A critique of Smith by Ricardo:
"Say's law" versus the "Vent for Surplus" argument

Debates on the relations between Smith's and Ricardo's theory of value are important and not closed. The literature about the opposition between labour theory of value in the *Wealth of Nations* (so called commanded labour theory of value) and labour theory of value in the *Principles* (so called incorporated labour theory of value) is huge[1]. However, I will limiting myself to one question: is Ricardo's theory an improvement of Smith's one, rectifying and correcting some (important) errors, in order to answer the *same* questions? The old (and respectable) theory concerning the unity of the "classical school" since Smith to Stiuart Mill answers "yes". J.M Keynes, in the first chapter of his *General Theory*[2] attributes to Marx (quite rightly, as far as I know) with this important idea. However, this idea can be be found also in the great liberal tradition, for example, in the great book of E.Halevy [1901 – 1995]..

As it is well known, Keynes criticized this thesis. For him the "classical school" begins with Ricardo, who made the conquest of England "as completely as the Holy Inquisition conquered Spain" (Keynes [1973 - 1936], p.32). Concerning Smith, Keynes remains cautiously silencious, and leaves open the issue: is Smith a sort of predecessor, as, for example, St. John the Baptist is said to be the predecessor of Christ?

Fortunately (or unfortunately) History of Economic Thought is not a matter of faith, and we have to investigate this issue. Curiously, historians of economics didn't study (as far as I know) Keynes' idea. Probably it is because Marxian and Liberal traditions are consistent and powerful. However at least one historian, P. Sraffa, gives us an useful information. In the "Introduction" to his edition of the *Principles*, he writes: « In the *Principles*, however, with the adoption of a general theory of value, it became possible for Ricardo to demonstrate the determination of the rate of profit in *society as a whole* instead through the *microcosm of one special branch of production*"[3]

Sraffa insists on the novelty of the *Principles*. Ricardo had to demonstrate the existence of a natural prices associated with a natural rate of profit "in the society as a whole". We know why. Ricardo wants to be sure that what we call today "Fundamental

[1] See Peach [2009].
[2] This chapter, devoted to history of economics, counts only one (important) page. , .
[3] Ricardo [1817-1951], « Introduction », xxxii, italics are mine. .

values" or "Intrinsic value" exists. It is the measure of capital which matters to the author of the *Principles*. In this quotation, Sraffa says us what he will demonstrate himself in *Production of Commodities by means of Commoditites*. The general theory of value, i. e; the general theory of natural prices (or of the production prices, as Marx will call them) is the necessary tool to answer this issue.

I will show that Smith inquiry is quite different and that Wealth of Nations doesn't need general theory of value. From this point of view, it is therefore the unity of classical school wich is at stake.

Sraffa's quotation is ambiguous on an important point. Sraffa assumes that before Ricardo, the rate of profit was determined into the "microcosm of a special branch of production. If we would follow Sraffa here, the ricardian novelty would be of the same nature of the general equilibrium one. Ricardian theory would be more general than previous ones. This story would be very dubious for (at least) two reasons. The first reason is that the relation between partial and general equilibrium theories can't be described as the story of a simple scientific progress leading from a particular result to a more general one. Marshall knew Walrasian theory. As a matter of fact we don't know exactly why not only Marshall but also most of the readers of Walras were reluctant to adopt general equilibrium theory.

To elucidate the second reason is the purpose of this paper. The *Wealth of Nations* doen't determines the rate of profit inside a "a special branch of activity". We know that Smith assumes the rate of profit is *given*. Consequently, he doesn't need to determine it. And I want to understand why. Naturally we can suppose (with Ricardo) that his position is erroneous. In this latter case it amount to saying that natural prices theory have *same* object, the same definition, in the *Wealth of Nations* than in the *Principles*. I want to show that it is not the case and that we have to study the relation between this book and Ricardo's one in another way.

Right from the "Introduction and plan of the work", we know which questions *The Wealth of Nations* intends to provide answers to. Here, Smith opposes two different economies. The first, referred to as that of the "savage nations of hunters and fishers" or "early and rude state" only involves workers who exchange the products of their labour. It is relatively egalitarian. The second, referred to as that of the "civilised and thriving nations" or "advanced state of society" causes workers and non-workers to coexist: capitalists who receive profits and landowners who receive rent. It is very inegalitarian, and yet:

"a workman, even of the lowest and poorest order, if he is frugal and industrious, may enjoy a greater share of the necessaries and conveniences of life than it is possible for any savage to acquire." [4]

Explaining this paradox is the specific purpose of *The Wealth of Nations*.

It is clear that this paradox results from the confrontation of two different causes of accumulating wealth: on the one hand, the progress of the division of labour that explains the growth in labour productivity, on the other hand, the accumulation of capital that *may* accelerate the latter. The text of *The Wealth of Nations* is clear: the first form of gain is perfectly possible without the second, and the second – the accumulation of capital – is not a form of deferred consumption, since capitalists accumulate simply to accumulate and not to consume to morrow. This is why this form of gaining wealth can be distinguished from the first without any ambiguity.

Two related propositions are associated with these two forms of accumulation of wealth:

1) Accumulation of wealth via the progress of the division of labour is limited by the extent of the market;
2) Accumulation of wealth via the accumulation of capital requires "vent for surplus", which Stuart Mill [1848] was later to name this "argument", without which capital may be in excess of requirements.

