

TOPICAL STUDY #19

THE TRIUMPH OF ADAM SMITH

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Economics

I. Introduction

Communism collapsed suddenly and unexpectedly in Eastern Europe at the end of 1989. In the Soviet Union, the Communist Party still rules, but the extraordinary social and economic chaos gripping the country suggests that the party's days are numbered. In the West, many commentators acclaim the triumph of capitalism over communism. However, neither the success nor the survival of capitalism is guaranteed by the failure and demise of Soviet communism.

Capitalism is a legal system that safeguards private property and permits free trade in competitive markets. Individuals are free to pursue their self-interest. As long as self-interest is restrained by competition, society benefits from lower prices and greater choices. The problem is that the powerful forces of self-interest have a natural tendency to collusion and corruption. In other words, capitalists tend to seek power and to use it to rig the market in their favor to the detriment of society.

The intellectual father of capitalism is Adam Smith. He observed over 200 years ago that the competitive market, as if by an "invisible hand," transforms self-interest into a force for public good. Smith explained how competition maximizes productivity and social welfare by assuring the optimal allocation of capital and labor in the overall economy. Yet, always a pragmatist, he recognized that capitalists could corrupt the system: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

Karl Marx predicted that capitalism would eventually collapse as a result of this and other internal contradictions of the system. Marx believed that the distribution of income and wealth would become increasingly unequal under capitalism. When the workers could no longer tolerate being exploited by the capitalists, a communist revolution would result. Initially, Marx said, there would be "a political transition period in which the state can be nothing but *the revolutionary dictatorship of the proletariat*," which would seize all private property from the capitalists on behalf of the working class. Eventually, class distinctions would disappear. Then the state would wither away and be replaced by an international, and presumably democratic, commune of the proletariat.

Marx devoted virtually all of his economic writings to an unrelenting attack on capitalism. He provided only the sketchiest of outlines as a guide to how a communist society would function. In countries that embraced Marxism, most property and the means of production are owned by the state. Citizens of the communist state are expected to work for the good of the community. The goods and services that they produce are also

owned by the state and are distributed among the members of the community by the governing communist party. Most economic activities are centrally planned by government bureaucrats. Only a few transactions are permitted to take place outside of the administered, or “command,” economy in tightly regulated markets.

Marx predicted that a society that was organized in a communist fashion would deliver the greatest welfare for the most people. That was the theory. In practice, the results have been disastrous. Every day the devastating consequences of Soviet communism are becoming more apparent. The ecological damage has been immense. Corruption and incompetence have stifled economic creativity. Central planning has produced massive economic stagnation and waste. Technology is often primitive and even dangerous, as demonstrated by the Chernobyl catastrophe. Products are inferior in quality and scarce in supply. The standard of living is miserable. Health conditions are among the lowest in the world.

On the other hand, Adam Smith’s predictions have been remarkably accurate. It is in this predictive sense that recent events mark the triumph of Adam Smith’s ideas over those of Karl Marx. Capitalism has outlived communism. Although capitalism tends toward an unequal distribution of income and wealth, it has delivered far greater prosperity to far more people than any other economic system. And in an ironic twist, it certainly confounded communists—most notably Marx, Engels, and Lenin—who predicted that capitalism would eventually collapse. Smith did warn that special interests could do a great deal of harm, but he believed that the power of capitalism would prevail. And it has.

Unlike Marx, who was a revolutionary, Smith was a reformer. Where Marx saw class struggle, Smith saw special interests that were often at odds with the public interest. If he were alive today, it is unlikely that he would join the chorus of triumphant anticommunists. Instead, he would warn that capitalism is prone to excess. He would observe that vigilance is required to ensure that the political system is not manipulated for the economic benefit of a few to the detriment of the entire society. He would be advocating political reforms to make sure that the system is not corrupted by special interests.

Smith recognized that in a capitalist economy some individuals might become much wealthier than others: “The order of proprietors may, perhaps, gain more by the prosperity of society, than that of labourers: but there is no order that suffers so cruelly from its decline.” Smith argued that as long as there was economic growth, the rich would get richer, but the poor would also be better off. Marx, of course, predicted that the poor would become poorer.

Smith and Marx do have something in common. Both attempted to formulate comprehensive and integrated models of society, economics, and politics. They stand out as two of the greatest political economists of all time because their intellectual reach was so ambitious. Neither one, however, fully finished the job.

The political foundation of Marx’s utopia always had a critical structural flaw. He never explained how the members of the transitional dictatorship would be chosen, and why they would voluntarily relinquish their authoritarian power once they had confiscated all private property. Similarly, Smith failed to resolve the grand political enigma that he himself posed: How can a capitalist society be protected from being corrupted by the special interests that are an integral part of its political economy?

