

THE ROLE OF THE STATE IN ADAM SMITH'S THOUGHT SYSTEM AND MODERN PUBLIC FINANCE THEORY: A COMPARATIVE EVALUATION

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Abstract

What are the main functions of the state? Which functions must be fulfilled by the state, which functions must be not? How should the state fulfill these responsibilities? What must be the main principles of the state, related to public expenditures, taxation and debt policies? In this paper, the place of the role and functions of the state in Adam Smith's thought system will be discussed. In this context, especially the related parts of the Wealth of Nations and Lectures on Jurisprudence will be focused on and evaluated in the light of contemporary public finance theory.

Key Words: Adam Smith, the role of the state, Modern Public Finance Theory,

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1. INTRODUCTION

As of the publishing date of The Glasgow Edition of the Works and Correspondence of Adam Smith (1976-1983), today we, at least, know that the Wealth of Nations (WN) is not an independent study focused on just one topic, but a part of a system of thought, in other words a part of a whole. Wealth of Nations composes only a part of the "Moral Philosophy" lectures, which he delivered at the University of Glasgow for nearly twelve years (1752-1764) (or a part of a system of thought formed within this period). The Moral Philosophy lectures consisted of four subjects: *natural theology*, *ethics*, *justice and political regulations*. While the existence of God, role of religion in human thought and its formation principles were dealt with in *natural theology*, in *ethics*, discussions were held on philosophy of ethics, which he considered to have a significant importance in understanding human behaviors, the role of ethical behaviors in human thought and human relations, and general (universal) and historical characteristics and effects of these principles on the humanity, shortly to say, ethical doctrines, all of which he later on published in his book *The Theory of Moral Sentiments*. In *justice*, the third part of the moral philosophy, matters of debate were clear and sound principles of jurisprudence as a requirement for socialization of people and historical development of these principles both in terms of existence and accumulation of property and their relevance to the development and revolutions caused by law and government. It's a known fact that although Adam Smith endeavored to collect this part of his lectures into a book, as well, he could not complete his work. In the last part of his lectures, he analyzed political institutions or regulations regarding trade, finance, religious and military issues based on problem-solving expediency principle, rather than the justice principle, so as to increase the sovereign and wealth of the society and the wealth of the nation. We know that the last part of his lectures composes the content of the WN.

So, in this study, of which aim is to evaluate the role and functions of the state within Adam Smith's thought system from the perspective of today's contemporary economics, we are going to

take *The Theory of Moral Sentiments* and especially *Lectures on Jurisprudence* into consideration presuming that solely the *WN* would not be sufficient.

Adam Smith discussed the subject of public finance in the last part of the *WN*(1985:15). In this context, when we take a look at the role and functions of the state in Adam Smith's thought system, we come up with the scope of contemporary public economics or its principal titles (public services, public expenditures and economic effects of taxes and borrowing as finance tools of the first two). Moreover, since it's in the last part of the book, economic analysis of the state (public finance) leaves the impression of an external issue to the main political economics (as is in mainstream economics) at first glance. We can specify the hypothesis of this study within this respect: Although the contents are really different from one another, to try to understand the role and functions of the state in the Adam Smith's thought system from the perspective of the *WN* brings Smith closer to the dominant economics in terms of scope. However, addressing this issue pursuant to his three books detracts Adam's conceptual framework from dominant economics (both in terms of the scope of the economy and analysis on the state) and makes it a multi-disciplinary research field. For this reason, first of all the scope of Adam Smith's political economy and his opinions on the role and functions of the state will be explained. Then, one step further, the scope of political economy within the Adam Smith's thought system will be addressed.

2. THE SCOPE OF POLITICAL ECONOMY, MARKET AND THE STATE

There are two definitions of political economy in the *WN*. The first one is given just at the beginning of the section, which includes a critical evaluation of the mercantile or commercial and the physiocratic or agricultural systems under the heading "*On Political Economic Systems*": "*Political economy, considered as a branch of the science of a statesman or legislator, proposes (...) to enrich both the people and the sovereign.*" (Smith, 1976:557) The second definition, which is shorter than the first one is given in the section, where opinions of physiocrats and Quesnay are discussed (Smith, 1976:903). This definition expresses both the entire expansion of the *WN* and century-old research field of the defined political economy (with the contributions of David Ricardo and Karl Marx): the production and distribution of value.