Smith's thesis whereby the pursuit of the accumulation of capital requires a vent for surplus was one of the notions that were the most often criticised by his successors (Ricardo, Stuart Mill). Ricardo doesn't understand how Smith can't understand Say's Law. The denial of this evident proposition seems to Stuart Mill the badge of a relic of mercantile system. However, since Allyn Young's famous article [1928], it has attracted the attention of commentators such as H. Myint [1958], A. I. Bloomfield [1975], H. Kurz [1992], Bruce Elmslie and Norman Sedgley [2002]. The "Vent for surplus" argument has then been interpreted as a first connection between the hypotheses of increasing returns and imperfect competition, providing the premises for a theory of endogenous growth (Young), while others interpreted it as a disequilibrium theory (Mynt), the presence of a theory of joint production equilibrium associated with no strictly positive prices (Kurz) or an expression of the distinction drawn by Smith between productive and unproductive labour (Elmslie and Sedgley). Further complicating the question is the fact that it is often read as a theory of

[4] Smith A. [1776-1976, I,10]

international exchange, which is rather strange since the concept of the nation is absent from *The Wealth of Nations* (Wallerstein [1996]).

This article seeks to shed new light on this question and contribute to this debate. I want to show why the "Vent for surplus argument" is not the badge of erroneous theories. It is the place of a general theory of value in the *Wealth of nations* which is at stake here..

Now, I would like to present the importance of the propositions 1) and 2° in *The Wealth of Nations* (I). Next, I will recall the criticisms made thereto by Ricardo (II). Finally, I will study under which conditions it is possible to respond to these criticisms, which will point to the absence of a *general theory of value* in *The Wealth of Nations* (III).

I

The propositions which affirm that the division of labour is limited by the extent of the market and that the accumulation of capital requiring a vent for surplus play a considerable role in *The Wealth of Nations*. They serve as a basis for formulating four difficult theses:

1° The increase in labour productivity via the extension of the division of labour is limited by the extent of the market. This is the initial proposition, which is developed from the second chapter of Book I.

2° We find it again at the heart of the analysis of rent: *The Wealth of Nations* affirms that the earth always produces more "corn" than is necessary for feeding the workers that cultivate it; and that "corn" is the *only* commodity that creates its own demand. This is why the price of "corn", not only can *always* pay the wages of agricultural workers and the profits of the farmers who exploit them, but above all, provide rent to their landlords. When the extent of the markets of the joint products of "corn" is insufficient, these products are either self-consumed, or they are "superfluities" with no value. However, if an effective demand does exist for these products (that is, a demand that is ready to pay the profit rates and wages necessary to "take these goods to market"), it should be such that it can also pay the rent. The "corn" situation is presented as an exception: the effective demand of other products may not to be such that they may pay a rent above and beyond the profits and natural wages required to lead them to market

3° We also find the proposition again at the core of the analysis of the "Natural Progress of Opulence", and it is used as a foundation for the famous metaphor of the

"invisible hand" in *The Wealth of Nations*. At its core, concluding Book II, we find chapter 5 entitled "Of the Different Employment of Capitals", which is followed by the first chapter of Book III entitled "Natural Progress of Opulence".

In these two chapters, Smith attempts to show that an order of investments exists which maximises income and employment per unit of capital invested (II, 5) ; then he attempts to show that investors would respect this order, if the system of natural liberty prevails. .

In order to do so, he starts by showing that employment and the income by unit of capital invested is higher in agriculture than in manufactures, and that it is also higher in these two sectors than it is in foreign trade. The demonstration is arduous, as is to be expected, and I shall not comment on it here.

In the following chapter, he outlines a dynamic whereby the "natural progress of opulence" implies that the order of investments "naturally" chosen by the capitalists is precisely that which leads from agriculture to foreign trade, via manufactures. Thus, Smith is able to deduce that this "natural" progress is optimal, as we would say today. Once again the demonstration is a difficult one, since it brings two propositions into play:

a) At *equal* net rates of profit, an investor will prefer to invest closer to home than far from it.

b) *Natural* rates of profit tend to decrease under the effect of competition.

I will not dispute the first of these propositions here, as it is odd, to say the least, if Smith considers the rates of profit net of risk here, in accordance with his analysis of risk developed in chapters 9 and 10 of Book I[5]. The second depends on the "general circumstances in which society finds itself" that is, its state of progression "towards opulence".

It is this fall in the rates of profit under the effect of the accumulation of capital that thus incites investors to overcome their reluctance to invest "far from home" which tends to broaden the market, thus increasing labour productivity and, consequently, actual real wealth. The metaphor of the "invisible hand" states this plainly.

It is interesting to examine this dynamic a little more closely.

[5] Critics, such as E. West [1990], often consider that Smith forgets in the last chapter of Book II what he wrote in chapter 10 of Book I. I have shown elsewhere (Diatkine [2010]) that it is not necessary to imagine such an incoherency.

