ADAM SMITH'S POLICY OF INTERNATIONAL TRADE

Trade policy in a mercantilist world

AUKE R. LEEN

Abstract

One of Adam Smith's foremost contributions to economic science is his compelling case for free trade. In the paper we do give Smith's framework for thinking about the economics and politics of international trade in a mercantilist world. A world that is hostile to the competitive market economy or what he called "an obvious and simple system of natural liberty". For Smith the goal of economic policy of a country was not to increase exports to its colonies and other nations and to limit imports from them, and in this way to end up with a favorable balance of trade. In other words, the goal was not an increase in the amount of precious metal for the sovereign (bullionism). For Smith the goal should be to open up new free-trade markets and to increase competition. International trade not only increases the division of labor, but it decreases also the likelihood of domestic monopolies. In general, trade does increase "the exchangeable value of the annual produce of the land and labor of the country" for everyone. The paper is meant as a historical reconstruction of Smith's ideas on international trade. The terms, problems, and theoretical approach of Smith are described as they were intended in their original context. Hence we do stay close to Smith's original writings.

JEL classification: B310, F13, F60

Keywords: Adam Smith, international trade, protectionism, mercantilism

1. Introduction

In book four of his *magnum opus*: *An Inquiry into the causes and nature of the wealth of nations*, of 1776 (1), Adam Smith gives an extensive discussion of the advantages of international trade and what to do if other countries do not stick to the maxim of free international trade. The whole book is an antidote against the monopolizing spirit of the mercantilists. Mercantilism has as its object "to diminish as much as possible the importation of foreign goods for home consumption, and to increase as much as possible the exportation of the produce of domestic industry. Its two great engines for enriching the country, therefore were restraints upon importation, and encouragements to exportation" (Smith, 1776, IV.1.35). Both last measures are as vital today as they were in Smith's time. It is also of interest to take a closer look at what Smith said in his days.

In short, in this paper we look at what, as is said, this great Scottish expounder of economic liberalism and the policy of *laissez-faire* has to say on international trade in general and more specifically on the selfsame mercantilist ideas today as he attacked in his days. Smith, however, is aware that complete free trade is an unrealistic goal. “To expect, indeed, that the freedom of trade should ever be entirely restored in Great Britain is as absurd as to expect that an Oceana or Utopia should ever be established in it. Not only the prejudices of the public, but what is much more unconquerable, the private interests of many individuals, irresistibly oppose it” (IV.2.43). We can also think of the “Member of Parliament who supports every proposal for strengthening this monopoly is sure to acquire not only the reputation of understanding trade, but great popularity and influence with an order of men whose numbers and wealth render them of great importance”(IV.2.43). Or, as said elsewhere with regards to some existing laws, “we may perhaps say of it what was said of the laws of Solon, that though not the best in itself, it is the best which the interests, prejudices, and temper of the times would admit of. It may perhaps in due time prepare the way for a better” (IV.5.92).

2. Smith’s theory of international trade and the system of individual liberty

What did this, as is often said, absent-minded, colorless professor of the University of Glasgow and commissioner of the customs (his father was a customs official too) wrote (cp. Schumacher, 2012: 55-57) during his, as described by all historians, uneventful life from 1723 till 1790 (e.g. Schumpeter, 1954: 181-186 and Skousen, 2007: 12-15) (2). More to the point, however, Adam Smith is mentioned almost universally in the standard accounts of the history of economic thought as the founder of economic science. For Joseph Schumpeter, however, it is an insignia “none of his contemporaries would have thought of bestowing on him” (1954: 194). The acclaim for Smith’s *Wealth of Nations* goes from “ ’probably the most important book that has ever been written,’ not excluding the Bible” (as mentioned in Skousen, 2007: 12), to, “Smith originality consists only in his failures, for the rest he did digest, not very systematically, other men’s ideas, expressed before by them much more clearly” (Taghizadegan, 2012: 25). As far as his theory of international trade goes, however, his fame is not that great. For Schumpeter, Smith “believed that under free trade all goods would be produced where their absolute costs in terms of labor are lowest” (1954: 374 and 607); he never went beyond stating what we call today the theory of absolute advantage (3) (4).

