The Abduction of Adam Smith

How a Brilliant Observer and Kindly Egalitarian Became the Symbol of Greed

Polly Cleveland, 2013

1776 was a banner year for liberty. In Philadelphia, the ragtag Continental Congress sweltered and argued in the summer heat while drafting the Declaration of Independence. Across the Atlantic, Scotsman Adam Smith (1723-1790) published the world's most famous treatise on economics, *An Inquiry into the Nature and Causes of the Wealth of Nations*[1]. A coincidence? No. Both sprang from the Enlightenment, or Age of Reason, a seventeenth and eighteenth century reaction against narrow church dogma and for science and humanism. While writing the book, Smith met and corresponded with Benjamin Franklin. Thomas Jefferson left us a précis of Enlightenment values: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness."

Were Adam Smith to return to earth today, allowing for differences between the eighteenth and twenty-first centuries, he'd probably fit somewhere out in the far political left, but without the anger. Smith and subsequent "classical" economists addressed inequality head on, asking what determines the distribution of income. They supported free markets and free trade, not as ends in themselves, but as means to create broad prosperity and to curb monopoly. They also supported taxing the rich and privileged.

So how come today so many of us imagine Smith a heartless avatar of "greed is good", a saint of the money-changers? What transformed Smith and the classical tradition into the "neoclassical" tradition we live with today—a tradition that exalts the "free market" and leaves no room for equality or fairness? It's a complex story, one that hinges ultimately on changing the meaning of words.

The Eighteenth Century World of Adam Smith

Adam Smith lived during what historian Thomas William Heyck has called "the golden age of the English landlords" following the "Glorious Revolution" in 1688 that installed William III and Mary II on the English Throne.[2] The landlords made up less than three percent of the population but received about 15 percent of national income and owned over half the land. The titled nobility—dukes, earls, and barons—consisting of fewer than two hundred families, owned estates that might date back to William the Conqueror in the 11th century; or to the conquest of Ireland by Henry II in the 12th century. Next came another fifteen thousand families, the landed gentry—baronets, knights, esquires and gentlemen. Many of these had acquired land in the 16th century, when Henry VIII sold off the property he had confiscated from the Roman Catholic Church. Below the landlords was a shrinking class of small "yeoman farmers," who worked their own land. In Parliament, the king appointed members of the nobility to the House of Lords; the landed gentry elected members of the House of Commons.

Besides the landlords, there were capitalists and workers.

The capitalists were a rapidly growing class of manufacturers, merchants and traders in the major cities, especially in the ports. The most successful capitalists naturally used their profits to buy land and join the landed gentry. Adam Smith noted with some satisfaction that the capitalists were undermining the power of the landed nobility. In particular, the new profusion of consumer goods tempted some of the nobility to spend themselves into bankruptcy!

The workers ranged from the peasants who farmed plots on the landlords' land to laborers in the growing urban factories. The urban workers lived in crowded, unsanitary squalor. Often they had been forced off common land they had farmed for centuries when the landlords "enclosed"—in today's language "privatized"—the land to raise sheep.

Adam Smith and Classical Economics

Adam Smith himself was the original kindly, absent-minded professor. He looked odd, walked awkwardly, and talked to himself. Once, deep in thought, he wandered fifteen miles out of town in his night dress. He never married, but lived with his mother until her death in 1785. He spent most of his career as a Professor of Moral Philosophy at Glasgow University and subsequently the University of Edinburgh. Like his close friend, philosopher David Hume, he was a prominent member of the "Scottish Enlightenment". In 1759, Smith published his first major book, *The Theory of Moral Sentiments*, arguing that an important motivation for human behavior is sympathy with the feelings of others. The book made him a celebrity.

Seventeen years later, in 1776, Smith published *The Wealth of Nations*. Right at the outset, his humanity shines through, when he writes, "The difference between the most dissimilar characters, between a philosopher and a common street porter, for example, seems to arise not so much from nature, as from habit, custom, and education."[3] This is an amazing statement for status-obsessed eighteenth-century England. The book is long, rambling, bursting over with fresh observations, and not always consistent. Dip into it at any point and you'll hear that voice—discursive, witty, skeptical and tolerant. *The Wealth of Nations* quickly became a worldwide bestseller.

The book set off a scholarly and popular explosion of writing on what was then called "political economy"; at the end of the nineteenth century it was renamed "classical economics" to distinguish it from new-style "neoclassical economics." The best known nineteenth century English "classical economists" are Thomas Malthus (1776-1834), David Ricardo (1772-1823) and later, John Stuart Mill (1806-1873). The classical era terminated with two radicals: the German, Karl Marx (1818-1883) and the American, Henry George (1839-1897).

A Sidebar on Classical versus Neoclassical Terminology

Between classical economics and neoclassical economics, four key words changed their meaning: "wealth", "capital", "land" and "rent".