Smith did devote a considerable amount of effort to constructing a theory of law and politics. But he was never satisfied with his work. Very early in his intellectual career, he

hoped to construct a definitive theory of the three types of human interaction—social, economic, and political. He managed to complete path-breaking works on the first subject, *The Theory of Moral Sentiments* (1759), and the second, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, which he spent ten years writing from 1767 to 1776. But the third book on jurisprudence, which he considered the most important, he never completed.

In his first book, Smith attempted to explain what motivates human behavior. In his second and most famous book, he argued that a free-market economy was the economic order best suited to human nature. But he never adequately explained what sort of political system was necessary to protect the competitive market from the manipulations of the special interests—though he did try. In an “advertisement” to the sixth edition of *Moral Sentiments*, Smith admitted late in his life that he no longer expected to complete the overall project:

What remains, the theory of jurisprudence, which I have long projected, I have hitherto been hindered from executing, by the same occupations which had till now prevented me from revising the present work. [M]y very advanced age leaves me, I acknowledge, very little expectation of ever being able to execute this great work to my own satisfaction

Just before he died on July 17, 1790, Smith asked his close friends to bum several folio volumes of his papers. They did, and he reportedly was quite relieved once the deed was done. In the two thirds of the system he did complete, Smith made enormous intellectual contributions to political economy.

Two hundred years after his death, his ideas remain as relevant as ever. The savings and loan debacle in the United States is an extraordinarily good example of the damage that special interests can do. Yet, the fact that the U.S. economy has continued to expand despite this and numerous other shocks, including the 1987 stock market crash and the 1989 collapse of the junk-bond market, strongly supports Smith’s unswerving faith in the resilience of the capitalist system. His brilliant expose of how mercantilism and protectionism lead to economic stagnation still stands as the most influential manifesto guiding so many governments to privatize their industries, to deregulate their markets, and to join their nations in free trade. His optimism was both refreshing and accurate during the late 1700s, when so many pessimists predicted ruin. His optimism is just as compelling today.

II. Self, Special, And Public Interests

Over the past two centuries, Adam Smith’s insights have been trivialized by his critics and disciples alike. His work is commonly associated with two phrases—the “invisible hand” and “laissez faire.” Actually, the first phrase appears only twice in his published writings. Still, the metaphor is useful because it neatly conveys the idea that individuals pursuing their self-interests inadvertently improve the condition of others. But the invisible hand hardly encapsulates Smith’s world view. Neither does the second phrase, which does not appear even once in Smith’s work. Yet “laissez faire” is frequently used to describe the central theme of *The Wealth of Nations*.

Today, Adam Smith is often remembered as a champion of the capitalist class. Nothing could be further from the truth. Contrary to the conventional view, Smith did not advocate unrestrained capitalism, and he certainly was not an admirer of capitalists. Smith repeatedly warned that in pursuing their self-interests, capitalists tend to join in powerful special-interest groups. These coalitions seek political influence to promote public policies that benefit themselves, often at the expense of the public interest.

During the second half of the eighteenth century, capitalists (i.e., the owners of capital) were mostly agricultural landlords, merchants, and small manufacturers. *The Wealth of Nations* is an all-out assault on numerous public policies that increased the wealth of these special interests to the detriment of the wealth of the whole nation. Smith believed that the wealth of the nation would increase much faster if these policies were abandoned.

Throughout the book, Smith railed against the capitalists and accused them of hoodwinking the nation. He frequently observed that the interests of merchants and manufacturers always run contrary to those of the general public. Because their interests are at odds with the public interest, capitalists advocate policies that they claim are good for the entire nation, but in fact are good only for themselves:

The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

These are hardly the words of a champion of the unbridled pursuit of self-interest. To counter the political manipulations of the special interests, Smith believed that self-interest could be disciplined and channeled in socially beneficial directions. He saw three mechanisms that together would do the job: self discipline, the competitive market, and a system of justice.

Smith believed that individuals have the capacity to be both good and bad. In *The Theory of Moral Sentiments*, which was one of the most popular books of the eighteenth century, he sought to explain the origins of the good instincts, i.e., the moral side of human behavior. In his view, “we either approve or disapprove of our own conduct, according as we feel that, when we place ourselves in the situation of another man, and view it, as it were, with his eyes and from his station, we either can or cannot entirely enter into and sympathize with the sentiments and motives which influenced it.”

Many scholars have noted that Smith’s two great books seem to paint radically different pictures of human nature: One is based on sympathy and social responsibility, and the other is based on self-interest and greed. In fact, German critics called the apparent contradiction “*Das Adam Smith Problem*.” However, Smith did recognize that self-discipline was not enough. Many people would violate their own moral conscience and act in ways harmful to society if there were not at least two other checks—the competitive market and a system of justice. In *The Wealth of Nations*, Smith exhaustively explored how competition forces capitalists to better society rather than to exploit it. He discussed justice in a cursory way in both books, but he never completed a definitive treatment of the subject.

