

## ADAM SMITH AND THE INVENTION OF NATIONAL ECONOMY

The aim of this paper is to show that Adam Smith's theory of the economic development can be better understood based on the modern idea of national economy in spite of the common view that Smith is a theorist of international division of labour or globalised economy. I am also concerned with the historiographic change in the image of the Netherlands (the Dutch Republic), because it is considered that this change essentially relates to the emergence of the theoretical distinction of nation-based economy and global economy, which can be found in Smith and other Enlightenment thinkers. This paper consists of 3 sections: firstly, I will outline the thrust of my argument, including some actual implications of my interpretation of long 18<sup>th</sup> century economic liberalism; next, I will elucidate Adam Smith's basic perspective on the economic structure of the wealth of nations; finally, how to understand Dutch political economy from his point of view will be investigated.

### 1. An Economic Nationalist, or a Liberal Advocate of National Economy

It can be misleading to think of the idea of nation and state as traditional or not sufficiently modern under globalisation. This is true with respect to 18<sup>th</sup> century Europe as well as the today's world. In this paper I will examine a perspective partially attributable to Adam Smith and Montesquieu, where the contemporary economic order which rose in the 18<sup>th</sup> century can be understood as the system of national economy.

This description might sound a little strange because they are often thought of as "globalists," rather than "nationalists." Both of them were generally in favor of international free trade and were against absolutist states and narrow-minded nationalism. However, as for the author of *The Wealth of Nations*, his main concern is analysing the structure of the economy inside the nation and he places a much bigger emphasis on domestic division of labour rather than on international trade. In fact, the main reason why he supported free trade is that national stocks would be, through free trade, employed by more productive and safer domestic industries, instead of luxurious, risky international commerce and finance. Division of labour as a prominent character of commercial society is, for him, mainly concerning national economy rather than global economy. Needless to say, this does not mean Smith was completely opposed to contemporary globalisation; instead he theorised that the nation-based economy was a response to globalisation. In order to understand this, it is essential to distinguish a theorist of globalized economy from a globalist who would push ahead with this radical change. Smith can be considered an advocate of national economy, not because of his rejection of globalisation in the 18<sup>th</sup> century, but because of his conviction that national economy could be one of the most suitable economic system for the age of international commerce.<sup>1</sup>

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<sup>1</sup> I am greatly indebted for the interpretation of Adam Smith in terms of economic nationalism or the science of a legislator, to K. Saeki, *Misjudgement of Adam Smith: The Delusion of Global Capitalism*, PHP Press, 1999; K. Watanabe, "The Political Economy as 'the Science of a Legislator,'" in H. Tanaka ed., *The Épistémè of Enlightenment and the Birth of Political Economy*, Kyoto University Press, 2008 . Both of them are written in Japanese.

This interpretation of Smith also relates to the relationship between 17<sup>th</sup> century Dutch economic liberalism and that in 18<sup>th</sup> century Britain. The idea of commercial society in the Scottish Enlightenment is, although based on Dutch idea of free trade, more or less differentiated from the Dutch vision of commercial society or commercial state. It is certain that the economic thought of natural liberty broadly found in Great Britain succeeded partly to libertin thought of the Dutch Republic. In spite of this, there seems to be some significant difference between them. While the most competitive industry was international commerce, finance and ocean fishery in Holland, the British Empire was basically an agricultural country and still needed to invest in agriculture rather than in international trade or financial markets. This seems one of the reasons why their main target of improvement was rural areas. Smith criticised ‘prodigals and projectors’ and thought highly of so-called ‘gentleman based economy.’ Therefore, the Scottish idea of commercial society was wary of attaching too much importance to international, commercial industry. This is why Smith criticised mercantilism as the system of commerce. This point is an important Merkmal to make a distinction between 18<sup>th</sup> century Scots and 17<sup>th</sup> century Dutch, and perhaps between the Father of Economics and contemporary neo-liberalists.

