# The moral sentiments of *Wealth of Nations*[*]

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(Forthcoming in the *Adam Smith Review)*

June 9, 2010

**Abstract**

Unequal power, unequal opportunities, and unequal pay are closely related according to Adam Smith. The disparities may lead to a low wage trap. More balanced power in the labor market would induce higher economic growth to the benefit of the majority, resembling the North European growth experience. Smith's commitment to progress through equity is the real moral sentiment of Wealth of Nations.

## 1 Introduction

Looking back, it is clear that Adam Smith has been kidnapped. It happened some time after his death in 1790 as *Wealth of Nations* was turned into an Employers' Gospel by right-wing economists and ideologists. As Beatrice Webb wrote in her diary 30 July 1886:

[*]This paper is part of a larger project at the research center ESOP, Department of Economics, University of Oslo, sponsored by the Norwegian Research Council. I wish to thank Astrid Jorde Sandsør for valuable assistance. Thanks also to the referees and editor for constructive suggestions, and to Cristel Fricke for encouraging advice.

> "The Political Economy of Adam Smith was the scientific expression of the impassioned crusade of the 18th century against class tyranny and the oppression of the Many by the Few. By what silent revolution of events, by what unselfconscious transformation of thought, did it change itself into the 'Employers' Gospel' of the 19the century. "

After a while the kidnapping was supported by the political left. Both ends of the political spectrum now have a vested interest in maintaining his captivity. In popular writing Adam Smith is involved in an ends-against-the-middle battle. He has not yet been released in spite of courageous individual attempts to free him.

Indeed, there is a growing literature that challenges the traditional perception of Adam Smith. Emma Rothschild (2001, from where the quote of Beatrice Webb is taken) offers an excellent historical and theoretical treatment of how Adam Smith's works contrast with conservative economics and relate to the French enlightenment. Likewise, Iain McLean (2006) nicely defends Adam Smith as a radical and egalitarian; Ashraf, Camerer, and Loewenstein (2005) strongly recommend Adam Smith as a modern behavioral economist; while Gavin Kennedy (2005, 2008) and Amartya Sen (1984, 2000, and 2009) fight against the unbalanced view on Adam Smith on a broad set of issues.[1]

My aim is more modest. I wish to demonstrate how Smith considered unequal power, unequal opportunities, and unequal pay to be closely related, and how these disparities have devastating effects on the utilization of human resources and on economic development. Smith's commitment to progress through equity, I claim, is the real moral sentiment of *Wealth of Nations*.

More is at stake, however, than Smith's reputation. One issue is whether markets need to be complemented by social intervention in order to work well, and whether social interventions need to be disciplined by market competition in order to achieve their intended goals. While conservative followers of Adam

[1] See also earlier treatments in Karl Polanyi (1944) and Robert Heilbroner (1953).

Smith claim that the discipline of markets would be eroded by social reforms, left-leaning opponents claim that partial social victories would continually be eroded by market forces. While the left-leaning opponents of Smith make 'the invisible hand' stronger than Adam Smith would admit, the conservative followers make it weaker. Both refer to an imagined version of *Wealth of Nations*—the conservative followers for ideological support, the left-leaning opponents as an ideological warning.

In contrast, the real version of *Wealth of Nations* is morally concerned about equity in society as well as the basic needs of its workers. "It is but equity, besides" Smith insists, "that they who feed, cloath and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, cloathed and lodged" (WN, Book I, Ch. VIII, p. 88).

Adam Smith considered the huge inequalities around him as a form of oppression that required social intervention. "For one very rich man" , he says, "there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many" (WN, Book V, Ch. I, p. 232). Yet, he was skeptical of governments simply because they tended to favor the rich over the poor: "We have no acts of parliament against combining to lower the price of work; but many against combining to raise it" (WN, Book I, Ch. VIII, p. 74).

To change the structure of power and influence Smith advocated not only more market competition, but also institutions and policies that could complement markets and mitigate income differentials. Unlike what most conservatives prefer to see, his arguments favor social interventions that could allocate social opportunities more fairly, empowering the poor and distributing incomes more equally. Unlike what most radicals prefer to see, his arguments point to how markets could be used to achieve social goals such as equity and poverty alleviation.