Today, in the United States, the clearest example of the excesses of capitalism and the destructive influence of special interests is the crisis in the savings and loan industry. The cost of fixing the problem is likely to exceed \$300 billion. It is by far the biggest and most spectacular failure in the entire financial history of the United States.

The essential features of the modern American credit system were established during the early 1930s, when Congress enacted a number of banking bills in response to the financial panics of the Great Depression. The Federal Home Loan Bank Act of 1932 and the Home Owners' Loan Act of 1933 permitted savings and loan institutions (S&Ls) to operate much like commercial banks, but they were limited to making home mortgages. The Federal Reserve was granted the power to set maximum deposit rates for commercial banks under the Glass-Steagall Act of 1933. The Interest Rate Control Act of 1966 extended deposit rate ceilings to the thrifts.

To prevent future bank runs, the Glass-Steagall Act also created the Federal Deposit Insurance Corporation (FDIC) to insure bank deposits. And in 1934, insurance coverage was extended to S&Ls and provided by the Federal Savings and Loan Insurance Corporation (FSLIC). Contrary to a widely held impression, Congress did not pledge the full faith and credit of the United States government behind the guarantees of the FDIC and the FSLIC. However, in 1982 and again in 1987, Congress did make such commitments.

During his first press conference in office, President Franklin Delano Roosevelt stated his opposition to deposit insurance: "As to guaranteeing bank deposits, the minute the government starts to do that . . . the government runs into a probable loss." And prophetically, he added, "We do not wish to make the United States government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future." But Roosevelt succumbed to congressional pressure.

This regulatory system, which clearly promoted home ownership, worked reasonably well for four decades following the end of World War II. As the postwar baby-boom generation matured during this period, the demand for housing exploded, and the S&Ls helped to finance the housing boom. By the mid-1970s, there were over 4,000 S&Ls, in just about every community in the United States. The S&Ls were mostly profitable because mortgage interest rates generally exceeded deposit rates.

But by the late 1970s, the S&Ls fell into deep trouble. Starting during October 1979, the Federal Reserve, under the leadership of Paul Volcker, pushed interest rates up to unprecedented heights in an effort to unwind a runaway inflation spiral. Depositors withdrew their funds and reinvested the proceeds in Treasury bills and other money-market instruments offering higher returns than available on fixed-rate deposits. Ultimately, the most fatal consequence of the Fed's actions was that the jump in rates immediately clobbered the market value of the mortgages and other fixed income assets held by the S&Ls.

The thrift industry's representatives turned to Congress for help, which they promptly received in the form of the Depository Institutions Deregulation and Monetary Control Act of 1980. The Act phased out "Regulation Q" deposit rate ceilings so that S&Ls could pay much higher interest rates on deposits. Congress also permitted investors to open an unlimited number of accounts, each insured up to \$100,000. Previously, \$40,000 was the

limit on insured deposits. These measures stopped the deposit outflows, but they battered profits because deposit rates soared well above the yields generated by the mortgage portfolios of the S&Ls.

Once again, the industry turned to their friends in Washington for more help. In 1982, the Garn-St Germain Act permitted thrifts to invest up to 55% of their assets in commercial real estate and other loans. Up to 30% of their portfolios could be in consumer loans. State-chartered S&Ls in Texas and California were permitted by their regulators to plunge as much as 100% of their assets into practically anything. Now both their assets and liabilities were deregulated.

The federal regulators were also amazingly helpful. In 1981, the Federal Home Loan Bank Board permitted S&Ls to be owned by only one shareholder. Prior to this ruling, an S&L was required to have at least 400 shareholders to limit the influence of developers who might use the institution as “a cash cow.” Furthermore, the Bank Board lowered the minimum capital requirement from 5% to 3%. Some of this capital could be in the form of accounting “goodwill.” Incredibly, the Bank Board issued “net worth certificates” to institutions that could not meet even these liberalized capital requirements.

But the greatest gimmick of all was the unique accounting system which the Bank Board used to determine the regulatory net worth of the thrifts. It was called regulatory accounting principles, or RAP. In October 1981, thrifts were allowed to amortize the losses on any assets sold over the remaining contractual life of the asset. The regulators thus encouraged the S&Ls to sell their “under-water” assets, which were typically packaged as mortgage-backed securities, and to buy loans with higher yields, which would boost profits.

This short-term fix was a huge gamble that interest rates would come down enough to reverse the capital losses created by the Fed’s inflation fight. The 1981 rule change created an enormous divergence between net worth measured under RAP and GAAP (generally accepted accounting principles). In 1984, 877 S&Ls were bankrupt as defined under RAP, with a 3% capital requirement; under GAAP with a 5% cut-off, 2,090 institutions were worthless! Rates did not fall enough to save the day.