## 2. The Natural Progress of Opulence and the Concentric-Circle Structure of National Economy

Smith’s ideal of the natural progress of opulence can be said to be one of the core issues found in his vision of nation-based economy. According to him, not international but rather domestic division of labour leads to fast economic growth. In historical reality, however, Europe has experienced the unnatural and retrograde progress and this would be the main point of ‘the causes of the slow progress of opulence’ (LJ(B): 521).<sup>2</sup>

Simply saying, his basic picture of the natural order of economic growth is as follows: first of all, agriculture develops, and this is followed by manufacturing in towns accompanied by domestic commerce; it is not until domestic industries are sufficiently invested that genuine international trade emerges (WN III, 1, p. 380).<sup>3</sup>

The reason for this order consists of a profit rate for each industry and basic human nature. Firstly, the order of the natural progress in book III of *The Wealth of Nations* is usually considered based on his analysis of investment behaviour in the last chapter of book II. Smith implies that investors’ care for their own interests results in the fastest progress of opulence. The investment of capital in

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Needless to say, this type of understanding was prominently presented by I. Hont. I should also mention that there was a debate between Hont and T. Nakano on how to understand economic nationalism. cf. T. Nakano, “Theorizing Economic Nationalism,” in *Nations and Nationalism* 10 (2004): 211-229.

<sup>2</sup> A. Smith, *Lectures on Jurisprudence, Report dated 1766*, eds. by R. Meek, D. Raphael, and P. Stein, The Glasgow Edition of the Works and Correspondence of Adam Smith, Liberty Fund, 1982.

<sup>3</sup> A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, eds. by D. Raphael and P. Stein, The Glasgow Edition of the Works and Correspondence of Adam Smith, Liberty Fund, 1976. “According to the natural course of things, therefore, the greater part of the capital of every growing society is, first, directed to agriculture, afterwards to manufactures, and last of all to foreign commerce. This order of things is so very natural, that in every society that had any territory, it has always, I believe, been in some degree observed. Some of their lands must have been cultivated before any considerable towns could be established, and some sort of coarse industry of manufacturing kind must have been carried on in those towns, before they could well think of employing themselves in foreign commerce”.

agriculture has priority over that in manufacturing just because this choice is more advantageous for individual investors, although it contributes to the public interests to the highest degree as a result. What we should pay attention to is that the most advantageous behaviour for individual investors is not necessarily or categorically equal to the most advantageous behaviour for the whole society. But, as far as private investors are left to be free and there are no artificial regulations which disturb the natural course of things, the former becomes equal to the latter. Smith states after the historical description of book III that “[every individual] generally, indeed, neither intends to promote the publick interest, nor knows how much he is promoting it. By preferring the support of domestick to that of foreign industry, he intends only his own security; by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention” (WN IV, 2, p. 456). Concretely, more profitable choices for investors (that is, agriculture rather than manufactures, and manufactures rather than international trade) add more value or profits to the society, especially to the working class.

There is another factor which explains how micro behaviour of each investor is in harmony with the maximum public interest. As rational beings, humans seek security as well as profits. According to Smith, “In seeking for employment to a capital, manufactures are, upon equal or nearly equal profits, naturally preferred to foreign commerce, for the same reason that agriculture is naturally preferred to manufactures. As the capital of the landlord or farmer is more secure than that of the manufacturer, so the capital of the manufacturer, being at times more within his view and command, is more secure than that of the foreign merchant” (WN III, 1, p. 379).<sup>4</sup> So-called conservative principles of investors consequently maximise the value added through the employment of labourers. This is because the agricultural sector can employ more labourers than the manufacturing sector and the latter can employ more labourers than the foreign trade sector, even if a profit rate for investors is indifferent in any case. “When the capital of any country is not sufficient for all these three purposes [=agriculture, manufactures and the trade of exportation], in proportion as a greater part of it is employed in agriculture, the greater will be the quantity of productive labour which it puts into motion within the country; as will likewise be the value which its employment adds to the annual produce of the land and labour of the society. After agriculture, the capital employed in manufactures puts into the motion the greater productive labour, and adds the greatest value to the annual produce. That which is employed in the trade of exportation, has the least effect of any of the three” (WN II, 5, p. 366).

The same conservative principles which give agriculture a higher priority over manufactures and

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<sup>4</sup> “Upon equal, or nearly equal profits, most men will chuse to employ their capitals rather in the improvement and cultivation of land, than either in manufactures or in foreign trade. The man who employs his capital in land, has it more under his view and command, and his fortune is much less liable to accidents than that of the trader, who is obliged frequently to commit it, not only to the winds and waves, but to the more uncertain elements of human folly and injustice, by giving great credits in distant countries to men, with whose character and situation he can seldom be thoroughly acquainted. The capital of the landlord, on the contrary, which is fixed in the improvement of his land, seems to be as well secured as the nature of human affairs can admit of. The beauty of the country besides, the pleasures of a country life, the tranquillity of mind which it promises, and wherever the injustice of human laws does not disturb it, the independency which it really affords, have charms that more or less attract every body; and as to cultivate the ground was the original destination of man, so in every stage of his existence he seems to retain a predilection for this primitive employment” (WN III, 1, pp. 377-8).