"Wealth" as in *The Wealth of Nations* meant useful *physical* things made by humans. "Capital" meant wealth used in the production of more wealth: buildings, tools and inventories of goods, especially stores of food to pay workers. Today wealth means "net worth". Capital today means anything that will deliver value in the future: "financial capital", "manufactured capital", "human capital", or what President George W. Bush earned by his reelection in 2004—"political capital"!

The classical economists used "land" as shorthand for natural resources very broadly understood. "Land" was not "wealth", because it was not man-made. "Land" included not just farmland but urban land, mines, rivers, ports, fisheries and any other kind of natural resource that could be made private under titles created and protected by the king. The Duke of Westminster owned (and still owns) much of the land under the posh West End of London! "Land" also included various territorial rights, granted by the king, including patents, bank charters, rights-of-way, and commercial monopolies such as the exclusive Indian trade granted to the British East India Company. By contrast, today we include land in wealth because it's part of net worth, and we include it in capital because it delivers value in the future.

In the classical scheme, the landlords receive "rent." This is what we today call "economic rent." It is *unearned income*, arising from the privilege of holding titles to property under protection of the state. Adam Smith writes: "As soon as the land of any country has all become private property, the landlords, like all other men, love to reap where they never sowed and demand a rent even for its natural produce."[4] Today we use the term "rent" for capital goods like buildings, planes and cars as well as for land; the term has quite lost its meaning of unearned income.

Note that unearned income did not carry the stigma it does today. On the contrary; it conveyed social superiority. Jane Austen's early nineteenth century landed gentry obsess about inheriting or marrying property income of so many thousand pounds a year—heaven forbid anyone actually had to work!

There's no exact modern equivalent for classical "land"—and that's a crucial part of our story. The closest is the ungainly term sometimes used in environmental economics, "natural capital." But that doesn't really convey the broad meaning of classical "land", which today would include such items as broadcast spectrum, geosynchronous orbits, drilling rights, taxi medallions, "air rights", "pollution rights," and internet domain names. Nor does "natural capital" imply economic rent or unearned income. When I say the classical economists supported taxing the rich and privileged, I mean they supported taxing the unearned income derived from owning titles to "land"—a point I will develop below. As we will see, by transforming classical "land" into a minor subcategory of capital and eliminating the unearned income called "rent", neoclassical economists successfully banished inequality.

The Classical Economists' Analysis of Income Distribution

How did the classical economists analyze their world? Still looking over their shoulders to the Middle Ages, they lived in a society which took great inequality for granted. Adam Smith writes, "Wherever there is great property there is great inequality. For one very rich man there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many."[5]

As I noted, this society fell quite visibly into three broad classes: the landlords, the capitalists, and the workers. These three classes supplied the three basic "factors of production": land, labor and capital. The landlords earned "rent", workers earned "wages" and the capitalists earned "profit" or "interest." The classical economists recognized that there was some overlap between the classes and their incomes; the term "profit" often conveyed a mixture of incomes. For example, a trader might own land, buildings and merchandise, and employ his own labor in the enterprise.

In his introduction to the *Wealth of Nations*, Smith poses a key question: what determines how "produce is naturally distributed among the different ranks and conditions of men in the society"?[6]. That is, what determines distribution of income between the three classes? What determines the shares going to rent, wages and profit? Inequality and distribution of income remained central topics throughout the classical era.

The mathematically-minded financier David Ricardo figured out what determines the level of rents: the amount of rent a parcel of land commands depends on its degree of superiority to land just barely worth using.[7] Note that superiority of land doesn't just depend on soil quality, but, much more important, on location. Land in the downtown of big cities commands the highest rents, due to its superior ability to facilitate the highest-value activities in an economy: the cooperation of highly skilled specialists like lawyers, bankers and brokers. Today economists still use the term "Ricardian rent" in explaining the value of choice locations.

Therefore, the classical economists said, when population growth brings inferior land into cultivation, that drives up the landlords' rents from superior lands. John Stuart Mill writes: "The ordinary progress of a society which increases in wealth, is at all times tending to augment the incomes of landlords; to give them both a greater amount and a greater proportion of the wealth of the community, independently of any trouble or outlay incurred by themselves. They grow richer, as it were in their sleep, without working, risking, or economizing. What claim have they, on the general principle of social justice, to this accession of riches?"[8]

Ricardo's explanation of landlords' rent left only wages for workers and interest (or profit) for capitalists to be explained.

Adam Smith was optimistic about workers' wages; he observed that their wages and conditions had already improved with population growth and new technology, and expected improvement to continue—as indeed would happen in the industrialized countries. But by the end of the eighteenth century, following the bloody French revolution of the 1790's, the growing hordes of poor urban workers inspired more fear and hostility than sympathy. Writing in 1798, Thomas Malthus advanced a radical "scientific" theory of wages: Workers breed faster than new land can be opened for production. Hence, famine, disease and "vice" will inevitably check their population, keeping their wages at "subsistence"—just enough for them to feed their families and reproduce.[9] In language dripping with upper-class contempt for the lower orders, Malthus even opposed aid to the poor, on the grounds this would just encourage them to breed faster. (As we will see, the last classical economists, Karl Marx and Henry George, vigorously opposed the subsistence wage theory.)