Why were Washington’s politicians so helpful to the savings and loan industry? In a word: money. The S&Ls’ troubles coincided with a dramatic increase in the funds needed to get elected to Congress. Ronald Reagan’s landslide victory in the 1980 presidential race convinced the Democrats that they had to raise large sums to counter the Republican challenge, which was well-financed by special interests. In 1986, the Democratic Congressional Campaign Committee, headed by Tony Coelho of California, collected huge contributions from special-interest Political Action Groups (PACs).

In *Honest Graft*, which was published in 1988, Brooks Jackson, a former investigative reporter for *The Wall Street Journal*, writes that the House of Representatives evolved “into a gigantic bureaucracy, a re-election machine designed principally to return incumbents to office.” The S&L operators learned how to press all the right buttons to make this machine work for them. The current chairman of the House Banking Committee, Henry B. Gonzalez of Texas, observed that “everything the industry has wanted, Congress has rolled over and given to them.”

The savings and loan industry established over 150 PACs to funnel millions of dollars in campaign contributions to several Congressmen, particularly key members of the House

and Senate banking committees. By far the most favored was former House Banking Committee Chairman Fernand St Germain, who was instrumental in raising the deposit insurance limit from \$40,000 to \$100,000. The contributions were mostly legal. But some gifts and favors were not legal. Representatives St Germain and Coelho and Speaker of the House Jim Wright all lost their offices largely because of their unethical ties to the S&L industry. And other Congressmen in both parties are under investigation.

Why were Washington's regulators as helpful to the industry as the politicians? George Stigler, who won a Nobel prize in economics for his pioneering work on the behavior of regulated firms, observed that such firms have an economic interest in "capturing" the regulator to achieve their own goals, thereby using "public resources and power to improve their economic status." Capture theory, which clearly is an extension of Smith's work, predicts that the most highly regulated industries will have the greatest influence over their regulators.

That is exactly what happened in the thrift industry. The United States League of Savings Institutions played a crucial role in establishing both the Federal Home Loan Bank System and the Federal Savings and Loan Insurance Corporation. The League has had a great deal of influence over the Bank Board, which provided liquidity to S&Ls and regulated and supervised their activities. The FSLIC was supposed to close insolvent institutions promptly. But under industry pressure, Congress refused to provide the FSLIC enough money to do the job properly in the second half of the 1980s.

The results of Washington's assistance to the savings and loan industry were disastrous. For every \$3 in capital, the operators of an S&L could accept and raise \$100 in government-insured deposits. Speculators and swindlers moved into the industry. They offered very high rates to attract deposits. The fastest-growing thrifts paid the highest return and invested in the most speculative projects. The depositors never worried about the riskiness of the S&Ls' assets because their deposits were insured by the government.

As things turned out, many of the loans were extraordinarily risky. The credit supplied by the S&Ls financed a building boom that created a glut of office buildings, condominiums, and shopping centers. As real estate prices started to sink, so did the net worth of more and more S&Ls. Last year, Congress responded to the crisis by restructuring and deregulating the industry and approving extra funds to pay depositors at failed institutions.

The deposit insurance program was a major contributor to the S&L debacle. The federal deposit guarantees are in fact a government subsidy, rather than an insurance program. The premiums were paid by the thrifts to the FSLIC. Unlike most insurance programs, high flyers paid the same premiums as conservatively managed thrifts. And the FSLIC's reserves were never sufficient to cover the potential liabilities of the insurance fund.

No one really knows how many hundreds of billions of dollars will be required to clean up the mess. Fortunately, the American economy, with annual GNP currently exceeding \$5 trillion, is big enough to absorb this enormous loss. But 200 years after the death of Adam Smith, the S&L debacle proves that his warning remains as relevant as ever: Capitalism is prone to excess, and vigilance is required to ensure that the political system is not manipulated for the economic benefit of a few to the detriment of the entire society.

III. Stagnation, Policy Ruts And Free Trade

Returning now to the eighteenth century, mercantilists were the special-interest group that particularly outraged Smith. Mercantilists argued that the key to national prosperity was a favorable trade balance. A surplus of exports over imports was necessary to assure an inflow of gold, which many of them believed was an important source and the best measure of national wealth. In their view, a nation could prosper only at the expense of other nations. After all, one country's trade surplus is another's trade deficit. In a mercantile world, international relations are a zero-sum game—for every winner there is a loser.

The mercantilists advocated high tariffs on imports and subsidies for exports. They were also empire builders. Colonies provided raw materials to the industries of the mother country and also exclusive markets for their finished products. A large military force was necessary to build the empire and to defend the colonies from other imperial powers. Financing these activities required a great deal of money, which is why many mercantilists measured the wealth of a nation by the amount of gold in the country's treasury.

Mercantilism made good sense during the fifteenth and sixteenth centuries, when the feudalism of the Middle Ages was gradually replaced by the nation-state. Mercantilists successfully centralized and strengthened national authority, which was challenged by the universalism of the Catholic Church and the provincialism of local barons. They created national markets out of the hundreds of fiefdoms that arbitrarily imposed tolls and regulated commerce within their small domains.

