

In general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so...

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer... Adam Smith, 1776

How Adam Smith Would Fix Capitalism

Jesse Norman June, 2018

. . . the 21st century is not going to script.

The market system from which global prosperity has emerged over two centuries is now under attack from all sides, its basic legitimacy assailed from the right by critics of unfair competition and crony capitalism, from the left by campaigners against inequality and “market fundamentalism.”

More than any other, the Scottish political economist and philosopher Adam Smith stands at the center of this ideological battlefield, while around him clash competing views of economics, markets and societies.

For many on the right of politics, the author of *The Wealth of Nations* is a founding figure of the modern era: the greatest of all economists; an eloquent advocate of laissez-faire, free markets, the “invisible hand” and the liberty of the individual; and the staunch enemy of state intervention in a world released from the utopian delusions of communism.

For many on the left, Smith is something very different: the true source and origin of “market fundamentalism,” homo economicus and the efficient market hypothesis; the prime mover of a materialist ideology that is sweeping the world and corrupting real sources of human value; an apologist for wealth and inequality and human selfishness — and a misogynist to boot.

Which, then, is the real Adam Smith? In fact, both these views are hopeless caricatures. Smith was not an advocate of laissez-faire; the phrase “invisible hand” occurs just once in *The Wealth of Nations*; and he did not oppose all state interventions in markets. Indeed, he positively advocates a range of them, from specific forms of taxation to regulation of the banks.

He did not think selfishness was a virtue, and he was not a misogynist; far from originating the idea of “market fundamentalism,” he would have opposed it; and homo economicus and the efficient market hypothesis are later ideas that badly distort Smith’s own views. Industrial capitalism itself, as the combination of freely trading markets and autonomous corporations, is a 19th-century phenomenon, and only emerged two generations after his death.

The real Adam Smith is a vastly wiser and more subtle thinker. He forces us to discard the usual simplistic slogans and tired clichés. But more than this: he still has a vast amount to teach us, not merely about economics and markets and trade, but about the deepest issues of inequality, culture and human society facing us today...

For Smith, the crucial linking idea is that of the continuous exchange that occurs in all human interaction. This may be the exchange of goods and services in markets. But it can also be the exchange of meanings in language and in other forms of communication. And it can be the exchange of regard or esteem that in Smith’s view underlies the formation of moral and social norms in society. Each of these

ideas is of extraordinary importance in its own right, but together they reveal a very different picture to the caricatures.

First, we need to recognise that *The Wealth of Nations* is a work of genius not merely because it sets out many of the central intellectual tools of political economy...Smith is the first person to put markets at the centre of economics itself. Smith is thus the hinge of our economic modernity...

But, second, markets for Smith are very different to those of economists today...Recalling his insights about language and ethics, markets are living institutions embedded in specific cultures and mediated by social norms and trust. They shape and are shaped by their participants, in a dynamic and evolving way. They often have common features, but they are as different from one another as individual humans are: markets for land and labour and capital, asset markets from product markets and all the innumerable rest of them. Yes, markets typically generate economic value, and they are unmatched in their ability to allocate goods and services and encourage innovation and technological improvement. But, third, what matters is not the largely empty rhetoric of “free markets,” but the reality of effective competition. And effective competition requires mechanisms that force companies to internalise their own costs and not push them on to others, that bear down on crony capitalism, rent extraction, “insider” vs “outsider” asymmetries of information and power, and political lobbying.

Fourth, markets constitute a socially constructed and evolving order that exists and must exist not by divine right but because it serves the public good. It follows from this that the modern doctrine of market failure, which derives from academic models assuming perfect competition, needs to be expanded and supplemented. The truth is that outside academic models there are few if any genuinely free markets, and the imagined benefits of perfect markets disappear once any imperfections are allowed. Instead, policymakers need to start by asking two much simpler questions: What is this specific market for? How is it actually working?

Fifth, for the same reason, both individual markets and the market order itself rely on the state. While political intervention can destroy market functioning, it can also enable it. But markets are not inviolable, and they derive their reason for being not from any supposed sanctity of capitalism itself, but from their place within modern commercial society. Ultimately, especially within democracies, it falls to the state to underwrite that legitimacy. And if the preservation of the freedoms, trust and order that make up modern commercial society requires the periodic reform of capitalism, then reform it we must.

This is a complex and nuanced message, as befits our ever more complex world. It is threatening enough to current orthodoxies that many on all sides, libertarian and socialist, will resist it. Properly understood, however, these Smithian ideas remain absolutely fundamental to any attempt to defend, reform or renew the market system...

...We live in a time when politics across Europe and the US is being hollowed out by populist ideologies of left and right. Yet the historic alternatives, of war over trade, of religious autocracy, authoritarian communism and nationalism over democracy, or indeed of empty economic materialism over the benefits of commercial society, are not to be contemplated. Smith shows us a way forward — a new narrative through which we can start to reconstruct the centre ground.