Malthus' subsistence wage theory seemed to solve the distribution problem. As Ricardo showed, with landlords' rent and workers' wages given, the balance of national income necessarily went to the capitalists—theoretically completing the entire distribution of income between the three classes of landlords, workers and capitalists! Based on subsistence wages, Ricardo also developed a crude "labor theory of value," explaining prices of goods by the amount of work it took to make them.

What about distribution in the long run? John Stuart Mill envisioned an eventual end to economic growth, a "stationary state", which he believed would be "a very considerable improvement on our present condition." It would be "the best state for human nature…in which, while no one is poor, no one desires to be richer, nor has any reason to fear being thrust back by the efforts of others to push themselves forward." [10]

How Smith Got his Ideas on Trade and Taxation from the French Physiocrats

Confirmed homebody though he was, Adam Smith couldn't resist the dazzling offer of £300 pounds a year to tutor the young Duke of Buccleuch on a tour of Europe; they spent 1764 through 1766 in France. After a spell in Toulouse, Smith and his party visited French skeptic and iconoclast Voltaire (1694-1778) in his hideout at Ferney on the Swiss border—whence he could easily escape periodic prosecution. Then they moved on to the Paris salons.

The Paris salons under King Louis XV teemed with Enlightenment intellectuals, including Benjamin Franklin, representing the British American colonies. Among the most influential were a group known as the "Physiocrats" or "*Oeconomistes*", who argued for the "rule of nature." Their leader was physician to the king, Francois Quesnay (1694-1774). He developed the earliest macroeconomic model, the *Tableau Economique*, showing the multiplier effect of investment in agriculture. (The salon ladies referred to the *Tableau* as "*les Zig-Zags*.") Another influential Physiocrat was Anne-Robert-Jacques Turgot (1727-1781), at the time Intendant of the French province of Limoges. In 1766, Turgot wrote a short, sophisticated monograph, *Reflections on the Formation and Distribution of Wealth*.[11] The Physiocrats greatly impressed Adam Smith. He would have dedicated the Wealth of Nations to Quesnay had the latter not died; while he doesn't cite Turgot, Smith's economic ideas closely track those in Turgot's monograph.

The Physiocrats coined the motto *laissez faire*, short for "*Laissez faire et laissez passer, le monde va de lui même!*" ("Let do and let pass, the world goes by itself!") To see where they were coming from, consider the pre-revolutionary French tax system: A small part of revenues came from taxes on land, exempting land belonging to the king, the church and the nobility. The bulk of revenues came from excise taxes on anything that moved, notably salt and tobacco. There were taxes on goods moving from one province to another, or in and out of cities; smuggling was a huge industry. There were also poll taxes. These taxes were administered by the notoriously corrupt "tax farmers" who paid the king for the privilege. In addition, the *corvee* required peasants to work for free on the roads. This corrupt and wasteful system no longer generated sufficient revenues; in short, the monarchy was broke.

The Physiocrats advocated abolishing this dog's dinner of imposts, and taxing land only—"*l'impôt unique*"—including royal, church and noble land! Why? Because, as Turgot makes clear, only land generates a surplus that can be taxed without impeding work or investment. As Intendant of Limoges, Turgot managed to put some Physiocratic principles into effect, with such good results that the desperately-strapped new King Louis XVI appointed him Finance Minister in 1774. However Turgot's reforms did not go down well with the noble cronies of Queen Marie-Antoinette, who shortly had him fired. They king and queen may have blown their last chance to save the monarchy; in less than twenty years, they would meet Madame Guillotine.

Adam Smith and the Classical Economists on Free Markets and Free Trade

Following the Physiocrats' logic, Smith and the other classical economists all advocated domestic free markets and international free trade. They advanced both positive and negative justifications.

In the first pages of *The Wealth of* Nations, Smith lays out a powerful positive reason for free markets and free trade: Cooperation and exchange vastly increase productivity by permitting division of labor and encouraging innovation. As a "trifling example," Smith gives us a tour of a pin factory. Here, "One man draws out the wire, another straights it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations…" In this fashion, where a man operating alone could make maybe one pin a day, a factory of ten men can make “upwards of forty-eight thousand pins in a day.” [12]

Smith of course isn’t particularly interested in pin factories. Rather, the pin factory graphically illustrates the staggering productivity made possible by cooperation, specialization and innovation, not just within individual businesses, but through market exchange. Division of labor, Smith writes, is limited only by “the extent of the market.”[13] (Nonetheless—typical of his humane outlook—Smith worries that excessive division of labor would mean that, “The man whose whole life is spent in performing a few simple operations, of which the effects are perhaps always the same … generally becomes as stupid and ignorant as it is possible for a human creature to become.”[14])

In addition to labor specialization, Smith also recognizes the benefit of regional specialization. Different locations have different natural resources; some areas have fishing ports, others have mines, yet others have rich farmlands. Trade means goods can be produced in the lowest cost areas, for the benefit of all. David Ricardo extended Smith’s argument with the principle of comparative advantage: two regions or countries can still trade advantageously even if one is absolutely better at producing everything. Ricardo gives a hypothetical example of Britain and Portugal. If Portugal is better than Britain at producing both wine and cloth, but Britain is “more better” at producing cloth than wine, then Britain can still specialize in cloth and Portugal in wine.