By the eighteenth century, mercantilism had clearly triumphed over feudalism. But it had also lost its *raison d'être*. Once a visionary creed, mercantilism now was just a cover for special interests. The mercantilists claimed that their objective was to place the country's economic resources at the disposal of the state. But, in fact, their policies put the state's power at the disposal of merchants, manufacturers, and landlords.

No one saw this more clearly than Adam Smith. He observed that Britain was stagnating rather than prospering under mercantilist policies. To get out of the rut, Smith argued that these policies must be abandoned. He advocated the repeal of the Corn Laws, which created a system of bounties, tariffs, and quotas to regulate the supply of grain—much to the benefit of the landlords. He also questioned the wisdom of laws which gave English shippers a virtual monopoly on all trade within the British empire and required most trade between the colonies and foreign powers to run through England. And he favored independence for the British colonies, particularly those in America.

Smith believed the wealth of a nation is ultimately determined by the prosperity of its consumers. Therefore, public policies should aim to maximize the welfare of consumers. According to Smith, mercantilist policies were unsound because they promoted the special interests of producers at the expense of the public's interests: "The mercantile system absurdly considers production and not consumption to be the end of industry and commerce. Restraints on importation of competing commodities sacrifice the interest of the consumer to the producer, and so do bounties on exportation. . . ."

Smith argued that all barriers to free trade and impediments to fair competition—including tariffs, subsidies, and state-chartered monopolies—artificially raised consumer prices, distorted the efficient allocation of scarce capital resources, and reduced Britain's competitive position in world trade.

Within a country, free trade increased prosperity by stimulating the division of labor. People have a natural inclination to “truck, barter, and exchange one thing for another.” By specializing in different occupations and trading with each other, everyone becomes more productive and enjoys a better standard of living than if they tried to make everything they need on their own.

Smith favored free trade among countries because he believed that the bigger the market, the greater the division of labor within each country, and the greater the prosperity for all concerned. He declared, “As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent. . . of the market.” In other words, the bigger the market, the greater the prosperity!

Trade barriers force a nation to produce virtually everything its citizens consume within its own borders. That made no sense to Smith: “If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.” Tariffs and subsidies also reduce competition. Facing less competition from abroad, domestic producers are under less pressure to innovate and to improve productivity. The quality of their products is lower and their prices are higher.

Even worse, tariffs and subsidies divert capital investment away from the most productive sectors of the economy and toward the most inefficient ones. According to Smith, in a free market, investors will naturally invest their capital in the most productive industries where the rates of return are highest. But tariffs and subsidies typically increase the rate of return of inefficient industries, which are the ones that are usually the most protected.

Smith ridiculed the idea of a zero-sum world. Mercantilists had a static view of economics because growth had been so slow prior to the eighteenth century that it was almost imperceptible to most people. Smith had a dynamic view: He believed that Britain’s economic potential was boundless, particularly if the country abandoned protectionism. Smith believed that economic growth was the source of prosperity; a nation could not grow wealthy at the expense of others.

Smith was not the first political economist to challenge the mercantilists’ zero-sum world view. David Hume, his good friend, attacked this fallacy almost two decades before Smith in an essay entitled “Of the Jealousy of Trade”:

Nothing is more usual, among states which have made some advances in commerce, than to look on the progress of their neighbours with a suspicious eye, to consider all trading states as their rivals, and to suppose that it is impossible for any of them to flourish, but at their expense. In opposition to this narrow and malignant opinion, I will venture to assert, that the encrease of riches and commerce in any one nation, instead of hurting, commonly promotes the riches and commerce of all its neighbours; and that a state can scarcely carry its trade and industry very far, where all the surrounding states are buried in ignorance, sloth, and barbarism.

Smith agreed completely: “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.”

This simple, yet powerful insight should be the guiding principle underlying the often tense and testy economic relationship between the United States and Japan. Both countries can prosper together by supporting free trade and the integration of the world's national markets. Instead, many Americans believe that Japan's successes are coming at their expense. The biggest complaint is that Japan's huge bilateral trade surplus with the United States is attributable to numerous "structural impediments" that effectively shut out U.S. goods from Japan. Many Japanese believe that America's problems are home grown. The real problem is that America is in decline, and that is not Japan's fault.

Several American "revisionists" claim that American policy toward Japan is guided by a traditional, but flawed view that Japan will remove the impediments to American imports if enough diplomatic pressure is applied. They believe that Japan will not change. Instead, like mercantilists, the Japanese will continue to sacrifice the consumers' welfare in order to strengthen their businesses. So negotiating with them is a waste of time.

Revisionists advocate a more aggressive approach, including more use of such trade crowbars as the Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act. This measure sets a time limit on negotiations. If the desired result is not achieved by the specified deadline, then the president of the United States must retaliate.

