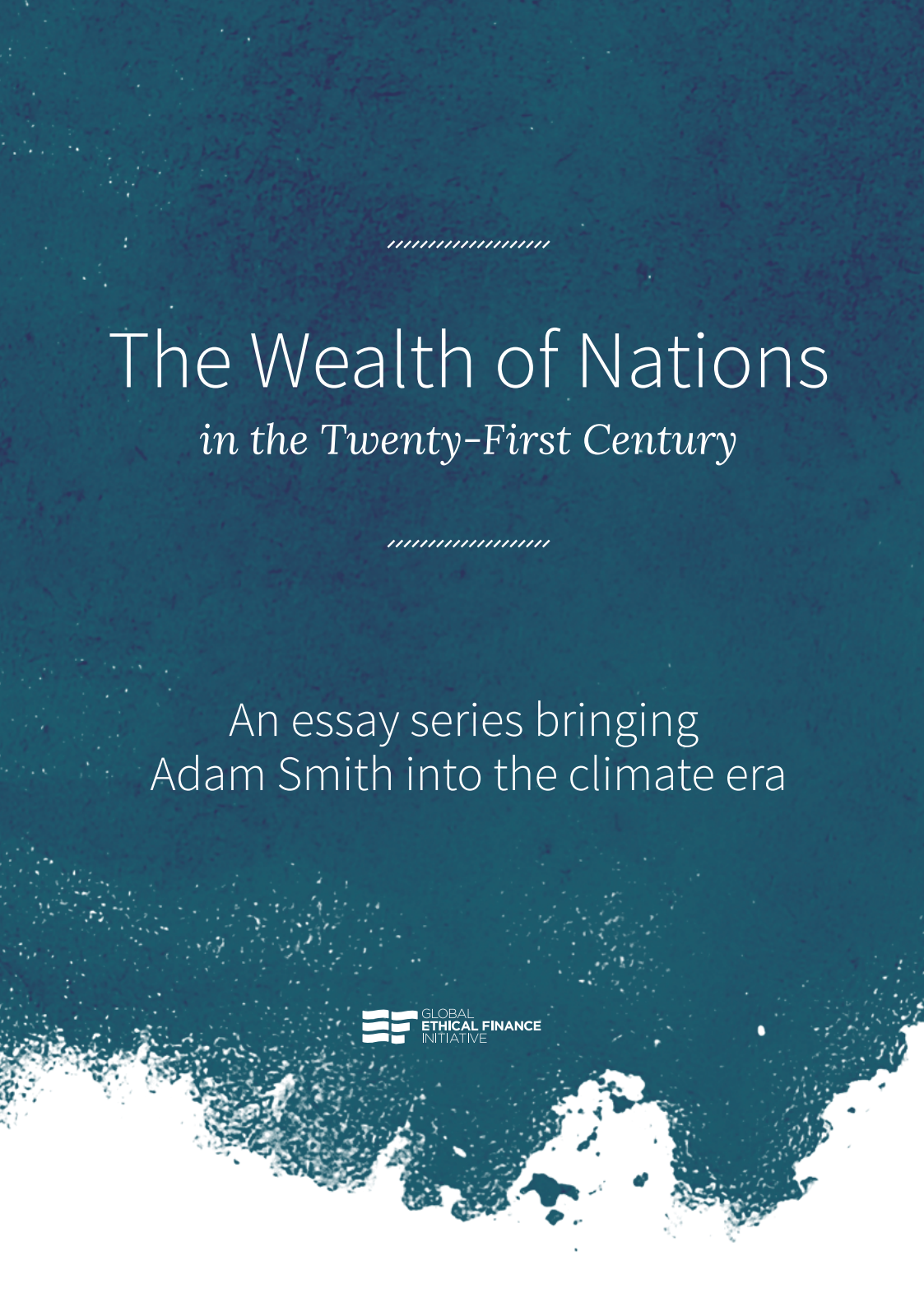




////////////////

The Wealth of Nations

in the Twenty-First Century

////////////////

An essay series bringing
Adam Smith into the climate era

“It is the work of nature which remains after deducting or compensating everything which can be regarded as the work of man.”

Adam Smith, *The Wealth of Nations*

SUSTAINABLE DEVELOPMENT GOALS



© 2021 Global Ethical Finance Initiative

The world depends on global finance making the right choices to deliver positive change and achieve the UN's Sustainable Development Goals. The Global Ethical Finance Initiative has become the hub at the centre of the ethical finance movement, and the partner for action on ethical finance.

Conversations

Research & Advisory

Strategic Campaigns

Practical Solutions

globalethicalfinance.org
Twitter: @finance4change



Contents

Foreword <i>Nicola Sturgeon</i>	2
Preface <i>Omar Shaikh & Sam Wheldon-Bayes</i>	4
Of the Causes of Improvement in the productive Powers of Labour <i>Lord Meghnad Desai</i>	6
Of the Nature, Accumulation and Employment of Stock <i>David Pitt-Watson</i>	18
Of the different Progress of Opulence in different Nations <i>Usha Rao-Monari & George Gray Molina</i>	28
Of Systems of political Economy <i>Prof. Sir Anton Muscatelli, Dr Michele Battisti & Dr Craig Smith</i>	36
Of the Revenue of the Sovereign or Commonwealth <i>Tan Sri Dr Zeti Aziz</i>	46
The Misinterpretation of Adam Smith: Bringing Back the Theory of Moral Sentiments <i>Kaisie Rayner</i>	56

Foreword

by Nicola Sturgeon



Nicola Sturgeon

First Minister, Scottish Government

Nicola Sturgeon is First Minister of Scotland and MSP for the Glasgow Southside constituency. Before she became an MSP, she studied law at the University of Glasgow and worked as a solicitor at Drumchapel Law Centre, helping people with legal problems. Nicola first became an MSP in 1999.

In government she served as Cabinet Secretary for Health and Wellbeing between May 2007 and September 2012 and then Cabinet Secretary for Infrastructure, Investment and Cities with responsibility for government strategy and the constitution until November 2014. Throughout this period, she also served as Deputy First Minister of Scotland before becoming leader of the SNP and First Minister in 2014.

In his important work, the *Wealth of Nations*, Adam Smith famously argued that a country's wealth should be measured not just by the total amount of its gold and silver, but rather by the value of its commerce. This idea – revolutionary in its time – was one of the earliest expressions of what we would now describe as GDP – Gross Domestic Product.

In the years since (and in ways I suspect Smith may not have approved of), GDP has taken over as not just one measure of a country's success, but as the primary measure of a country's success. And, as we know, what we choose to measure drives political focus and public activity.

GDP measures only the output of our work. It says nothing about whether that work is worthwhile. Socially or environmentally harmful production is measured, while factors like equality, wellbeing, unpaid care work and environmental protection are ignored.

At this pivotal moment for the planet and as we emerge from the challenges of the pandemic, progressive nations and governments are increasingly focussing on wellbeing, not simply an increasing GDP for the sake of it. That is why Scotland is placing the UN's Sustainable Development Goals at the heart of its economic strategy, and why we – along with Iceland and New Zealand – have established the network of Wellbeing Economy Governments.

Adam Smith is often perceived as having been in favour of an unregulated free market. While he certainly was a believer in the power of markets, a detailed examination of his work reveals a far more nuanced position. It shows someone who was in favour of ensuring the right conditions were in place to allow markets to function properly, not to simply let them loose.

We cannot know exactly how Smith would have responded to the climate emergency, but given his support for reasonable protections against, for example, abuse of monopolies it seems likely that he would have supported regulation to guard against the destruction of the planet.

This series of essays takes the *Wealth of Nations* and updates it for the climate change era, asking how the themes of Smith's work apply to the challenges of today and teasing out how Smith himself might have reacted to the climate emergency. It showcases Scotland's proud academic history, and is a timely celebration of one of the key figures of the Scottish Enlightenment.

5 leading thinkers from across the world, including from the land of his birth, take inspiration from Smith and apply his thinking to the biggest challenge of our age. Taken together, they show that Smith's thinking is as relevant now as it was when it was first written

They reveal a side to Smith that people are becoming increasingly aware of – a measured thinker who understood the need for proper regulation to ensure his famous invisible hand worked properly.

As we gear up for COP26, it is the perfect time to reach back into our past as we look ahead to a future that is cleaner, greener and more just.

Preface

by Omar Shaikh & Sam Wheldon-Bayes



Omar Shaikh

Managing Director & Co-founder of Global Ethical Finance Initiative

Omar is the Managing Director and Co-founder of the Global Ethical Finance Initiative (GEFI). A Chartered Accountant by profession, he specialises in ethical and responsible finance, Islamic finance and private equity. He has extensive experience in financial services and has advised multiple governments and regulators.



Sam Wheldon-Bayes

Editor, *Wealth of Nations in the 21st Century* & Marketing Analyst – Events & Research, Global Ethical Finance Initiative

Sam Wheldon-Bayes is a researcher, economist, and marketing analyst with GEFI. He was the primary researcher for Lord Robert Skidelsky on the book *What's Wrong With Economics*, which explored the history and philosophy of economics.

During the 18th Century, the Scottish Enlightenment put Glasgow at the heart of world thinking. Today, as the world comes to Glasgow for COP26, we ask what we can learn from one of the great pioneers of the Scottish Enlightenment: the renowned economist and former lecturer at the University of Glasgow, Adam Smith.

The Global Ethical Finance Initiative (GEFI) is a non-profit devoted to delivering finance for the SDGs, with over 10 years' experience in the ethical finance space. From our base in Scotland, we have planned and delivered our Path to COP26 campaign. The campaign has brought together a diverse coalition of 60+ signatories, managing or advising on trillions of dollars in assets and collectively desiring to drive finance for positive change at COP26.

“Adam Smith at the COP” is one of our four campaign workstreams. Adam Smith was both a student and professor at the University of Glasgow and with COP coming to Glasgow what better lens to reflect on profit and purpose than through the City’s most famous academic.

The contemporary movement of markets seeking to reconcile profit and purpose, is key to achieving climate targets and the SDGs more broadly. This underpins our work at GEFI and in 2019 we expanded our advocacy programme by adding the Radical Old Idea series which explores the systemic questions being asked by financial institutions, such as the nature of purpose and how we measure and report this alongside traditional financial factors.

Our inspiration was taken from the Scottish enlightenment and in particular, Smith’s approach to reconciling between the predominant views of his two great mentors: Francis Hutcheson and David Hume. Between them, Hutcheson and Hume wrestled with the basic question of the importance of innate goodness and self-interest; markets are wrestling with the same ontological question today regarding profit and purpose.

As part of the Adam Smith at the COP workstream, we have prepared this unique essay series entitled *The Wealth of Nations in the 21st Century*, looking at the climate crisis through the eyes of Smith.

This work is an update to Smith’s *The Wealth of Nations*. The original is split into 5 ‘books’ and we take the same format in this compilation. Expert authors from the fields of finance, economics, politics, development and central banking have written 5 essays drawing on Smith’s themes and reflecting on the climate crisis. They consider both how Smith’s thinking can guide our approach to climate action, and what he himself might have thought about the climate crisis.

We are extremely grateful to Lord Meghnad Desai, David Pitt-Watson, Usha Rao-Monari, Prof. Sir Anton Muscatelli, Tan Sri Dr Zeti Aziz, George Gray Molina, Dr Michele Battisti & Dr Craig Smith for sharing their fascinating insights. They have provided a truly remarkably review of the on-going relevance of Smith’s work, applying the *Wealth of Nations*, as well as drawing on the *Theory of Moral Sentiments*, to contemporary climate issues.

We hope you enjoy reading this unique publication and invite you to explore our work promoting finance for positive change. Our wish is that the essay series encourages and inspires creative thinking and practical action to leave a small and enduring legacy after this crucial summit.

Book I

Of the Causes of Improvement in the productive Powers of Labour

by Lord Meghnad Desai

Book I of the *Wealth of Nations*, 'Of the Causes of Improvement in the productive Powers of Labour', is devoted to Smith's perspectives on value theory, his ideas about labour productivity and his explanation of the determination of wages, profits and rent. The central insight of the chapter is that value is primarily driven by labour, and labour productivity can be achieved through division of labour, and by augmenting it with capital.



Lord Meghnad Desai

Professor Emeritus, London School of Economics & Chair, Official Monetary and Financial Institutions Forum

Lord Desai is a Professor Emeritus at the London School of Economics, having joined as a lecturer in 1965. He is an expert on Marxian economics, development economics and the history of economic thought. He has written numerous books on Marxian economics, and currently chairs the Official Monetary and Financial Institutions Forum (OMFIF).

