The Intertemporal Adam Smith

Roger W. Garrison

On the 200th anniversary of the publication of the Wealth of Nations, James Buchanan (1976, p. 273) posed the question—somewhat rhetorically—"Is [Murray] Rothbard the modern analogue to Adam Smith?" His answer followed immediately: "Little or no exegesis is required to answer such a question emphatically in the negative." Significantly, Buchanan pointed to Rothbard's For a New Liberty (1973) rather than his Man, Economy, and State (1962) as the most telling contrast to Smith's Wealth of Nations. Absent in Rothbard and present in Smith is the notion of public benefits to collective action. Rothbard's "modern libertarian anarchism" (Buchanan's term) stands in contrast to Smith's classical liberalism.

Buchanan could hardly have been surprised at Rothbard's subsequent assessment of the putative Father of Economics, particularly when the economics of public goods and externalities is at issue. In fact, his own overall assessment of Smith on policy issues is very similar to Rothbard's. "[I]t is not difficult for us to imagine [Smith] constructing a catalogue of market abuses or failures and calling directly for corrective action" (Buchanan 1976, p. 278):

he would have supported legislation for anti-monopoly action, for the definition of the monetary unit, for the regulation of banking, for public utility operation and/or regulation, for minimal public education, for standardized weights and measures, for grade labeling, for limited building codes, possibly for publicly supplied information and support for the arts.

Compare this list of interventions with the one offered by Rothbard (1995, p. 466), showing that in addition to advocating usury laws, Smith was an advocate of

public education, regulation of bank paper, public works (including highways, bridges and harbors) government coinage, the post office, compulsory building of fire walls, compulsory registration of mortgages, some restrictions on the export of corn, and the outlawing of the practice of paying employees in kind.

According to West and others, Smith believed that capital accumulation has a public-goods character to it, or, equivalently, that it generates external benefits. It is a short step from this belief to the understanding that Smith recommended policies

Roger W. Garrison is professor of economics at Auburn University. Special thanks to Thomas J. McQuade and an anonymous referee for helpful guidance.

aimed at correcting for these perceived external effects. He favored a higher rate of capital accumulation—and hence a lower rate of present consumption—than would spontaneously occur in a market economy. Although the issues of public goods and external benefits are clearly discernible in the Wealth of Nations and provide a basis for a contrast with the writings of Rothbard, Smith’s pro-growth policy recommendations are more straightforwardly understood, I have argued, as stemming from a fundamental value bias. People interacting with one another in a system of natural liberty systematically discount the future. Smith believed, or wrote as if he believed, that they should not do so. Policy should be aimed at overriding people’s shortsightedness. In practice, rapid growth was simply taken to be an ultimate policy goal.

In two of the nine sections of his chapter on the “Celebrated Adam Smith,” Rothbard (1995, chap. 16) makes some use of my “Comment” (Garrison 1985) on Edwin West’s “Reappraisal” (1985) of the relationship between Richard Cantillon and Adam Smith. (West’s paper and my comment were presented in August of 1980 at a Liberty Fund Symposium on Richard Cantillon; Rothbard was a participant at that symposium.) Rothbard’s 1995 section 16.4 (“Productive vs. unproductive labor”) and his section 16.8 (“The myth of laissez-faire”) deal directly in the first instance and indirectly in the second with Smith’s views on the intertemporal allocation of resources.

Rothbard assessed Smith, as he did all the major and minor figures in the history of economic thought, against the standard of Austrian economics. He found that some of Smith’s predecessors, especially Cantillon and Turgot, fared better than Smith on issues involving intertemporal allocation. Rothbard’s assessment may seem surprising—and surprisingly harsh—to many of today’s market-oriented economists. To put this assessment in perspective, we must recognize that his assessment of modern mainstream thinking on the intertemporal issues (interest rates, saving, investment, and growth) was similarly negative and harsh. The modern mainstream is more closely akin to Smith than to the Austrians. In Rothbard’s own words (1995, p. 445), “Smith wanted far more investment toward future production and less present consumption than the market was willing to choose.” Mainstream pro-growth economists, even—or especially—those who fondly associate themselves with Adam Smith and his system of natural liberty, are unlikely to sympathize with criticism of this sort precisely because they have a similar intertemporal bias—a Smithian bias—in their own thinking.