In the following, we will focus on “a theorem of almost unlimited power on the behavior of man: his [Smith’s] construct of the self-interest-seeking individual in a competitive environment” (Stigler, 1976: 1212). Or as Smith called it “an obvious and simple system of natural liberty” (IV.9.51). We will apply the concept to international trade. Though international trade, of course, has the same cause as any trade. It is the consequence of the human “propensity to truck, barter, and exchange one thing for another” (I.2.1).

Just as any human endeavor, for Smith, trade is also based on the universal tendency of pursuing one’s self-interest. This behavior, however, is restrained by the laws of justice. “To hurt in any degree the interest of any one order of citizens for no other purpose but to promote that of some other, is evidently contrary to that justice and equality of treatment which the sovereign owes to all the different orders of his subjects" (IV,8.30). In other words: " Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring his industry and capital into competition with those of any other man, or order of man" (IV.9.51) (Cp. Heyne, 2008: 391-392 and Buchanan, 2001a: 296-298).

As self-interest, in general, is the underlying cause of all human behavior, for trade, in particular, however, it is the division of labor and the increase in wealth as a result. Since the only limitation on the division of labor is "the extent of the market" (I.3.1), we can safely infer that if by international trade the market is expanded, economic growth and wealth will increase. The international market is simply bigger than the domestic market. It should also not be a surprise for us that for Smith, "The discovery of America, and that of a passage to the East Indies by the Cape of Good Hope, are the two greatest and most important events recorded in the history of mankind" (IV.7.166).

3. Book IV: Of Systems of Political Economy

Smith starts his book IV on international trade, which compromises about a quarter of the whole *Wealth of Nations*) (5), with stating something quite obvious for us but certainly not in his time: an import restriction or export subsidy has not only a direct effect on the industry effected but has also an effect on the economy as a whole (IV.1.45) (Cp. Irwin, 1996: 76). Smith shows that not only single merchants but the society as a whole benefits or loses from the mercantilist policy to stimulate exports and to hinder imports. For Smith, e.g., an import restriction, though to the advantage of the protected industry, is detrimental for the competition in a country; it makes an industry lazy and gives the inland industry monopoly power. As a result, the price level rises.

Next, we come to the point in the *Wealth of Nations* in which Smith mentions, what George Stigler (1976: 1201) has called "the crown jewel" of the book: the invisible hand (6). For Stigler it is "the most important substantive proposition in all of economics." Smith's problem is how to give analytically the effect of government policies on the economy as a whole. Individuals use their labor and capital there, where the gain is the biggest. While doing that they are looking at their self-interest. By doing that, however, they are forced to invest their money where society values it at the most----"*led by an invisible hand to promote an end which was no part of his intention"* (IV.2.4, 8-9). In this process the competitive market, Smith system of natural liberty, takes center stage. If a foreign country can supply a good cheaper than we can, for sure it is better to buy it abroad with a part of our own produce than to produce it ourselves. "It could, therefore, have been purchased with a part only of the commodities […] which the industry employed by an equal capital would have produced at home, had it been left to follow its natural course" (IV.2.12). In short, we can buy it with only a part of the produce which we could have produced if we had led the economy run its own course: there were a free market and the self-interest of the producer had brought us. This conclusion is completely the opposite of the one made by the mercantilists; it is also first and foremost with international trade that Smith proclaims that the national income of a country necessarily goes down with government intervention. Given the existing stock of capital and labor, if the produce in one sector of the economy rises, that of another sector can only go down. The wealth of nations can only grow if capital grows as a result of individual savings. Government intervention let revenues go down and in this way the possibilities of saving and the formation of capital (IV.2.13).

Smith not only mentions the static advantages of international trade; we sell goods of which do have abundance (vent-for-surplus). He also mentions the dynamic advantages of trade. Trade does increase the division of labor; trade increases specialization which increases productivity. International trade, however, also shares the knowledge all-over-the-world of new ways of producing goods (IV.7.166). And finally, because of international trade, domestic producers are confronted by increased competition; the likelihood of domestic monopolies decreases.

But what should we think of the balance of trade if free trade prevails? Of all ruin foretold by "the pretended doctors of this [mercantilist] system" because of an unfavorable balance of trade nothing has happened. The more free trade we do have, the richer a country is (IV.3.43). In general, the whole focus on the balance of trade is for Smith the result of the idea that wealth consist in money. "[A] popular notion which naturally arises from the double function of money, as the instrument of commerce and as the measure of value" (IV.1.1). In other words, it is the ambiguity of the expression that money in common language frequently signifies wealth that has rendered this popular notion so familiar to us (IV.1.34).

