневма", 1999, p. 45.

<sup>48</sup> Smith, A. Op. cit., p. 800. Population is not viewed by Smith as a given restricted factor, but as variable, having an impact on the value of annually consumed "basic necessities and living

land refers to the rest of production factors as well. Smith asserts that “it is not possible to keep other people’s money with such caring alertness”, with which “a private company’s associates keep their own money”.<sup>49</sup> Although the above-mentioned envisages the directors of limited companies, it is completely true of the civil servants managing “people’s money.

Summarizing Smith’s notions on the role of the state in economy we can conclude that he is a proponent of *maximal competition and market, and minimal, but strong state*. This means governments should focus their efforts to fulfill their primary functions – those of a “caretaker” state. Its intervention in economy should be restricted and complementary. Should we use the stages in the development of capitalism founded by the French economist M. Albert Smiths conceptions correspond to the first stage of “capitalism (market – author’s remark, L.K.) versus state”. This is a classical liberal conception in the old English sense, which does not fully correspond to what has been imposed as theory by the neo-classics, and M. Thatcher, R. Reigan and other governors of the 1980s as the economic policy of “capitalism (market) versus state”.<sup>50</sup>

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The analysis made gives grounds for several conclusions.

1. Economic thought owes Smith the pattern of homo economicus, led by his economic self-interest. Self-interests are ultimate basis of economic development. Carrying out activities ensuing from their self-interest, economic agents contribute to the growth of public welfare. Personal benefit is not contradictory to public interests; it acts in the same direction and in concert with them as a way of their realization.

2. In the famous metaphor of “the invisible hand” of the market, Smith reveals the “conductor” of individuals’ selfish interests in the conditions of free competition. Under “natural freedom and order” market economy is only archaic at first glance. It should not be identified with economic anarchy. In fact its development is subordinated to strict “natural” laws, independent of the will and consciousness of men. In an embryonic form he has developed the conception of optimal resource distribution under the conditions of complete competition.

3. “The Scottish sage” gives grounds for the positive effects of free foreign trade activity, stigmatizes the constraints on free international trade and qualifies them as unreasonable, useless, absurd, etc. The two cases discussed by him as cases of protections in foreign trade activity, related to defense and

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comforts”. As a fund for supplying those products productivity of labor along with the number of those employed in: useful” labor have an impact on annual labor, and the growing of population is one of the ways to achieve welfare.

<sup>49</sup> Ibid., p. 722.

<sup>50</sup> See Альбер, М. Капитализм против капитализма (пер. с франц.). - In: Экономическая школа. Санкт-Петербург, 1996, p. 265 -267.

the equalizing of the terms and conditions of trade, he determines as “the most foolish way of compensation of local productive labor”.

4. Smith is an opponent of interventionism in economy. He defends the thesis of as maximal competition and market as possible, and of a minimal state. However, to him market economy does not mean lawlessness. Complete freedom in economy is unthinkable without “perfect jurisdiction”, secured by the state. Free manifestation of “the invisible hand” is arrayed in judicial norms. He rather assigns to the state the functions of a guarantor (“caretaker”) with a limited and complementary intervention in economy.

Smith gives grounds for his understanding of the cosmopolitan nature of capital. To him the owners of capital are citizens of the world. By his vision in this realm he paves modern neoclassical explanation of the migration of capital with the threshold productivity of the factors of production.

Based on the above-mentioned we can conclude that Adam Smith is not the founder of the liberal economic tenet, but he lays the liberal principles at the basis of economics, incorporates them as a building block and inevitable condition of the economic system he creates.

There is a telling incident in A. Smith’s biography told by the Russian historian of economic thought A. Anikin. In 1787 during his stay in London Smith went to a reception party attended by the elite of society, including England’s prime minister at that time William Pitt. On Smith’s entering the room everybody stood up. In a professorial manner he raised his hand and gestured for them to sit down. However, the Prime Minister approached Smith and said: “After you, doctor, we are all your students here”.<sup>51</sup> Maybe the Prime Minister of England, owing to the reforms carried out by him in the field of trade, had good reason to call himself a student of Smith’s. However, this remains valid even better with those who consider themselves economists. Nowadays, as well as in the future.

1.XII.2005

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<sup>51</sup> *Аникин, А. В. Младостта на науката. “Наука и изкуство”, София, 1978, р. 215.*