commerce also affect the order of precedence of several types of foreign commerce. “[U]pon equal or nearly equal profits, every wholesale merchant naturally prefers the home-trade to the foreign trade of consumption, and the foreign trade of consumption to the carrying trade. In the home-trade his capital is never so long out of his sight as it frequently is in the foreign trade of consumption. He can better know the character and situation of the persons whom he trusts, and if he should happen to be deceived, he knows better the laws of the country from which he must seek redress” (WN IV, 2, p. 454).<sup>5</sup> This order of preference motivated by a risk aversion brings about a boost in the national economy, without any intention of investors to make a contribution to the society. Only security-oriented activities of individual investors ensure as much employment as possible for the domestic labourers, which means the highest value is added to the commonwealth. To be concrete, Smith says: “a capital employed in the home-trade, it has already been shown, necessarily put into motion a greater quantity of domestic industry, and gives revenue and employment to a greater number of the inhabitants of the country, than an equal capital employed in the foreign trade of consumption: and one employed in the foreign trade of consumption has the same advantage over an equal capital employed in the carrying trade. Upon equal, or only nearly equal profits, therefore, every individual naturally inclines to employ his capital in the manner in which it is likely to afford the greatest support to domestick industry, and to give revenue and employment to the greatest number of people of his own country” (WN IV, 2, p. 455).

The structure of the natural progress of opulence we have elucidated so far can be also characterised as a ‘concentric-circle’. With respect to multi-layered foreign commerce, Smith points out that there is a strong incentive for wholesale merchants to substitute the foreign trade of consumption for the carrying trade as an employment to their capital, and to substitute the home-trade for the foreign trade. “He [=a merchant who is engaged in the foreign trade of consumption] saves himself the risk and trouble of exportation, when so far as he can, he thus converts his foreign trade of consumption into a home-trade. Home is in this manner the center, if I may say so, round which the capitals of the inhabitants of every country are continually circulating, and towards which they are always tending, though by particular causes they may sometimes be driven off and repelled from it towards more distant employments” (WN IV, 2, p. 455).

It goes without saying that it is not only the basic human nature of preference to security but also the different cost of transportation that cause this concentric circle structure. Explaining why “[t]he great commerce of every civilized society, is that carried on between the inhabitants of the town and those of the country” (WN III, 1, p. 376), Smith clarifies the logic of the so-called ‘general geography of price’<sup>6</sup>: “The corn which grows within a mile of the town, sells there for the same price with that which comes from twenty miles distance. But the price of the latter must generally, not only pay the expence of raising and bringing it to market, but afford too the ordinary profits of agriculture to the farmer. The proprietors and cultivators of the country, therefore, which lies in the neighbourhood of the town, over and above the ordinary profits of agriculture, gain, in the price of what they sell, the whole value of the carriage of the like produce that is brought from more distant parts, and they save, besides, the

<sup>5</sup> On the contrary, “[i]n the carrying trade, the capital of the merchant is, as it were, divided between two foreign countries, and no part of it is every necessarily brought home, or placed under his own immediate view and command” (WN IV, 2, p. 454).

<sup>6</sup> Rosanvallon, Pierre, *Le capitalisme utopique : Histoire de l'idée de marché*, Seuil, 1999, p. 98. (also cf. p. 94.)

whole value of this carriage in the price of what they buy” (WN III, 1, pp. 376-7). As this passage shows, Different kind of industrial structure emerges as a result of the economic geographical factors; this is not only because location where investors’ capital is employed should be as nearer as possible in terms of their security, but because goods with a lower cost of transportation can be much more competitive.

### 3. The Transformation of Economic Liberalism from 17<sup>th</sup> century Holland to 18<sup>th</sup> century Britain

In the previous section, we investigated the major traits of the natural progress of opulence, where agriculture is prior to manufactures and domestic division of labour is prior to the international one. It is easy to see that the order of precedence among three industrial sectors and the concentric circle structure of each economic sphere have a closer affinity with the idea of national economy rather than contemporary globalist ideas.

It is broadly known that the main target of Smith’s critique was so-called mercantilism. The mercantilist order of investment is completely opposite to the natural progress of opulence, which appeared to decelerate economic development in Europe to him. In his criticism of mercantilism, the idea of the natural progress of opulence functions not purely as a descriptive one but also as a normative one. It is always according to this ideal that he criticises actual economy and the government’s artificial policy which has promoted the distorted industrial structure.