“Labour was the first price, the original purchase-money that was paid for all things. It was not by gold or by silver, but by labour, that all the wealth of the world was originally purchased”

Adam Smith, *Wealth of Nations*: Book I

The first impacts of the climate crisis are upon us, from a steadily-increasing rate of natural disasters, to the gradual retreat of the polar ice. If humanity is to avoid even greater impacts, there must be radical shifts in the ways in which our economy operates, what it values and how it values it.

The question of what “value” is, and where it comes from, will always be a somewhat abstract discussion, an attempt to provide a theoretical framework to underpin the ordinary business of life. It is nonetheless important – the ways in which we conceive of value itself and how it comes about affect how we think about the entire economy.

A brief history of value

To most pre-modern scholars, the answer to where value came from would have been simple – value is gold, and gold is value, with silver playing a supporting role. The usefulness of gold and silver as proto-currencies, or stores of value, was their scarcity. The supply of these metals was relatively fixed and – despite their best efforts – alchemists had failed in their attempts to synthesise them.

Combined with the relatively static pre-modern economy, this meant that the purchasing power of gold and silver remained more or less constant.

That changed with the ‘modern’ period. This began in the late 15th century, when the Spanish Royal Family – Ferdinand and Isabella – sponsored Columbus’s attempt to find India. Setting sail in 1492, Columbus hoped to discover a Western route to India, after the fall of Constantinople to the Ottomans in 1453 had closed the Silk Road to Christian traders.

He instead “discovered” the Americas. His mistake was to prove – initially at least – Spain’s boon. Over the subsequent centuries, the Spanish looted Latin America of gold and silver; their rapacious greed was driven in part by the debts of colonialists such as Cortés, who had borrowed heavily to finance his expeditions. However, a windfall of precious metals was not without its downsides.

The flood of this gold and silver into Spain (and Europe more widely) inaugurated the Century of Inflation. No amount of gold would actually change the productive power of European economy. The major change was simply that gold, while still desirable, bought less than it did previously as it flew eastwards from Latin America to Europe, and onwards to Asia, flooding Europe with imports.

This massive, sustained shift in the purchasing power of gold and silver naturally raised the question of value. What it was that determined value was now a mystery, since the value of gold and silver had been shown to fluctuate. Could an object be discovered that was invariant, just as gold and silver had previously been thought to be?

The answer to this thorny question was found by the joint effort of many philosophers during the Enlightenment period, but it is generally agreed that the definitive contribution came from Adam Smith (1723-1790) in 1776. This was a year that featured three significant contributions to the modern world, all of which have some tie to Scotland, and to Glasgow, the host city for the COP26 climate negotiations.

Smith published his most famous work in 1776, *An Inquiry into the Nature and Causes of the Wealth of Nations* (or, as it is more commonly known, *The Wealth of Nations*). Though Smith had taught at Glasgow during the 1750s, he wrote most of *The Wealth of Nations* in his hometown of Kirkcaldy, not far from Glasgow.

The second event was the American Declaration of Independence, which counted University of Glasgow alumnus James Wilson among its signatories. The third event was the least noticed at the time, the most tied to the city of Glasgow, and perhaps the most important – James Watt's invention of the steam engine. This provided power to the industrial revolution, and stimulated the demand for hydrocarbons which has left us in this perilous position.

Interesting though this diversion might be, it tells us nothing of the concept of value, which Smith had refined in *The Wealth of Nations*. For Smith, a good had both 'use-value' and 'exchange-value'. Value was a product of human labour: gold and silver could command value, but the true wealth of a nation was deeper. It was not found in its store of gold or silver, but rather in the productivity of its labour force. That was what ultimately enabled it to create goods which would sell for gold and silver.

Smith had a deep understanding of the idea of the productivity of human labour. In his famous pin factory example, Smith unveiled the idea of the division of labour. He posited that, working alone, a pinmaker could make twenty pins each day. However, by separating the work of pinmaking out into its component operations and dividing the tasks among them, 10 pinmakers could together make upwards of 48,000 in a day.

One man draws out the wire, another straightens 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, which, in some manufactories, are all performed by distinct hands'.¹

Thus, productivity of labour depended on the nature of the labour process, the labourers and the contribution of "stock" – capital as we would refer to it. Then, given the use-value, exchange-value would depend on the costs of production, taking into account inputs, labour costs, capital costs and a rate of profit. A constant theme of the last two hundred and fifty years has been continuous rise in labour productivity and a consequent rise in real income of people. The important point is that, while labour is the main living input, other inputs which are bought must be accounted for.

1 Smith, Adam (1976) [1776] *An Inquiry into the Nature and Causes of the Wealth of Nations*. 2 vols. Edited by R. H. Campbell & A. S. Skinner, Oxford: Oxford University Press. Hereafter '*Wealth of Nations*'

Value and the environment

The crucial omission from the above framework, particularly as it relates to the environment is that *free inputs are not accounted for*. In Smith's era the land to population ratio was much more favourable than now and clean air was freely available. Things which were not privately owned were free and were not accounted for; in modern economics, these are referred to as externalities.

In searching for an invariant measure of value, Smith (after an extensive discussion) settled upon corn as a proxy for the price of bread, which was then the most important staple. He reports that over centuries, the price of corn was steadier than that of gold or silver.

Although goods have value measurable by the labour time contained in them, Smith rejects a strict labour theory of value by adding that people cannot compare hours of labour embodied. In the marketplace, they compare commodities with each other and their money price. Exchange-value is realised only in the market by the social process of buying and selling.

However, labour time was the basic and common input into all goods. Smith's solution was to suggest that value of labour time could be measured by the corn which the labourers consumed to be able to work for the next day. David Ricardo, who followed Smith and standardized value theory, was a powerful mind able to reduce complex realities to simple logical concepts.

For Ricardo, all the (paid) inputs, such as farm machinery or cattle, which did the hard work of ploughing were reducible to labour time, so ultimately only labour costs remained. Items such as labour time of women spent in housework disappeared, as did freely available inputs provided by the natural environment. In this way, the labour theory of value became the sole guide for economists.

While such reductionism is regarded as a virtue for theoretical economics, from an ecological perspective, there is a huge gap in this analysis. Between sowing and harvesting, there is a time gap in which nature performs the difficult task of ripening seed into crop.

The time and the inputs (in terms of nutrients and water), create value are unpaid for. The elementary production process in agriculture is reduced to labour alone, ignoring this crucial input. The surplus which counts as profit can be attributed to nature as much as to labour or capital. We can of course

generalise this from the example of agriculture: there is widespread neglect in economic value accounting of unpaid inputs. We have a circular argument here: only inputs which carry value can create value.

Thus, Economics chose a theory of value which was so reductionist that it ignored the difficulties of reducing all inputs to labour time (and thus subsistence wage). All the free inputs of nature were ignored; they could be wasted as they had no monetary value.

Thomas Paine seems to be one contemporary of Ricardo who explicitly mentioned Natural property in his book *Agrarian Justice*. He distinguished between “natural property” that was a product of original creation such as the natural right to earth, air and water, and the “artificial or acquired” property that was the invention of man. Natural property belonged to everybody and acquired property was private. He proposed a scheme of income entitlement from natural property but did not specify the mechanism by which natural property would earn income.²

From the physiocrats to Malthus

Contemporaneous with Smith, in France, was an economic school known as the *Physiocrats*. The originator of the physiocratic school was a physician with a Royal appointment, Dr. Francois Quesnay (1694-1774), who Adam Smith had met during his visit to Paris in 1764-6. Quesnay put forward a remarkably different theory of value. He presented his theory in a mathematical form called *Le Tableau Economique*³. It dazzled as many people as it confused.

Quesnay analysed the economic problem France was facing in terms of the overtaxation of agriculture, which financed the luxury consumption of the urban rich, including the courtiers to the Bourbon monarchy. Quesnay took the extreme view that only agricultural products had value. No manufactured products concocted out of agricultural materials (such as chairs made from wood) could have value. Indeed, far from adding value, any further work on agricultural raw material diminished value for Quesnay. He considered the grain output the sole form of added value and hence that prosperity of the nation was measured by total agricultural harvest.

2 Paine, Thomas, *Agrarian Justice*, quoted in Gertrude Himmelfarb (1984) *The Idea of Poverty*

3 Quesnay, François (1759), *Le Tableau Economique*

The amount saved by the farmer and replanted as seeds ('invested', as we would say) was crucial as it determined the total income (agricultural output) for next year. The taxation imposed by the King diverted grain from replanting by the farmer to luxury consumption by the urban elite and their dependents. The expenditure incurred by the Royal court on the baubles was a total waste of income. All manufacturing was valueless. To increase a kingdom's income, the King should reduce taxes on the farmer and increase them on urban elites.

Quesnay's System is more a critique of the policy of taxing agriculture which ruins farmers to finance urban luxury consumption than a theory of value. He wanted to shift taxation from agriculture to the urban economy. Quesnay's System is somewhat extreme but a useful starting point if we were to reconstruct the theory of value for our times.

The point of the system is that surplus value can only be extracted from nature because it returns any input by a multiple as output, turning seed to fruit. Other processes transform one commodity into another but there is no surplus generated. The fact that at each successive stage of output value is added is not accepted by Quesnay. It may have higher exchange-value but not true value.

Despite the philosophical differences, Adam Smith was complementary of Quesnay. He says in the *Wealth of Nations*, that "their system with all its imperfection is perhaps the nearest approximation to the truth that has yet been published upon the subject of political economy and is, upon that account, well worth consideration of every who wishes to examine with attention the principles of that very important science".

Smith in his many observations does not miss the idea of land as an input in the production of food, as well the property rights in minerals or in fishing on lakes and in rivers. But these latter do not play a vital part in his theory. Through much of the Eighteenth century, Britain was a net exporter of grain. Land ownership was highly unequal and the landed elite - Earls, Viscounts and Lords - wielded not just economic power but political power as well.

Smith was arguing for much more extensive trade with the expanding 'global' economy. There was never any doubt that land conferred power as well as represented wealth. His interest was in extending trade without imposing monopolistic trade barriers on the colonies. Coming at the very time when steam power of fossil fuels - as inspired by Watt - was at the start of

transforming labour productivity, the idea of value as a creation of human labour was very powerful.

Political economy soon got occupied with the problem of distribution of wealth: the proceeds of labour if Smith's theory of value holds. Smith was followed by Robert Malthus and David Ricardo. Malthus was alarmed by the popular agitation inspired by the French Revolution. Inflation due to rising scarcity of corn in the years of Anglo-French wars had caused distress and an increase in expenditure on 'Poor rates', a system of social welfare in England and Wales.

Malthus formulated his theory of population in terms of the two famous ratios: the geometrical growth of population, which he suggested would double every twenty-five years, and the arithmetical growth of the amount of available food. So, for Malthus, hardship and moral degradation were inevitable if the poor rates were to be generously provided.

The ideal situation was to keep wages at subsistence level. That will keep population constant. David Ricardo lay down 'principles' of political economy which stated that, as population grows, cultivation would move to inferior lands where the corn cultivated would cost more. In a closed economy where, as in Ricardo's time, import of corn was restricted, then since real wages are constant, the higher rent on land would raise money wages and eat into profits. Land limited profitability of agriculture as population grew.

David Ricardo proved to be the greatest and most influential economist of the Nineteenth century. Adam Smith had titled his book "An Inquiry...", suggesting that there is still a lot to learn for the economist. Ricardo was different; he had a capacity for stripping down the real-world complication from any situation.

Even the agricultural question of price of corn was not seen as a problem of conserving land but one of casting all calculations in terms of labour, not land. Once Malthus had provided a theory of why labour should be confined to a constant real wage, Ricardo added rent and profit calculated in terms of labour which alone constituted a constant measure of value. The final value of a commodity is the sum of the hours of labour time equivalent to the labour time contained in the wage, labour time used up in material inputs and then the surplus labour which was the difference between the use-value of labour power and the value contained in the bread consumed by the worker. Marx labelled this surplus labour the source of profit – surplus value.

The opening sentence of the Gotha Programme, a manifesto issued in 1875 at the founding of the German SDP and claiming to be based on Marx's ideas read as follows:

*Labour is the source of all wealth, and since useful labour is possible only in society and through society, the proceeds of labour belong undiminished with equal rights to all members of society.*⁴

However, in Critique of the Gotha Programme, Marx clearly recognised the importance of nature, and the natural environment as a source of value alongside labour. In it he wrote, perhaps surprisingly, that:

*Labour is **not the source** of all wealth. **Nature** is just as much the source of use values (and it is surely of such that material wealth consists) as labour , which itself is only the manifestation of a force of nature, human labour power....And in so far as man from the beginning behaves towards nature , the primary source of all instruments and subjects of labour as an owner , treats her as belonging to him, his labour becomes the source of use values, therefore also of wealth.*⁵

Economics, which Smith, Ricardo, Malthus and Marx described as 'political economy', has shaped modern life for the last two and a half centuries. The theoretical foundation that they built has been the intellectual cornerstone of the capitalist economic system. Even as people dispute whether economics is a science or not, we agree that things are not wealth unless they command a money price. Things which have exchange-value end up as someone's private property. Common property may have use-value, but it has no exchange - value unless someone makes it their private property.