In our opinion, the first definition is more important in terms of understanding Adam Smith's view regarding the scope of (political) economy and the role of the state within this. Pursuant to this definition, we can come to the following conclusions considering contemporary economics literature:

- First of all, definition of political economy as a branch of the science of a statesman or legislator shows that the state is not excluded from the analysis; on the contrary it was included in the analysis. The state and the market are considered as two natural parts of the analysis. In this subject, while there are ones, who claim that the scope of the political economy should be limited only to the analysis of the market, there are also others, who think that market and political processes should also be included in such analyses. (Two examples are N. Senior and J. Buchanan, respectively).
- On the other hand, when we take into account that in explaining human behavior Adam Smith based his thoughts on a system, which consisted of especially moral philosophy and sociological, judicial and economic aspects, we can point out that Adam Smith's state analysis as a part of the political economy is not in parallel with the approach, in

which the state is considered “as a field of application of contemporary mainstream [micro] economics”. In recent years, developments, which support a multi-disciplinary framework in state analysis, have increased the importance of A. Smith. (See Little, 2004)

- The fact that Adam Smith built his analyses on a method, which was space and time connected and had historical and institutional aspects, is not in conformity with the “formalist, self-enclosed, body of abstractions” nature of the contemporary dominant economics, and comprises a basis for questioning the methodological framework of the formalist economy and reconsidering the methodological boundaries of the economy. We can say that economists have a lot to learn from Adam Smith with regards to methodological problems of economics.

The second important point to be highlighted is that neither Adam Smith (his thought system) nor the known images of the WN reflect the reality. First of all the WN is not an ideological book. Adam Smith, quite surprisingly discusses strong and weak points of the market and the state as a social institute within the historical development process. For this reason, we think that it would be wrong to label Smith and his book as “the defender of limited state and laissez faire” as a cliché even in textbooks (Stiglitz, 1988:7, Rosen, 1999:5-6) or “the virtue of private market decisions without government” (Hillman, 2003:3). It’s necessary to note that wrong inferences will be obtained by evaluating Adam Smith’s views from the perspective of modern economics (named as absolutist method by the economist Blaug) ignoring their contexts and especially the fact that his approach had an important historical perspective. The followings may be pointed out to show the incoherence between Adam Smith’s writings and his image in economics and public opinion:

- While in the WN the concepts of self-interest and self-love become prominent, we notice that there are many other important human instincts or feelings such as sympathy, justice, prudence, generosity, gratitude, benevolence, conscience, wonder, surprise and admiration, when we think of the entire corpus of Adam Smith as a thought system aimed at explaining human relations. In this sense, “Das Adam Smith Problem”, which is addressed in the concepts of “self-love – sympathy”, remains behind. Even if the words “self-love – sympathy” are included in *the Theory of Moral Sentiments*, it’s set forth that these words should be considered “bad to the extent that it hinders general gratitude and not acceptable as any kind of virtue” (Smith, 2004:358).
- We can put forward that “self-interest and self-love” are never dignified, but criticized in the WN. For example, Smith describes the ones, who spend their fortune in things which are consumed immediately or non-durable commodities as “a base and selfish disposition” (Smith, 1976, p.464).
- Adam Smith complains not only about the violence and injustice of the political power ruling the society, but also about the impertinent jealousy of merchants and manufacturers, the mean rapacity, the monopolizing spirit of merchants and manufacturers, which has suppressed freedom of trade and legislature.
- Adam Smith goes further and sets forth that colonial policies of the European Nations including the Great Britain have two aspects not to boast of but to be ashamed of: folly and injustice (Smith, 1976:777-778).