Perhaps Smith should be considered a 'libertarian' in his skepticism against the government and a 'socialist' in his sympathies for the lower ranks in society. He resembles modern social reformers today, for instance modern European social democrats, who wish to establish a business friendly environment in order to raise the real incomes of the majority in society. One major difference, however, is that Smith in *Wealth of Nations* is less naive about capital owners' motives than social democrats normally are. In any case the book emphasizes how more equality in the labor market would induce higher economic growth to the benefit of the majority in a way that resembles the North European experience.

I proceed by a discussion of Smith's views on unequal power, unequal opportunities, and unequal pay, making a case for a reinterpretation of his efficiency wage considerations. I then turn to how more equality of earnings would fuel the process of modernization and economic growth, before I conclude by a brief discussion of how Smith's arguments shed light on the Scandinavian development strategy of the second half of the 20th century.

## 2 Unequal opportunities and power

Smith considers common workmen as a huge productive source not only in routine production, but also in inventions and innovations if the labor force has the opportunity to participate in developing local improvements. As he observes in the beginning of *Wealth of Nations*:

> A great part of the machines made use of in those manufactures in which labour is most subdivided, were originally the inventions of common workmen who, being each of them employed in some very simple operation, naturally turned their thoughts towards finding out easier and readier methods of performing it. Whoever has been much accustomed to visit such manufactures, must frequently have

> been shewn very pretty machines, which were the invention of such workmen... (WN, Book I, Ch. I, p. 13).

More independence of working groups would also raise worker productivity and power. The rewards to society of worker independence and empowerment are so obvious and important to Smith that he uses strong words: “Nothing can be more absurd [...] than to imagine that men in general should work less when they work for themeselves, than when they work for other people. A poor independent workman will generally be more industrious than a journeyman who works by the piece. The one enjoys the whole produce of his own industry; the other shares it with his master”. And he continues: “The superiority of the independent workman over those servants who are hired by the month or by the year [...] is likely to be still greater” (WN, Book I, Ch. VIII, p. 93).

Less dependence on their masters could be achieved by empowering the workers, first of all by creating more equal opportunities for all. One important example was to allow free migration between trades and between districts. His vivid protests against the English poor laws should be viewed in this light.

Smith’s protests are in reality concerned with the restrictions the poor laws imply for free movements of labor. He is not against public support for the poor per se, as the conservative interpretation would have it. He emphasizes rather how the poor are to lose from poor laws that make them unable to search for employment outside their parish. He concludes that this law is the cause of the very unequal price of labor in England (see the long discussion in Book I, Ch. X, pp. 151-157).

Secondly, less dependence could be achieved by more power over wage setting. The wages of labor, Smith emphasizes, depend on “the contract usually made between those two parties, whose interests are by no means the same. The workmen desire to get as much, the masters to give as little as possible.” (WN, Book I, Ch. VIII, p. 74)

In such bilateral bargaining the one who can tolerate a conflict the best, has an edge. He can pose more severe credible threats; he is less vulnerable to threats from the opponent; and he is thus the most powerful of the two. Smith recognizes this bargaining logic as when he claims: "the workman may be as necessary to his master as the master is to him, but the necessity is not as immediate" (WN, Book I, Ch. VIII, p. 75). The employer can hold out longer; he can subsist for a year or two without a single employee, while many workers cannot subsist for a week without employment. It is therefore not difficult, says Smith, "to foresee which of the two parties must [...] have the advantage in the dispute, and force the other into compliance with their terms" (WN, Book I, Ch. VIII, p. 74).

The employers have this advantage not only because they have more financial resources, however, but also because they more easily can utilize their collective monopsony power. "Masters are always and every where in a sort of tacit, but constant and uniform combination, not to raise the wages of labour above their actual rate." Masters sometimes combine "to sink the wages of labour even below this rate" (WN, Book I, Ch. VIII, p. 75). Of course, Smith clearly recognizes that masters could not reduce the wages below a certain subsistence level for long.