The route forward for economics

The challenge for economic is thus to find a way of properly accounting for nature – incorporating ecology – when that nature cannot be privatised and subject to the laws of the market. There is the common root 'eco' between ecology and economics, but they have departed in different ways. Ecology has much use-value to impart but often it has no exchange-value. Because ecology, the natural environment, has no exchange-value, it has no value according to our methods of accounting, and thus we have destroyed it.

⁴ German SDP (1875), Gotha Programme

⁵ Marx, Karl (1875), Critique of the Gotha Programme

What economists have done quite successfully is to correct market prices in terms of the negative externalities. Its origin is in the critique of market pricing of goods and services. The usual assumption in economics is that equilibrium market prices correctly reflect the cost of producing the goods. But, as Arthur Cecil Pigou pointed out a century ago in his book *The Economics of Welfare*, some commodities emit damages or shower benefit on others who are not voluntarily involved in their consumption or production.

Smoke emitted by a factory imposes a cost on others living near the factory. A well-maintained garden benefits those in the neighbourhood. As any good economist is taught, price equals marginal cost in market equilibrium. But here we need to add the social cost or deduct the social benefit from equilibrium market price. What the climate crisis suggests is that this act of deducting is not a rare occurrence, to be implemented on a case-by-case basis, but an integral part of 21st century economics.

On this front, economists James Tobin and William Nordhaus initiated a program of recalculating GDP by using margin social cost pricing than the normal marginal cost prices. Nordhaus won a Nobel Prize for his part in the project, Tobin having already earned one for other work. The current challenge is to generalise the notion of market pricing reflecting the true costs, especially reflecting the use of nature.

Consider the following example of modelling agriculture. In Ricardo's version of value theory, the final value of a commodity is the sum of the labour time used directly, and that used indirectly in producing other inputs. Marx labelled the difference between that value and the wage the source of profit – surplus value. That constituted a simple model of value in factory work.

But in agriculture, there is a time interval between sowing and harvesting. Labour (mostly peasants' labour time) is idle and unpaid during the fallow period. But, it is nature that adds value to the previously invested labour time by the peasants. Labour and land are not the sole inputs in agricultural production. The physiocrat Quesnay's stated position was extreme, suggesting that nothing of value could ever be created by anything other than nature. But it could be interpreted as saying that nature adds value to the seed and multiplies it; only nature can create such pure surplus.

It is not just in peasant or any other agriculture that we ignore the economic contribution of Nature. Even more seriously, we do not allow for the

depreciation of nature as we do for fixed capital routinely in cost accounting. There is no notion of calculating the ‘wear and tear’ on the natural world, and thus all goods are underpriced in terms of the costs of inputs consumed.

Nature contributes unaccountable valuable inputs directly or indirectly in all the economic activities of consumption and production that we indulge in. Its absence or overuse imposes health costs that ought to be reflected in the prices charged to consumers, and if companies will not do this, governments will have to.

Thus, value remains the key to rethinking economic calculus. If we are to address the climate crisis, we must **re-value the notion of value** by combining a conservative approach with a radical one. We need a conservative approach to bring in old perspectives such as those of the physiocrats which deified the agrarian economy, which must be married to a radical approach of assigning value, through the principles of cost accounting, to the ‘free’ goods nature provides us.

////////////////////////////////////

Book II

Of the Nature, Accumulation and Employment of Stock

by *David Pitt-Watson*

Book II of the *Wealth of Nations*, 'Of the Nature, Accumulation, and Employment of Stock' is devoted to Smith's perspectives on 'stock', or capital as we now know it. He describes the different types of capital, the economic justification for charging of interest, the balance between consumption and saving, and the process of capital accumulation. Smith explains how having surplus resources allow for the investment and reinvestment into productive activities.



David Pitt-Watson

Investor & Visiting Fellow, Cambridge Judge Business School

David is a leading thinker & practitioner in responsible investment. Born & brought up in Scotland, he was co-founder, and CEO of Hermes Focus Funds & Equity Ownership Service. These became the largest responsible investment group of any fund manager in the world. Throughout his career he has been deeply involved in policy, particularly in the field of corporate governance and financial market regulation. He has led numerous initiatives to improve the performance of the financial system, including chairing UN Environment Programme's Finance Initiative in the run up to the Paris Climate Conference, COP 21.

“In agriculture... Nature labours along with man; and though her labour costs no expense its produce has its value as well as that of the most expensive workmen.”

Adam Smith, *Wealth of Nations*: Book II

“During the space of a single human lifetime—my lifetime—we have changed the planet so much that the benign stable conditions which underpinned both the growth of our civilisations and the trade and financial systems that you preside over, have ended.”

David Attenborough to a City audience, at the launch of the CoP 26 Finance Agenda for CoP

The second book in the *Wealth of Nations* concerns ‘the nature, accumulation and employment of stock’. Stock is what we would call ‘capital’, which is how it will be referred to in this essay. It consists of assets; buildings, machinery, inventory and most particularly money.

Capital is very important for Smith. First because it is necessary to underpin trade, and as he notes in his first book, trade allows specialization, which in turn allows greater productivity. But rather more fundamentally, Smith notes that nations with high levels of capital are wealthier ones. Indeed, so keen is Smith on capital that he divides labour into that which is ‘productive’ and ‘unproductive’; the former being labour which leaves a product which has yet to be consumed and so adds to the capital stock. As regards capital, Smith is hardly ‘laissez faire’. He is against conspicuous consumption. Rather he would encourage savings which will be loaned out and employed in building capital stock, since that will make the country more prosperous⁶.

What about natural capital? As the quotation above demonstrates, Smith recognized that it existed. Never did he consider that the services of nature as

we know them might come to an end. While the occasional harvest might fail, in general nature could be relied upon. It underpinned our trade and financial systems. As Smith noted of agricultural workers, who were nearly half the working population in his day; “*after all their labour [planting and tillage], the great part of the work always has to be done by [nature]*”⁷. Indeed, he went on to note that it was the gifts of nature—what was left after the cost of labour and other capital—which allowed the landlord to receive a rent⁸.

For the whole of the history of human civilization, nature has showered its bounty. In the last 250 years, humankind has also added hugely to productivity. Smith would have been amazed at what has been achieved. Trade and the factory system have allowed a degree of specialization beyond anything Smith had seen⁹. Technology has advanced beyond his wildest imaginings. These, plus a combination of markets and sophisticated organization have given a standard of living and life unimaginable in earlier generations. We live longer, healthier lives. We have better education. But there is one huge problem. If we stay on our current trajectory, the natural capital which has supported human life for millennia, will not be available to us in the future.

As quoted above, that is how David Attenborough, the ninety five year old British naturalist and broadcaster put it when he delivered a speech to 800 senior financiers from the City of London, who were there to mark the launch of the Finance Agenda for CoP 26. He went on:

The value we place on a stable natural world will ultimately determine its future. Do we invest in the practices which take us deeper into this crisis, or the solutions that could get us out of it?

6 Indeed, where Smith’s “Inquiry into the Wealth of Nations” is particularly explicit about what causes that wealth, it is the creation of productive capital, noting that the ‘annual capital of land and labour can be increased in its value by no other means’ than an increase in the labour force, or its productivity. “in either case’ he goes on ‘an additional capital is always required’. Smith’s economics are often rightly seen as in contrast to mercantilist economics which are generally described as trying to hoard bullion. Smith sees little intrinsic value in gold and silver, whose value is only to assist with exchange. Indeed he approves of certain devices, (such as bank overdrafts), which limit the need for such currency. But Smith does want to maximise national capital since it leads to higher productivity. *Wealth of Nations* Book II, Chapter III, Accumulation of Capital.

7 *Wealth of Nations*: Book II, V, Employment of Capitals

8 [the landlord’s rent]..may be considered as the produce of those powers of Nature, the use of which the landlord lends to the farmer. *Wealth of Nations* Book II Chapter 5

9 Smith is sometimes assumed to have observed the industrial factory system in describing his pin factory. But the first big factory—by Arkwright in Cromford—was built only five years before the publication of the *Wealth of Nations*. The first in Scotland, came after the publication. Smith might less be considered the chronicler of the industrial revolution, but rather its prophet.

Attenborough is using Smith's logic. He is asking whether we will invest in natural capital or deplete it to such an extent that our economy, and our very civilization is under threat. It's my belief that, had Smith lived today, he would have wanted to address this question. For Smith, political economy was not an abstract science. It was a practical question of how "provide a plentiful revenue or subsistence for the people, or more properly to allow them to provide such a revenue for themselves"¹⁰. His friends were scientists, philosophers and inventors; as the boxed example shows, they too would have been interested in these issues.

In this essay, I would like to speculate what Smith might have said if he were alive today. In particular, what he might have said about the way we manage financial capital. If he had followed on from David Attenborough's speech, what might he have said have said to those 800 financiers who met in the Guildhall last year.

Smith, the Enlightenment and Global Warming

Smith was a key figure in the 'Scottish Enlightenment', an extraordinary period in the history of his country. It was one of unprecedented multidisciplinary intellectual achievement from such a small nation.

As we look to the issues which will be discussed at the climate conference in Glasgow, we might reflect that while Smith was completing the *Wealth of Nations* in his home town of Kirkcaldy, at his old university in Glasgow, James Watt was perfecting the steam engine, which would use fossil fuel to power an industrial revolution. One of Watt's mentors was Joseph Black, one of the first people to isolate and describe the properties of carbon dioxide. Black, in turn was one of Smith's friends and an executor of his will. The other James Hutton, 'the father of modern geology' whose explanation of the immensity of geological time allowed an understanding how, over millions of years, coal, oil and gas had been created.¹¹

¹⁰ *Wealth of Nations*: Book IV, Introduction

¹¹ It should not be forgotten that the period of the Scottish Enlightenment was also one of cultural destruction for many of Scotland's Gaelic speaking people. Nor that the trade and prosperity which the country enjoyed was at great cost to other peoples of the world—particularly the enslaved peoples west Africa and the Americas.

What would Adam Smith do? The classical economic framework

Adam Smith would have understood that we needed to get to 'net zero'. Anything above that figure would destroy natural capital. So, I think the first thing he might have said is that we must stop subsidizing fossil fuels. Smith was famous for having figures and illustrations at his fingertips. He might have noted the \$300 billion per annum which the IMF reckons is given in direct subsidy, and the similar amount received in tax breaks.

But there are other 'subsidies' which the IMF identifies where the calculation would have been new to Smith. These include the costs of pollution and of global warming. If these costs are added, the subsidy to fossil fuels reaches \$5 trillion¹².

Today we have become more used to the notion that commerce often creates 'externalities'; that is costs and benefits which the producer and the consumer don't pay, but others do. For example, a company which trains its workforce, gets some benefit, but the worker also receives a benefit, even if (s)he changes employment. That is a positive externality. Similarly, a contribution to global warming is a negative one.

Smith doesn't really deal with this issue in the *Wealth of Nations*. That was left to Pigou, whom Meghnad Desai mentions in another essay. Pigou build on Smith's teachings, but noted that, if markets were to be efficient, subsidies and taxes can be used to encourage positive and discourage negative externalities. Pigou's solution remains the holy grail for economists in tackling climate change.

Indeed, more than one hundred of them have become members of the Pigou Club, whose founder describes it as 'an elite group of economists and pundits with the good sense to have publicly advocated Pigovian taxes, such as gasoline taxes or carbon taxes'¹³. That indeed might be the most elegant solution to solve the climate crisis. The revenue raised could be redistributed, maybe on a per capita basis to advantage poorer countries. It would, at little 'net cost', (since the tax raised would be redistributed), set a sustainable economic course for the world.

But so far the diplomacy needed for such an elegant solution has simply not emerged from any of the climate talks. Some say we are making progress and should not give

¹² IMF (2021), Fossil Fuel Subsidies. <https://www.imf.org/en/Topics/climate-change/energy-subsidies>

¹³ The Club does include many very eminent economists, and other supporters, from Al Gore to Neil Young. Their names can be found here. It also includes surprising advocates of Pigovian taxes, such as the CEO of Exxon.

up trying to agree on this sort of solution. But all agree that any global agreement is unlikely to be signed in time to address the climate emergency.

