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IS *THE WEALTH OF NATIONS'* THIRD DUTY OF THE SOVEREIGN COMPATIBLE WITH *LAISSEZ FAIRE*?

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THERE IS A WIDELY held belief in the economic literature that Adam Smith would have had the intuition of the existence of public goods and market failures. Smith would have entrusted their production to the state and that would be precisely the third duty of the sovereign in *The Wealth of Nations* (1976a). For example, Musgrave, among others, perfectly summarizes this position in modern economic thought (Musgrave 1985). Fleischaker similarly wrote in his recent book:

> indeed, the third category of duties he [Smith] proceeds to give the sovereign . . . is broad enough to include practically all the tasks that modern welfare liberals, as opposed to libertarians, would put under government purview. (Fleischaker 2004, pp. 234–35)

Back in 1927 Viner had already stressed that in *The Wealth of Nations* the Scottish philosopher would have made several exceptions to the *laissez-faire* tradition, contrary to the *Theory of Moral Sentiments*. According to Viner, Smith should be considered as a pragmatist who is against *laissez faire* and in favor of government action if it seems beneficial to the welfare of the general public. Thus, in *The Wealth of Nations* the state would have become (with the third duty) a supplier of several public goods.[1] Rothbard in his last book expressed the same opinion (Rothbard 1995, p. 465).

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[1]See Viner (1927) where he writes that there is "wide divergence between the perfectly harmonious, completely beneficent natural order of the *Theory of Moral Sentiments*, and the partial and limited harmony in the economic order of the Wealth of Nations" (p. 214).

But it is possible to have an interpretation of the third duty in *The Wealth of Nations* which, as we shall see, turns out to be much more compatible with *laissez-faire*. Since Menger, Austrians have always been interested in the role of economic institutions (property rights, freedom of contracts, etc.) and Smith had a similar approach to the role of the state.

The third duty of the sovereign[2] is presented in book V of *The Wealth of Nations*. It consists in

> erecting and maintaining certain public works and certain public institutions, which it can never be the interest of any individual or small number of individuals to erect and maintain. (Smith 1976a pp. 687–88)

The contemporary reader may effectively have the impression that public works correspond to public goods and that public institutions must be public sector providers or state enterprises. But our argument is that for Smith these goods (1) suffered from absence of property rights and (2) needed great amounts of capital.

E.G. West (1977) seems to be the only scholar who has understood the third duty in this way, as far as it concerns public works favoring commerce. Our study will extend his approach to include the case of education as well. In section 1 we will discuss the property rights aspect of public works in *The Wealth of Nations*. Section 2 will clarify the role of the sovereign in establishing private joint stock companies in order to collect the vast amounts of capital needed for the supply of public works, especially those supporting commerce. Finally, in section 3, the case of education will be similarly analyzed from the point of view of economic institutions.

1. SMITH'S PROPERTY RIGHTS APPROACH TO PUBLIC WORKS

The goods discussed in this part of *The Wealth of Nations* (bridges, canals, roads, education, etc.) are often classified in economic theory as public goods *à la* Samuelson (Samuelson 1988). The reasoning of public goods theorists always leads to the conclusion of market failure. Thus, there would be difficulties in financing these goods because the consumers who benefit from them cannot be excluded

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[2]The first duty concerns defense and the second, justice. Part of the third duty (protecting particular branches of commerce and merchants' goods on the international level) is similar to the defense argument, and so to the first duty. In classical-liberal tradition these duties are generally considered as compatible with *laissez faire*.

and, therefore, don't pay for their consumption: the state must intervene and produce them. Retrospectively, this view seems to justify why Smith is discussing these goods in this part of *The Wealth of Nations*, concerning the different roles of the sovereign.

Nevertheless, this interpretation appears incorrect and the notion of public works in Smith has a sense quite different from the modern one of public goods. As West[3] suggests, exclusion is almost always possible for Smith and consumers can, and ideally should, finance the public work they use. Contrary to the theorists of public goods, Adam Smith was interested in the institutional aspect of their production.