Smith firstly introduces the thesis whereby “The great commerce of every civilised society is that carried on between the inhabitants of the town and those of the country”[6]. The production of “corn” not only allows rural inhabitants to be fed, but also city dwellers, whose consumption thus constitutes an outlet for the excess of agricultural products. Obviously, this is an application of the theory whereby the division of labour is limited by the extent of the market. Then the second proposition intervenes:

“In countries, on the contrary, where there is either no uncultivated land, or none that can be had upon easy terms, every artificer who has acquired more stock than he can employ in the occasional jobs of the neighbourhood endeavours to prepare work for more distant sale. The smith erects some sort of iron, the weaver some sort of linen or woollen manufactory. Those different manufactures come, in process of time, to be gradually subdivided, and thereby improved and refined in a great variety of ways, which may easily be conceived, and which it is therefore unnecessary to explain any further.” [7]

This describes the process whereby the accumulation of capital takes over; the broadening of the scope of the market has thus been established. Since the funds accumulated by the artisan cannot be invested in the land, they are invested in a manufacture, so long as the artisan’s products can be sold in more extensive markets, which are hence more distant. This phenomenon seems so obvious to Smith that he thus considers it pointless “to explain any further”. Nonetheless, we would like to know a little more on the point of departure of what would later be called the “industrial revolution”! Yet we know that it is necessary that this capitalist blacksmith exist, although this is not always the case. For example, Smith evokes the case of the colonies of Ancient Greece: the demographic growth following the development of the production of corn “overflowed”, owing to the territorial expansion in the colonies. This was the “simple and obvious” reason for the Greek colonisation. The search for profit is a less “simple” motivation that characterises an advanced state of societies and it is in this context that the accumulation of capital substitutes the “simple and obvious reason” of demographic growth, in the absence of available land. The accumulation of capital would take place “naturally”, if the mercantile system hadn’t incited it to take other channels, following the agricultural sequence, then manufacturing and finally foreign trade. Thus, according to *The Wealth of Nations*, the accumulation of capital

[6] “As subsistence is, in the nature of things, prior to conveniency and luxury, so the industry which procures the former must necessarily be prior to that which ministers to the latter. The cultivation and improvement of the country, therefore, which affords subsistence, must, necessarily, be prior to the increase of the town, which furnishes only the means of conveniency and luxury. It is the surplus produce of the country only, or what is over and above the maintenance of the cultivators, that constitutes the subsistence of the town, which can therefore increase only with the increase of this surplus produce” Smith A. [1776-1976, I,377]
[7] *Ibid*, 379.

requires an extension of markets, otherwise it will find itself in a situation in which the "surplus produce of domestic industry exceed the demand of the home market"[8]

The example that would cause Ricardo to react, as we shall see, immediately follows. An exchange is undertaken, writes Smith, in which "the surplus produce of domestic industry" in Great Britain is traded for 96 000 hogsheads of tobacco from Virginia and Maryland. Only 14 000 hogsheads are consumed and the rest is re-exported, thus safeguarding the productive labour of Great Britain, which produces manufactured goods exchanged for North American tobacco.

I will now study Ricardo's criticism. Before, it may be useful to summarise Smith's theory as follows:

1° The progress of the division of labour is conditioned by the extension of the market. Furthermore, in the advanced periods of societies, when the accumulation of capital exists, if this condition was not fulfilled, after a certain lapse of time the capital would become in excess supply.

2° The fall in natural profit rates, following the accumulation of capital, incites investors to invest increasingly further from "their view", from the agricultural sector through to "foreign trade".

3° Now, since employment and revenue per unit of capital invested is higher in the agricultural sector than in the manufacturing sector, and higher in this sector than in that of "foreign trade", this investment sequence is optimal.

These last two propositions are those that lay the foundations for the metaphor of the "invisible hand".

4° Foreign trade is therefore doubly justified, since it permits the extension of the market and prevents an excess of capital. This analysis would later rapidly be interpreted as an analysis of the benefits of free trade.

II

Chapter XXI "Effects of Accumulation on Profits and Interest" of the *Principles of Political Economy and Taxation* is, in fact, devoted to pursuing the critique of *The Wealth of Nations*, since only the analysis proposed by Smith on the effects of accumulation is being called into

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[8] « When the foreign goods which are thus purchased with the surplus produce of domestic industry exceed the demand of the home market, the surplus part of them must be sent abroad again and exchanged for something more in demand at home" (*Ibid*., 372)

question. This critique combines several different arguments but which all draw on core Ricardian theories.

What then, according to Ricardo, are the effects that Smith attributes to accumulation?

The first effect is the fall of profit rates following the competition of capital; the second effect is that capital may remain unused, meaning that it may be devoted to producing "redundancies". These are the two theses that Ricardo seeks to criticise.

Finally, and with no obvious link to the previous discussion, Ricardo adds three pages that aim to demonstrate that the existence of a legal interest rate is pointless.

The first argument put forward against *The Wealth of Nations* concerns the theory of distribution, which, as is common knowledge, constitutes for Ricardo, "the principal problem in Political Economy"[9].

Characteristically, Ricardo reads in Smith a proposition similar to the one he is supporting, but this reading is inaccurate. Smith effectively states that the same cause – that is, the accumulation of capital – engenders two effects, a rise in wages and a fall in profits. This proposition is important from a political point of view, since Smith seeks to show that while the workers' interest is always identical to the general interest – since a rise in wages denotes a gain in wealth for everyone – the interest of merchants and manufacturers is, on the other hand, contrary to the general interest, since the profit rates decrease as the society becomes wealthier. Ricardo, on the other hand, seeks to establish a causal relationship between the rise in the price of wages and a fall in rates of profit, which explains that, for Ricardo, the natural profit rate may only be lowered under the effect of a rise in wages, that is, under the effect of a rise in the difficulty of production of wage goods. It is only by way of this phenomenon that the accumulation of capital leads to a fall in profit rates. On the other hand, it seems inconceivable that competition can lower the natural rate of profit, since its role is to cause the market rate of profit to converge on the latter, in the course of the gravitational process, which he acknowledges that Smith was responsible for discovering. Hence it seems to Ricardo to be inconsistent to attribute, as Smith does, both the evolution of market rates of profit and those of natural rate of profit to the same cause (the competition of capital). This argument is submitted to the restrictive hypothesis whereby competitive forces *only* operate when market values gravitate around natural values, which is perhaps why this criticism is insufficient for Ricardo. He later changes register, in opposition to Smith, with what has come to be called "Say's Law".