What would Adam Smith do next? Financial Institutions

It is often wrongly assumed that Adam Smith was wedded only to free market philosophies. This is not the case. If confronted with the failure of a Pigovian approach Smith would have other strings to his bow. For example, Smith was in favour of laws against usury. Why? Because if you needed to lend at very high rates of interest, the money was likely to be going to someone who was a poor credit risk, much of the sum loaned would be lost, and thus the capital stock of the nation would fall which in turn would reduce national prosperity¹⁴.

In today's world, it is the financial system—banks, investment and pension managers—who provide financial capital. Smith would surely have noted that if that money is applied in a way which destroys natural capital, it will reduce the prosperity of the world, potentially catastrophically. Funds need reapplied away from investments based on fossil power towards greener solutions. He would certainly want to lean on the banks and the fund managers, telling them not to lend to, or buy the bonds of any company which would apply the proceeds to new fossil fuel developments.

However, I wonder what he would have said about the current desire by some to sell the equity of public companies involved in fossil fuels. Smith was not fond of public companies, believing that the separation of ownership and management was likely to lead to 'negligence and profusion', as the managers profited at the owners' expense. Indeed he only thought that particular types of activity which require lots of capital—banks, insurance, canals, water—should ever be established as joint stock companies¹⁵. However Smith would have recognized that the shares in these companies are permanent capital, so selling them to others doesn't affect the world, unless it shames the company into changing course. Using the powers which those shares confer might have far more influence. In particular to appoint only those directors who will not be negligent of the climate.

14 *Wealth of Nations*, Book II, Chapter 4. Smith notes that, if the legal interest rate is too high, 'a great part of the capital of the country would be kept out of the hands which were most likely to make profitable and advantageous use of it, and thrown into those who were likely to waste and destroy it'

15 *Wealth of Nations*: Book V, Chapter 1. Smith says, 'except for the four trades mentioned I have not been able to recollect any other in which all three circumstances requisite for rendering reasonable the establishment of a joint stock company concur.'

Given the negative comments he made about them, I think Smith would have been surprised at the success of public companies over the last 150 years. Smith thought that unless you know who you were giving your money to – that they were honourable and skilled – you would be likely to end up with bad debts. He would simply have deemed it extraordinary that a pension fund today, would invest in an index of thousands of companies, and that that be considered a safe way to proceed¹⁷.

Smith would also have recognized one glaring problem. While it may well be the case that northern legal and financial systems make investment relatively safe for northern financiers, those same people often have little experience of how to finance projects in the developing world. Yet it is in the developing world where green finance is most needed.

Let me mention two other areas where I think Smith would have been curious, and perhaps concerned about what the finance industry is up to. One relates to the City of Glasgow, or more particularly to a bank of that name which went catastrophically bankrupt in 1878, having spent several years issuing false accounts. The response was that from then on banks, and later all companies, needed to publish accounts to demonstrate they were solvent—and to have these independently audited¹⁸.

I think Smith would have been shocked that, facing a climate crisis, auditors were allowing companies to value their assets as though there was no climate challenge. As though, despite the clear evidence to the contrary, the destruction of natural capital could continue forever. And while he might have welcomed new initiatives for corporate disclosure—some of which will be announced at CoP 26-- he would surely have asked why those who produce and audit accounts fail to do their day job. He would have noted that if David

16 *Wealth of Nations*: Book II, Chapter 2, Smith envisages the need for lenders always to be able to oversee their funds. He puts it thus. A private man who lends out his money to half a dozen or a dozen debtors, may...observe and inquire both constantly and carefully into the conduct and situation of each of them. But a banking company which lends money to perhaps five hundred different people...can have no regular information; ‘

17 There is no definitive explanation for this extraordinary and positive development of public companies. Perhaps the best, and one that Adam Smith would have recognized, relates to ethics. It is from Alfred Marshall, Pigou’s predecessor as professor of Economics at Cambridge. He concluded it was due ‘the marvellous growth in recent times of a spirit of honesty and uprightness in commercial affairs’ [*Principles of Economics*, Book 4, Chapter xxii, 9]. That uprightness will be tested as never before as we grapple with the climate crisis.

18 The USA passed similar legislation in the 1930’s following the banking collapses which followed the Wall Street crash of 1929.

Attenborough and the climate scientists are right, they may in aggregate, be signing off on an environmental Ponzi scheme.

And one other point, he might have noticed; it concerns insurance. Smith thought that since insurance companies needed to be well capitalized and to share risk, it made sense for them to be joint stock companies¹⁹. But no private sum of money could insure the damage from climate change. Yet Smith would note that our insurance companies still offer liability insurance to companies and their directors who will surely be sued out of existence should we experience a global climate disaster. I think he would suggest that such insurance only be given to companies which are clearly sustainable in the way they manage their affairs.

Are Financial Markets Responding?

3rd November 2021 is scheduled to be ‘finance day’ at CoP 26. Companies from every corner of the Northern finance industry will have signed up for the Glasgow Finance Alliance for Net Zero emissions, (GFANZ). They will be urging negotiators to reach a clear tough deal. Indeed, some parts of the finance industry have been asking this for many years. The Paris CoP received the first mega-petition from investors, from signatories who manage \$25 trillion in assets. It asked negotiators to agree a tough deal. There is no doubt that those who manage our savings, think that by far the costliest route is to delay our response to global warming.

But while it is all well and good to support action by public policy makers, the finance industry itself needs to do if it is to play its part in reaching net zero. To my personal knowledge, some of the signatories of GFANZ, are working hard on doing precisely that, unilaterally if needs be, to ensure they play their part in delivering a sustainable world. Others, however, will note that every promise which GFANZ signatories have made, is subject to policy makers achieving a net zero world by 2050. One might argue, that such a caveat lets the finance industry off the hook. They can blame any failure on policy makers.

That in turn must lead us to ask what might be required of those financial institutions which have told the world of their commitment to net zero. Here is what I would think was the bare minimum.

¹⁹*Wealth of Nations*: Book V, Chapter 1

- » Banks and investment banks must promise not lend or help to raise new money for fossil fuel development. The International Energy Agency has made it clear that no new development is needed. They would support fossil fuel companies, but only against a plan to run down their polluting operations.
- » Investors should not buy any new bonds or equities issued for future fossil fuel development.
- » Equity investors should demand companies commit to net zero and explain how that is to be achieved. They should not vote for directors who will not, in good faith make that commitment.
- » Accountants and auditors should never calculate profits and draw up accounts without taking climate into consideration. Material assumptions should be clear. Further those assumptions should be compatible with sustainability. Should they fail to do this, the investors should not agree to reappoint the auditor.
- » Insurers should not offer liability insurance to companies which cannot demonstrate their affairs are managed in a way which is compatible with sustainability.

None of these commitments seem very difficult to do. And it would seem clear that those banks, investment firms, auditors and insurers who have committed to net zero, must surely commit to carrying out these actions. If they did, that would have a huge effect in ensuring our private companies stopped destroying natural capital in a way which threatens our future. They would in effect be prevented from doing so by their financiers, their owners, their auditors and their insurers.

There is one other critical thing which we need to hear about. That is how we are to get new green finance flowing, particularly from North to South. Following Paris, there was a considerable and successful effort to promote green bonds. In 2015 the cumulative issuance of green bonds was around \$100 billion. At the end of last year it was \$1,000²⁰. But there is still a huge gap in the necessary funding for green development, particularly in the global south. There is also a slippage in the promise made at Copenhagen that \$100 billion a year would be made available by the wealthy countries (who had benefited by absorbing the world's carbon budget), to the poorer countries who had not.

²⁰Climate Bonds Initiative, *Record \$269.5bn green issuance for 2020: Late surge sees pandemic year pip 2019 total by \$3bn* <https://www.climatebonds.net/2021/01/record-2695bn-green-issuance-2020-late-surge-sees-pandemic-year-pip-2019-total-3bn>

However sophisticated and knowledgeable they may be the financial institutions of the North, just do not have the ability to fill that gap. As Smith would have noted they lack the skills and knowledge to ‘observe and inquire both constantly and carefully into the conduct and situation’ of everyone to whom they propose to lend. This needs a new Marshall Plan, with local banks, the World Bank and other multi-lateral development banks raising money—most likely in northern capital markets—and investing in the green investment the world needs.

If anyone says this is too difficult, because it is too expensive, we should refer them to Adam Smith, the father of modern economics. He would say that those who made such an excuse either entirely misunderstood the nature of the environmental problem, or the point of his writing the Wealth of Nations. That wealth depends on the accumulation of capital to make workers productive. If nature withdraws its capital, no prosperous future can await our children. The economic gains of the last 250 years will all be lost.

To policy makers and financiers alike he would be calling not for kind words but for credible action, based on the best evidence, to protect the natural capital of the world.

When David Attenborough made his speech in the Guildhall he was given not one, but two standing ovations. On the 3rd of November 2021, at the Glasgow CoP we will learn if the finance industry is willing to follow its applause with effective action.

////////////////////////////////////

Book III

Of the different Progress of Opulence in different Nations

by Usha Rao-Monari & George Gray Molina

Book III of the *Wealth of Nations*, 'Of the different Progress of Opulence in different Nations' is concerned with what we would refer to as 'long-term economic growth'. Smith seeks to explain why some countries are rich and others are poor. He explains the process of moving from the manufacture of products for subsistence to those for convenience and finally luxury, and the importance of a strong agricultural base for further development.



Usha Rao-Monari

Associate Administrator, UNDP & Under-Secretary-General, UN

Usha Rao-Monari became Associate Administrator of UNDP in 2021. Ms. Rao-Monari has over 30 years of investment experience and has held several senior positions, including as Senior Adviser to Blackstone's Infrastructure Group, as Chief Executive Officer of Global Water Development Partners, and as Director of the Sustainable Business Advisory Group at the International Finance Corporation, part of the World Bank Group.



George Gray Molina

Head of Strategic Policy Engagement and Chief Economist, UNDP

George Gray Molina is Head of Strategic Policy Engagement and Chief Economist at UNDP's global policy bureau. He is a former Chief Economist for UNDP's Latin American and the Caribbean bureau, and a former Chief Economist at the Ministry of the Presidency (UDAPE) in his home country, Bolivia.

“According to the natural course of things, therefore, the greater part of the capital of every growing society is, first, directed to agriculture, afterwards to manufactures, and last of all to foreign commerce. This order of things is so very natural that in every society that had any territory it has always, I believe, been in some degree observed....[...] But though this natural order of things must have taken place in some degree in every such society, it has, in all the modern states of Europe, been, in many respects, entirely inverted. The foreign commerce of some of their cities has introduced all their finer manufactures, or such as were fit for distant sale; and manufactures and foreign commerce together have given birth to the principal improvements of agriculture.”

Adam Smith, *Wealth of Nations*: Book III

The Industrial Revolution catalysed a dramatic shift in the “opulence of nations” – from mercantilism to commerce, with dramatic improvements in well-being across generations and throughout the globe. Adam Smith’s ‘theory of development’ laid out in Book III, provides an unusually modern appreciation of regulation and risk. Could these insights help us understand the global economy today –and assist policymakers to adopt choices that maximize human well-being within planetary boundaries?

Smith’s ideas on progress have been debated throughout centuries. This essay is inspired by that ongoing conversation, written from the perspective of developing economies in the 21st century. We believe we are witnessing an epic shift, as consequential and wide-ranging as the one witnessed by Smith, that will also lead to a redefinition of ‘progress’ – this time, bounded by a carbon emissions clock that is ticking.

Progress within planetary boundaries

The Industrial Revolution kicked off a vast shift in the global economy. In Book III Smith contrasts the ‘natural order of things’ in England (where improvements in

agriculture were followed by improvements in manufacturing, in turn, followed by growth in commerce) while Europe ‘inverted this order’ through regulation, particularly primogeniture laws that inhibited improvements in the productivity of land. Smith contrasts the accelerated paths of ‘convergence’ between town and country in England vis-à-vis slower convergence patterns in Europe, thus describing ‘different progress of opulence in different nations’.

Smith’s insights have survived across the centuries. What has changed is the speed of technological adoption. What we today describe as ‘convergence’ between poorer and richer economies took a century for the United States, 50 years for Japan, but only 30 years for South Korea.²¹ At present, convergence happens in a matter of months for pockets of the ultra-connected digital economy around the world. Reams of academic papers have zoomed in on this process, driven by catch-up in productivity, innovation and technological change.²²

For most of the 20th century, convergence around GDP per capita was how ‘opulence’ was defined. It continues to be a pending assignment for dozens of countries and follows very different development pathways. The economic growth patterns of China, Peru, Ghana or Vietnam, since 1990, for example, illustrate very different constellations of starting points, policy tools and effects over jobs and incomes over time.