For the encouragement of domestic industry, there are two legitimate cases that justify a restriction or duty on imports. A first reason for protection is if an industry is important for national defense. For Smith defense is of much more importance than opulence. Safety, however, is finally not an economic argument. Though Smith also mentions, as an economic argument, that keeping a standing army of sailors in peace time would probably be more expensive (IV.5.27). This since the defense of Great Britain depends on the number of sailors and shipping. As an example he mentions the act of navigation: a series of laws, started in 1651, that restricted the use of foreign shipping for trade between England and its colonies. For Smith the act was "perhaps the wisest of all the commercial regulations of England" (IV.2.30). Though it was, next to national animosity against the wealth of England's neighbors, especially Holland, for sure the "monopolizing spirit of merchant and manufacturers" (IV. 3.38) that started the process of law-giving. In general, however, "though dangerous in war and politics, it is certainly advantageous in trade" (IV.3.40) to have a rich neighboring nation. "As a rich man is likely to be a better customer to the industrious people in his neighborhood than a poor, so is likewise a rich nation" (IV.4.40).

A second reason for protection is the situation when inland goods are taxed but foreign goods are not. In that situation, an import duty levels the playing field for all industries. Though some people, Smith says, do say that the limitations on trade should be extended much farther. We should not only look at the necessaries of life imported from other countries but at all sorts of foreign goods. The reason is that since subsistence becomes necessarily dearer in consequence of such taxes, the price of labor will rise and hence all other goods also become dearer. For Smith, however, first it is impossible to know with exactness how much indeed the price of any commodity increases for this reason. Second, those taxes would have the same effect upon the circumstances of the people as a poor soil and a bad climate. In that case too it is the best to let the people find out themselves those employments in which they might have some advantage either at home or in the foreign market.

Next to the just-given general reasons, there are two practical things to look out for in the case of import restrictions. First, suppose a country restricts our trade, do we, in return, do the same? In the real world, Smith mentions, a country always reacts in this way. Smith, however, does give the practical advice to look if there is a chance that the retribution will be successful. This, however, too is a non-economic argument. If there is no hope that the import restriction is repelled, it is not a good tactic. Not only the industry concerned has a handicap but the whole country has because of the expected inevitable counter measures of the other country (IV.2.39). There is a second practical point if we lower our import duties. What should be the speed by which to introduce free trade after it has been interrupted for some time by high duties? If the country needs to make big inland adaptations, a gradual introduction, for reasons of humanity, is to be preferred. Though for Smith the damage is probably much less than is commonly expected. Smith, e.g., mentions how speedy after a war the superfluous soldiers and seamen do find a new job. And for sure, Smith continues: “Our manufactures have no doubt great merit with their country, but they cannot have more than those who defend it with their blood, nor deserve to be treated with more delicacy” (IV.2.42). The best policy for speedy adjustment after lowering import duties might therefore be to restore the natural liberty of the people, e.g., by breaking down the exclusive privileges of corporations, repealing the statute of apprenticeship and the law of settlements. In general, for Smith, in these matters decision-making is a political process in which the economist can only give advice. For sure, however, every measure that curtails international trade lowers the welfare of the country.

Smith also looks at foreign export subsidies or what he calls bounties upon exportation. With a subsidy, in fact a foreign country is paying us for consuming its goods (IV.5.1). For Smith this is a rather stupid strategy since it forces a country to produce in a direction it would never have chosen if it was free to choose. The trade is actually disadvantageous since it cannot be carried on but by means of a bounty. As a result the general welfare in the country that subsidies its exports is lower.

In a short chapter: Of Treaties of Commerce (IV: 6), Smith discusses the treaty of commerce between England and Portugal of 1703. The main aim of the Treaty was to supply England with enough gold for coinage and hence to seigniorage: the government’s revenue from the creation of money.