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[9] Ricardo [1821-1951], p. 5.

More precisely, the following proposition seems ludicrous to him:

"When 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." [10]

Here Smith claims that capital may be surabondante (in excess supply) as a simple effect of accumulation. Against this proposition, Ricardo affirms "demand is only limited by production", the mere opposite of smithian thesis "the division of labour is limited by the extent of the market"

This time, he deals with the second outcome attributed by Smith to the accumulation of capital: as capital is accumulated, not only does the natural rate of profit falls, but capital may also become excessive. Against this idea, Ricardo invokes "Say's Law", in two forms.

1° In the first form, he states that "at the same time that capital is increased, the work to be effected by capital, is increased in the same proportion". And Ricardo continues: "M. Say has, however, most satisfactorily shewn, that there is no amount of capital which may not be employed in a country, because demand is only limited by production. No man produces, but with a view to consume or sell, and he never sells, but with an intention to purchase some other commodity, which may be immediately useful to him, or which may contribute to future production." [11]. In other words, supply creates its own demand.

It is not difficult to note that this affirmation is exactly the reverse of that whereby the division of labour is limited by the extent of the market.

2° Ricardo then quickly evokes the argument whereby "Say's Law" is justified by the properties of money, that is, by the inconceivable character of hoarding. This argument is derived from Say himself. I believe it is of secondary importance here, since, in substance, in the Ricardian world where scarcity of capital is identified by the natural profit rate, it is inconceivable – so long as the latter remains positive – that the capital can be in excess supply.

It is therefore impossible to understand how Smith can support the thesis whereby foreign trade may be necessary in order to avoid capital from becoming in excess of requirements. Ricardo cites Smith in order to denounce the idea affirmed by the latter, whereby, without the re-exportation of Maryland tobacco, the capital used for its importation

[10] WON, Bk. ii, ch. v; vol. i, p. 373. The italics are Ricardo's.
[11] Ricardo [1817-1951], 290.

will not be used, since "The land and labour of Great Britain produce generally more corn, woollens, and hardware than the demand of the home market requires."[12]

Ricardo's argument is solid: Smith supports the idea that external trade is necessary, whereas for Ricardo, it is clearly the result of the investment choices. If Great Britain produces more of certain goods than is required by internal demand, it is "obviously" because they are exported, and if they are exported it is "obviously" because it makes better economic sense to import others that are paid in this way. This thesis of Smith's seems to be in contradiction with those that defend free trade, which Ricardo cites, affirmed in the second chapter of Book IV of *The Wealth of Nations*, in the famous passage that follows the metaphor of the "invisible hand". In this passage, Smith affirms that:

> "It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy" […] "What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom" […] "*The general industry of the country, being always in proportion to the capital which employs it*, will not thereby be diminished." [13]

The misunderstanding is remarkable, and I will come back to this shortly, since Ricardo reads his own proposition into this last one – the one that underpins "Say's law", and which affirms that the extent of the market is limited by the division of labour, or in other words, the notion that supply creates its own demand.

Then Ricardo adds another citation from *The Wealth of Nations*:

> "The desire of food is limited in every man by the narrow capacity of the human stomach; but the desire of the conveniences and ornaments of building, dress, equipage, and household furniture, seems to have no limit or certain boundary. Those, therefore, who have the command of more food than they themselves can consume, are always willing to exchange the surplus, or, what is the same thing, the price of it, for gratifications of another kind. What is over and above satisfying the limited desire, is given for the amusement of those desires which cannot be satisfied, but seem to be altogether endless. The poor, in order to obtain food, exert themselves to gratify those fancies of the rich; and to obtain it more certainly, they vie with one another in the cheapness and perfection of their work."[14]

This citation is interesting since it is a passage in which Smith alludes to another "invisible hand", the one that is evoked in the *The Theory of Moral Sentiments.* Consequently, it is possible to the rich to exchange his surplus of corn for other goods produced by the poor.

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[12] Smith [1776-1976, I, 372]
[13] Ricardo [1817-1951], 295. The italics are Ricardo's.
[14] Smith [1776-1976, I, 181].

Ricardo can therefore, it would appear, conclude that a "universal glut" is inconceivable within the very terms of *The Wealth of Nations*, and its reader can adopt John Stuart Mill's theory, whereby the argument of "Vent for Surplus" results from a somewhat unclear understanding of the phenomenon, which is based on the last remains of the mercantile system, as Stuart Mill states:

"The vulgar theory disregards this benefit, and deems the advantage of commerce to reside in the exports: as if not what a country obtains, but what it parts with, by its foreign trade, was supposed to constitute the gain to it. An extended market for its produce—an abundant consumption for its goods—a vent for its surplus—are the phrases by which it has been customary to designate the uses and recommendations of commerce with foreign countries. This notion is intelligible, when we consider that the authors and leaders of opinion on mercantile questions have always hitherto been the selling class. It is in truth a surviving relic of the Mercantile Theory, according to which, money being the only wealth, selling, or in other words, exchanging goods for money, was (to countries without mines of their own) the only way of growing rich—and importation of goods, that is to say, parting with money, was so much subtracted from the benefit"…"The notion that money alone is wealth, has been long defunct, but it has left many of its progeny behind it; and even its destroyer, Adam Smith, retained some opinions which it is impossible to trace to any other origin. Adam Smith's theory of the benefit of foreign trade, was that it afforded an outlet for the surplus produce of a country, and enabled a portion of the capital of the country to replace itself with a profit. These expressions suggest ideas inconsistent with a clear conception of the phenomena."[15]

The cause therefore seems to have been settled: the argument of "Vent for Surplus", and the two central propositions that it summarises, whose central place in the *Wealth of Nations* I have just shown, since they serve as the basis for the theory summed up by the "invisible hand" metaphor, are no more than archaisms from the perspective of export merchants, partisans of the mercantile system, the target of their "destroyer", Adam Smith.