Some countries have thrived through industrialization, others through commodity exports or dynamic service sectors. Some successful economies have pursued deliberate industrial policies, using state-owned development banks to prosper; others have followed a more laissez faire approach. Most have in common strong macroeconomic fundamentals, openness to trade and investment – with an associated capacity to ‘catch-up’ to richer economies over time.

In the 21st century, this model of convergence has hit a wall. Planetary boundaries, as measured by CO2 emissions or energy and material footprints, have collided with the 20th century growth model, and is once again multiplying potential pathways to development. What will ‘opulence’ look like in the 21st century?

21 Barro, Robert J., and Xavier Sala-i-Martin (1992). Convergence. *Journal of Political Economy* 100(2): 223-251 https://dash.harvard.edu/bitstream/handle/1/3451299/Barro_Convergence.pdf

22 Patel, Dev et al. (2021). *The New Era of Unconditional Convergence*. https://scholar.harvard.edu/files/devpatel/files/the_new_era_of_unconditional_convergence.pdf

In 2020, UNDP adjusted its Human Development Index – which measures, income, schooling and longevity – by planetary boundaries, to find out.²³ The new ranking showed how countries would fare, if they stayed within the 1.5-degree carbon emission target and kept material and energy footprints within sustainable thresholds. The re-ranking of human development “within planetary boundaries” provides a fascinating glimpse of the future.

A prosperous and dynamic economy such as Luxembourg’s drops 131 positions on the adjusted human development index. The sheer energy and CO₂ intensity of Luxembourg’s economy are advantageous by today’s standards of living but become disadvantageous in the future. Emission-intensive economies of today will become the “least sustainable countries” of the 2050s. This is a static projection, of course. Emission-intensive countries have choices to make and policy tools at their disposal to translate aspirations to reality.

All of this has implications for convergence between poor and rich economies in the 21st century. The 2021 IPCC report, which projects a 2.7 degree increase in temperatures, in a business-as-usual scenario, has choked off the idea of decarbonization happening only for a subset of advanced economies.²⁴ The global carbon budget simply requires all countries to decarbonize eventually. We do not have enough time to see the process play out gradually. Time constraints will drive the convergence process from one equilibrium (of about \$3/ton price on CO₂ emissions at present) to a new equilibrium (of around \$100-150/ton of CO₂) by 2050.

How will transitions happen? The role of markets and regulation

How will these transitions happen? What is the role for markets –including markets that do not yet exist? Smith’s insights on the European and English pathways are again valuable. While the ‘natural order of things’ would allow markets to gradually price in both climate risks (of extreme weather events like droughts and floods) as well as transition risks (the effects of decarbonization policies over banking and insurance markets), time is running out, and global CO₂ emissions are still growing. Rather than follow the ‘natural order of things’, the world is poised to take the ‘European pathway’.

²³ UNDP, *2020 Human Development Report, ‘The Next Frontier: Human Development and the Anthropocene’*
<http://hdr.undp.org/en/content/2020-human-development-report-next-frontier-human-development-and-anthropocene>

²⁴ IPCC (2021), *Sixth Assessment Report*. <https://www.ipcc.ch/assessment-report/ar6/>

We are thus likely to see a ratcheting up of regulatory policies. First, regulation concerning explicit or implicit carbon pricing. The options on the table are multiple: explicit carbon taxation (fixing prices, but allowing CO2 emissions to adjust), emissions trading (fixing supply of CO2 emissions, and allowing prices to adjust) as well as implicit pricing – subsidising shifts to renewable energy, funding green infrastructure as well as funding technological breakthroughs with tax breaks for greening along the way.

Carbon pricing is likely to be implemented jointly with some form of border adjustment mechanism or carbon pricing floor. How else to ensure that greening in certain economies is not simply followed by carbon leakage in the rest of the world? The European Commission has sketched out a proposal for carbon border adjustment tariffs to kick in for emission-intensive trade such as cement, steel and others. The IMF has also put forward a proposal for a three-tiered carbon pricing that would gradually converge – allowing developing countries space to catch-up and transform their energy matrix.²⁵

Second, regulation concerning disclosure standards and metrics for private financing will also become more prominent. The size of sustainable investing has ballooned over the past few years – ESG assets under management have reached 35 trillion dollars.²⁶ With this huge volume, comes closer scrutiny over the composition and distribution of ESG assets. Where are these flowing? What markets are they feeding into? In 2021, about 80% of ESG financing is equity financing, mostly distributed among the largest publicly listed companies on the S&P 500. About 20% is in the bond market, and a subset of these include green and Sustainable Development Goal-linked bonds.²⁷

Despite the explosive growth of sustainable investing, we are far from where we need to be. UNEP has projected the climate financing gap to be in the order of about 4 trillion dollars per year, until 2050.²⁸ This is a vast gap, that will again require understanding how to jumpstart markets that are not yet developed.

25 IMF (2021), Proposal for an International Carbon Price Floor Among Large Emitters <https://www.imf.org/en/Publications/staff-climate-notes/Issues/2021/06/15/Proposal-for-an-International-Carbon-Price-Floor-Among-Large-Emitters-460468>

26 Bloomberg (2021), *ESG Assets Rising to \$50 Trillion Will Reshape \$140.5 Trillion of Global AUM by 2025*, *Finds Bloomberg Intelligence* <https://www.bloomberg.com/company/press/esg-assets-rising-to-50-trillion-will-reshape-140-5-trillion-of-global-aum-by-2025-finds-bloomberg-intelligence/>

27 Hamlin, Jessica (2021), *Institutional Investor*. 'The ESG Fixed-Income Universe Is Growing Rapidly — But Green Bonds Are Still Being Overlooked' <https://www.institutionalinvestor.com/article/b1shpgwdt90m61/The-ESG-Fixed-Income-Universe-Is-Growing-Rapidly-But-Green-Bonds-Are-Still-Being-Overlooked>

28 UNEP (2021), *State of Finance for Nature* <https://www.unep.org/resources/state-finance-nature>

From a developing country perspective, the crucial ingredients are building portfolios that fund the infrastructure of tomorrow, at a reasonable cost. UNDP assists a major G20 initiative on sustainable finance that aims to provide common disclosure, standards and metrics for banks, investors, insurance companies and all financial players to assess climate and transition risk –in their asset pricing and in their lending.

Ultimately, the speed of green transitions are defined by the speed of technological change – in green hydrogen production, carbon capture technologies and others that will ensure how sectors and cities move from high-carbon to low-carbon before 2050. Bill Gates has underlined the need to lower the “green premium” paid by investors as they contrast prices per unit of the best existing renewable technologies and existing fossil fuel alternatives.²⁹

This leads us back where we started: research and development, technology, innovation and productivity as drivers of future growth – as they were in the 1770s. This time, with the added pressure of improving the well-being of 7.9 billion people and achieving this within planetary boundaries.

Concluding thoughts: What is ‘Opulence’?

Amartya Sen, Nobel Laureate for Economics, shifted the conversation on progress and development in the 1990s. Together with Mahbub Ul Haq, Sen proposed the concept of human development – that tracks a long, healthy and prosperous life.³⁰ They rolled the concept within a normative framework, that understood “development as freedom” – defined not by the accumulation of assets, income or wealth, nor the achievement of a steady state goal, *but the capability of each human being to choose both the ends and means of their daily lives.*³¹

The United Nation’s Sustainable Development Goals (SDGs), adopted by 191 countries in 2015, also conceives of development beyond the confines of growth or income.³² We understand the SDGs not to be a checklist for the good life, but a response to the major challenges and risks of our times. With

29 Gates, Bill (2021), *How to Avoid a Climate Disaster* <https://www.penguinrandomhouse.com/books/633968/how-to-avoid-a-climate-disaster-by-bill-gates/>

30 UNDP (1990), *Human Development Report* <http://hdr.undp.org/en/reports/global/hdr1990>

31 Sen, Amartya (1999), *Development as Freedom* <https://www.penguinrandomhouse.com/books/163962/development-as-freedom-by-amartya-sen/>

32 UN (2021), *The SDGs* <https://sdgs.un.org/goals>

the pandemic, the question of ‘what is development’ has been tested yet again: reversals in poverty, inequality, health and education as well as gender equality will take years to address and confirms that development is not linear, nor is it a one-way street.³³

‘Opulence’ can be traced to the tectonic shifts that were visible in Adam Smith’s lifetime. While Smith is often revered as the Father of Economics, his other distinguished role is being part of the Scottish Enlightenment with other luminaries such as David Hume and Francis Hutcheson. The 21st century is once again faced with a period in history where scepticism to authority of all types and the power of reason is in question – in post-truth and fake-news settings alike.

And once again, we are tasked with a simple but powerful challenge: to use evidence, truth and reason to address the problems of our times.

////////////////////////////////////

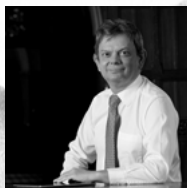
33 UN (2021), *SDG Progress Report* https://sustainabledevelopment.un.org/content/documents/27610SG_SDG_Progress_report_2021.pdf

Book IV

Of Systems of political Economy

*by Prof. Sir Anton Muscatelli,
Dr Michele Battisti & Dr Craig Smith*

Book IV of the *Wealth of Nations*, 'Of Systems of political Economy', sees Smith forcefully criticise the antiquated government restrictions that dominated the economy of the era, arguing for the removal of crude tariffs and trade barriers. He is specifically concerned with the Mercantile System, and its restriction of the power of mutually beneficial trade. Importantly, Smith is not arguing for a purely *laissez-faire* system, but simply for removal of the arcane system of controls on the production and movement of goods that 18th century entrepreneurs faced.



Prof. Sir Anton Muscatelli
Principal & Vice-Chancellor, University of Glasgow

Professor Sir Anton Muscatelli is a graduate of the University of Glasgow, who began his post as Principal in 2009, having previously graduated with a PhD in Economics. He was a lecturer in Economics from 1984 and Daniel Jack Professor of Economics from 1992 until 2007.



Dr Michele Battisti
Senior Lecturer in Economics, University of Glasgow

Michele Battisti is a Senior Lecturer in Economics at the University of Glasgow Adam Smith Business School. His research interests focus on labour economics, particularly relating to migration and education.



Dr Craig Smith
Adam Smith Senior Lecturer in the Scottish Enlightenment (Politics),
University of Glasgow

Craig Smith is the Adam Smith Senior Lecturer in the Scottish Enlightenment (Politics) at the University of Glasgow. His research interests focus on the Scottish Enlightenment and its legacy on political economy and philosophy.

“Every town and country, on the contrary, in proportion as they have opened their ports to all nations; instead of being ruined by this free trade, as the principles of the commercial system would lead us to expect, have been enriched by it”

Adam Smith, *Wealth of Nations*: Book IV

In Book IV of the *Wealth of Nations* Adam Smith considers systems of political economy and demonstrates the close relationship between politics and economics. He provides a compelling case against a mercantilist system in which countries sought to grow their economies by restraining imports and encouraging exports. The case he makes builds on the earlier arguments in the *Wealth of Nations* that trade and exchange are mutually beneficial. In the same manner, trade across national borders better secures the wants and desires of society.

Trade and the division of labour

The proposition by Smith was simple: that the division of labour and specialisation plays a crucially important role in driving the wealth of both individuals and nations. Hence countries should specialise in producing and exporting goods that they can produce more efficiently than other countries, and vice-versa they should import goods which other countries produce more efficiently. His ideas were subsequently developed by Ricardo and others and became the basis of the modern theories of international trade.

Smith's analysis is nuanced, pragmatic and gradualist. It is based on a case-by-case analysis of the impact on incentives and the unintended consequences of the policy. Smith demonstrated that the trade restrictions of the mercantilists represented a monopoly against their fellow countrymen³⁴, showing how the concentrated benefits to the merchants were bought at the expense of higher prices for the rest of the population. His point, as famously illustrated by his metaphor of the invisible hand³⁵, was that policies have unintended consequences, and these consequences can be negative as well as positive.

When considering free trade, the positive side includes the empirical observation that 'Every town and country, on the contrary, in proportion as they have opened their ports to all nations; instead of being ruined by this free trade, as the principles of the commercial system would lead us to expect, have been enriched by it.'³⁶ But on the negative side lies the potential social dislocation caused by the rapid decline of an industry opened to international competition. A problem Smith faces head on when he accepts a gradual move towards free trade may be necessary to reduce the social upheaval of unemployment, though he maintains that such unemployment will be temporary and will generally be less than feared³⁷.