The obvious large benefits of exchange, both domestic and international, lead Smith and the other classical economists to oppose artificial restrictions on exchange, such as excise taxes, tariffs or quotas. David Ricardo, who spent 1819-1823 in Parliament, vigorously opposed the so-called “corn laws”, which imposed heavy tariffs on the import of grain. The corn laws, enacted in 1804 at the behest of large landowners, increased their rents at the expense of workers’ wages. The laws were repealed in 1846 due to a growing free-trade movement, which by then had broad support among English merchants and manufacturers.

As a negative reason for advocating free markets and free trade, the classical economists saw such policies as a curb on monopoly. Smith especially attacks the mercantile guilds that controlled occupations in the cities. To become a tailor or a baker, you had first to be accepted as an apprentice by guild member. Like today’s Medical or Bar associations, the guilds acted as cartels, keeping up prices by restricting membership and preventing competition.

At the national level, remember that the classical economists lived under a monarchy. They opposed royal charters granting special privileges, such as monopolies of silk imports. Even the now semi-constitutional monarchy of England still operated as government by and for the nobility and landed gentry at the expense of everyone else. Smith himself lived under the same King George III (1738-1820) who “lost” the American colonies. As for free international trade, remember that England, France, Netherlands, Spain and Portugal were mercantile nations, perennially at war over trading monopolies. The British Navigation Acts barred the American colonists from manufacturing, and forced them to trade only with the mother country. When the British East India Company teetered on the verge of bankruptcy, Parliament gave it a special monopoly to sell tea in the colonies—inspiring the 1773 Boston Tea Party. The colonial revolutionaries played on British-French animosity to get vital French aid. The classical economists hoped international free trade would put an end to war!

Smith's free market advocacy shows up in some of his most famous passages. He writes, "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest."[15] In the spirit of the Physiocrats' "the world goes by itself," Smith observes that an individual merchant may be "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."[16]. In context, Smith is describing the benefits of a highly competitive trade in merchandise, not capitalism in general. He is recognizing that people naturally act in their self-interest; he is not advocating selfishness.

Smith was indeed no naïve admirer of business. In another passage he writes, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[17]. He particularly had it in for "joint-stock companies," as corporations were then known. (In 1720, the South Sea Company created a bubble that brought down the English economy.) Referring to joint-stock companies, Smith coined that famous phrase "other people's money": "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."[18]. Indeed!

By "free market" and "free trade", Adam Smith and the other classical economists meant free entry, as in an open, broadly competitive market, a level playing field accessible to many buyers and sellers. They objected to tariffs and subsidies because these favored some parties over others, usually to the detriment of both sides. They objected to rules limiting the number of participants in a market, such as guild rules. They objected to fraud and monopoly of any sort—"a conspiracy against the public."

A Sidebar on the Meaning of "Free Market" and "Free Trade"

Let me take another sidetrack here on changes in the meaning of words, in this case "free market" and "free trade."

To understand "free market" in Smith's day, remember the Physiocrats' motto: "*Laissez faire et laissez passer"*: let do and let pass. That is, allow unimpeded movement of goods and people. At that time national governments, local towns and noble landholders restricted movement at will, to extract tariffs and labor or to protect monopolies. Today the term "free" has come to mean "free of government interference." This subtle twist obscures the reality that government also facilitates movement as well as impedes it. From the earliest times that people have regularly met for exchange, government has necessarily provided at least a safe physical space. That government might have been no more than the local chief, who protected the traders for a cut of their profits. The early Sumerian, Chinese and Egyptian governments not only provided market places; they also built roads to those markets. They established and enforced systems of weights and measures, as well as standardized forms of money. They also drew up sets of rules, such as the Code of Hammurabi, and provided courts to resolve disputes. In the time of Christ, under the Roman Empire, it's no surprise to find money-changers in the temple, along with all sorts of other merchants—because that was a nice, safe, central location for a market.

Genuine free markets require governments that actively prevent coercion, fraud or monopoly. In modern times, governments also help participants find the information necessary to make good decisions, such as requiring accurate labels. And they restrict transactions that could do damage outside the market, for example, barring trade in skins of endangered cats, or requiring background checks on gun purchasers. Even further, genuine free markets require governments that provide some sort of social safety net, including bankruptcy protection, to enable participants to risk innovation, and to protect losers when tastes and technology change. Your modern economics textbook assumes genuine free markets just pop up spontaneously like mushrooms after a rain.