I shall now show that this statement of the failings of *The Wealth of Nations* established by Ricardo and Stuart Mill is perhaps the effect of an optical illusion, which would not be the only one of its kind, which consists of asking a text to answer questions that it does not pose. However, before we get to this, we should note that Ricardo's text contains a quirk, which in itself should alert us to the fact that things are not quite so simple. Indeed, the last two pages of chapter XXI are devoted to the critique of the legal interest rate. This excursion is not connected to the rest of his text, and it is only if readers are familiar with chapter 4 of Book II of *The Wealth of Nations* that they may know that Smith is a partisan of the government's establishment of an interest rate that is as close as possible to the natural profit rate. Without being named, Smith is therefore once again targeted, here. The connection with the argument

[15] Mill [1848 -1965, III, chap. 17] .

for “Vent for Surplus” is not at all explicit, but it is easy enough to tie it in. It is also easy enough to see that this connection is misleading.

III

To understand the link that exists between Ricardo’s critique of the legal interest rate[16] and the one that he opposes to the argument for “Vent for Surplus”, it is sufficient to recall the raisons given by Smith to justify what seems to be an infraction of his own principles, which Bentham[1787 -1952] had already noted. According to Smith, this legal measure aims to force merchants and manufacturers to act cautiously. More precisely, to oust from the loan market those that he names *projectors* and who, instead of borrowing money, borrow capital. As Perlman [1989] demonstrated, this approach, outlined in *The Wealth of Nations*, is similar to that of Wicksell. I will add this point: If the *projectors* are left to act freely as they please, not only do they oust the *prudent men* from the loan market, but they also corrupt them. The *prudent men* thus *all* consider that the profit rate anticipated by the *projectors* is the natural profit rate. The outcome is inevitable:

> “No complaint, however, is more common than that of a scarcity of money. Money, like wine, must always be scarce with those who have neither wherewithal to buy it nor credit to borrow it. Those who have either will seldom be in want either of the money or of the wine which they have occasion for. This complaint, however, of the scarcity of money is not always confined to improvident spendthrifts. It is sometimes general through a whole mercantile town and the country in its neighbourhood. Overtrading is the common cause of it. Sober men, whose projects have been disproportioned to their capitals, are as likely to have neither wherewithal to buy money nor credit to borrow it, as prodigals whose expense has been disproportioned to their revenue.”[17]

The crisis described here in *The Wealth of Nations* is a credit crisis and it is likely that Smith is referring, for instance, to the crisis of 1772[18]. However, I would like to insist on the fact that Smith’s tone is full of his usual irony when he speaks of the *illusion* of which merchants are the victims. As a matter of fact, *overtrading* is indeed the consequence of an illusion of which the merchants are both the victims and the perpetrators. This illusion

[16] Furthermore, one of the arguments evoked by Ricardo is strange: for him, fixing a legal interest rate is absurd since the government borrowed above the legal rate (especially in wartime). Yet, if we are to believe S. Homer and R. E. Sylla [1902-2005], the legal rate did not apply to the government.
[17] Smith [1776-1976, I, 437].
[18] Murphy [2009]

consists in mistaking the profit rate resulting from colonial monopolies for the natural profit rate, that is, for the profit rate that, Smith tells us, the community of capitalists would consider natural, in the absence of colonial monopolies[19].

This passage comes within a chapter (IV, ii) that aims to explain “the Principle of the Commercial, or Mercantile System”, and this principle is organised by type, from its most rudimentary form (the confusion between money and wealth) through to its subtlest form (the political necessity to ensure the balance of external exchanges). The credit crisis is one phase in this progression. The demand for money that characterises the credit crisis is the expression of this illusion –with its hubbub deafening the market square. According to Smith, the “demand for money. It therefore cannot be considered to be an argument in favour of the mercantilist theory, whereby money is usually scarce. Money, *under normal circumstances*, can never be lacking, except if a partial policy, merging the interest of merchants with the general interest, leads the former to *confuse* the profit rate induced by the system of colonial monopolies (for example) with the natural rate, and overtrading is the result of this situation.

The point I wish to stress is that, according to Smith, the excess of supply on the goods market is the consequence of a debt burden caused by *overtrading*, and not, as would be the case in the discussion of *universal glut*, the result of demand being diverted from the goods market (following, for instance, a decrease in rent after the repeal of the corn laws). Therefore, it seems to me that this causal relationship is very different from the one involved in the controversy between Malthus and Ricardo. Smith justifies the existence of a usury rate by the existence of financial crises in *The Wealth of Nations*, but it is difficult to speak of a *universal glut* in this context: at best it would be a local crisis, striking a particular place, but not an excess of the *overall* supply of capital. Smith’s defence of the usury rate effectively appears to be one of the measures destined to protect banks and, more broadly, lenders, but not as a measure associated with the risk of *universal glut*.