"Managed trade" is another revisionist policy idea, supported by several influential Americans including Henry Kissinger. The Advisory Committee for Trade Policy and Negotiations, which reports to Congress and includes the chief executives of several leading companies, recommended last year that America should declare how much of each type of good it should be selling to Japan, and if the Japanese are buying less, they should be pressured to buy more.

While economic nationalists are fanning the flames of protectionism in the United States, the capitalists of the world are quietly developing global business relationships that are producing free-market solutions to trade frictions. The world economy is becoming increasingly integrated as more and more businesses form joint ventures with their overseas competitors. Capitalism is proliferating all around the world; more governments are privatizing their industries and deregulating their economies; and free trade is expanding.

The Japanese are slowly abandoning many of their mercantilist policies. At home, the Japanese are changing: They are becoming a more consumer-oriented society and they are purchasing more imported products. Overseas, the Japanese are expanding their manufacturing capacity. So less of their domestic production will be exported, and more will meet the growing demands of Japanese consumers.

The liberation of Eastern Europe from Soviet communism has accelerated the move toward economic and even political unity among the 12 nations of the European Community (EC). They have already agreed on roughly 60% of the measures designed to create a single market by 1992. Fears of "Fortress Europe" are dissolving: The EC is conducting free-trade talks with the six members of the European Free Trade Association, and there is a greater willingness in the EC to consider American proposals to eliminate farm supports.

The Latin Americans are concerned that more of the world's capital will be drawn toward rebuilding Eastern European nations at their expense. To counter this development, countries like Mexico, Brazil, and Argentina are selling state-owned enterprises and creating more inviting conditions for foreign investors. Mexico has indicated a strong interest in joining the United States in a free-trade association.

In more and more countries, fear of stagnation and fear of being left behind are pushing governments to abandon policies that perpetuated their economic ruts. Instead they are embracing the free-market and free-trade approach of Adam Smith. They are starting to understand that the bigger the market, the greater the opportunities for all to prosper together.

IV. On 'Imperial Overstretch'

Why did Adam Smith write *The Wealth of Nations*, a project that consumed ten years of his life? Obviously he had a number of motivations, but perhaps one of the most important can be found in the last sentence of the book:

If any of the provinces of the British empire cannot be made to contribute towards the support of the whole empire, it is surely time that Great Britain should free herself from the expence of defending those provinces in time of war, and of supporting any part of their civil or military establishments in time of peace, and endeavor to accommodate her future views and designs to the real mediocrity of her circumstances.

When Smith published *The Wealth of Nations* in early 1776, the American colonies were already rebelling and about to declare their independence. For well over a century, Britain protected the colonies, mainly from the French and hostile Indians, and provided certain essential supplies. In return, the colonists agreed not to compete with British producers in certain areas and to trade exclusively with the British according to a specified list of goods. Both sides benefited.

In 1763, the British finally succeeded in defeating the French and Indians in a long, seven-year war. As a result, the American colonists became almost entirely free from the threat of military attack. For the British, the war had been terribly expensive. According to estimates published by William Knox in 1768, Britain's public debt doubled as a result of the French and Indian War to 148 million pounds.

The British believed that the colonists were prosperous enough to pay more for their own defense. In 1764, one year after the war, Parliament passed the Revenue Act and the infamous Stamp Act a year later. The new taxes immediately produced a great uproar in the American colonies.

Parliament repealed the hated Stamp Tax in 1766. But the following year the Townshend Act levied duties on a variety of goods entering the colonies. The colonists continued to resist these taxes and started a nonimportation movement between 1768 and 1770. Following the Boston Tea Party of December 1773, the British responded with the so-called Intolerable Acts.

The Americans enthusiastically declared their independence in 1776. The British became increasingly pessimistic about their country's future. The colonies had served as guaranteed markets for basic British goods. If they broke away, those markets might disappear. Furthermore, the Americans probably would become serious competitors in world trade. In 1772, as tensions with the American colonists were beginning to mount, Arthur Young declared,

We are now at a crisis. Formerly it mattered but little, whether our statesmen were asleep or awake: And why? Because the increase of the colonies did the business for them: their increase occasioned the national trade to increase, and all went on silently but prosperously. But late ill-judged measures have irritated the colonists, and at the same time, by confining them, forced them into those manufactures which their anger made them wish for. Their scheme, according to the present conduct of Britain, must succeed, and will end in the ruin of a vast part of our commerce and manufactures....

The American Revolution was the worst possible nightmare for the mercantilists. But for Smith, Britain's colonial policy was the real nightmare. It "is likely to cost, immense expence, without being likely to bring any profit; for the effects of the monopoly of the colony trade, it has been shewn, are, to the great body of the people, mere loss instead of profit." For many of the same reasons he condemned protectionism, he opposed the enforcement of exclusive trade on the colonies. Monopolies over colonial trade produced artificially high prices and profits and therefore attracted capital away from more productive uses. British producers benefited, but consumers suffered.