Yet, employers' monopsony power is important as wages could fluctuate over their lower bound. It is a consequence in part of unequal wealth and in part of unequal political influence. "We rarely hear, it has been said, of the combinations of masters, though frequently of those of workmen. But whoever imagines, upon this account, that masters rarely combine, is as ignorant of the world as of the subject" (WN, Book I, Ch. VIII, p. 75). These are clear examples of how the government in Smith's view tended to favor the rich.

In sum the power of employers is so strong that in most cases Smith considers them as defacto wage setters. He does not openly support labor unions or other combinations of workmen, but he points to the unbalanced power between employers and employees that easily emerges without them, and hence the need for countervailing powers in the labor market.

Smith's emphasis both on common workmen as a potentially huge productive source, and on the prevailing inequalities of opportunities and power that hampered the utilization of the workmen, are important for the interpretation of his theory of effort inducing wages, or simply efficiency wages – to which I now turn.

# 3 Unequal efforts

Smith observes how a higher pay may lead people to work harder both because they get better nourished and thus become stronger, and because they are better motivated. He talks about how employers use piece rates to raise work efforts and how they use fixed wage payments as rewards for higher effort and stronger commitment to their work tasks.

### Positive and negative encouragements

He states that in general "[t]he wages of labour are the encouragement of industry, which, like every other human quality, improves in proportion to the encouragement it receives" (WN, Book I, Ch. VIII, p. 91).

Smith emphasizes that high wages may have a positive encouragement, and low wages may have a negative encouragement: "The liberal reward of labour, as it encourages the propagation, so it increases the industry of the common people [...] Where wages are high, [...] we shall always find the workmen more active, diligent, and expedious, than where they are low" (WN, Book I, Ch. VIII, p. 91).

This is in some contrast to the modern use of efficiency wage arguments where the mechanism indicates that both wages and effort are 'higher' than they otherwise would have been. According to the modern use, it simply pays for the employer to raise wages to induce higher effort (see Shapiro and Stiglitz

1984, Weiss 1994, Bowles and Gintis 1993). In Smith's exposition, however, he imagines a certain prevalence of less "active, diligent, and expeditious" workers where wages are low (WN, Book I, Ch. VIII, p. 91).

Could smart employers benefit from setting a low wage knowing that it would lead to a less active workforce? If so, why are they not always doing that? It is in the answer to questions like these that the difference between Smith's efficiency wage story and the traditional one becomes clear. The key is the importance that Smith attaches to unequal power at the workplace.

It matters how much local influence workers have over working speed and the quality of work; how secure their employment is; what kind of protection they can garner against their employers and so on. It is decisive who can 'force the other into compliance with their terms'.

If low-paid and worn-out workers can be easily replaced, for instance, it indicates a low level of worker control. The distribution of power and control may therefore also reflect the general conditions in the labor market — workers' monopoly power when labor is scarce and employers' monopsony power when labor is abundant.

The main point to be emphasized is the possibility of a divergent work performance between high and low productivity enterprises: A high pay and a high effort constitute a form of *high-wage leverage*, an outcome of positive reciprocity within high productivity enterprises. Low pay and low effort can constitute a form of *low-wage trap*, an outcome of negative reciprocity within low productivity enterprises.

Both reciprocity and fairness considerations are important sentiments in the *Theory of Moral Sentiments*. The mechanism I suggest is in that spirit. It is also inspired by Matthew Rabin's (1993) influential discussion of how fairness can be incorporated into game theory. Rabin also discusses similar mechanisms, emphasizing that efficiency may require a balance of power.

### A simple model of the low wage trap and the high wage leverage

To be more precise, let me set up a simple model where jobs and workplaces may differ in their 'productivity', denoted $p$, depending (in Smith's case) on the level of specialization and the type of production technique that employers apply. An employer with a given degree of specialization earns a profit

$$\pi = pe - w \tag{1}$$

where his workforce (normalized to size 1) puts in an effort $e$ and is paid a wage $w$. An efficiency wage relationship is simply a link between effort and wages: $e = e(w)$ with $e'(w) > 0$. The traditional efficiency wage mechanism is to increase wages to induce higher efforts till the marginal benefit of higher efforts equals the marginal costs, i.e. till $pe'(w) = 1$. This is indeed the equilibrium outcome when productivity $p$ is sufficiently high relative to how strongly workers respond to higher and lower wages.