Two alternative systems of economic policies, which may be named as a 18th century calculation debate in Buchanan (2008) expressions, are discussed in the fourth book of the WN: the mercantilist system, defined as the system based on encouragement and constraints and the free market system defined as the system of natural liberty by Adam Smith. In the second system argued by Smith: *“Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men.”* (Smith, 1976:914)

Adam Smith objects to the government intervention in the natural liberty system via various regulations and controls based on the following rationale:

As per the first rationale, the main source of increase in the wealth and employment of the state is the capital of the society: *“No regulation of commerce can increase the quantity of industry in any society beyond what its capital can maintain. It can only divert a part of it into a direction into which it might not otherwise have gone; and it is by no means certain that this artificial direction is likely to be more advantageous to the society than that into which it would have gone of its own accord.”* (Smith, 1976:590)

Here we can claim that the phenomenon named as “misdirection of the capital” by Hayek, which may develop as a result of expansionary monetary policy of the state (Hayek,1939:49 and 172) or self-financing of the budget deficit by the state, may come into prominence through commercial regulations.

The famous concept of “invisible hand” by Adam Smith is seen two pages after this citation: *“...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. (...) By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.”* (Smith, 1976:593-594)

In this sense, the second basis for Adam Smith’s objection to the government intervention in economy is the problem of knowledge: *“The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society.”* (Smith, 1976:914)

The third rationale is the euphoria of power, as the phrase is, to be observed in statesmen, who have seized the political power, *“The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it..”* (Smith, 1976:594)

The fourth one is the public prodigality and misconduct: *“Great nations are never impoverished by private, though they sometimes are by public prodigality and misconduct.”* (Smith, 1976: 454)

Although Adam Smith objects to regulations and limitations, he draws attention to one exception: Banking and Finance Sector(Smith, 1976:430).

3. FUNCTIONS AND FINANCING OF THE STATE: AN EVALUATION

According to Adam Smith, in the system of natural liberty, the sovereign has only three duties to attend to: defense, justice and infrastructural services. Economist Musgrave (2005:3-5) states that Adam Smith explained how these duties of the state emerged in the historical process and how they were to be conducted; however, he didn't make clear why these works had to be undertaken by the public sector. Even if there is a key concept of publicness for undertaking works such as infrastructure, which cannot be done individually, the concepts of externality and free-rider do not exist in Smith's system.

Adam Smith names 4 main principles regarding taxation, he considers taxes as ordinary and main revenue in financing public services (Smith, 2006:927-930):

- i) Taxes must be related to each tax payer's ability to pay or to the benefits he gets from the state. (equality or equity principle)
- ii) Taxes must be clearly defined and not arbitrary. (certainty principle)
- iii) Taxes must be collected in a reasonably painless way (timing and convenience principle)
- iv) Taxes must have low costs, both in administrative terms and in terms of the inefficiencies they cause the economy. (efficiency principle)

It's argued that in Adam Smith's system, the tax equity is based on the benefit principle (each tax payer pays his tax in proportion to the benefit he has obtained from public services); tax equity may vary depending on the structure of public expenditure and thus this principle should be evaluated as a tax-expenditure policy tool rather than a tax policy tool (Musgrave ve Musgrave, 1989:219). On the other hand, according to the ability to pay principle, another taxation principle that is effective today, citizens contribute to the tax revenue of the public in proportion to their ability to pay; taxation has no relevance with the public expenditure. However, Smith uses the two principles together in the first taxation principles. Taxpayer's tax is determined in proportion to the revenue obtained for the state protection.

In *The Economics of Taxation* by Bernard Salanie (2003), the reflection of taxes in the *WN* is discussed thoroughly; however, it's specified that it's only a supply-oriented analysis and the demand aspect of partial equilibrium analysis is developed by marginalists. Again in Salanie's study we observe that modern public finance literature regarding optimum taxation is based on the aforementioned four taxation principles of Smith; and flexibility principle was added so that taxes were adapted to economic fluctuations like an automatic stabilizator; and clearness principle was added so that the tax payer was provided with the information on who paid the tax in reality (Salanie, 2003:59). Although the trade-off between vertical equity principle, the first principle, and efficiency, the fourth principle, is an important subject of the current taxation theory, today the inefficiencies are meant the distortions of tax (excluding administrative costs) induced in the economy. (Salanie, 2003:60).