In Smith's view, the establishment of property rights in public works would allow the introduction of the price system in their production. With this introduction of price signals he had two main objectives: (1) to exclude nonconsumers from paying[4] and (2) to allow the circulation of the information on these goods in order to supply them where needed.

Property rights and financing of public works

Smith's first objective was above all to introduce the price system in order to avoid the financing of public works by any person whom it would be unjust to require to pay because he is not using it. Let only the consumer pay: "[it] seems scarce possible to invent a more equitable way of maintaining such works" (Smith 1976a, p. 725).

Smith's idea is that the "sovereign" would make every passenger individually responsible by setting up a price system via tolls on bridges, canals, roads, etc., and by conferring property rights to these tolls.

Unfortunately the Scottish philosopher doesn't consider private property rights to such goods but only to the tolls established on them. This incomplete property rights system leads to some inconsistencies in Smith's analysis and he doesn't resolve them clearly. He was not consistent enough to go so far as to consider complete privatization of these facilities. Thus, when he analyzes goods, such as canals or bridges whose maintenance is necessary to get the tolls, they should be maintained, according to him, by private persons because it is in their interest to do it:

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[3]West (1977, p. 17) writes: "The fact remains that where public works were concerned Smith relied on finance by the users of each project in turn."

[4]Smith's reasoning was very different from that of public goods theorists and much closer to that of Coase-1960 and Coase-1974.

> In several different parts of Europe the toll or lock-duty upon a canal is the property of private persons, whose private interest obliges them to keep up the canal. If it is not kept in tolerable order, the navigation necessarily ceases altogether, and along with it the whole profit which they can make by the tolls. If those tolls were put under the management of commissioners, who had themselves no interest in them, they might be less attentive to the maintenance of the works which produced them. (Smith 1976a, p. 725)

But this incomplete property rights system makes the maintenance of a high road inefficient:

> (the) tolls for the maintenance of a high road, cannot with any safety be made the property of private persons. A high road, though entirely neglected, does not become altogether impassable, though a canal does. The proprietors of the tolls upon a high road, therefore, might neglect altogether the repair of the road, and yet continue to levy very nearly the same tolls. (p. 726)

Adam Smith is confused, because such possible neglect could serve as a pretext for the intervention of the state (through trustees and commissioners) in supplying road services: "It is proper, therefore, that the tolls for the maintenance of such a work should be put under the management of commissioners or trustees" (Ibid.).

Yet such a solution is not an efficient one either: Smith exposes at length and very critically all the government failures deriving from such state intervention: "In Great Britain, the abuses which the trustees have committed in the management of those tolls, have in many cases been very justly complained of" (Ibid.).

Trustees were levying tolls which far exceeded what was necessary for road maintenance, and sometimes they didn't even repair them at all. Another danger, a more serious one according to Smith, derived from state intervention in levying tolls. It was very likely that tolls would have been artificially high and the resulting surplus would have been used to cover the general expenses of the state. Politics, then, would destroy the price system, and tolls as price signals would have no connection with consumer needs:

> if the tolls which are levied at the turnpikes should ever be considered as one of the resources for supplying the exigencies of the state, they would certainly be augmented as those exigencies were supposed to require. (p. 727)

So when the state is entrusted to levy tolls, it can very easily increase them and make the trade more expensive. Thus the state may turn out to be responsible for economic losses. The cases of public monopolies for postal service and money production must be understood in this perspective: even if there were public monopolies at the time of Smith, these works could finance themselves, and therefore there is no reason to forbid competition and their private production.

Price signals and the production of public works

By introducing the price system, Smith also wanted to allow the production of public works really useful for market participants. He knew that only the market process with a price system can indicate where, in what quantity and quality, the market needs canals, bridges, roads etc.