In his last chapter, before the conclusion, Smith extensively discusses the role of colonies (IV: 7). For Smith colonies in general and the American colonies in particular were not worth the cost of their support even if they wanted to remain part of the empire. Free trade would be much more advantageous than a monopoly of the colony trade. Smith proposes to depart from the colonies as good friends and predicts that “the natural affection of the colonies to the mother country […] would quickly revive. It might dispose them […] to favour us in war as well as in trade [… and] become our most faithful, affectionate, and generous allies (IV. 7.152). Smith, however, was well aware that “[n]o nation ever voluntarily gave up the dominion of any province, how troublesome soever it might be to govern it, and how small soever the revenue which it afforded might be in proportion to the expence which it occasioned (IV.7.152). Notwithstanding that, “Smith advocated the complete emancipation of America from all dependency upon England. He even proposed transferring Canada, Nova Scotia, and the Floridas to the new states or returning them to France and Spain” (Morrison, 2012: 409) (7).

Smith ends his discussion on international trade with the remark that though the goal of mercantilism to increase the welfare of the country is noble, the result is the opposite. A country grows by innovation; it does not grow by a decrease in the production of his neighbors and to put competition out of order. The interests of the consumers are sacrificed to that of the producers. It looks like production, not consumption, is the goal of all trade (IV.8. 48-49).

4. Summary and conclusion

For Adam Smith, political economy as a branch of the science of a statesman or legislator has as its objects, next to supply the state with a revenue, “to provide a plentiful revenue or subsistence for the people”, or, and that is the kernel of the *Wealth of Nations*, “more properly to enable them to provide such a revenue or subsistence for themselves” (IV.1.1). The focus of the book lies on how the mercantilist system operates so as to reduce the level of revenue for the people. Book IV, in particular, is a demonstration of mercantilist failure and, what is just as important for Smith, how mercantilism arbitrarily restricts personal liberty. The market, also, reduces the need for collective or political choices, “the market serves a *political* as well as an *economic* function—one that may well be the more important of the two” (Buchanan, 2001b: 358). On the basis of the underlying behavioral reality that people try, in general, to improve their own well-being, Smith shows the inadequacies of the mercantilist policies.

In sum, for Smith the division of labor, or specialization, is at the basis of economic growth. Hence the extent or size of the market, both the internal and external market, is of great weight. The political function of the statesman or legislator in making detailed direction of resource use is unnecessary. Book IV let us understand the economic limits of politics. We do have to make a “distinction between structural (constitutional) and hands-on adjustments” (Buchanan, 2001a: 303). On the one hand, the size of the network of market interdependence is a critically important institutional variable. On the other hand, the mercantilist network of regulatory controls only reduces the wealth of the nations.

Smith concludes Book IV, by stating that “the obvious and simple system of natural liberty establishes itself of its own accord”. In other words, “[e]very man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way” (IV.9.51). The duties of the sovereign are for sure not the mercantilist duties to increase as much as possible the exportation of the produce of domestic industry by restraints upon importation, and encouragements to exportation (IV.1.35) (8).

Notes

1. Smith started to write *The Wealth of Nations* while traveling in France in 1763 as the tutor of the stepson of Charles Townshend. Townshend later became Britain's treasury minister and had many discussions with Smith on the subject of this paper. He held Smith in high esteem (Morrison, 2012: 406). To finish the book, however, took him until 1776.

2. For a recent biography of the life and times of Smith see Nicholas Phillipson (2010).

3. It was David Ricardo who stated the theory of "comparative advantage, the bedrock on which the case for free trade stands even today" (Irwin, 1996: 218). For Smith absolute advantage is determined by a simple comparison of labor productivity across countries. Hence it is possible for a country to have an absolute advantage in nothing. Ricardo, however, looked at labor productivity ratios. Technologically backward countries can be part of a world trading system even thought their labor productivity in every good may be lower than that in the developed countries. Ricardo linked specialization with opportunity costs, which is the basis of modern trade theory. See Ricardo (1817 [1821]) Chapter Seven: http://www.econlib.org/library/Ricardo/ricP2a.html#Ch.7, On Foreign Trade.

4. For Buchanan and Yoon (2002) Smith and Ricardo do represent two different logics of trade. For Smith persons do trade because specialization is productive, "people can produce more economic value if each person does one thing instead of trying to do everything" (2002: 400). People also do not need to differ in their relative capacities to produce. For Ricardo persons do trade because of differences among persons in their capacities to produce separate final goods. Hence for Smith, but not for Ricardo, market extension (globalization) does not lead to permanent differentials in rewards. As a result "the basic Smithean logic generates a stronger support for extensions of the market nexus that does a comparable incorporation of the Ricardian logic" (2002: 401).