Adam Smith concludes with debt, another form of public sector financing: Smith expresses that the state should not have a deficit in the budget except for extraordinary situations (war, natural disasters) and that growing public debt, even if in the form of self-financing, is dangerous for the society. He claims that it's a mercantilist fallacy that the society perceives the payment of the interest of the public debt as "it is the right hand which pays the left" (in other words, as if it were unimportant) and that when time of reimbursement time arrives, taxes will have to be increased

and this will have a negative impact on the domestic manufacturers. Public debts (due to the fact they caused the sources to be transferred from efficient private sector to the inefficient public sector) hinder natural fortune and wealth development of the society. Even if taxes somewhat interrupt capital accumulation, citizens can pay a part of their tax debts by cutting their consumptions, the remaining part from their savings. However, since public debts is related with the savings of the private sector, this will have a consequence like directly cutting (in modern saying, crowding out) the investments of the private sector and a shrinkage in the production capacity of the society (See Smith, 1976:1248). Briefly, taxes and debts are not identical as a form of financing public expenditure: Smith is opposed to Ricardian equivalence theorem (Tsoulfidis, 2007). In this sense, if wars were financed with tax increase rather than debts, they would be more speedily concluded (Smith, 1976:1250). We can state that the hypothesis of R. Lucas- N. Wallace (or Unpleasant monetarist arithmetic) is somehow envisaged by saying that the end of growing debts is either bankruptcy or payment by coinage.

4. ROLE OF POLITICAL ECONOMY AND STATE IN LECTURES ON JURISPRUDENCE

Smith argues that jurisprudence “is that science which inquires into the general principles which ought to be the foundation of the laws of all nations.” (...) (in short) “Jurisprudence is the theory of the general principles of law and government.” (Smith, 1982:397-398)

The four great objects of law are Justice, Police, Revenue and Arms (Smith, 1982:398). Number of pages per aforementioned objects in the lectures dated 1766, which has 130 pages in total, can give us an idea on the importance of each topic: Justice 73, policy 34, revenue 10, arms 2 and law of nations 7 pages.

Police, the second section of Lectures on Jurisprudence covers, in general, government policies and regulation activities. Smith collects the content of the concept under three headings: cleanliness, security, and cheapness or plenty (Smith, 1982:486). According the Smith, security, the second object of *police*, is extremely important not only for social peace but also long-term healthy economic relations. Finally the third object of police is to provide cheapness, opulence and plenty for the state. To do this, first of all one has to discuss the meanings of opulence “and plenty” and variables affecting these two concepts. Discussing how to provide cheapness and plenty in meeting the basic needs of human, shows us the role of political economy and the *WN* in the Adam Smith’s thought system. Accordingly, addressing public opulence requires discussions of five different topics: First of all, the fundamental pre-requisite for opulence/plenty is the specialization of labor (division of labor) and increasing the workforce in the industry sector. In this sense, firstly the way, in which barter/exchange relation and good prices are established, should be examined. The second important topic is the importance of money as a standard of value and an exchange tool. Third topic is the factors, which result in a slow increase of wealth or prevent it from improving, in the context of industry and agriculture sectors. The fourth topic is determining negative effects of taxes, state revenue and various commercial laws on the wealth. And lastly the fifth object is advantages and disadvantages of trade and natural solutions for its disadvantages (Smith, 1982:353 and 494).

5. CONCLUSION

Although it has been 250 years since *The Theory of Moral Sentiments* was published, and 233 years since *The Wealth of Nations* was published, Adam Smith maintains his importance for

economists. The reason for that lies behind the fact that he was able to develop a thought system, in which he approached relations of human, as a social being, from nearly all perspectives. In this sense, we can neither explain how the civilization can follow a sustainable development trend only with the criterion “efficiency”, nor can we evaluate it decently within the scope of contemporary main-stream economics, which is based on this concept to a large extent. Social structure should, without doubt, create production and revenue; as the phrase is, “economic wheels” should be circled. However, the sustainability of social structures depends on development of certain institution, rules or feelings related with justice and ethics. In short, societies should be fair so much as they are efficient; and ethic so much as they are fair. So long as an individual can find these elements, which are the fundamental abettors of life, in the society, he is a part of, and then the sustainability of the society will also increase. In recent years, when economists have become more interested in ethics and political philosophy, Adam Smith is still an important source for economists, who do not consider the analysis of individual-state relations based on theoretical framework of economics, which has changed into being *a-politic*, *a-moral* and *a-historical*, to be sufficient.

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