> When high roads, bridges, canals etc. are in this manner made and supported by the commerce which is carried on by means of them, they can be made only where that commerce requires them, and consequently where it is proper to make them. (Smith 1976a, p. 725)

In Smith's view, the sovereign cannot have proper knowledge of all these aspects, and his role should be the establishment of property rights and the price system instead of supplying them through general taxation. Without prices there could exist absurdities, as in Smith's example of France where the most useful roads were completely neglected in favor of some roads which flattered, by their greatness (despite their limited utility), the vanity of some statesman or minister. Hence when it is the consumer who pays and where there is a price system,

> [a] magnificent high road cannot be made through a desert country where there is little or no commerce, or merely because it happens to lead to the country villa of the intendant of the province. . . . A great bridge cannot be thrown over a river at a place where nobody passes, or merely to embellish the view from the windows of a neighbouring palace: things which sometimes happen, in countries where works of this kind are carried on by any other revenue than that which they themselves are capable of affording. (p. 725)

The meaning of public works is simply that these goods are consumed by several persons in common: it is the case with bridges, roads, canals, etc., but also with education when dispensed to many students at the same time. Public works as understood by Smith are definitely very different from public goods as presented in economic theory. There is no reference to nonrivalry or nonexcludability as modern public goods theory pretends.

2. CAPITAL MARKETS AND PUBLIC INSTITUTIONS

A second problem is that public works needed lots of capital. That's precisely the role of public institutions, which are discussed in this part of *The Wealth of Nations*.

The legal nature of public institutions

Smith opposed public institutions to "private companies" or "private partnerships." It seems easy for modern readers to understand public institutions as government-run entities. But in the context of industrial organization at the time, public institutions had a different meaning for Smith. The distinction between "public" and "private" is not based on the distinction between state property and private property, or between government-run enterprises and private firms (see Table 1). It is based on a legal distinction between big private corporations and small, private (usually family) firms. The essential difference between them was twofold.

Table 1
Institutional Aspects of the Distinction
"Public/Private" for Adam Smith

Type of institution	*Type of responsibility*	*Type of entity*
"Public"	Limited liability	Corporate Legal Bodies (Artificial Persons)
"Private"	Unlimited liability	Natural Persons (Partnerships of natural persons)

(1) First, public institutions—that is, private joint stock companies—contrary to small private partnerships, were legal entities, incorporated bodies established exclusively by royal charter or by edicts of Parliament.

(2) Second, even though joint stock companies were the private property of the shareholders, they were run in common under limited liability, thus allowing huge quantities of capital to be collected.

Those two reasons made them public institutions in Smith's terminology. He explains,

> in a private copartnery, each partner is bound for the debts contracted by the company to the whole extent of his fortune. In a joint

> stock, on the contrary, each partner is bound only to the extent of his share. (pp. 740–41)

In this perspective, contrary to members in partnerships,

> no member [of the joint stock companies] can demand payment of his share from the company; but each member can without their consent [of the other members], transfer his share to another person, and thereby introduce a new member. (p. 740)

Thus the third duty of the sovereign was supposed to allow the erection of private joint stock companies, an institution whose existence was entirely dependent on the state. Modern legal procedures which allow their easy creation didn't exist at the time. As West wrote:

> The key historical fact is that in Smith's time large groups of individuals were so hindered by the absence of an appropriate variety of legal instruments with limited liability that much needed capital markets were blocked. (West 1977, pp. 6–7)

That remained the case until the mid-nineteenth century, when legislation was enacted to make their creation easier, with the Joint Stock Company Act in 1844, the Limited Liability Act in 1855 and with the comprehensive Companies Act in 1862 (Micklethwait and Wooldridge 2003, pp. 49–53). Before those legislations there were for example 165 acts submitted to Parliament between 1758 and 1803 just in order to build canals (Micklethwait and Wooldridge 2003, p. 40).

Advantages and inefficiencies of public institutions in Smith's view

It is in discussing the third duty that Smith analyzes the advantages and inefficiencies of public institutions, that is, of joint stock companies. They didn't fare well in the opinion of writers at the time. Even the Scottish economist advised against their establishment because of their exclusive and monopoly privileges usually granted by the sovereign (being thus detrimental to competition and consumers in his view). Moreover, according to Smith, the managers of such companies lack incentives to run them well.

> The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. (Smith 1976a, p. 741)

From a modern economics perspective, one of the main controls available over such companies is via the stock exchange. But this institution, which was the only one able to reconcile the property rights of shareholders with the control over managers, was also in its beginnings and Smith completely missed this potential solution in *The Wealth of Nations*.