What Smith shows is that the simple arguments of the mercantilists are bound to fail in explaining the complexity of global trade. But Smith also resists reversing the mistake. He recognised that complete free trade is unlikely because it is opposed by the prejudices and interests of many individuals. Smith acknowledges that there is little chance of a free trade utopia and instead commits himself to careful, pragmatic policy analysis with a view to improvement rather than perfection.

As he puts it: 'changes of this kind should never be introduced suddenly, but slowly, gradually, and after very long warning. The legislature, were it possible, that its deliberations could always be directed, not by the clamorous importunity of partial interests, but by an extensive view of the general good...' ³⁸ These views, favouring a gradualist evidence-based approach, which takes account of the complexity of these issues is a very valuable lesson for today. Because international trade tends not to be a primary concern for most

³⁴ *Wealth of Nations*: Book IV, Chapter 2

³⁵ *Wealth of Nations*: Book IV, Chapter 2

³⁶ *Wealth of Nations*: Book IV, Chapter 3

³⁷ *Wealth of Nations*: Book IV, Chapter 2

³⁸ *Wealth of Nations*: Book IV, Chapter 2

voters, there is potential for free trade to be sacrificed in favour of policies that are seen as benefiting particular segments of the population, potentially at the cost of many others, at home and abroad.

Smith argued that the gains from trade depend upon the basic stability of the political and legal structures of a society. To the extent that the gains from modern trade have generated levels of internal inequality that foster dissatisfaction with the society (and provide fertile grounds for populists³⁹ with simple answers to complex questions), they have generated a set of economic interests and political incentives that pose a challenge to modern societies.

Our discussion of the contemporary debate about trade focuses precisely on how the political economy of these different interests has resulted in a more divided view on the benefits and costs of trade and globalisation. As we shall see, modern economics can highlight why free trade and globalisation can create division in domestic politics. In addition, Smith's core insight in Book IV still holds true: that the system of political economy which is established is dependent on how trade impacts on domestic interests.

As trade creates winners and losers, the political economic effects of trade openness and its acceptance among most people will be crucially affected by the success of other policies, including industrial policies and the ability to find employment for those who may be negatively affected, as well as on the role of the welfare state and redistributive policies at large.

Free trade's ascendancy and 21st century protectionism

The importance of free trade and the lowering of trade barriers has been a feature of the liberal economic order since 1945, and the progress of free trade would have perhaps surprised Adam Smith. The protectionism and economic nationalism of the inter-war years were seen as playing a major role in the drive towards war and global conflict. The Bretton Woods Conference of 1944 had recommended that governments should reduce barriers to international trade.

³⁹ There is an extensive recent literature linking populism and voter behaviour with openness to trade. See for example: Rodrik, Dani (2020), "Why Does Globalization Fuel Populism?" CEPR Discussion Paper No. DP15002, July; Autor, David, David Dorn and Gordon H. Hanson (2017), "Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure", *NBER Working Papers*, n. 22637, December; Bergh, Andreas and Kärnä, Anders (2020), "Globalization and Populism in Europe". IFN Working Paper No. 1304, October.

In 1947 the General Agreement on Tariffs and Trade (which evolved into the WTO in 1995) were established as a mechanism to encourage the removal of trade barriers. Up until around the turn of the 21st century, the overall direction towards economic integration and the reduction of trade barriers worldwide did not seem to be challenged. The World Bank's World Development Indicators show that the global trade-to-GDP ratio increased from around 25% in the 1960s to a peak of around 61% in 2008 and then slightly fell to 58 percent in 2019.

In this spirit, Rodrik (2000)⁴⁰ discussed a political trilemma of the world economy, i.e. that international economic integration, the nation-state, and mass politics cannot co-exist, and that it is only possible to have two out of the three. Rodrik's view, which may be referred to as economics-over-politics, predicted that the nation-state system will disappear.

While this prediction may not be accurate for the immediate future, it highlights that the economics and politics (nationally and internationally) of trade are fundamentally interlinked. The last two decades have shown us that the complex relationships between trade policies, the welfare state and inequality can produce outcomes in which it is economic integration that is sacrificed in some countries (and mass politics in others), rather than the nation-state. In a context in which a very large share of total international trade is trade in intermediates within complex global value chains, the costs of isolationist policies can be very large.

Our 21st Century reading of Adam Smith's *Wealth of Nations* takes place against the backdrop of a recent resurgence of protectionist tendencies⁴¹. Even where national policy agendas are not explicitly protectionist on trade, the smooth functioning of the trading system is increasingly seen as secondary to other objectives. The UK's exit from the European Union involved an explicit decision by the UK to erect trade barriers with neighbouring economies to regain control over immigration and regulatory autonomy.

The Trump administration, in an attempt to protect employment in certain parts of manufacturing, may have hurt American consumers and has

40 Rodrik, Dani (2000). "How Far Will International Economic Integration Go?" *Journal of Economic Perspectives*, 14 (1): 177-186.]

41 Gunnella, Vanessa and Lucia Quaglietti (2019) *European Central Bank Economic Bulletin*, Issue 3/2019, 'The economic implications of rising protectionism: a euro area and global perspective', shows that trade integration experienced a 'golden age' in 1990-2008, during which period total trade in goods and services increased from 39% to 61% of world GDP. On the other hand, the same statistic falls from 61% in 2008 to 58% in late 2018, despite the continuing growth of international trade in a number of developing countries.

undermined international trade rules. While the current administration has signalled a certain change in priorities, there does seem to be a lot less support for free trade from the electorate. Countries like the UK and the USA seem to be seeking a ‘system of political economy’ which is different from that of their post-war past, and one in which the rhetoric around trade has significantly changed across the political spectrum.

Adam Smith’s perspective over alternative systems of political economy, which was driven by his observation of history and 18th Century trade, can aid our understanding of the nuances of recent developments, and potentially guide us in policy making. We see that in the current context trade policy cannot be seen in isolation, but rather as part of an overall policy agenda that concerns itself with inequality, the role of the welfare state and sustainability. An effective and open trade policy is not sustainable in an environment in which some or all of the redistributive policies of welfare states do not generate improving living standards for the poorer sections of the population (Smith’s overall justification for the value of trade).

One way in which the trade literature has attempted to look at the consequences of trade taking the perspective of all countries involved has been through the focus on global inequality. Among many others, two recent books by François Bourguignon (2016)⁴² and by Branko Milanovic (2016)⁴³ brought this discussion to the forefront of the debate. Both point out that globalization, as predicted by trade theory, has allowed inequality to decrease between countries. It has hundreds of million people in developing countries above the threshold of absolute poverty.

However, *within* individual nations globalization has contributed to a rise in inequality. Workers with lower levels of education in developed countries have faced increased competition from the cheap labour costs of emerging economies, while many of the benefits of a large rise in trade and migration were more directly felt by individuals with relatively high incomes. In addition, it is argued that globalization has increased the returns to capital and highly skilled labour across the world. Thanks largely to the huge progress being made by Asian countries including China, global inequality has steadily decreased between 1990 and 2010.

42 Bourguignon, François (2016), *The Globalization of Inequality*

43 Milanovic, Branko (2016), *Global Inequality: A New Approach for the Age of Globalization*

We have also witnessed a more focused attention on the role of trade for inequality in developing countries⁴⁴.

Over the last few decades, trade economists have indeed taken the heterogeneous effects of trade very seriously. The literature has discussed how effects may vary not only across countries, but also within countries, driven by how trade interacts with different parts of the economy, including labour markets, innovation, and income inequality. Among many others, Gene Grossman and Elhanan Helpman have written a series of seminal papers that included heterogeneity (in several dimensions) in theoretical models of international trade, allowing for the estimation of different effects of trade for different parts of the population, thereby going beyond a simple concept of aggregate gains from trade. Recently, they discuss how the effects of international trade may be different in different sectors of the economy and for workers with different characteristics.⁴⁵

Some of the recent contributions have been extremely influential in the recent political debates around the effects of globalisation for different types of workers, which focused primarily on rich countries. For example, David Autor and co-authors have been studying the effects of Chinese import competition on American communities.⁴⁶ Their research shows that Chinese imports have had significant and long-lasting economic impact (on employment, wages, as well as voting outcomes) in towns where local manufacturers have faced competition from Chinese imports.

It is also interesting to note that effects of the same ‘China shock’ have arguably been milder in other countries, including Germany and France. We believe that, while the debate on this issue is very much ongoing in the research community, these findings again stress the complexity of the issue at hand, and perhaps provide support for the gradualist approach advocated by Adam Smith.

Indeed, in this sense it is interesting to observe that the Chinese approach has been very much gradual in terms of international trade after WTO membership in 2001.⁴⁷

44 Pavcnik, Nina (2017) “The impact of trade on inequality in developing countries”, *NBER Working Paper 23878, National Bureau of Economic Research*

45 Grossman, G.M. and Helpman, E. (2018), Growth, Trade, and Inequality. *Econometrica*, 86: 37-83.

46 Autor, David, David Dorn and Gordon H. Hanson (2016), The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade, *Annual Review of Economics* vol. 8:1, 205-240

47 Very recently, Mavroidis, P., & Sapir, A. (2021). *China and the WTO: Why Multilateralism Still Matters* offers a very insightful view on the need to look for a multilateral solution to address the tensions that the role of China within the WTO has created over the last two decades.

On the other hand, one can argue that the approach followed by countries such as the US has been less gradual.

This, together with timid labour market and industrial policies, and the relative taxation burden on capital and labour may have brought about larger negative effects for some segments of the population. A similar point could be made about Brexit. While it is very simple to judge events from today's perspective, one could argue that the fact that the UK (unlike almost all other EU members) opened its labour market fully immediately after the EU's Eastern Enlargement, had long-lasting political consequences. This was probably exacerbated by tight fiscal policies post-2010 and stagnating median real wages⁴⁸ following the financial crisis.⁴⁹ These US and UK examples demonstrate how politics can trump economics.

Looking forward

If we look ahead, what does Adam Smith's warning to heed complexity tell us about the way we should look at trade and globalisation in the 21st Century? A full analysis lies beyond the scope of a short essay. However, there are three areas which merit close attention.

The first is the obvious one which Smith recognised in the 18th Century. One should consider the impact of trade on different groups in society. Traditional trade theory focused all too often on aggregate impacts on each economy and the aggregate gains from trade. Modern approaches to the economics of trade and its political economy emphasise that trade will have differential impacts on different parts of society, and that interest groups matter for political outcomes.

The second point is that trade policy cannot be treated as an issue in isolation. As we saw Adam Smith was a political economist, aware that international

⁴⁸Wadsworth, Jonathan, Swati Dhingra, Gianmarco Ottaviano and John Van Reenen (2016). "Brexit and the Impact of Immigration on the UK". Centre for Economic Performance, LSE, Brexit paper n. 05., May. demonstrates that it was not the direct impact of immigration into the UK from the EU which depressed real wages but the weakness of the economic recovery. But it created a political environment in which it was easy to blame immigration. Indeed, post-Brexit economic analysis has shown a fall in living standards for the median household due to higher prices (see Breinlich, Holger, Leromain, Elsa, Novy, Dennis and Sampson, Thomas (2021). *International Economic Review*, 'The Brexit Vote, Inflation and UK Living Standards', in press).

⁴⁹The 'daunting' policy challenges to make globalisation work for all are discussed in Catão L, Obstfeld M (2019), *Meeting globalization's challenges: policies to make trade work for all*. They provide a view on the complex interplay of trade, deindustrialization, inequality, and the troubling surge of nationalism and populism.

trade was integral to international relations. This was well understood when the post-World War 2 economic institutions were created in 1944-47. Trade imbalances matter for international politics: the linkages between trade imbalances, saving and investment decisions across different countries and global financial imbalances are a major driver of international tension. Klein and Pettis (2020) emphasise this interdependence, and that major decisions taken by major economic actors like the USA, China and the EU will have unanticipated effects, and that inequality is a key variable which can fuel political conflict.

The third and final point is linked to the second one and takes us to COP26, and the need to revitalise international multilateral institutions as we seek to tackle climate change. Perhaps surprisingly given the linkages between international trade and climate change, the WTO states that: “...The issue of climate change, per se, is not part of the WTO’s ongoing work programme and there are no WTO rules specific to climate change...”⁵⁰. Having said that, the inclusion of environmental provisions in bilateral and regional trade agreements has driven the harmonisation of environmental regulations between advanced and emerging economies.