While "free markets" implicitly assume a single government, "free trade" necessarily implies the involvement of multiple governments. That's where problems really begin. Different governments have different rules for labor, property rights, environment, health, consumers, patents, finance and many other areas. They also incline to protect "their" citizens and corporations against the others, regardless of merits. So whose rules should prevail? We have treaties, which even ideally can't spell out all the contingencies as trade patterns and technology change. As for "safety nets", yes, we can and do have procedures allowing one nation to make claims against another for unfair practices such as "dumping." Such procedures don't stop subsidized U.S. rice and cotton from wiping out third world farmers. As for establishing some form of global government to resolve trade conflicts, the current Eurozone disaster makes any such notion preposterous. That leaves truly free international trade as more of a mirage than the classical economists perhaps hoped. In their defense, they couldn't possibly have imagined the complexity of modern markets or the power of multi-national corporations.

In short, when the classical economists advocate "free markets" and "free trade" they mean markets where, as much as feasible, governments actively provide equal access to all sellers and buyers. Of course, few real life markets even come close, then and now.

Adam Smith and the Classical Economists on Taxation

Adam Smith's views on taxation would also put him way out on the modern left. Remember that in his day, most business was conducted in cash. Record-keeping wasn't adequate for our modern income taxes or sales taxes. That left two basic kinds of tax: land taxes on the value of the landlords' land, and imposts and tariffs on bulk goods, collected mostly in ports and other trading centers.

Land taxes are the oldest form of tax, not only in Britain, but in all civilizations. They were (and are) relatively easy to assess, though not always to collect, because as grantor, the king could have a pretty good idea what the land was worth. In Britain, unlike France, the king had to rely on Parliament to impose the tax, giving Parliament increasing control over government. After 1688, during the reign of William and Mary, Britain's "financial revolution" depended on an extraordinary land tax of four shillings to the pound, or 20% of assessed value (which was often much less than actual value). This high tax enabled Britain to develop a modern financial system: a permanent national debt consisting of bonds that paid regular interest; and a central bank, the Bank of England, founded in 1694, which loaned money to the government and issued currency. This system enabled Britain to fight several successful wars, especially against

France's expansionist "Sun King," Louis XIV, and to extend its naval power around the world. With naval protection, Britain's merchant fleets prospered and its colonial empire expanded, bringing ever more tariff money into government coffers.

So what did Adam Smith propose? Following Physiocrats' guidance, Smith set out four "maxims of taxation". They challenge our comfortable modern assumptions about taxation:

Smith's first maxim holds that: "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."[19] Notice he isn't just saying taxpayers should contribute in proportion to ability to pay, but effectively in proportion to the benefits they receive from government. As he makes clear, the greatest benefit is the security of property.

Smith's second and third maxims are just common sense: taxes should not be arbitrary, and they should be imposed at a time and place convenient to the taxpayer.

Smith's fourth maxim holds that, "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state." Taxes should cost as little as possible in expense and staff to collect. They should not "obstruct the industry of the people." The tax should not at once tempt people to evasion and then punish them severely for yielding to temptation. Finally, the tax should not subject people to "the frequent visits and the odious examination of the tax-gatherer." [20]

What tax best meets these criteria? Of course, the land tax! Smith says it admirably meets the second, third and fourth criteria. It fails the first—the proportionate burden—because, while landlords had greatly increased in prosperity, assessments hadn't increased since William and Mary almost 100 years before! (Sound familiar?) That problem, says Smith, can be solved by following the recommendation of the French Physiocrats to let the taxes rise and fall with the level of rents.[21] That would make them "the most equitable of all taxes."

Allow me another quick sidetrack on taxation, then and now. Smith's land tax, based on proper assessments, is roughly equivalent to a modern wealth tax, including corporate wealth. It is also equivalent to the land component of a modern property tax, which falls on corporate property as well as homes. Compared to a modern income tax, a land tax is very progressive. That's because property ownership is much less equal than income—remember the landowning nobility and gentry held over half the land but received only 15% of the income. Today's One Percent own about 35% of net worth, about 43% of non-home wealth, while receiving about 21% of income.[22] And of course a land tax falls on rent, that is, unearned income. As such, it doesn't "obstruct the industry of the people" that is, it doesn't distort incentives to work and invest.

By contrast, today's ideal tax is "broad-based" and "balanced." That is, it's considered fair and equitable to tax everything at least a little bit. States have increasingly shifted from property taxes to sales taxes, and Social Security and Medicare rely on payroll taxes. Federal and state income taxes have become far less progressive since the Reagan Revolution in 1980. Adam Smith would not approve.

The Radical Classics and the Neoclassical Counter-revolution

The earlier classical economists belonged to an educated aristocracy, not ready to throw bombs. But towards the end of the nineteenth century, the Gilded Age of the Rockefellers in the U.S., and the Rothschilds in London, two intellectual bomb-throwers came to prominence, both drawing on classical ideas.