In jobs with low productivity relative to worker control, however, there may be no wage where the first order condition is satisfied. In that case $pe'(w)$ is less than the marginal wage cost of 1 for all wage levels $w$, implying that the employer would benefit from lowering the wage until it reaches the level of the participation constraint $h$.

Reciprocity can account for both cases that I for simplicity denote good and bad jobs, to use a metaphor by Acemoglu (2001).

In good jobs there is positive reciprocity: Employers raise wages above the norm, and workers respond by a work effort above the norm. How much the work effort is raised depends on their retaliation power.

In bad jobs there is negative reciprocity: Employers reduce wages below the norm, and workers respond by a work effort below the norm. The reason why wage reductions are profitable in these jobs is that the retaliation power is low relative to the productivity of the jobs.

I shall now derive a specific relationship $e(w)$ to demonstrate how the outcome may depend on worker control and retaliation power. The social work norm is an effort level equal to $q$ which is given. Workers consider a wage equal to $w_f$ to be fair in order to put in the effort level $q$. The pay-off to a worker is

$$U(w,e) = w - \frac{1}{2}(q-e)^2 + re\ln(\frac{w}{w_f}) \tag{2}$$

Here the first term just states that the worker 'desires' higher wages to lower wages. The second term indicates that it is costly for the worker to deviate from the work norm $q$. The third term indicates the worker's desire for fairness. It capture the worker's ability to reciprocate in his choice of effort with a strength $r$ — his retaliation power. The reciprocity is positive when $w > w_f$ and negative when $w < w_f$. The particular functional forms are chosen to get an explicit solution in a simple manner.

Given the wage $w$ a worker determines his effort to maximize $U(w,e)$ in (2). This yields an effort level equal to

$$e(w) = q + r\ln(\frac{w}{w_f}) \tag{3}$$

As seen, the worker puts in an effort level equal to the work norm $q$, when he receives what he consider a fair wage $w_f$. When he is paid less, his effort is lower than $q$; when he is paid more, his effort is higher than $q$. This is so since

$$\ln(\frac{w}{w_f}) \begin{cases} \leq 0 & \text{when } w \leq w_f \\ > 0 & \text{when } w > w_f \end{cases} \tag{4}$$

The employer then chooses the wage level $w$ that maximizes his profits $\pi = pe - w$, taking the worker response into account:

$$\max_{w}\left[p\left(q+r\ln(\frac{w}{w_f})\right)-w\right]\qquad \text{s.t } w\geq h \tag{5}$$

The solution can be expressed as

$$w=\max[h,pr] \tag{6}$$

There are two rather different possibilities:

*High wage leverage*: When $pr$ is sufficiently high, the wage is determined by $pr=w>h$. These are good jobs since workers get more than what is required for them to participate and workers effort is high. Starting from $w=h$, the rise in employers' revenues in good jobs is higher than the rise in wage costs, implying that profits go up as wages are raised until the equilibrium is reached where $w=pr$. Thus, there is a gain to the employer of inducing higher efforts by paying a higher wage than $h$, either because high effort is particularly valuable, $p$ is high, or because workers have sufficient power to punish employers by a low effort if they instead were paid a low wage.

*Low wage trap:* When $pr$ is sufficiently low, a strict inequality $pr<w=h$ applies. These are bad jobs since workers get no more than what is required for them to participate and effort is low. In bad jobs the gain to the employer of paying higher wages, to induce higher efforts, does not pay off as the increase in revenues in the job is lower than the rise in wage costs. The employer would therefore, instead, lower the wage as much as possible. By so doing, efforts decline. Yet this decline is less than the corresponding decline in wage costs, implying that profits go up as wages are reduced. The gain to the employer of inducing higher efforts does not support the higher wage costs, either because productivity $p$ is low, or because the workers have little power $r$ to punish employers by a low effort in response to a low wage.