The linkages between trade and climate change are complex. For instance, trade expansion which does not consider environmental factors can drive climate change if it drives the specialisation of pollution-intensive activities towards countries which as a result of climate agreements may have lower emission constraints. On the other hand, greater trade can drive efficiency in production and can improve access to new technologies which helps emerging economies to reduce energy use, and the use of other scarce resources like water. In other words, environmental factors, like inequality, add a further degree of complexity to the political economy of international trade. As many economists have argued⁵¹, the answer to this is to reinvigorate the multilateral regime by ensuring that institutions like the WTO can handle the challenges ahead informed by the latest, empirical research by political economists.⁵²

50 WTO (2021), Trade and Climate Change https://www.wto.org/english/tratop_e/envir_e/climate_intro_e.htm. Although of course the WTO is aware of the interdependence between climate change and trade.

For its activities in relation to climate change see WTO (2021), Activities of the WTO and the challenge of climate change https://www.wto.org/english/tratop_e/envir_e/climate_challenge_e.htm

51 See Carney, Mark (2021), Value(s): Building a Better World for All, who argues that a ‘values-based’ approach would provide a better way to create a cooperative internationalism.

52 There is parallel here with the argument by Mavroidis and Sapir (2021) that the way to deal with the issue of integrating different economic systems through the WTO is not through unilateral action but through multilateral agreement.

Smith would have appreciated that these are complex issues and that the economic and political sides of the impact of globalisation were intimately and not straightforwardly linked. When it comes to policy choices between different systems of political economy we should beware ‘speculative physicians’⁵³ with simple answers to complex problems, just as we should be wary of ‘the interested sophistry of merchants and manufacturers.’⁵⁴.

////////////////////////////////////

53 *Wealth of Nations*: Book IV, Chapter 4

54 *Wealth of Nations*: Book IV, Chapter 3

Book V

Of the Revenue of the Sovereign or Commonwealth

by Tan Sri Dr Zeti Aziz

Book V of the *Wealth of Nations*, 'Of the Revenue of the Sovereign or Commonwealth' concludes Smith's magnum opus. Having criticised the existing state of government involvement in the economy in Book IV, Smith uses Book V to outline his principles regarding when and how governments should intervene in the economy. He sets out the obligation of the state to care for its citizens, proposes theories of taxation, advocating for taxation proportional to income, in addition to land values taxes, and describes a theory of public goods.



Tan Sri Dr Zeti Aziz

Former Governor, Bank Negara Malaysia & Co-Chair,
Board of Governors, Asia School of Business

Tan Sri Dr Zeti Aziz served as Governor of Bank Negara Malaysia from 2000 to 2016, and currently serves as the Co-Chair for the Board of Governors at the Asia School of Business. She is known for her role in successfully managing the 1997-1998 Asian Financial Crisis and the strong recovery that followed. She was instrumental in transforming the Malaysian financial system and building its robust resilience. She was a voice for the emerging world on many issues concerning the international financial system and financial and economic management. Dr Zeti holds a doctorate in economics from University of Pennsylvania.

“The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals”

Adam Smith, *Wealth of Nations*: Book V

“How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.”

Adam Smith, *The Theory of Moral Sentiments*

Adam Smith has left the world with an enduring legacy. Written in the 18th century during the early years of the Industrial Revolution (1760-1840), his treatise on *An Inquiry into the Nature and Causes of the Wealth of the Nations*⁵⁵ has transcended generations. Despite the radical and powerful forces that have continued to transform our world environment, the *Wealth of Nations* remains relevant today. One of the world’s greatest pioneers on the political economy, Adam Smith in the *Wealth of Nations* outlined the intellectual framework for the functioning of the free market economy.

The legacy of Smith

The main premise in this monumental work is that the division of labour, together with rational individual self-interest, would produce an equilibrium that would be beneficial to the overall community. In essence, the price system would accurately capture the accumulated preferences of investors and consumers in the functioning of the free market economy. Famously describing the unseen forces driving the market as “the invisible hand”, Smith maintained

⁵⁵*Wealth of Nations*

that the equilibrium generated would result in economic prosperity that would be beneficial to society. He asserted that any interference with such free competition would likely be injurious to the economy, absent a compelling reason to intervene.

While his ideas and principles articulated have provoked much debate, it continues to be relied upon as an intellectual framework from which powerful solutions can be derived - while being contextualised in dramatically different environments. Years later, Milton Friedman described this phenomenon as “cooperation without coercion”⁵⁶.

Unlike some of his contemporary followers, however, Adam Smith did recognise that certain parts of the economy did require targeted intervention by the state. Book V of the *Wealth of the Nations* represents his overture into the role of the state within his core thesis of the laissez faire market economy. In it, Smith acknowledges that the invisible hand did indeed need a helping hand from the state to achieve a good life for society.

However, Smith clearly stated that this should be targeted and limited in scale with the responsibilities of the government being confined to specific areas as outlined in Book V. He emphasised that production and distribution should still be predominantly privately owned.

The global economy

In the generations since, we have experienced fundamental changes to our environment in terms of the productive capacity and interconnectedness of the global economy, both shifts anticipated by Smith’s focus on the transformative power of the division of labour. As we fast forward into the contemporary world, these changes have been even more profound and transformative.

Alongside these positive changes to the global economy, the world has also becoming increasingly disordered with extreme and unstable conditions. These have arisen from a range of major global disruptions - including the catastrophic consequences of the global health pandemic, the climate change crisis and the accelerated advances in technology which have cumulatively led to unimaginable changes in how business is conducted and how we live our lives.

⁵⁶ As quoted in many of his works, including Friedman, Milton and R.D. Friedman (1962), *Capitalism and Freedom*

Some of these developments are also reinforcing other systemic issues, such as indebtedness and inequality. The world has also become more vulnerable and prone to recurring crises with highly damaging consequences on the environment and on humanity. How relevant then are Adam Smith's ideas to this contemporary environment? Equally importantly, how relevant are these ideas to a developing world that is becoming increasingly significant in the global economy?

The duties of the state

The most urgent and pressing issue confronting contemporary economies is sustainability. This essay will examine the ideas proposed in the fifth and final book of the *Wealth of Nations* and whether indeed it provides an intellectual framework for solutions to this challenge. What would Adam Smith have said on such issues surfaced by the climate crisis and the interventions being envisaged to address them?

For several of these complex and ambitious agenda, neither the market nor the state can achieve the aspired outcomes on their own. Is there then an optimal arrangement in which the private sector can participate collaboratively with the government in the provision of the public goods that would not cause injurious outcomes alluded to in the *Wealth of Nations*? Also considered is its relevance to emerging and developing economies. This essay will also discuss some of the pre-conditions that would be needed for the effective functioning of the free market and for generating the optimal outcomes envisaged in the *Wealth of Nations* that would benefit society.

As mentioned previously, Book V of *The Wealth of the Nations* highlights that, while private markets function more efficiently and are more productive to create the best outcomes for a nation, there are specific areas in which intervention by the state is required. Covered in three Chapters, Book V discusses the specific areas that should be the responsibility of the sovereign, how these responsibilities might be managed and financed including his views on public indebtedness. He believed that the most important responsibility of the government is to protect society.

He asserted that the first duty of the state was to provide protection from the dangers to society, which during that time was predominantly against violence and crime and from invasions from other nations. The state therefore needed to provide a policing and military force, to be maintained for this purpose and eventualities.

The second duty of the sovereign, as identified in Book V, is to protect members of society from oppression and injustice. Smith believed that such actions and crimes were driven by avarice. A justice system was therefore an integral part of the system to provide protection to society from such crimes.

The third duty of the state concerns its role in providing the supporting infrastructure and public works that were considered as vital for the well-being of the society. This part of his work foreshadows the modern thinking on public goods. While the state had an important role, Adam Smith was still of the view that it should be as limited as possible and that such activities would function more efficiently if it was privately funded.

In Chapter 2 of Book V, Adam Smith outlines the sources of revenue to provide funding for the public expenses outlined in Chapter 1. Here, the most enduring contribution is his conception of the tax system which he believed should be proportionate to the ability to pay and have sufficient clarity to avoid any ambiguity while also being convenient. Such taxes should also not be any more than that required for the functioning of the state. Additionally, if the taxes were not well formulated it would not only affect pricing but could result in distortions.

He also discusses at length the corporate structure for such public works, believing private institutions would be superior to public ones. He was not keen for public companies, noting that the separation of ownership and management could not only lead to negligence, but it risked managers to profit at the owner's expense⁵⁷. He nevertheless suggested that for activities that required a lot of capital, such as those for financial institutions and utility companies, that it would be best managed by a group of persons. In Chapter 3 he raised warnings on overborrowing by the government and maintained that if spending is unchecked it would result in the ruin of nations.

Specifically mentioned in Book V is the provision of education by the state, essentially considering it as a public good. Adam Smith also believed that everyone should have access to education. He was an early advocate for inclusion and being inclusive on grounds that it would increase the potential of the labour force. While tuition fees should be charged to the students, he also had the view that it should be made available to the poor and that such education should be subsidised and paid for by the state. He maintained that

⁵⁷ Indeed, this illustrates Adam Smith's intuitive understanding of the problem of moral hazard before it formalised in the modern literature

a more educated society would be better positioned to make better choices, thereby making for a more orderly and prosperous society. Indeed, for emerging and developing economies, this is the one single manner in which poverty can be eradicated and for inequalities to be reduced.

From public goods to climate action

Knowing Smith's position on public goods, what can we surmise that he would have said about the planet? Under the public goods framework, the planet can essentially be considered as the ultimate public good, with the stock of natural resources that includes the air, soil and water that has been bestowed upon us by nature. With decades of negligence and plundering of nature, the owners of capital in this era have an additional responsibility and accountability - to ensure the sustainability of our planet.

Until now, the planet has contributed towards sustaining human life. For those of Smith's era, the idea that human activity could permanently damage the capacity of the planet to sustain humanity would have seemed unthinkable. However, as we well know, it is now at risk of being destroyed and depriving our future generations of the means to provide for themselves⁵⁸. The protection of the environment would certainly fit with Adam Smith's overall framework described in Book V. It would not be inconsistent with his premise that state interventions are necessary in the areas in which the agenda to protect the well-being and, indeed, the very security and existence of humanity. In this particular instance, the need to avert a climate catastrophe provides not just clear grounds for state intervention, but that this is in fact one of the most important responsibilities of the state.

The contemporary reality of environmental degradation has now prompted urgent attention. Three fundamental reasons explain this urgency. The first is that staying on this trajectory without action will render our planet no longer habitable in the long term, due to atmospheric conditions with high concentrations of carbon dioxide, amongst other pollutants, along with the resulting extreme temperatures and increasingly frequent natural disasters. The second fundamental reason for urgent action is the immediate repercussions on human livelihoods arising from droughts and floods, and the third is the overall irreversible physical damage to our entire eco-system.

⁵⁸Forcefully presented in Dasgupta, Partha (2021), *The Economics of Biodiversity*

Cumulatively, these outcomes are affecting health, food security and lowering the potential for economic growth and employment. These developments have therefore called for action to be taken for the protection of society from these risks and eventualities. However, given the enormity and scale of the climate crisis being anticipated, it cannot be addressed by the state alone. Necessarily, it requires joint actions and combined efforts from the public and private sectors to avert the biggest challenge faced by humanity. Again, this is not inconsistent with the point made in Book V by Smith, that one of the fundamental responsibilities of the state is to protect its citizens and their livelihoods.

Interventions to support the climate change agenda have recently been centered on the objective of transitioning economies to net zero emissions. In addition to investments made by the state to respond to the risk of a climate-related crisis, the interventions have ranged from providing the incentive structure to achieve these goals to the implementation of specific and targeted environmental regulation.

In the case of the former, the discussion on appropriate design of taxation in Book V can for example serve as a guide in the imposition of charges for emitting greenhouse gases to thereby determine an appropriate pricing for such activities, an example of the enduring power of Smith's work. In the case of the latter, it has included compliance to standards, such as on transparency and disclosure, in addition to prudential regulation and guidelines.

Within financial systems, financial institutions have taken on an increasingly important role in the financing of investments in this domain and in the channeling of funds to the various respective sectors that support sustainable technologies, while avoiding those investments related to high carbon activities⁵⁹. The increased requirements for disclosure of information in effect strengthens the invisible hand. It provides information on the risk taking that may damage the environment by the investment. It is maintained that such market discipline provides a powerful mechanism to constrain excessive risk taking⁶⁰.

59 At the institutional level, banks and financial institutions now publish the criteria that is used to assess, monitor and report the green impact on the investments that is being undertaken. Global Alliance for Banking on Values (GABV) is a network of leaders from around the world that commit to advancing positive change in the banking sector to environmental sustainability. This is through transparency in terms of their assets that are committed to meeting the needs of the planet.