Smith concluded that it would be in Britain's best interest simply to free the American colonies. The British would not only save the expense of defending the colonies, but also would quickly find their domestic capital flowing into more productive investments. Finally, he correctly predicted that trade with the Americans would expand, not diminish.

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Adam Smith would have agreed with the main theme of Paul Kennedy's 1987 epic, *The Rise and Fall of the Great Powers*: Great powers fall when their excessive military ambitions sap their economic power base, which, in turn, leads to a decline in their military might and to their downfall as first-rate powers. The Yale historian examines the rise and fall of such great powers as Edwardian England, Bourbon France, and Hapsburg Spain. All of these hegemonies suffered from "imperial overstretch." They took on more global obligations than they could afford. They crumbled under the weight of their own empires, usually after long and expensive wars. Similarly, Smith argued that the cost of maintaining King George's empire was damaging the country's economic power.

Today, there is no doubt that the Soviet Union is heading for a fall. The Soviet Union has a population of 290 million people, 40 million more than the United States. Yet by most estimates, the Soviet economy is no bigger than half the size of the American economy—most likely a third as large. The Soviet economy virtually stopped growing in the early 1980s.

During the 1970s and 1980s, the Soviets spent as much as 20% of their GNP on defense. Under Brezhnev, they propped up their puppet regimes in Eastern Europe; they supported unpopular communist dictators and rebels around the world; and they aided the world's terrorists. The Soviets also spent the equivalent of \$100 billion in a ten-year war in Afghanistan. For many years, these expensive imperial activities were financed with revenues from oil exports. When oil prices collapsed in the mid-1980s, the Soviets quickly ran out of money to finance their imperial activities.

Unlike the Soviet Union and the other great powers that eventually declined, the United States is not a colonial power. Moreover, the country spent only 6.6% of its GNP on military outlays during the 1980s. Now that the Soviet empire is crumbling, this percentage will be even lower in the 1990s. America's economic power base is growing: Real GNP rose 30%, and employment expanded by almost 20 million over the past decade. Just as Adam Smith predicted that Britain would become an even greater power by abandoning the causes of its military overstretch, today the end of the Cold War bodes very well for the United States.

V. The Original Optimist

Fifteen years after Smith's death, William Playfair published *An Inquiry into the Permanent Causes of the Decline and Fall of Powerful and Wealthy Nations*. His title was strikingly similar to Kennedy's, but his message quite different. Like Kennedy, Playfair traced the fortunes of various empires over a long stretch of history, ranging from ancient Egypt to seventeenth-century Holland. However, he stressed "interior causes," rather than imperial overextension as the main cause of decline.

Playfair observed that prosperous nations wither because many of the essential preconditions for prosperity, such as educational rigorousness and commercial industriousness, are difficult to sustain in an environment of affluence. For example, necessity is the most powerful spur to industry and innovation. When it disappears, lethargy often sets in.

He also observed that rising wealth inevitably produces an increasingly unequal division of property. This ignites class strife and similarly threatens the foundations of prosperity. In short, affluence tends to create the forces of its own demise.

Playfair effectively summarized many concerns and fears pervasive in eighteenth-century Britain. Yet, he lightly dismissed the problem of Britain's huge national debt, which was the country's biggest concern throughout the 1700s. Debt first surged at the turn of the century, precipitating a crisis that culminated in the financial panic of 1720, the so-called "South Sea Bubble." Then there were the huge debts accumulated during the mid-century to finance the Seven Years War. And finally, just after Smith died, England piled up a new mountain of debt during the Napoleonic wars.

Pessimists throughout the country believed that these debts would eventually lead to Britain's ruin. Many of them were particularly upset about foreign-held debt. The Dutch were the biggest foreign owners of British public debt. Arthur Young was one of those who sounded the alarm in the 1770s: "[T]he national debt will increase so much," he wrote, "that the payment of the interest to foreigners will impoverish the kingdom, at a time when exportation declines."

Debt was the main source of pessimism during the eighteenth century, but British naysayers found plenty of other worries. They bemoaned declining public morals, worsening conditions among the poor, and the proliferation of taxes on all types of goods. They especially feared that they were falling rapidly behind the French because British prices were too high and British workmanship was deteriorating.

Is it of no importance to an Englishman, [asked William Knox in 1768] that the trade and manufacture of the nation are going to ruin; that Great-Britain is in danger of becoming a tributary to France, and the descent of the crown dependent on the good pleasure of that ambitious nation!

To counter these loud and pervasive clamors of ruin, Adam Smith offered a well-reasoned case for optimism in *The Wealth of Nations*. He knowingly dismissed the pessimists, observing that constructive economic change can often be mistaken for decline by casual critics. Why was the illusion of economic decline so pervasive? Declining industries usually get more attention than rising ones, so even though “the country in general be in great prosperity, there frequently arises a suspicion, that the riches and industry of the whole are decaying,” wrote Smith.