This point poses the following question: in these conditions, how are we to understand that the extension of the markets is necessary not only to increase the division of labour, but also to avoid capital from being “excessive”? How are we to understand that this excess is local, yet also distinct from market disequilibrium?

It is not easy to answer this question, if, as Ricardo affirms in the concluding chapter of the *Principles*:

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[19] It is perhaps useful to recall here that the natural profit rate is “given” in *The Wealth of Nations*. Therefore, we can consider it to be the result of a conventional phenomenon. This approach was to subsist for a long time in the British (marshallian) tradition.

"for it may be laid down as a principle uniformly true, that the only great encouragement to the increased production of a commodity, is its market value exceeding its natural or necessary value"[20].

Therefore, it is not absurd to imagine that Ricardo would also accept as "uniformly true" the inverse relationship, whereby an excess in supply naturally entails a fall in the market value (that is, the market price), providing an "encouragement" to reduce production until this excess is reabsorbed. Hence, it may only be temporary.

Kurz [1992] has shown that at least one part of the difficulties for interpretation posed by the "Vent for Surplus Argument" was resolved if we recall that *The Wealth of Nations* frequently evokes joint production. If we accept that joint production is a general case (insofar as it is necessary to recall this), and if we also accept that techniques are not perfectly substitutable, as it is generally the case, it is normal to find goods whose equilibrium price is nil. This is exactly the case in point in *The Wealth of Nations*, as Kurz has shown, based on chapter XI of Book I, concerning rent, in which a very long passage analyses the case of goods that are the joint products of corn and which may have a positive or nil price depending on whether an effective demand for them exists or does not exist. Joint production is also found at the core of the highly important analysis of the process of specialisation. From chapter II of Book I, Smith uses the example of hunters, some of whom specialise in the production of tools once they have discovered that it is more efficient to specialise in these goods rather than conjointly produce game and tools, provided of course that an effective demand for the tools they are producing exists. Joint production is thus invoked in important passages of *The Wealth of Nations*, and it is easy to understand that in this case, a *part* of the capital is made up of superfluous joint products, in other words, products whose associated price is nil. This part is therefore in excess supply. It postulates that goods, which are also elements of capital – as *The Wealth of Nations* introduces at length in the first chapter of Book II – remain goods even when they have a purchasing power of zero[21]. Hence, the ball can be thrown back to Ricardo: it is up to him to demonstrate under which conditions the prices of goods are strictly positive.

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[20]Ricardo [1817-1951, 426]:

[21] In my opinion, this poses one of the most difficult questions concerning the theory of value: how do we distinguish between goods with a price of zero and "things" (as Walras puts it) that have no price?

The last pieces of the puzzle still need to be assembled. Why does competition make natural profit rates fall? Which conception of the natural price might be compatible with this theory? Why does Say's Law have no place in *The Wealth of Nations*?

In order to understand how, in Smith's view, the profit rate falls as a consequence of accumulation; it might be useful to return to the definition of the natural price provided in *The Wealth of Nations*:

> "When the price of any commodity is neither more nor less than what is sufficient to pay the rent of the land, the wages of the labour, and the profits of the stock employed in raising, preparing, and bringing it to market, according to their natural rates, the commodity is then sold for what may be called its natural price."
> "The commodity is then sold precisely for what it is worth, or for what it really costs the person who brings it to market[22]."

Also, a little further on:

> "When the quantity brought to market is just sufficient to supply the effectual demand, and no more, the market price naturally comes to be either exactly, or as nearly as can be judged of, the same with the natural price. The whole quantity upon hand can be disposed of for this price, and cannot be disposed of for more. The competition of the different dealers obliges them all to accept of this price, but does not oblige them to accept of less."[23]

What does effective demand mean here? It is a notion connected to the extent of the market, that is, the purchasing power Qp present on the market, which may be written as: $E \equiv Qp$ the extent of the market.

The price, whether it be the market price or the natural price, is therefore defined by the identity $p \equiv E/Q$. The effective demand is the quantity Qe, Smith tells us, which satisfies those who are able to pay the natural price and hence wages and profits at their natural rates. The natural price is therefore defined by the identity $pn \equiv E/Qe$. We shall accept this *definition*[24]. In order for the accumulation of capital to lead to a decrease in the natural profit rate, it must induce a fall in the natural price, thus an increase in the quantity Qe that thus

[22] Smith [1776-1976, I, 72].
[23] *Ibid*.
[24] It is important to note that Stuart Mill is absolutely right to state that this conception of prices is an old one. Locke, for instance, explicitly referred to the term *Vent* that Smith calls the extent of the market. For Locke [1691] the price is the relationship between the Vent and the quantity of goods present on the market: "That which regulates the Price, i.e. the quantity given for Money (which is called buying and selling) for an other Commodity, (which is called Barting) is nothing else but their quantity in Proportion to their vent." For a deeper reading of a similar approach, see Benetti [2002].

satisfies the effective demand. In order for this to be possible, it is necessary to suppose that capitalists, who accumulate for the sake of accumulating, are constrained by the competition to consider as *natural* a lower profit rate. If capitalists considere as natural the increase of the quantities brought to the market, they consider also as natural the falling rate of profit which result if the extent of the market does not increase sufficiently. The natural price of certain joint products, in the absence of perfect substitutability of techniques, may become nil. The capital thus becomes excessive (since the goods brought to the market represent capital in the hands of those who possess them).