I will return to the Smithian bias in the modern mainstream after offering a restatement of my own thesis and a comparison with an alternative thesis also found in recent literature.

A RESTATEMENT

Given the attention that Rothbard has called to my comment on West, I offer a restatement here by reproducing the two major sections, slightly condensed and edited to allow them to stand alone. While Buchanan focused broadly on the issues of political philosophy in his comparison of Smith and Rothbard, my comparison of Cantillon and Smith, which is based more narrowly on issues of resource allocation, lends support to Rothbard’s negative assessment of Smith.
The Economics of the Here and Later

My comparison of Cantillon and Smith entails a rather unflattering view of both thinkers. The unflattering view of Cantillon is the common one: Cantillon the Mercantilist. (Here I am simply accepting the interpretation of Professor West and many others.) Although Cantillon showed a deep understanding of a market economy and opposed state intervention of most sorts, he advocated interventions that would result in a more favorable balance of trade. Left to its own devices the market would, in general, allocate resources in a satisfactory manner. But the market would not allocate as many of the world’s resources to the homeland as Cantillon preferred the homeland to have. He was not satisfied with the interspatial allocation, or more specifically the international allocation, of resources. He therefore advocated policies aimed at increasing the wealth of one nation at the expense of others.

The unflattering view of Smith is not so commonplace, but is one that, once stated and explained, should command broad acceptance (or so I believed in 1980). There is in Smith’s writings an important analogue to the Mercantilists’ position. Stated simply, Smith is to time as Cantillon is to space. In general, the market’s allocation of resources was largely satisfactory to Smith. But the intertemporal allocation under a system of natural liberty was in conflict with his own vision of economic growth. The market will not allocate as many of society’s resources to capital formation, and hence to future consumption, as Smith would prefer. He was therefore inclined to advocate policies (e.g., usury laws as discussed in another section of my comment and as discussed in Rothbard 1995, section 16.8) aimed at increasing the capital stock at the expense of consumption, or what amounts to the same thing, increasing future consumption at the expense of present consumption.

Smith saw his intertemporal bias as “entirely different” from the interspatial bias of the Mercantilists, but his economics of time is closely analogous to their economics of space. This is nowhere more clear than in Smith’s own comparison. After explaining the unreasonableness of international restraints aimed at making the balance of trade more favorable, Smith (1937, p. 464) argued that

There is another balance . . . very different from the balance of trade, and which, according as it happens to be either favorable or unfavorable, necessarily occasions the prosperity or decay of every nation. This is the balance of annual produce and consumption. If the exchangeable value of annual produce . . . exceeds that of the annual consumption, the capital of the society must annually increase in proportion to this excess.

Although Smith maintained that “This balance of produce and consumption is entirely different from . . . the balance of trade,” the difference is one that derives straightforwardly from the difference between time and space. From the standpoint of economic efficiency the two balances can be treated the same: Under the system of natural liberty there will be a natural balance in the allocation of resources between one nation and another as well as between one period of time and another. From the standpoint of policy they were treated the same: Smith advocated a favorable balance of produce and consumption in the same sense that Cantillon and the other Mercantilists advocated a favorable balance of trade.

This relationship between Cantillon and Smith appears in West’s paper in a slightly disguised form. West compares the “zero-sum game” of the Mercantilists
with the “dynamic system” of Smith. While the connotation of these terms make Smith’s vision look the more appealing, the terms themselves are based on the relationship just outlined. Cantillon was concerned with the allocation of resources among nations during a given period of time; Smith was concerned with the allocation of resources among periods of time for a given nation. West (1985, p. 30) imputes the dynamics of Smith’s vision to the constant improvement in technology brought about by the division of labor. But Smith’s vision involved something more: He wanted the system to be a little more dynamic than natural liberty, by itself, would allow. He evaluated the market against a standard that was more future oriented than the market itself, and he prescribed policy accordingly.