In London, deep in the British library, Karl Marx (1818-1883) beavered away on his masterwork, *Capital*, publishing Volume I in 1867.[23] (*Capital* first appeared in English in 1887, after Marx's death.) A radical socialist scholar, Marx had escaped Europe during the crackdown following the publication of his *Communist Manifesto* in 1848. Building on Ricardo's labor theory, Marx argued that capitalists increasingly exploited workers by paying them less than the value of their labor. Eventually, inevitably, the workers would overthrow capitalism, ushering in a new era of proletarian harmony.

A far more unlikely bomb-thrower emerged in western United States: Henry George (1839-1897). An impoverished, self-educated San Francisco journalist, he recorded the spectacle of graft and violence as the Southern Pacific Railroad and other speculators grabbed vast chunks of land in advance of incoming settlers. In 1879, he published *Progress and Poverty: An Inquiry into the Cause of Industrial Depressions and of Increase of Want with Increase of Wealth…the Remedy*.[24] Rejecting the Malthusian "subsistence" theory of wages, George argues that large landholders actually drive down wages by keeping good land and other resources away from workers. The remedy for this evil does not lie in some future revolution. Rather, the remedy lies in the hands of every state and municipality: simply shift the general property tax onto land values only, and eliminate any other taxes. The land tax would collect the unearned income of the "land monopolists", forcing them to disgorge their holdings, making land available to workers. The tax would effectively redistribute the ownership of natural resources, redistributing income in the process. While Adam Smith and the other classical economists had merely claimed the superiority of land taxation; George made it a worldwide crusade. *Progress and Poverty* sold millions of copies in over forty languages. It inspired leaders as diverse as John Dewey in the U.S., Winston Churchill in England, and Leo Tolstoy in Russia.

The robber barons reacted, like, well, the Koch brothers faced with attacks from environmentalists. After all, the captains of oil, steel, coal and timber industries—such as John D Rockefeller, Ezra Cornell, Henry Clay Frick and Andrew Carnegie—owned vast tracts of eminently taxable land and other natural resources. As Mason Gaffney has documented,[25] they hired their own experts to confuse and diffuse the opposition. So when Rockefeller set up the University of Chicago in 1890, the economics department understood its founder's needs. So did the economics department of Columbia University, recruited by its President (and later New York Mayor) Seth Low, an ally of JP Morgan, financier to the robber barons.

What did the robber-baron-friendly scholars do? Most influential was John Bates Clark (1847-1938) of Columbia University—in whose honor is named the John Bates Clark Medal. Willfully misunderstanding the classical meaning of "land," Clark simply eliminated land altogether, by merging it into capital, because "land and artificial goods are blended in an intimate mixture."[26] That's about as logical as saying if you spread a layer of jam on peanut butter, you might as well treat the result as a jam sandwich.[*] But it served a useful political purpose: it eliminated economic rent—unearned income—by merging it into profit. Thus Clark rendered George's –and Smith's—analysis and remedy meaningless. There was no longer any unearned income to tax! Without unearned income, it followed that all taxes were harmful, as, according Smith's fourth maxim, they discouraged both work and capital investment! Hence the modern maxim advocating "broad-based" taxes: tax everything a little bit, to minimize the inevitable damage.

Clark emphasized efficiency; laborers should be paid what they contributed at the margin. Thus, Clark writes, "the share of wealth that falls to any producing agent tends, under natural law, to equal the amount that he creates. A man's pay tends to equal the value of the product or fraction of a product that can be specifically imputed to him."[27] So much for any claim that laborers were exploited!

Clark also eliminated time, and with it, history. Neoclassical economics became what it remains today, a flat world through which we flit for a moment like mayflies, a world of timeless truth like physics, good for showing that rent control creates a housing shortage, and a minimum wage creates unemployment, but helpless before phenomena like growing inequality or events like the 2008 crash. Clark's students, notably Frank Knight (1885-1972), shaped the Chicago School of neoclassical economics.

Let's recap what Clark accomplished. Clark merged land and capital into a timeless entity, "Capital", designated "K," that mates with another timeless entity "Labor," designated "L," to produce timeless output, "Q." Wages depend solely on what the last bit of labor adds to Q. At a blow, Clark has eliminated inequality and unearned income, and reduced wages to a scientific formula, determined by the inexorable operation of "natural law"! Neoclassical economics in the U.S.A. followed Clark, to the extent that the future Clark medal and Swedish Bank "Nobel" prize winner Robert Solow could joke in 1955 that "…if God had meant there to be more than two factors of production, He would have made it easier for us to draw three dimensional diagrams."[28]

While Clark was reconstructing economics in America, European economists responded to the growing threat not only of George but also of Marx. One of these was Italian nobleman Vilfredo Pareto (1848 to 1923). Pareto contributed two major concepts. First, he estimated that 80% of the land in Italy belonged to 20% of the population, from which he concluded that inequality follows a natural law: the 80:20 rule, with which we shouldn't tamper. More famously, he developed the policy rule known as "Pareto optimality." Pareto optimality holds that we should undertake no policy changes unless they make at least one person better off and no one worse off. Sounds fair and reasonable, doesn't it? By that logic we should have paid the slaveholders in full after the Civil War! By that logic once having cut taxes on the rich, we cannot raise them again! The status quo rules, no matter how cruel or illogical the route that got us there.