I have stated here that this hypothesis allows us to partially justify Smith's proposition, since it is obviously not possible to transpose it to the *entire* economy. Simply because the "entire economy", or the "society as a whole" is meaningless for Smith. This point is very important, since here we can found the very difference with ricardian (or marshallian) approach. For it is now possible to measure the distance that separates Smith's analysis from that of Ricardo. Under certain conditions, it is possible to show how the pursuit of accumulation causes the natural price of a *particular* commodity to fall within a *particular* market. If we were to extend this logic to an *overall* economy, defined by the basic factor of a complete list of all goods (or all markets, which amounts to the same thing), we would be obliged to generalise this partial approach. This is exactly what Smith does not do, and what Ricardo does. For Ricardo, the rate of profit expresses the difficulty of production of all of the goods of a *given* economy. It is therefore determined, for a *given* wage rate, by the production conditions of all of the goods within the economy. The Sraffa's quotation above (about the "microcosmos" opposed to "a general theory of value") matters exactly on this point.

However, in *The Wealth of Nations*, the natural rate of profit is the one that is judged as such within the community of capitalists (the market place) in question (which is very different from the "branch" evoked above by Sraffa.). This judgement, of course, depends on the competition provoked by the accumulation itself, among other considerations. Furthermore, we shall now see that no such thing as "a society as a whole" exists in *The Wealth of Nations*.

In order to understand this, we must continue to look for the final piece of the puzzle. *The Wealth of Nations* affirms that:

> "What is annually saved is as regularly consumed as what is annually spent, and nearly in the same time too; but it is consumed by a different set of people." [25]

It would be easy to read into this a perfect adherence to Say's Law. The revenue that results from the production of consumer goods and investment goods is spent by consuming and investing. Only local disproportions are possible, and the market's role is precisely that of putting an end to these disproportions. However, the text – which is devoted to the difference between productive and unproductive labour – develops this idea further. Revenue may certainly be consumed or saved and thus increased; but it can also quite simply be *destroyed*, and along with it, the circulating capital that it represents. Ricardo's model makes it difficult to conceive of the idea that revenue may be deliberately destroyed – that is, wasted.

Today, not only is all activity considered labour[26], but all labour is productive. Yet Smith tells us that the revenue (the capital) that pays for unproductive labour is partly destroyed. This is a delicate position. The main thesis formulated by Smith regarding the distinction between productive labour (Tp) and unproductive labour (Ti) formulates that the rate of growth is a direct function of the ratio Tp/Ti. But that is not all: the workers, whether they are productive or unproductive are paid in "corn". The corn consumed by the productive workers is reproduced with a profit[27]. The corn, when it is self-consumed by the unproductive workers, just like that which is self-consumed by their employers, is destroyed, unlike the part of the corn that is exchanged for goods. Feeding the servants was not so very different from the consumption of the famous Earl of Warwick who "is said to have entertained at his different manors thirty thousand people"[28]. In such cases, the "stomachs" of the rich were expanding prodigiously, at a time when the possession of land remained a "means of power and protection"[29]. In *The Wealth of Nations*, the purchasing power of rent may not be completely brought onto the market. It is therefore *cancelled*. Similarly, the "extravagance" of a minority, the failures provoked by the imprudence of "projectors", but also the military spending "abroad"[30] are examples of moments of destruction of capital that are often evoked by Smith. These moments of destruction are of course compensated (at least they are in Great

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[25] Smith [1776-1976, I, 337 - 338].

[26] As Hannah Arendt [1958] deplored.

[27] Is there any need to emphasise the fact that this is the point at which the text of *The Wealth of Nations* is most similar to the works of Marx?

[28] Smith [1776-1976, I, 413] :

[29]Smith [1776-1976, I, 382]

[30] It is important to call to mind the crucial political importance of the question of public debt, which fatally threatens the political body (Hume); the growth of public debt is provoked by wars. The French revolution, as we know, was spurred by the management of the accumulated debt at the time of the War of Independence in the United States.

Britain, probably not in Spain or Portugal and certainly not in Bengal) by the "incessant desire to improve one's sort". Later, these cases were to be perceived as aberrations, provoked by irrational behaviour, or by the imperfections of competition or of the markets. However, this is not necessarily the case in *The Wealth of Nations*. The idea that the reproduction of the social body also involved destruction (death) – an idea that was banal in the 18th century – marks *The Wealth of Nations*. Seen from this angle, Say's Law sits uncomfortably here.

Furthermore, and above all, Say's Law presupposes a reasoning couched within the framework of a *given economy*, as seems "natural". In other words, it takes as a given the list of all the markets that compose this economy (or the list of all goods, which amounts to the same thing). Without this list, which allows us to conceive of the macroeconomic notion of revenue, Say's Law has no meaning, since it affirms that the overall revenue is inevitably spent. It is this notion of overall revenue that is not found in *The Wealth of Nations*. However, is this point meaning that the *Wealth of Nations* is a partial equilibrium analysis "a la Marshall"?