**Productive and Unproductive Labor—Once Again**

The contrast between productive and unproductive labor figures importantly into the comparison of Cantillon and Smith. The distinction between the two uses of labor is significant as a manifestation (probably the most pronounced manifestation) of Smith’s bias against the present and in favor of the future. Much has been written about this curious contrast that dominates the third chapter of Book II of the *Wealth of Nations*. Undoubtedly, the controversy is at least partly attributable to Smith’s own choice of words. The word “useful” appears early in the book as a synonym for “productive”; later on, the same word is used to characterize both productive and unproductive labor. (Editor Edwin Cannan points out this ambiguity in a footnote: Smith 1937, p. 315.)

It is common in classroom presentations to claim that Smith’s distinction between the two kinds of labor is often misinterpreted. Presumably the misinterpretation consists of taking “unproductive” to mean “useless,” and of viewing unproductive laborers as wards of society. In this view, unproductive laborers would be dependent on productive laborers in the same way that welfare recipients are dependent on income earners and—worse yet—in the same way that non-agriculture classes are dependent, in the Physiocratic view, on agriculture. The now-dominant interpretation entails a purely stipulative distinction. Productive labor produces capital goods; unproductive labor produces services. Remaining dissatisfaction with this reading hinges on the fact that it does not readily accommodate the categories of durable consumer goods or human capital.

More relevant in the context of Smith’s intertemporal bias is the seemingly incongruous use of antonyms to contrast services with capital goods. In what sense are they opposites? Smith’s distinction between productive and unproductive labor is to be linked not to his journey to France, as some have believed, but to his upbringing in Scotland. The basis for the distinction is not Physiocratic fallacies but Presbyterian values. Productive labor is future oriented; unproductive labor is present oriented. The former is good (or, at least, undervalued by the market) and the latter is bad (or, at least, overvalued by the market). This is the sense in which the two categories are opposites. Smith’s value bias is clearly acknowledged by West (1969, p. 173) in an earlier exposition: “Smith, like a prudent steward of a Scottish aristocrat’s estate, could hardly disguise a strong personal preference for much private frugality, and therefore for ‘productive labor,’ in the interest of the nation’s future accumulation” (emphasis added). West quotes from the *Theory of*
Moral Sentiments (1969, p. 311) to show that Smith’s standard of intertemporal values is exhibited by his “impartial spectator.” In modern parlance we would say that the impartial spectator has a zero rate of time preference.

The spectator does not feel the solicitations of our present appetites. To him the pleasure which we are to enjoy a week hence, or a year hence, is just as interesting as that which we are to enjoy this moment.

The quotation can be extended to show the impartial spectator’s view of mere mortals, who have positive rates of time preference.

When for the sake of the present, therefore, we sacrifice the future, our conduct appears to him [the impartial spectator] absurd and extravagant in the highest degree, and he cannot enter into the principles which influence it.

It is also quite clear (from Smith 1969, p. 312) that in the absence of policy prescription based on the values of the impartial spectator, individuals would fall far short of Smith’s standard.

The pleasure which we are to enjoy ten years hence interests us so little in comparison with that which we may enjoy today; the passion which the first excites is naturally so weak in comparison with that violent emotion which the second is apt to give occasion to, that the one could never be any balance to the other.

It is not difficult to see how Smith’s standard of zero time preference, coupled with his awareness of the sharply positive time preferences that govern actual market activity, could lead him to make the very policy recommendations that West found to be surprising. Smith sought to correct this natural imbalance by policies aimed at creating a favorable balance of production and consumption. He sought to reallocate resources away from the present and toward the future, that is, away from the employment of unproductive labor and toward the employment of productive labor. His proposed usury laws were designed to do just that.

IMPOSING HIS OWN VALUES
OR CORRECTING FOR MARKET FAILURE?