60 A parallel can be drawn in the world of financial regulations in relation to financial stability in which financial regulation reinforce market discipline to internalise systemic risks. Bernanke, Ben (2007), *Financial Regulation and the Invisible Hand*

Other policy measures and tools applied to preserve financial stability include the adoption of stress testing applied to financial institutions. Such tests now incorporate assumptions on the risks of climate-related shocks. It also includes guidelines for incorporating environmental issues into their risk management processes. In several emerging economies in Asia and in Latin America, it has also included measures such as guidelines for loan documentation that require compliance with environmental standards and efforts taken to advance green financing in the capital markets.

To promote this asset class in South East Asia, the ASEAN Green Bond Standards were introduced in November 2017⁶¹. Further interventions have also included direct spending by the public sector on green physical infrastructure. Initiatives have also been taken to develop a common language to facilitate understanding and progress in taking the agenda forward. Notably, the ASEAN economies have also commenced work on the Taxonomy for sustainable finance, similar to that in the European Union, to be completed in 2021⁶².

Given the magnitude of the ambitions to address the climate change agenda, the goal to transition to low carbon economies cannot be achieved by governments alone. There needs to be increased investment activity by the private sector that embeds environmental considerations. Such investments by the private sector have included those that aim at providing technological solutions to environmental problems, such as wind, solar power and hydro plants and other potential renewable energy generations⁶³. There are also investments in other sectoral industries such as climate-aligned investments in agriculture. Finally, there are also the investments both by the private and public sectors in energy efficient public transportation, water, electric vehicles and green buildings.

What are the elements that would draw the market process to support such activities? Several initiatives have already been implemented to encourage and facilitate such investments. Broadly, it has included initiatives to align the market to the medium- and long-term targets to be achieved, such as the SDGs, improving the overall investment climate and the removal of counterproductive policies such as barriers and impediments for such investments. Central to this

61 ASEAN economies, comprising of ten countries in South East Asia, with a population of 260 million and collectively in terms of the size of their economies, it is now the fifth largest country in the world.

62 AFMGM (2021), Joint Statement of the 7th ASEAN Finance Ministers and Central Bank Governors' Meeting

63 The 2016 IFC Climate Investment Opportunities in Emerging Markets, An IFC Analysis provides an account of the progress in such investment in these respective regions.

is having in place the incentives that generate the appropriate carbon pricing. A further key initiative is the integration of the climate change agenda into the governance arrangements of businesses.

Most of all, boards now have a duty to address climate issues. It is an opportunity for shareholders to influence corporate behavior in addressing this climate change agenda. The command of knowledge and expertise on the subject matter is equally important. Finally, most companies now release a sustainability report on their strategies, progress and achievements in contributing towards the transition to a low carbon economy and towards environmental sustainability. Overall, this is indeed only a start. Encouraging is the momentum of further policy actions that harness both the strengths of the public and private sectors to advance this agenda.

Amidst the urgent concerns on the prospective climate change crisis, emerging and developing economies while being part of this agenda, are also transitioning towards becoming more market-driven to achieve greater development and progress. Experience has indeed shown that economies that have moved to accelerate deregulation to achieve greater market orientation and heightened liberalisation to participate in more competitive international markets have benefitted immensely in terms of the contribution to their growth and prosperity.

However, during periods of significant shocks, such economies have tended to experience greater damaging consequences⁶⁴. The lessons that have been drawn from these experiences are that important pre-conditions need to be in place prior to deregulation and liberalisation and the move towards a more market driven economy.

Among them are to have strengthened financial institutions, developed financial markets and the necessary information and payment systems that are in turn reinforced with a developed and robust regulatory and supervisory oversight and that is supported by sound governance and risk management practices. These financial reforms which were implemented in many emerging economies in many parts of the world have indeed increased their resilience during the 2008-2009 Great Financial Crisis in the developed economies. While the emerging economies were affected by the crisis, it did not trigger a financial crisis in their economies.

⁶⁴ Discussed at length in Zeti Aziz (2014), Managing Financial Crisis in an interconnected World: Anticipating the Mega - Tidal Waves. Per Jacobsson Lecture <http://www.perjacobsson.org>

Such risks, however, are always present. The 2008-2009 crisis also demonstrated that even developed financial markets have not been immune to becoming dysfunctional when confronted with extreme shocks. A further lesson is that policy tools such as ‘market maker of the last resort’, recently been implemented during extreme conditions to avert the severe consequences of a financial crisis. Such interventions have generally been accompanied by conditionalities to address moral hazard concerns. Necessarily they have also been targeted and temporary.

Finally, to conclude on the subject of Adam Smith’s premise that the invisible hand essentially translates the pursuit of self-interest into a public benefit. He believed that self-interest will eventually enrich the whole community. It was in his earlier work, ‘*The Theory of Moral Sentiment*’, that he provided the ethical, philosophical and psychological underpinnings to the *Wealth of Nations*. He maintained that social psychology gave a better explanation to moral action than reason. He believed that overall, man would act in the best interest of others.

“How selfish so ever man may be supposed, there maybe some principles in his nature, which interests him in the future of others and renders their happiness necessary to him, through it derives nothing from it except the pleasure of seeing it”⁶⁵.

From this, it can be interpreted that, had Adam Smith lived in the twenty first century, he would have been a strong voice and advocate for the protection of the environment, including to the risks that may have intergenerational implications leading to higher overall costs to our planet and humanity. In this case, the call would be for urgent action from both the state and the market to deliver an outcome that would allow our progress and prosperity to be enjoyed by our future generations.

////////////////////////////////////

65 This quote is from the first line in Smith, Adam (1759), *The Theory of Moral Sentiments*

The Misinterpretation of Adam Smith: Bringing Back the Theory of Moral Sentiments

by Kaisie Rayner



Kaisie Rayner
Climate Change Lead, Royal London

Kaisie's mission in life is to help financial institutions understand sustainability and their role in enabling the transition to a low carbon economy. She is currently the Climate Change Lead at Royal London, a commissioner at the Edinburgh Climate Commission, a fellow at the RSA and occasional lecturer at Cambridge Institute of Sustainability Leaders. Prior to working with Royal London Kaisie was the Sustainable Investment Lead at Scottish Widows and has worked with Aegon, Lloyds Banking Group, RBS and Standard Life Investments.

In closing this essay series, I would like to take the opportunity to reflect on Smiths' intentions for his legacy; his lesser known but perhaps more important book *The Theory of Moral Sentiments*; and the relevance this has as we navigate the 21st century.

The Theory of Moral Sentiments was Adam Smith's first book. Initially published in 1759 it was republished 6 times with the final edition comprehensively updated and published in the year of his death, 1790. For Smith *The Theory of Moral Sentiments* was the magnum opus of his work, and the *Wealth of Nations*

a subsidiary. Had his death wish been honoured by his dear friend David Hume then we may never have known of either.

For it was Smiths' intention that the entire body of his work – essays, lecture notes and publications – be destroyed upon his death. For better or worse this was not to be the case, and quite how *The Wealth of Nations* became so favoured and *The Theory of Moral Sentiments* neglected is not the subject of this discussion.

But if *The Wealth of Nations* is to provide an explanation of wealth, markets, the role of self-interest; it is *The Theory of Moral Sentiments* which boldly asserts the role of sympathy and articulates a fundamental principle which we appear to have overlooked – **that for society to function fairly the invisible hand must be guided by a moral compass**. And it is in the *Theory of Moral Sentiments* that Smith explores the way in which the excess of hubris and consumption can be tempered by the feelings of mutual obligation.

*However selfish man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though they derive nothing from it except the pleasure of seeing it.*⁶⁶

In *The Theory of Moral Sentiments* Smith tackles the fundamental question of what it means to be human, articulating a theory of human nature which has underpinned the development of social psychology up to the present day. Principally Smith suggests that “**our moral ideas and actions are a product of our very nature as social creatures**”. In forming our views of what is morally appropriate, we are informed by the opinions and behaviour of those around us, which we would now explain as the influence of social norms on identity and attitude formation.

Smith brings forward the view that our nature and happiness is fundamentally driven by a desire to be ‘beloved’ and in seeking to achieve this state we subsume selfish behaviours and seek to demonstrate selflessness lest our companions judge us harshly. And in the role of the impartial spectator Smith supposes there is a voice of reason or virtue living within each of us that helps us to be our better selves.

⁶⁶Adam Smith, *The Theory of Moral Sentiments*, Part I

On the limitations of the impartial spectator...

“It is a stronger power, a more forcible motive, which exerts itself upon such occasions. It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct. It is he who, whenever we are about to act so as to affect the happiness of others, calls to us, with a voice capable of astonishing the most presumptuous of our passions, that we are but one of the multitude, in no respect better than any other in it; and that when we prefer ourselves so shamefully and so blindly to others, we become the proper objects of resentment, abhorrence, and execration.

It is he who shows us the propriety of generosity and the deformity of injustice; the propriety of resigning the greatest interests of our own, for the yet greater interests of others, and the deformity of doing the smallest injury to another, in order to obtain the greatest benefit to ourselves.⁶⁷

On the limitations of human sympathies...

Smith proposes that whilst we can be moved by the experiences of those close to us, the extent to which we can authentically display sympathy is reduced by distance. Such that the injury of a close friend will be felt more keenly than the injury of many strangers far away. One could argue that the hyper connectivity of the 21st century, where we can connect with and hear about things that are happening on the other side of the world, can help overcome this limitation.

However, the ability to select our social groups through the online world can also lead to a self-reinforcing “echo chamber” preventing engagement with alternative viewpoints and the development of cohesive and pervasive social norms. In a digital world, individuals can curate and customise an identity while the collective ‘we’ is relegated to a fragile and ethereal role. In the context of climate change our ability to understand and feel sympathy for the multitude is a limitation of our human nature that must be overcome if we are to take collective action for the benefit of the global population.

⁶⁷ Adam Smith, *The Theory of Moral Sentiments*, Part III

On the limitations of the profit motive...

For the first time in decades a serious mainstream debate has begun on the social purpose of the corporation. With organisations such as Business Roundtable, World Economic Forum and the Vatican challenging the power of multinational corporations and their profit maximisation motive, which is putting at risk the habitability of the planet. This is where Smith would contradict his 21st century supporters such as the Adam Smith Institute. Where company intentions and actions are not aligned with the needs of society he would argue for intervention – to reassert the human nature of sympathy for others – into our corporate world.

This poses an interesting question which is beyond the scope of this short essay and worthy of further consideration. What would our economic system look like if we were to amend our conception of rationale economic man whose self-interest guides the free and invisible hand of the market. To one where we prioritise the well-being of society rather than purely private profits; act in the interests of the multitude, recognising that acting in ‘good conscience’ is how we each conceptualise the best version of ourselves; and provide direction for the allocative efficiency of the market through a clear articulation of the moral purpose of finance and its’ role in society.

In conclusion

The authors preceding have argued that Nature determines the worth – the value – of our future – which is increasingly compromised. That the reductionist concept of rationale, selfish economic man, which has underpinned the theology of markets for the last 40 years is insufficient as a tool to navigate our future. This is where the role of effective government and institutional interventions are key, as highlighted by Sir Muscatelli in his revisit of Book IV of *The Wealth of Nations*. In 2015 the Paris Agreement set a north star for our social, political and economic systems to aim towards. And with recent rulings on the inclusion of a sustainable future as an inalienable human right we can see that we are beginning to moving in the right direction – even if the pace is problematic.

And so – in an age of rising individualism – we are confronted by an existential crisis which forces us to recognise our inherent interdependence and reliance on each other. Our challenge is to move beyond the reductionist concept of rationale economic man to encompass a more holistic understanding of

human motivations and willingness to undertake action for the benefit of all. And in doing so realise the fundamental misinterpretation of Adam Smith, who would remind us that for society to function fairly the invisible hand must be guided by a moral compass.

Ultimately It is our generation that are mutually responsible for determining the shape of the century to come. The question I leave you with is will we create a future worth living in or preside over our civilisations decline?

*To restrain our selfish, and to indulge our benevolent affections. Constitutes the perfection of human nature; and can alone produce among mankind that harmony of sentiments and passions in which consists their whole grace and propriety.*⁶⁸

⁶⁸Adam Smith, The Wealth of Nations, Part I



The world depends on global finance making the right choices to deliver positive change and achieve the UN's Sustainable Development Goals. The Global Ethical Finance Initiative has become the hub at the centre of the ethical finance movement, and the partner for action on ethical finance.

Conversations

Research & Advisory

Strategic Campaigns

Practical Solutions

globalethicalfinance.org

#Twitter: @finance4change