As I indicated above, Smith stresses that the "great commerce of every civilised society is that carried on between the inhabitants of the town and those of the country". It is possible to measure the importance of this proposition if we bear in mind that the "system of natural liberty" defended in *The Wealth of Nations* is that which deals *impartially* with this fundamental interdependence[31]. It seems clear to me that Smith is thinking in the classical terms of *civitas*, or *polis*, which unites an agglomeration, concentrating manufacturing activities and the "neighbouring" countryside. It is within the framework of this *civitas* that the community of merchants and manufacturers unite around the notion of rates of profit deemed natural, just as they unite around wage rates that are deemed natural. Evidently, this view is fundamentally different from the marshallian industry! Moreover, this view does not in any way imply that the economy may be confined to this narrow horizon. Foreign trade, in this sense, is the commerce that connected, for instance, Athens and Corinth, or Philadelphia and New York, Glasgow and London. The characteristic of foreign trade is to place the retailer's capital still "further from his sight". However, that being said (which is very important), under the System of Natural Liberty, capital would circulate with no more difficulty from London to Lisbon than it does from London to Birmingham or from Calcutta

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[31] The *Wealth of Nations* opposes symmetrically the Mercantile System which favours the town and the manufactures and the Agricultural System, which favours the country and the agriculture.

to Boston… The economy, in the *Wealth of Nations*, is cosmopolite, i. e., *without borders*. A very famous passage says that very clearly :

"The effects of the division of labour, in the general business of society, will be more easily understood by considering in what manner it operates in some particular manufactures. It is commonly supposed to be carried furthest in some very trifling ones; not perhaps that it really is carried further in them than in others of more importance: but in those trifling manufactures which are destined to supply the small wants of but a small number of people, the whole number of workmen must necessarily be small; and those employed in every different branch of the work can often be collected into the same workhouse, and placed at once under the view of the spectator. In those great manufactures, on the contrary, which are destined to supply the great wants of the great body of the people, every different branch of the work employs so great a number of workmen that it is impossible to collect them all into the same workhouse. We can seldom see more, at one time, than those employed in one single branch."

This text opens the *Wealth of Nations*. It opposes two types of manufactures. The first type – the "trifling" one- may be studied as models of the second type, the more important. Yet this one cannot be directly studied, for the "number of people of whose industry has been employed" to produce "the accommodation of the most common artificer"…"exceeds all computation"[32].

If I am right, the economy of the *Wealth of Nations*, is a worldwide network of *civitas* without borders defining national economies.

This absence of a overall dimension to the economy also explains that the definition of natural prices is of course not a determination of natural prices. In fact, it is well known that if there is one element that has met with the unanimous agreement of all the commentators of *The Wealth of Nations*, it is their affirmation of the absence of such a "general theory of value". By and large, commentators have felt the need to fill in this gap, which is most often attributed to inexperience or clumsiness on the part of its author. At any rate, a general theory of value, a theory providing some form of general coordination of the economy, involves the given factor of the initial resources of this economy. For example, and in its most elementary form: to use the notion of labour as a theory for determining exchange relationships, it is necessary to know the quantity of labour (which may be homogenised by wage rates) that is available in the economy and its distribution per branch of activity[33]. The famous example of beavers and deer may be read as follows: if the agents *agree* that the natural price of one deer

[32] Smith (1776 – 1976), I, I, 11)
[33] In another form, it is important to be able to add up the budget constraints, given the preferences of agents.

is two beavers[34], it is *because* one hour of work for a deer hunter is deemed to be worth two hours of work by a beaver hunter. However, if the natural price is unknown, then it is necessary to know the quantity of labour undertaken and its distribution among the various branches, or alternatively, to construct the system of subsistence described by Sraffa [1960] to determine it, which is possible by way of the hypothesis of the *self-replacing state*. This construction and this hypothesis are not present in *The Wealth of Nations* because naturel prices are not supposed unknown by agents. This is an important point, as it simultaneously explains the fact that Say's Law is not conceivable in Smith's terms and that no general theory of value exists. In the same way, the absence of any overall dimension of an economy explains the absence of a theory of international exchange, which also means that "foreign trade" is not the equivalent here of international commerce. Foreign trade is the commerce between cities.

It seems clear to me that in order to construct a general theory of prices, it must be accepted that if the division of labour is limited by the extent of the market, the extent of the market is determined by the division of labour, or alternatively, that supply and demand are interdependent, which amounts to the same thing. If one believes, as Ricardo does, that this last procedure is indispensable, then *The Wealth of Nations* is struck to its core. At the same time, it is the question that this book seeks to answer that finds itself obliterated and replaced by the one that *On the Principles of Political Economy and Taxation* seeks to answer. Thinking as Ricardo does, means concerning oneself with the question of knowing why we are so poor, why we don't possess no much capital as we possess, which first requires that a precise measure of our capital be made, which the theory of value is supposed to achieve.

On the other hand, thinking as Smith does means marvelling at our wealth and concerning oneself with making this situation last. The question posed by Smith is very clear, I recalled it at the start of this text, and it may be reformulated as follows: under which conditions is the accumulation of wealth by non-workers compatible with that of workers? The two propositions of the "Vent for surplus" argument fall within this perspective: if the accumulation of capital increases the productive power of labour, it is still necessary that the increase in the extent of the market authorises this and delays the moment at which capital becomes excessive. Evidently, we may dispute the pertinence of the answer thus provided by

[34] How do we know this? Here, we are not so far from the notion of equilibrium price, since it is the agreement of both parties that seems to be the touchstone for the natural price.

The Wealth of Nations to the question it poses. However, the question seems to me to continue to be relevant today.

Is it possible to affirm that the ease with which *The Wealth of Nations* deals with both endogenous growth and financial crises is at the expense of the absence of a general theory of value? Keynes or Foucault [1966] have already incited us to take into account the profound heterogeneity of the classical school.

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