Smith had enormous faith in progress. He believed that man’s condition naturally tends to improve over time. Even the government’s errors and excesses are not enough to stifle progress completely:

The uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement, in spite of the extravagance of government, and the greatest errors of administration. Like the unknown principle of animal life, it frequently restores health and vigour to the constitution, in spite, not only of the disease, but of the absurd prescriptions of the doctor.

Smith was right again: British industry in the late eighteenth century was not falling into decay, as the pessimists prophesied. Rather, it was on the verge of the Industrial Revolution and explosive growth. Smith was not privy to this piece of economic history, but he seemed to understand the power of the market and the untapped potential of the British economy. Although the pessimists identified real problems, Smith recognized that the best way to solve them was simply to let the market work.

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In *The Wealth of Nations*, Smith noted that “five years have seldom passed away in which some book or pamphlet has not been published, written too with such abilities as to gain authority with the public, and pretending to demonstrate that the wealth of the nation was fast declining, that the country was depopulated, agriculture neglected, manufactures decaying, and trade undone.” He wrote the book to discredit not only mercantilism, but also the rampant pessimism of his day.

Today, in the United States, the clamors of ruin seem to be as loud as during Smith’s time. Numerous books have been published in the past few years with predictions as ominous as their titles: *The Deindustrialization of America*, *Beyond Our Means*, *Day of Reckoning*, *The Debt Threat*, *On Borrowed Time*, *Blood in the Streets*, *The Great U-Turn*, *Buying Into America*, *Falling From Grace*, *Trading Places*, and *The Great Depression of 1990*.

The authors of these books generally agree that Americans have been on a credit-financed spending spree. The borrowing binge was made possible by a lending binge. Credit

demands, bloated by huge federal deficits, have exceeded domestic savings. Meanwhile, productivity growth has languished and America's global competitive position has deteriorated. As a result of all these developments, the United States has been running huge trade deficits that transformed the country into the world's largest debtor.

They predict that Americans can look forward to a future of lower living standards and reduced influence in world affairs unless important changes are made soon. Many of them favor higher income taxes to reduce both the federal deficit and consumption growth. They also tend to favor "industrial policies," i.e., government assistance to important businesses that are facing intense competition from abroad. A few advocate more aggressive, managed trade policies and some limits on foreign ownership of U.S. assets.

There is an underlying theme of mercantilism in many of these policy prescriptions. The British mercantilists of the eighteenth century were disturbed by the listlessness of their country, so they prescribed even heavier doses of mercantilist medicine. Smith, however, argued that the mercantilist policy rut was the cause of Britain's stagnation. More of the same mercantilist policies would only make matters worse. The same conclusion applies today.

VI. The Political Enigma

Smith believed that a capitalist economy would prosper "in spite of the extravagance of government, and the greatest errors in administration." However, Smith was never a dogmatic believer in laissez faire. He favored some limited government involvement in the economy. The government should have three responsibilities—to defend the nation against foreign attack or intimidation; to provide a system of justice to protect property, enforce contracts, and punish fraud, exploitation, and violence; and to provide vital public goods and services that the private marketplace was unlikely to produce.

Moreover, Smith acknowledged the necessity of circumventing the market in certain cases. He conceded, for example, that it might be necessary to grant a temporary monopoly to a company of merchants who "undertake, at their own risk and expence, to establish a new trade with some remote and barbarous nation. . . ." "In short, it is permissible temporarily to violate fundamental market principles in order to achieve a public objective that the market would never deliver on its own.

Smith favored public education because he recognized that the division of labor could transform workers into virtual beasts of labor unless the state provided education. Smith wrote, "The man whose whole life is spent in performing a few simple operations . . . generally becomes as stupid and ignorant as it is possible for a human creature to become . . . unless government takes some pains to prevent it."

Without a doubt, Smith believed that government had a vitally important, if relatively narrow, role to play in the conduct of economic affairs. However, governments rarely accept limited roles. Furthermore, special-interest groups are incessantly pushing for some political advantage in the economic marketplace.

Smith was unable to design a political system that would contain the size of government and limit the government's involvement in the economy to its most effective roles. Also

missing from Smith's work is a reform process that will ensure that money does not corrupt the government—a reform process that can anticipate and avert such excesses as the S&L debacle. Without such a mechanism, capitalism will have bouts of crisis. Even so, the system will continue to produce prosperity. Adam Smith said it best:

But though the profusion of government must, undoubtedly, have retarded the natural progress of England towards wealth and improvement, it has not been able to stop it.... In the midst of all the exactions of government, this capital has been silently and gradually accumulated by the private frugality and good conduct of individuals, by their universal, continual, and uninterrupted effort to better their own condition. It is this effort, protected by law and allowed by liberty to exert itself in the manner that is most advantageous, which has maintained the progress of England towards opulence and improvement in almost all former times, and which, it is to be hoped, will do so in all future times.

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