There is also a historical background to the mercantilist thoughts, which has had a huge influence in early modern Europe. What Smith found in European history is opposed to the natural order as a normative reference; so far as the order of industrial development is concerned, historical reality after the fall of the Roman Empire was rather in line with the mercantile idea.<sup>7</sup> In contrary to this “unnatural and retrograde progress of opulence” in feudal Europe, Smith thought, the typical natural progress where agriculture takes the first priority can be found in the North America. “It has been the principal cause of the rapid progress of our American colonies towards wealth and greatness, that almost their whole capitals have hitherto been employed in agriculture” (WN II, 5, p. 366).<sup>8</sup> Most ancient empires like China or India developed in a similar way. More importantly, even Europe has been restored to the natural course as the feudal government becomes changed to the empire of laws, which implies that such radical reform as Physiocrat’s is not needed at all.<sup>9</sup>

<sup>7</sup> “[T]hough this natural order of things must have taken place in some degree in every such society, it has, in all the modern states of Europe, been, in many respects, entirely inverted. The foreign commerce of some of their cities has introduced all their finer manufactures, or such as were fit for distant sale; and manufactures and foreign commerce together, have given birth to the principal improvements of agriculture. The manners and customs which the nature of their original government introduced, and which remained after that government was greatly altered, necessarily forced them into this unnatural and retrograde order” (WN III, 1, p. 380).

<sup>8</sup> Cf. “It is thus that through the greater part of Europe the commerce and manufactures of cities, instead of being the effect, have been the cause and occasion of the improvement and cultivation of the country. / This order, however, being contrary to the natural course of things, is necessarily both slow and uncertain. Compare the slow progress of those European countries of which the wealth depends very much upon their commerce and manufactures, with the rapid advances of our North American colonies, of which the wealth is founded altogether in agriculture” (WN III, 4, p. 422).

<sup>9</sup> Cf. Hont, Istvan, *Jealousy of Trade: International Competition and the Nation-State in Historical Perspective*, The Belknap Press of Harvard University Press, 2005, chap. 5 (Adam Smith and the Political Economy of the

Apart from mercantilism, it can be said that there is another potential target for Smith and Physiocrats by introducing the descriptive and normative distinction of the natural and unnatural order: that is the Dutch Republic, or British economic theorists who idealise the Netherlands without considering any difference in industrial structure or historical situation.<sup>10</sup> Surely the proto-liberalist thoughts of free trade of the Dutch Republic had deep effects on British economic thoughts; but they did not necessarily agree in what type of industrial structure would emerge through civil liberty. According to Scots like Smith, the capital which has been employed by international traders and a financial sector would naturally come back to domestic agriculture and manufacturing by abolishing artificial regulations on trade. This way of advocacy for free trade is clearly different from the Dutch one in the sense that, for Smith, the end-purpose of free trade is restoration of the natural order of opulence. In contrast, what Dutch liberalism expected as a result of free trade is that the greater part of their capitals would flow into international trade and finance as a much more competitive industry than agriculture. While they share the promotion of free trade against protectionism as a prescription, Smith and Dutch liberalists or their admirers are distinct in their ideal vision of their own countries' industrial structure.

It is obvious that Smith does not criticise Dutch economy because it has an unnatural structure as mercantile Britain or France. But compared to vast countries such as the American colonies, ancient oriental empires, or ancient Rome, historical development Holland has experienced was not in accordance with the natural developmental course Smith idealises. Although Smith admits that its seemingly unnatural inclination towards the foreign trade is not necessarily unnatural for Holland, its economic structure appeared to Smith more or less unstable and even vulnerable. It is rather easy to find his implicitly negative comments on the Dutch Republic.<sup>11</sup>

To understand Smith's ambivalent attitude to the Dutch Republic, it is useful to distinguish the two different political forms: the small city-state from the vast monarchy or commonwealth, or the commercial republic from the agricultural monarchy or commonwealth. Owing to this distinction, it is possible to state that the Dutch Republic has its proper model for economic development while Britain and France have their own model. Holland's dependency on the international market is compared to the domestic division of labour as follows: "[t]he inhabitants of a town, though they frequently possess no lands of their own, yet draw to themselves by their industry such a quantity of the rude produce of the lands of other people as supplies them, not only with the materials of their work, but with the fund of their subsistence. What a town always is with regard to the country in its neighbourhood, one independent state or country may frequently be with regard to other independent states or countries. It is thus that Holland draws a great part of its subsistence from other countries; live cattle from Holstein and Jutland, and corn from almost all the different countries of Europe" (WN IV, 9,

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"Unnatural and Retrograde" Order).