The neoclassical revolution accomplished something more: it removed the taint of privilege and unearned income from corporations. In a recent article, *Financial Times* U.S. economic

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[*] Appraisers routinely separate land from buildings, because the value of land depends primarily on location, while the value of buildings depends on construction costs less depreciation. New York law requires assessors to report land and building values separately—a lingering effect of Henry George's influence.

editor Robin Harding glosses over the transition from classical to neoclassical economics by simply assuming that classical "land" means only "farmland." He writes "As land became less important to the industrial economy, labour unions rose and European aristocracies were overthrown, the idea of economic rents died away." [29] How convenient! But I'm glad you mentioned unions, Mr. Harding, for after all, what is a corporation but a union of landlords? And what is the modern "industrial economy" but vast constellations such unions, heavy in natural resources—think Exxon-Mobil. And that even includes Walmart. What is Walmart U.S., after all, but a collection of over 4500 huge parking lots and one-story stores and distribution centers, occupying prime real estate at highway intersections across the country—not to mention extorting tax privileges from their local hosts?

Finally, what about the population issue? At the very time Malthus wrote, improving (though still awful) wages and conditions of workers in England already gave the lie to his model. Later in the nineteenth century, Henry George and Karl Marx had denounced Malthus for blaming poverty on the improvidence of the poor rather than the exploitation of the rich. But with George marginalized and Marx demonized, overbreeding by the poor hummed along nicely as the explanation for poverty and lack of growth in "underdeveloped" countries, notably British, European, and American colonies and "spheres of influence". At its ugliest, Malthusianism inspired the eugenics and Nazi movements of the early twentieth century. Later, the new environmental movement laid the burning of Brazilian rain forests and the starvation of Bangladeshi babies at the loins of too many (little brown poor) people breeding too fast. As a young Sierra Club activist in the 1970's, I uncritically swallowed Garrett Hardin's "Tragedy of the Commons" [30]or Paul Ehrlich's *The Population Bomb: Population Control or Race to Oblivion*?[31], published by the Sierra Club. When I eventually stumbled on Henry George, I felt shocked and ashamed at my own naïveté. I scurried off to grad school in economics. Little did I know!

Adam Smith in the Modern Era

While neoclassical economics has effectively erased inequality and unearned income from consideration, it has reinterpreted domestic free markets and international free trade. To this day textbooks happily chirp the old free market and free trade song. A leading macroeconomics textbook blandly asserts "If a strong company decides to drive the competition out of the market by setting prices below cost, it would be aggressively prosecuted by the Antitrust Division of the Justice Department."[32] The reality is otherwise.

Regulation and anti-trust enforcement in the U.S. began in the Progressive era, notably with the break-up of Standard Oil in 1911 under the Sherman Anti-Trust Act. After Wall Street surged and crashed in the Roaring Twenties, Franklin Roosevelt reined in the banks with Glass-Steagall in 1933. Vigorous anti-trust continued. But in the late 1970's during the Carter Administration, as documented by Jacob Hacker and Paul Pierson in *Winner-Take-All Politics*[33], the U.S. Chamber of Commerce and its allies got their act together to reverse the trend. The rising Chicago School of economics, now led by Milton Friedman, provided the ideology. Free markets now meant "markets free from government interference", including regulation of any sort. Monopoly supposedly wasn't so bad after all; economies of scale allegedly would bring lower prices. Anti-trust enforcement slowed to a crawl during the Reagan Administration, and deregulation commenced. (Some deregulation was justified; in cases such as the Interstate

Commerce Commission, the regulated had captured the regulators.) Inequality, which had dropped to its lowest ever in the 1970's, began to soar again to Gilded Age levels.

As for international free trade, remember that the classical economists meant a "level playing field", free entry for large numbers of buyers and sellers. As I noted above, that well-intentioned goal has never been too realistic. Yet the last three decades have seen a proliferation of so-called "free trade agreements"—bilateral treaties between the U.S. and smaller nations—that quite defeat the "level playing field" objective. These deals, such as the North American Free Trade Agreement (NAFTA) or the just-passed Korea Free Trade Agreement, essentially allow the U.S. to dictate the domestic policies of the smaller nation, to the ultimate benefit of U.S.-based multinational corporations and local elites. Just as bad, as apparent in the Trans-Pacific Partnership (TPP) now under negotiation between the U.S. and ten other nations, TPP rules will allow foreign corporations to sue the U.S. if our environmental or health laws affect their trade. Other major developed nations have followed suit with their own "free trade" agreements. Even that arch-promoter of globalization, economist Jagdish Bhagwati, has called these preferential agreements *Termites in the Trading System.* [34]