On the occasion of the 200th anniversary of Smith’s death, West (1990) reports on my analogy between Smith and the Mercantilists and my charge of a value-based intertemporal bias in Smith’s writings. He offers as an alternative account of Smith’s pro-growth stance the idea that capital formation involves technological spillovers, or externalities—or that it has a public-goods character to it. Here West is drawing from Jadlow (1977) and Buchanan (1976). Jadlow (as quoted by West 1990, p. 78) argues that Smith “supported interferences with the ‘natural liberties’ of individuals when significant technological spillovers were involved.” The interference here consisted of outlawing high-interest consumption loans (and risky business loans) so that savings would be channeled towards secure, externality-producing capital formation. Buchanan, according to West, gives some credence to the idea that there are likely to be infra-marginal external economies to capital formation but wonders out loud about the policy implications. Why would Smith have advocated interest-rate ceilings rather than some more direct subsidy to capital formation?
"In so far as these external economies arguments are persuasive," West (p. 78) writes, "they offer one answer for ... Garrison." West's particular wording here suggests that he himself may not find this application of modern externality theory and public-goods theory wholly persuasive. After reporting on "an important remaining problem" identified by Jadlow (the problem of black markets in high-risk loans), West (p. 81) identifies two more problems with Smith's policy recommendations: (1) The information requirement would be overwhelming: In order to exploit the externalities on a project-by-project basis, the government would have to have knowledge—indeed, independent of the market itself—of the true social rate of return. Here, West's argument echoes the Austrian insights into the difficulties of economic calculation in a socialist economy. (2) Prescribing the particular intervention and enforcing it would require much more public spiritedness than Smith normally attributed to government. (But see Stigler [1971, p. 272], who, as pointed out by Jadlow [1977, p. 1198f.], "has compared Smith's attitude toward political behavior as that of a 'parent toward a child: the child was often mistaken and sometimes perverse, but normally it would improve in conduct if properly instructed.'"

To West's even-handed but skeptical treatment of the external-economies argument, I can add, if only marginally, to the reasons for dismissing it. If we think macroeconomically, we see that the existence of externalities to capital formation does not, by itself, have clear policy implications. We cannot simply claim that a high growth rate is good and that a higher growth rate is better. Even benevolent, public-spirited policymakers would find themselves faced with a dilemma: They could maintain a policy of laissez-faire and forego the social gains that exploiting the externality would entail, or they could intervene and risk overcorrecting for the perceived market failure, which may well entail a net social loss. The market operating in a system of natural liberty may produce a growth rate of, say, 2 percent. Forced growth of 2.5 percent may entail a higher social rate of return; forced growth of 3 percent may entail the same social rate of return as natural growth of 2 percent; and forced growth of 3.5 percent may entail a social rate of return that is actually less than would have been enjoyed with the economy growing at its natural rate. If we had the effect of forced growth on social well-being expressed mathematically, we could take a derivative and set it equal to zero. But we cannot know if a particular pro-growth policy will leave us short of the hump or put us at the hump, beyond the hump, or even beyond the horizontal intercept of this growth-effect function. This and all other instances of alleged market failure are also instances in which the policymaker is operating in the dark. The systematic occurrence of the "need for interventionist policy" together with the lack of information on which to base a particular policy prescription is what I have elsewhere called Vaughn's conundrum (Garrison 1992).

The knowledge problem identified here may be seen as a macroeconomic perspective on the information problem pointed out by West. However, to state the problem in such twentieth-century terms is to make it obvious that this is not how Smith saw the problem. In fact, even to believe that Smith based his policy recommendations primarily on an external-economies argument or on a public-goods argument requires, in my judgment, a hefty dose of hindsight and a creative reading of the Wealth of Nations. At best, hints of public-goods qualities and external
economies, such as were cited by Buchanan and Jadlow, are used by Smith to help rationalize a value-based policy prescription that runs counter to his general defense of the system of natural liberty.