Despite these inconveniencies, when economic activity required great amounts of capital, the sovereign had to accomplish his third duty by establishing or incorporating private (that is "public" in the Smithian framework) joint stock companies, without exclusive privileges. How could he know which particular situations did or did not require such an act on his part? Smith gives some indications:

> The only trades which it seems possible for a joint stock company to carry on successfully, without an exclusive privilege, are those, of which all the operations are capable of being reduced to what is called a Routine, or to such a uniformity of method as admits of little or no variation. (Smith 1976a, p. 756)

Two other requirements can be found in the succeeding pages of *The Wealth of Nations*:

> (1) the trade must have greater utility than the utility other trades commonly have;
>
> (2) the trade must require "greater capital than can easily be collected into a private copartnery."

Smith concludes

> [if] a moderate capital was sufficient, the great utility of the undertaking would not be a sufficient reason for establishing a joint stock company; because, in this case, the demand for what it was to produce would readily and easily be supplied by private adventurers. (Smith 1976a, p. 757)

The meaning of the third duty was constitutional, i.e., incorporating private joint stock companies and other collective entities and thus expanding the market process when needed, according to Smith.

Examples of the role of public institutions

Without surprise one finds that the fields of activity for public institutions (private joint stock companies) are the public works mentioned above (roads, bridges, canals, etc.). Two other examples are mentioned: insurance and banking.

Thus, according to Smith,

> the insurers should have a very large capital. Before the establishment of the two joint stock companies for insurance in London, a list, it is said, was laid before the attorney-general, of one hundred and fifty private insurers who had failed in the course of a few years. (p. 757)

As we have just emphasized, these were also private insurers in modern economic terminology.

Banking is another activity of this kind. A very interesting anonymous paper attributed to Smith was discovered a few years ago by Gherity (1993) in which the distinction between public and private banks is made very clear. For example, concerning the two "public banks" in Edinburgh, which were

> established by authority, the proprietors are no further bound, than to the amount of their respective shares of the bank-stock: whereas every partner of a private banking-company, is not only bound to the amount of the stock advanced, but is further liable to the whole extent of his fortune, for every obligation that is contracted. Thus the establishment by authority makes a difference very material in favour of the bank-proprietor, and as material against the public. The proprietor in all events risks no more than the stock he trades on, . . . whilst a private banking company, uncovered by any such legal protection, is obliged to interpose the whole estates, real and personal, of every of its members, in satisfaction of its engagements to the public. (Gherity 1993, pp. 277–78)

It is obvious that for Smith's contemporaries, "public institutions" meant private joint stock companies, legal collective corporate bodies with limited liability, a statute accorded exclusively by the sovereign, thereby fulfilling his third duty. It did not mean what we define in modern terminology as government-run or state enterprises.

3. EDUCATION AS A PUBLIC GOOD

In Smith's view of education we find the same distinctions as for other public works and institutions.

On the one hand, public education—which implies teaching many children at once and is thus a good consumed in common by them—is opposed to private or domestic education provided individually by families and private tutors (see Table 2). For Smith, education included not only scientific knowledge but also the acquisition of some moral rules as explained in the *Theory of Moral Sentiments*. On this last point only family or domestic education was able to provide satisfactory results.

> Do you wish to educate your children to be dutiful to their parents, to be kind and affectionate to their brothers and sisters? . . . educate them in your own house. . . . Surely no acquirement, which can possibily be derived from what is called a public education, can make any sort of compensation for what is almost certainly

> and necessarily lost by it. Domestic education is the institution of nature; public education, the contrivance of man. It is surely unnecessary to say, which is likely to be the wisest. (1976b, p. 222)

Table 2

Institutions, Types of Education and Financing

	Private or domestic education (good of private consumption)	Public education (good of collective consumption)	
Institutions of education	Private institutions (Families / private teachers or tutors)	Private institutions (Private teachers working on their own account)	Public institutions (Incorporated entities: colleges, universities, schools)
Mode of financing	Families cover all the costs (in money or in time spent)	Direct financing (Students or families pay directly the teachers)	Direct and / or third party financing (Students, private donors, foundations, rent of land, money interest, state subsidies, etc.)