For a given (intermediate) level of $p$ there can be either good or bad jobs depending on the relative power of workers and employers. Good jobs may be characterized by a high degree of worker control over the work process; a high willingness and ability of workers to harm 'unfair' employers; a high vulnerability of employers to such effort adjustments. Bad jobs have powerless workers who as a consequence are not very 'active, diligent and prosperous'.

I have shown how powerful employers can generate a low wage trap. They can exercise monopsony power without the usual reduction in labor demand. They gain from obtaining a larger share of a smaller pie. Thus the low wage trap can be costly not only to the workers, but also to society at large. Production goes down and poverty increases, as profits go up. Employers simply gain by employing human resources inefficiently. It is an example of a behavior that "comes from an order of men, whose interests are never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who have, upon occasion, both deceived and oppressed it." (WN, Book I, Ch XI, p 278)

The inefficiency is associated with inequality. As the two cases above demonstrate, there can be unequal pay for equal work depending on distribution of power between workers and employers. The wage gap between good and bad jobs, for instance, can magnify with differences in $r$. More worker influence over own work performance and over contract negotiations would generate more equal wages, and less inefficient use of resources, since 'the low wage trap' become easier to escape.

There may obviously be jobs below a certain threshold productivity $p^*$ that cannot become good jobs even if workers were all powerful. To improve performance in these cases one has to rely on new investments and structural change. The wage equalization effect of empowering workers and leveling the playing field is likely to induce this kind changes as well (see sections 4 and 5).

# 4 Unequal pay

Smith's labor market mechanisms easily lead to unequal pay for equal work. Depending on the distribution of bargaining power and retaliation power over different enterprises, similar workers may obtain very different wages. In some instances or locations employers may effectively utilize their collective monopsony power, in other cases they may be less effective. In some instances the low wage trap applies, in others the high wage leverage applies.

In a few instances or locations workers may have some bargaining power, in other cases they may have none. In some cities workers may have better outside options than in others, and so on. All this would lead to wage differentials across more or less identical workers.

Smith also discusses inequalities in pay that arise from the nature of the employment in itself. He discusses how wages depend on the "agreeableness or disagreeableness of the employments themselves" (WN, Book I, Ch. X, p. 112), on the cost of learning the trade, on the insecurity of the job, on the expected trust, and of the probability of success in the occupation. Most of these causes of inequality would today go under the name of compensating wage differentials. The last one—the probability of success in the occupation—deserves some remarks as Smith here comes with some rather intriguing observations.

After mentioning how men have "an over-weening conceit [...] of own abilities"—an ancient evil remarked by the philosophers and moralists of all ages—he goes on: "Their absurd presumption in their own good fortunes, has been less taken notice of" (WN, Book I, Ch. X, p. 120). Here Smith gives a precise account of a risk behavior that today goes under the name of overconfidence: "The chance of gain is by every man more or less over-valued, and the chance of loss is by most men under-valued" (WN, Book I, Ch. X, p. 120).

This bias in the perception of good fortunes implies inequality in pay, as Smith hints to. The general principle seems to be this: In risky occupations where workers are remunerated for their successes only, actual pay becomes lower with the bias as workers are too willing to take these jobs. In occupations where workers are remunerated with a fixed pay independent of success and failure, actual pay becomes higher as their employers have a presumption of the good fortunes of the enterprise increasing their willingness to pay for the labor services they employ.

More important than overconfidence, according to Smith, is the political economy in favor of the rich and wealthy. Smith discusses how "exclusive privileges given to corporations, which require long apprenticeships and limit the number of apprentices" (WN, Book I, Ch. X, p. 133) lead to high wage inequality. He points out that these arrangements reap monopoly gains and insists that "corporations were established to keep up prices and consequently wages and profits" (WN, Book I, Ch. X, p. 138). It is in this connection he comes with the famous statement: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices" (WN, Book I, Ch. X, p. 144).

The corporation laws further obstruct social mobility again to the disadvantage of poor workers: "It is every-where much easier for a wealthy merchant to obtain the privilege of trading in a town corporate, than for a poor artificer to obtain that of working in it."(p 151)

Lifting the restrictions of free movements of labor would affect all the wage setting mechanisms that I have mentioned. It would tend to eliminate monopoly rents in protected occupations associated with guild privileges and production monopolies by increasing the competition for these jobs. It would raise the outside options in local wage negotiations and limit the profitability of employers to raise profits by reducing both wages and the corresponding worker efforts.