Linking Smith's understanding of the system of natural liberty to his ethical ideas in the *Theory of Moral Sentiments* and with specific reference to the "impartial spectator," Robert Prasch (1991, p. 348) inverts the conventional interpretation of Smith, turning cause into effect and effect into cause: "The process of capital accumulation is thus at heart a process which compels the rationalization of the 'rustic' world which precedes it." This idea comes from Smith's book 3, chapter 4, "How the Commerce of the Towns contributed to the Improvement of the Country." In Smith's own words (1937, p. 385), as quoted by Prasch (1991, p. 348):

commerce and manufactures gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived in a continual state of war with their neighbors, and of servile dependence upon their superiors. This, though it has been the least observed, is by far the most important of all their effects. [emphasis added]

Commerce fosters liberty. Or is it the other way around? The evidence provided by Prasch, coupled with the more conventional understanding, suggests that we might have to take Smith as simply believing that liberty and commerce (including capital accumulation) go together and of being in favor of both.

The prominence of the far-sighted impartial spectator in Smith's thinking warns against undue reliance on any notions of the supposed synergistic effects of commerce and liberty or on the positive externalities or the public-goods character of capital accumulation in understanding Smith's intertemporal bias. His bias, at root, is simply a reflection of his values. If this judgment is in need of some qualification, it is only because of the fact, reported by Rothbard (1995, p. 436), that Smith's *Wealth of Nations* lacks the lucidity and clarity that is so often imputed to it.

**INTERTEMPORAL BIAS IN MODERN ECONOMIC THOUGHT**

In my original comment, I summarized my thesis and brought the issues forward to modern times: Smith succeeded in ridding economic theory of the interspatial bias associated with Cantillon and other Mercantilists and then proceeded to introduce a strong intertemporal bias of his own. From the vantage point of the twentieth century, it can be said that while the battle against the interspatial bias has long since been won—due largely to the efforts of Adam Smith—the battle against the intertemporal bias is still being fought.

Evidence of the bias can be seen in professional papers as well as in textbooks at all levels. Although specific pieces of evidence abound in the literature, I focus on a passage from Milton Friedman, who may well be Buchanan's "modern analogue to Adam Smith," and one from Gregory Mankiw, whose new principles-level textbook is quickly winning him the reputation as the next Samuelson.

The *Modern Guide to Macroeconomics* (Snowden, Vane, and Wynarczyk 1995) gives play to the multiplicity of schools of thought by presenting macroeconomics in a school-per-chapter format. In their introductory chapter, the authors try
to avoid giving the false impression that macroeconomics is nothing but a "battlefield, with regiments of economists grouped under different banners" (p. 3). They claim that "economists tend to disagree more over theoretical issues, empirical evidence and the choice of policy instruments than they do over the ultimate objectives of policy." In order to drive home the idea that in this one area (ultimate objectives of policy) there is a virtual unanimity of opinion, they quote Milton Friedman (1968) to this effect: "There is wide agreement about the major goals of economic policy: high employment, stable prices, and rapid growth." I suspect that most readers of the Modern Guide or of Friedman's seminal article would read right through this statement in search of some more substantive proposition. That is, these goals do command such broad assent that the statement is little more than a throat-clearing introduction to some other issues more worthy of our attention.

While Rothbard and most Austrian economists would have critical remarks to make about each of the three goals announced by Friedman, my immediate concern is with the third goal: rapid growth. Had Richard Cantillon or François Quesnay, rather than Adam Smith, achieved the status of the Father of Economics, Friedman may well have announced the third goal as a favorable balance of trade or as a prosperous agriculture sector. To modern mainstream economists, these mercantilist and physiocratic goals seem misconceived or, at best, redundant. We would certainly want the quantity and price of imports and exports to be consistent with supply and demand conditions for these internationally traded goods—and similarly for the quantity and price of agricultural products. But these balances are not policy goals; they are a result of the market itself. Similarly, we are entitled to wonder why Friedman's third goal should not seem equally misconceived or, at best, redundant. A rapid growth rate simply means a high ratio of future output to current output. The more we sacrifice today, the more we can consume tomorrow. We certainly want this sacrifice and the corresponding growth rate to reflect the intertemporal consumption preferences of market participants. But this is not a policy goal; it is a result of the market itself. In comparing Friedman and Smith, it is significant that Friedman considers the goal of rapid growth to be an ultimate one in some sense. He does not argue that the goal is an implication of some theory of externalities or theory of public-goods as applied to capital formation. Those theories shed no more light on Friedman's views than on Smith's. While Smith relied on the impartial spectator and the other-worldly perspective that this construction entails, Friedman relies on the broad consensus among economists. Though no Presbyterian, Friedman does exhibit a Smithian bias—an underlying value bias—by embracing rapid growth as an ultimate policy goal.