The state system of education is also in the category of "public institutions" (for example the French system considered by Smith).

On the other hand, private schools, private colleges, and universities, are considered by Smith as public institutions even if they are privately owned and are not state-run establishments. Public institutions—as incorporated bodies—are opposed in Smith's language to private teachers or tutors (natural persons) who work on their own account. In his approach only the last ones should be viewed as "private institutions."

The Scottish philosopher was convinced that private teachers were responding better to individual needs of education. Thus for Smith private institutions were the most capable of supplying satisfactory education, at least before the extension of the division of labor when education did not require great capital:

> Those parts of education, it is to be observed, for the teaching of which there are no public institutions, are generally the best taught.

> . . . Were there no public institutions for education, no system, no science would be taught for which there was not some demand; or which the circumstances of the times did not render it, either necessary, or convenient, or at least fashionable to learn. (Smith 1976a, p. 780)

Moreover, the direct payment by the consumers to the suppliers within the private institutional framework eliminates any useless knowledge:

> A private teacher could never find his account in teaching . . . a science universally believed to be a mere useless and pedantick heap of sophistry and nonsens. Such systems, such sciences, can subsist no where, but in those incorporated societies for education whose prosperity and revenue are in a great measure independent of their reputation, and altogether independent of their industry. (Ibid., pp. 780–81)

Obviously, Smith did not have a good opinion of public institutions in education. As in the case of other public works, he tried to introduce the price system. For him, teachers should have been paid mainly by the direct beneficiaries of education. Smith was clearly in favor of a system in which the professors were paid directly by the students (without third-party payers).

> The institutions for the education of the youth may, in the same manner, furnish a revenue sufficient for defraying their own expenses. The fee or the honorary which the scholar pays to the master naturally constitutes a revenue of this kind. (Ibid., pp. 758–59)

However, the education system at the time was also financed by third parties: by private donors or by the "publick," that is, most of the time, by private foundations through scholarships, bursaries etc. Most modern scholars interpret "publick" as government or state financing of education. But in Smith's terminology modern private foundations are collective incorporated entities and, so, public institutions also in Smith's view. He writes: "sometimes the public, and sometimes the piety of private founders have established many pensions, scholarships, exhibitions, bursaries etc" (Ibid., p. 146). Some elements may be found in a similar quote about what exactly "publick" means: it's about "the charitable foundations of scholarships, exhibitions, bursaries, etc." (Ibid., p. 762). I.e., corporate bodies, opposed as such to private founders (natural persons).

And it is with third parties' financing that inefficiency could arise for Smith. He reviewed a full range of different institutions according to the mode of financing:

- in some universities, the professors were paid mainly by the students (as was the case in Scotland). Smith considered Scottish universities the best in the world. And in elementary schools in Scotland, the salary of the teachers was paid mainly by the families, and school premises and buildings were provided by local private owners (West 1977, p. 15);
- in other places education was financed more or less by the revenues of rent (Oxford), or by the money interest of a sum given by private donors, by charitable foundations, or by the sovereign;
- education could also be financed by state subsidies, and Smith was aware of that possibility. That was the case, for example, with state universities in France at his time. But for Smith it was the worst solution.

While economists after Smith entrusted education to the state, the Scottish philosopher disapproved of this solution because of the "arbitrary and discretionary" power of state administration.

> Whoever has attended for any considerable time to the administration of a French university, must have had occasion to remark the effects which naturally result from an arbitrary and extraneous jurisdiction of this kind. (Smith 1976a, p. 762)

CONCLUSION

Modern private joint stock companies and private universities and colleges would be considered public institutions by Smith. He didn't invent the public goods concept and didn't make the state responsible to supply them. This sheds a new light on the third duty of the sovereign, which is essentially a constitutional duty of property rights attribution and of incorporating limited-liability companies, private universities, and charities in order to bring about a better functioning of the market process. Finally, in this perspective the third duty turns out to be also much more compatible with the classical liberal *laissez-faire* tradition. Instead of producing and financing public goods directly, the government is assumed by Smith to provide the legal framework of property rights and contracts within which the market process is supposed to evolve.

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