<sup>10</sup> For examples, John Keymer, Benjamin Worsley, or Roger Coke can be said as British admirers of the Netherlands in the 17<sup>th</sup> century. See S. Ito, "The Trade Controversy in 17<sup>th</sup> century England," in H. Tanaka ed., *Barbarism and Enlightenment*, Kyoto University Press, 2014 (written in Japanese).

<sup>11</sup> See, for example, WN IV, 9, p. 668.

p. 677).<sup>12</sup> Basically Smith differentiates domestic from international division of labour especially when discussing the natural and unnatural progress of opulence; but in some case, considerable international interdependency can be indispensable. Holland is the exact case, since they do not have a big domestic market, and their major production is manufactures, which require much more extensive market than farm products.<sup>13</sup>

If the difference in the economic structure between small commercial republics and grand agricultural nations is taken into account, the desirable state for Britain could not be confused with the Dutch economic vision. Smith, criticising the common mistake of the carrying trade for the source of wealth, argues in book II that: “[w]hen the capital stock of any country is increased to such a degree, that it cannot be all employed in supplying the consumption, and supporting the productive labour of that particular country, the surplus part of it naturally disgorges itself into the carrying trade, and is employed in performing the same offices to other countries. The carrying trade is the natural effect and symptom of great national wealth: but it does not seem to be the natural cause of it. Those statesmen who have been disposed to favour it with particular encouragements, seem to have mistaken the effect and symptom for the cause. Holland, in proportion to the extent of the land and the number of its inhabitants, by far the richest country in Europe, has, accordingly, the greatest share of the carrying trade of Europe” (WN II, 5, p. 373). In contrast with Holland’s situation, Britain should have invested in several industries other than the carrying trade, which were more productive for the British national economy (he guessed at the same time that England would be nevertheless the second richest country in Europe). According to Smith, the foreign trade which Holland was dedicated to was the least productive industry in the sense that it could employ few domestic labourers and what it could add to the national wealth was only profits for capitalists, which would not include wages or rent.<sup>14</sup>

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<sup>12</sup> This passage continues as follows: “A small quantity of manufactured produce purchases a great quantity of rude produce. A trading and manufacturing country, therefore, naturally purchases with a small part of its manufactured produce a great quantity of rude produce of other countries; while, on the contrary, a country without great part of its rude produce, a very small part of the manufactured produce of other countries” (WN IV, 9, p. 677).

<sup>13</sup> “Manufactures, as in a small bulk they frequently contain a great value, and can upon that account be transported at less expence from one country to another than most parts of rude produce, are, in almost all countries, the principal support of foreign trade. In countries, besides, less extensive and less favourably circumstanced for interior commerce than China, they generally require the support of foreign trade. Without an extensive foreign market, they could not well flourish, either in countries so moderately extensive as to afford but a narrow home market; or in countries where the communication between one province and another was so difficult, as to render it impossible for the goods of any particular place to enjoy the whole of that home market which the country could afford. The perfection of manufacturing industry, it must be remembered, depends altogether upon the division of labour; and the degree to which the division of labour can be introduced into any manufacture, is necessarily regulated, it has already been shown, by the extent of the market” (WN IV, 9, p. 680).

<sup>14</sup> “That part of the capital of any country which is employed in the carrying trade, is altogether withdrawn from supporting the productive labour of that particular country, to support that of some foreign countries. Though it may replace by every operation two distinct capitals, yet neither of them belongs to that particular country. The capital of the Dutch merchants, which varies the corn of Poland to Portugal, and brings back the fruits and wines of Portugal to Poland, replaces by every such operation two capitals, neither of which had been employed in supporting the productive labour of Holland; but one of them in supporting that of Poland, and the other that of

From the previous discussion, we can conclude that Adam Smith, as well as other important Enlightenment thinkers, reinterpreted and transformed the 17<sup>th</sup> century liberalism into that which could be adaptable to territorial states such as Britain and France. While Dutch republican liberalism was hugely influential to the British who strongly supported free trade, he maintained at the same time that grand countries needed to have a different economic model from the Netherlands. This is because conditions of his vast monarchy could not be considered the same as the small city-state, in which international commerce naturally had an essential role. By contrast, Smith suggested that a nation-based economy, where agriculture and domestic manufacturing were relatively important, should come into existence in Britain and France. He even seems to have implied that it is not commercial republics but modern territorial states which had huge national economies that would survive well in his contemporary age.

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Portugal. The profits only return regularly to Holland, and constitute the whole addition which this trade necessarily makes to the annual produce of the land and labour of that country” (WN II, 5, pp. 370-1).