Empowering workers means more retaliation power in cases where employers try to gain by exploiting negative reciprocity. It would lead workers to leave low productivity jobs and to enter into higher productivity jobs. While the pay for the jobs that workers leave would rise, the pay in the jobs where they enter would decline.

In all cases empowerment by opening up for more equal opportunities for all workers would tend to equalize wages by leveling the playing field. Low wages in bad jobs would rise and high wages in good jobs would decline, but as more workers would be employed in good jobs, average wages would tend to go up. The more equal worker opportunities are (combined with increasing competition in the product markets), the stronger the rise in the average wage.

# 5 Unequal growth

In *Wealth of Nations* it is possible to identify a two way link between wages and economic growth: Economic growth affects the wage distribution and the wage distribution affects economic growth. Combined, they can explain why economic growth is unequal across countries and across segments of each society.

The first linkage goes from prosperity to wage increases. For Smith as for so many economist after him, a booming labor market is considered workers' best friend. Nothing could improve the living conditions for workers more than progressive economic growth. It would reduce poverty as the mass of people at or below subsistence would decline.

Smith emphasizes that it is not the wealth of nations that makes the average wages high, but its increase that leads to a higher demand for labor and thus to wages that are persistently above subsistence levels. Thus high average wages are caused by the increase, not by the actual size of national wealth: "It is not", Smith explains, "in the richest countries, but in the most thriving, or in those who are growing rich the fastest, that the wages of labour are highest" (WN, Book I, Ch. VIII, p. 78). He compares England to the not as rich North America. Wages in North America were higher since the economic growth was higher there than in the England.

The second linkage goes from the distribution of wages to the rate of growth and structural change: Wage equalization would tend to increase economic growth which in itself would stimulate the demand for workers. Smith's description of the mechanisms of economic growth is simple but powerful. The most important source of growth and for the improvements in the productive powers of labor is seen to be division of labor and the corresponding gains from specialization. A process of increasing division of labor is like a production process with increasing returns to scale. The larger the scale, the wider the division of labor can be, and the higher the productivity per worker can become. Smith provides several examples of which the best known is his case study from simple pin making.

He then goes on to explain how the division of labor is limited by the extent of the market where the size of the market again depends on the level of the division of labor. Economic growth also requires fixed capital investments. Markets expand by the higher incomes that further division of labor and capital investments generate. Division of labor becomes wider the more the market expands. This mutual dependence between the market size and the division of labor is crucial for continuous economic growth.

Firstly, growth slows down if further division of work is restricted by the monopoly practices of reducing output to reap high prices. Smith calls this capitalists' tendencies "to levy, for their own benefit, an absurd tax upon the rest of their fellow-citizens" (WN, Book I, Ch. XI, p. 278). The extent of the market then stagnates, which in turn hampers further division of labor in other branches of industries.

Secondly, growth slows down if further division of work is not profitable because of wage premiums to local workers associated with guilds, unnecessary long apprenticeships, and restrictions on free labor mobility. This would be particularly harmful to growth when the sectors with the highest potential for further division of labor must pay the highest wage premiums.

Smith does not elaborate much on the second aspect, but there are hints.

He says for instance that “[p]rofits are less unequal than wages, and their inequality is often only due to the inclusion of wages” (WN, Book I, Ch. X, p. 124). He also observes that “[w]ages are generally higher in new than in old trades” (WN, Book I, Ch. X, p. 128), indicating that rising industries where the potential for further division of labor must be particularly great, can be hampered by low profitability. Old or declining industries where specialization gains already have been fully exploited, pay low wages. These industries may have both low productivity $p$ and low worker power $r$, in terms of the model sketched out in section 3. The wage gaps can obviously lead to development traps that one could have escaped with more equal wages across new and old trades.