Today, as documented in Barry Lynn's chilling book, *Cornered: The New Monopoly Capitalism*[35], we may think we live in a world of dazzling consumer choice—but in fact the brands are all controlled by giant international trading monopolies, one or a very few in each field, who often share the same suppliers. Wal-Mart is more than twice the size of the next nine general merchandisers combined. GM, VW, Toyota and Hyundai between them produce most of the cars. The Italian firm Luxottica owns production and retail sales of virtually all the world's eyewear. Mergers that would have seemed unthinkable even a decade ago—such as the new combination of U.S. Air and American Airlines or Comcast and NBC (2009-11)—happen without more than a peep from the Justice Department. And don't forget the shotgun marriages of 2008—as between Wachovia and Wells Fargo; or Bank of America, Merrill Lynch and Countrywide—leaving us with a handful of Even-Too-Bigger-to-Fail banks.

Finally, here's the tax story. After the 16th Amendment in 1913 authorized a national income tax, in 1916 Congress established the U.S. federal graduated income tax. Designed by avowed admirers of Henry George, it was intended to fall primarily on very wealthy taxpayers, whose income was assumed to be mostly economic rent, that is, unearned income. Initial rates were low: 1% lowest; 7% highest. Top marginal rates climbed over the years, reaching peaks over 90% during World War II. They were still at 70% when Ronald Reagan took office in 1981. With George forgotten, neoclassical economics enabled supply-siders to make the public-spirited claim that high marginal taxes on the rich discourage investment and hinder economic growth. Under President Reagan, top rates fell immediately to 50%, and then under the Tax Reform Act of 1986 to 28%! While top rates rose again to 39.6% under President Clinton, and fell again under President Bush II, neoclassical economics to this day gives scientific credence to right-wing support of low taxes on the "job-creator" One Percent. Meanwhile, under President Reagan, Alan Greenspan engineered a dramatic increase in the regressive payroll taxes supporting Social Security and Medicare—commencing the practice of "borrowing" from Social Security to effectively fund tax cuts for the wealthy. Today, federal payroll tax collections equal or exceed collections from the federal income tax!

So who's the poster boy for this brave new world of inequality, un-free markets, un-free trade and low taxes for the wealthy? You guessed it! Adam Smith. If you can't suppress an inconvenient super star, reinterpret him. Don't let him speak for himself either: Physicists don't read old papers by Einstein and other giants of physics because physics is a science. Each generation of physicists builds on the work of the last. On the conceit that economics is just as hard a science as physics, university economics departments over the last forty years have almost completely cleansed the history of economic ideas from both undergraduate and graduate curricula. Modern students of economics think they're learning a science, founded by Adam Smith, who cared only about efficiency, and who proved that free markets create the best of all possible worlds! As for the other classical economists, most modern economists know only a mangled version of Marx, the "anti-Smith."

The Enlightenment ideals that inspired Adam Smith and our founding fathers threaten the world's resource monopolists and their bankers. Over the years, these interests have stripped mainstream economics of any ability to address inequality or fairness. But all is not lost. Remember that Adam Smith lived in a society that was far more corrupt, unequal, unfair, and undemocratic than our own. Yet England reformed itself over the years. In the U.S., again and again, including the eras of both Roosevelts, reformers have organized and won partial victories. Sam Pizzigati's new book tells the story: *The Rich Don't Always Win*.[36] Today, Adam Smith remains alive and well among pockets of resistance. These include ecological economists—who have rediscovered the classical economists, and economic historians—who have never forgotten them. Occupy Wall Street, are you listening?

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[1] (Smith, [1776] 1904)
[2] (Heyck, : p. 47)
[3] (Smith, : I.2.4)
[4] (Smith, : I.6.8)
[5] (Smith, : V.1.45)
[6] (Smith, : I.I.5)
[7] (Ricardo, [1818] 1996)
[8] (Mill, : V.2.28)
[9] (Malthus, 1798)

[10] (Mill, : IV. 6.5)
[11] (Turgot, [1766] 1793)
[12] (Smith, : I,1.3)
[13] (Smith, : I.3.1)
[14] (Smith, : V.1.178)
[15] (Smith, : I.2.2)
[16] (Smith, : IV.2.9)
[17] (Smith, : I.10.82)
[18] (Smith, : V.1.107)
[19] (Smith, : V.2.25)
[20] (Smith, : V.2.28)
[21] (Smith, : V.2.36)
[22] (Wolff, 2010)
[23] (Marx, [1867] 1906)
[24] (George, [1879] 1962)
[25] (Gaffney, 1994)
[26] (Clark, 1908: XIII.5)
[27] (Clark, 1898: 4)
[28] (Solow, 1955: 101)
[29] (Harding 2012: 2/22)
[30] (Hardin, 1968)
[31] (Ehrlich, 1968)
[32] (Case & Fair, 2004: p 378)
[33] (Hacker & Pierson, 2010)
[34] (Bhagwati, 2008)
[35] (Lynn, 2010)
[36] (Pizzigati, 2012)