5. In Book IV Smith discusses two systems of political economy: the system of commerce or mercantile and that of agriculture. We look at the mercantile system. In the agricultural system, the produce of the land is represented as the sole source of the revenue and wealth of every country. In Chapter IX: Of the Agricultural Systems Smith discusses the famous *Tableau Économique* of François Quesnay. "The capital error of this system, however, seems to lie in its representing the class of artificers, manufactures, and merchants as altogether barren and unproductive" (IV.9.29). The discussion of the agricultural system takes only a few pages of Book IV. Since, in Smith's own words, it is a system "which never has done, and probably never will do, any harm in any part of the world" (IV.9.2) and for that reason is not worthwhile to examine at great length.

6. Smith mentions the expression "invisible hand" only three times in his writings (cp. Skousen, 2007: 21-22). The first time is in his *History of Astronomy*. In it he does discuss superstitious

people who ascribe unusual events to the work of unseen gods, "nor was the invisible hand of Jupiter ever apprehended to be employed in those matters" (See the Online Library of Liberty: http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=201&chapter=56013&layout=html&Itemid=27.

In *The Theory of Moral Sentiments*, Smith writes about rich landlords, who "are led by an invisible hand to distribute much of their substance among a circle of retainers, and so, without intending it, without knowing it, advance the interest of the society, and afford means to the multiplication of the species" (See The Online Library of Liberty: http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=192.

7. For the story of the influence of Smith on the Earl of Shelburne (prime minister from 1782-83) and Shelburne's vision on the struggle for independence of the United States, see Morrison (2012). Shelburne made a complete *volte-face* from mercantilist to free-trader after a journey he made with Smith from Edinburgh to London in 1761.

8. The duties of the sovereign are "first the duty of protecting the society from violence and invasion of other independent societies, secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it […], and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions" (IV.9.51).

References

Buchanan, J.M., (2001a), Adam Smith as Inspiration, in: J.M. Buchanan, *Ideas, Persons, and Events*, the Collected Works of James M. Buchanan, Indianapolis: Liberty Fund.

Buchanan, J.M., (2001b). Reform without Romance. First Principles in Political Economy, in: J.M. Buchanan, Ideas, Persons, and Events, the Collected Works of James M. Buchanan, Indianapolis: Liberty Fund.

Buchanan, J.M. and Y. J. Yoon (2002), "Globalization as Framed by the Two Logics of Trade", *The Independent Review*, Vol. VI (3), Winter 2002: 399-405.

Heyne, P. (2008), *"Are Economists Basically Immoral?" and Other Essays on Economics, Ethics, and Religion*, Indianapolis: Liberty Fund.

Irwin, D.A., (1996), *Against the Tide, An intellectual history of free trade*, Princeton: Princeton University Press.

Morrison, J.A. (2012), Before Hegemony: Adam Smith, American Independence, and the Origins of the First Era of Globalization, *International Organization*, Vol. 66 (3), July 2012: 395-428.

Phillipson, N. (2010), *Adam Smith: An Enlightened Life*, New Haven & London: Yale.

Ricardo, D. (1817), *On the Principles of Political Economy and Taxation*, London: John Murray.

Schumacher, R. (2012), Adam Smith's theory of absolute advantage and the use of doxography in the history of economics, *Erasmus Journal for Philosophy and Economics*, Vol. 5, Issue 2 (Autumn 2012): 54-80.

Schumpeter, J.A., (1954), *History of Economic Analysis*, New York: Oxford University Press.

Skousen, M., (2007), *The Big Three in Economics. Adam Smith, Karl Marx and John Maynard Keynes*, Armonk, NY: M.E. Sharpe.

Smith, A. (1776). We use the fifth edition (1789) of the *Wealth of Nations* as this edition can be found at http://www.econlib.org/library/Smith/smWN.html. It is the last edition that was published during Smith's life time, as published in 1904 by Edwin Cannan (Methuen and Co, Ltd).

Stigler, G.T., (1976), The Successes and Failures of Professor Smith, *Journal of Political Economy*, Vol. 84, No. 6 (Dec. 1976): 1199-1213.

Taghizadegan, R., (2012), *Wirtschaft wirklich verstehen. Einführung in die Österreichische Schule der Ökonomie,* München: FinanzBuch Verlag.