Another aspect of the modern intertemporal, or pro-growth, bias is found most commonly in principles-level texts, in the curious treatment of compounding. It is true that small differences in saving rates and hence growth rates can, over a span of many years, translate into large differences in standards of living. Yet the so-called "magic of compounding" provides no basis for a rapid-growth policy. The role of the economist here should be one of dispelling the illusion of magic rather than one of transforming the perceived magic into a special defense of rapid economic growth as a policy goal. Writing for college sophomores, Gregory Mankiw (1997) chooses to perpetuate rather than dispel the illusion of magic. His chapter on
production and growth includes an "FYI Box" titled "The Magic of compounding and the Rule of 70" (p. 240). Why should we care, he asks, whether the economy grows at 1 percent or at 3 percent? The difference in the two growth rates, i.e., 2 percent, seems small. But over a period of forty years, income in the high-growth economy will be more than twice the income in the low-growth economy. Voilà! It's magic! And only forty years!

But, wherein lies the magic? Is it in the economics? Or is it in the mathematics? It is ironic, I think, that Rothbard and the Austrians, who tend not to present their economics in mathematical dress, would see no magic in compounding, while those who would readily write $y_t = y_0(1+g)^t$ somehow see this exponential function as entailing magic. Surely, the economist should assess the two growth rates in accordance with the intertemporal preferences of the market participants. Whichever one, if either, is consistent with those preferences is the one that should prevail and that—absent persuasive arguments to the contrary—will prevail in a system of natural liberty.

In a subsection titled "Economic Growth and Public Policy," Mankiw seems to shift without warning from an unbiased view of the intertemporal trade-off to a policy view that is colored by a Smithian bias. First, he anchors his ideas in basic economic principles:

Because resources are scarce, devoting more resources to producing capital requires devoting fewer resources to producing goods and services for current consumption. That is, for society to invest more in capital, it must consume less and save more of its current income. The growth that arises from capital formation is not a free lunch: it requires that society sacrifice consumption of goods and services in the present in order to enjoy higher consumption in the future. (p. 247)

This statement of the economic relationship between present and future consumption would no doubt have been gleefully embraced by Rothbard. The market process that governs the trade-off between consuming now and consuming later is on a par with the market process that copes with other aspects of scarcity. In his very next paragraph, however, Mankiw notes that "encouraging saving and investment is one way that a government can encourage growth and, in the long run, raise the economy's standard of living." But, on what grounds would the government "encourage" people to make the intertemporal trade-off differently from how they would make it without the encouragement? Mankiw does not mention externalities or public goods. And he tends not to be paternalistic generally in his policy prescriptions. Is there some informational asymmetry whereby policymakers are more attuned to the "magic of compounding" than are market participants? No such argument is offered. More plausibly, the alleged magic simply serves as a rhetorical device for introducing an intertemporal bias that has its roots in Adam Smith.

From Smith's day to our own, economists have tended to treat the intertemporal trade-off as something quite different from other trade-offs that market participants face. Whether based on the impartial spectator or on a perceived consensus among economists or on a supposed magic of compounding, their thinking is biased in favor of the future. They write as if they believe that the prospect of a more-than-doubled real income forty years hence should have a greater effect on our current
willingness to save than it actually has. On this idea, whether offered by Smith himself or the modern mainstream, Rothbard has expressed dissent.

REFERENCES