Leveling the playing field by increasing competition both in the output market and in the labor market would therefore stimulate growth. Thus less worker privileges to insiders with high wage premiums and fewer monopoly positions in the output market would generate a more equitable growth. In tandem with higher growth this would over time increase average wages, reduce poverty and improve the circumstances of the lower ranks in society.

There would be winners and losers from more egalitarian developments. Privileged insiders among masters and workers may lose, while disadvantaged outsiders would gain. Smith asks: Is “improvement in the circumstances of the lower ranks of the people to be regarded as an advantage or an inconveniency to the society?” (WN, Book I, Ch. VIII, p. 88). High real wages to workers are an advantage, he answers, since ”what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable” (WN, Book I, Ch. VIII, p. 88).

# 6 Smith under the Northern light

The Scandinavian model is to some extent Smithian. It characterizes a market-based free-trade economy distinguished by comprehensive labor market organizations, a large welfare state and a system of routine consultation among government and representatives of interest organizations. The typical policies are wage compression, lowering high wages and raising low wages; the provision of basic goods for all citizens as a right of citizenship; and a government commitment to full employment. In fact, these aspects of the Scandinavian model of social democratic development owe more to Adam Smith than to Karl Marx.

The intellectual inspiration is not direct. The similarity is caused by the same social sympathies and a similar quest for feasibility. Both Adam Smith and social reformers of northern Europe were ardent defenders of the poorest groups in society. Both saw modernization and expansion of markets as the key to escaping poverty. Both saw the primary task as being one of removing the obstacles to rapid modernization. Adam Smith viewed the primary obstacles to modernization as restrictions on the free movement of labor and capital, such as guild privileges and monopolies that limited the size of the market and the extent of specialization.

The social democrats, in effect, saw the primary obstacle to modernization as strong local unions whose wage premiums restricted the expansion of the most productive sectors. What distinguished the social democrats from more conservative followers of Adam Smith like Margaret Thatcher was their solution to the problem of restricting the power of local unions. While Thatcher's solution was to weaken unions as institutions, the social democratic approach was to strengthen unions as institutions and to structure collective bargaining in a highly centralized manner that reduced the influence of high-paid workers in the wage setting process.

The oppressing nature of economic inequality, as Smith saw it in Wealth of Nations, was to some extent remedied by empowering weak groups in the labor market and of course by extending the franchise.

**Equalizing opportunities:** Like in most European countries, democracy in Scandinavia extended the opportunities for people, especially for the lower ranks in society that Smith was so concerned about. Public education, health-care and other programs of the welfare state made each person less dependent on their parents' income and wealth. Social mobility went up. Restricting workers' geographical movements were not an issue. On the contrary the Scandinavian countries utilized active labor market programs, pioneered by the Swedes in the 1950s, with the explicit goal of increasing the mobility of labor without increasing wage differentials. Social insurance by the welfare state also enables workers to seek employment in the best paying sectors even when the prospects are risky.

**Equalizing power:** To escape the unequal power between employers and employees that Smith emphasized, one might wonder whether it is possible to increase the union power at the local level without increasing the bargaining power of the best paid workers. This is a challenge as higher bargaining power among high-wage workers can lead to a profit squeeze in the most productive enterprises, limiting economic growth for the whole economy. In Scandinavia this challenge is resolved by an encompassing union movement that includes strong union locals with a mandate to coordinate wage setting with an employers' association at the central level. The strong employer associations are equally important as the union movement. Together the two tend to take wages out of competition by way of collective centralized wage negotiations.

**Equalizing efforts:** Union power and the presence of welfare state benefits are important remedies to escape Smith's low-wage trap. The employer strategy that leads into the trap is profitable only when declining wages raise profits in spite of lower worker efforts. When workers are able to retaliate backed by local union power and when welfare benefits set a lower bound on how low wages can become, the strategy that leads to the trap becomes less attractive to employers. Thus both worker empowerment and safety nets help eliminate Smith's low-wage trap implying that both the lowest wages and the lowest effort levels go up together with social efficiency.

**Equalizing pay:** In the imagined version of *Wealth of Nations* the performance of markets are often associated with the way they are described in the economic textbooks of today. As I have tried to illustrate, the real version of *Wealth of Nations* is different. Here Smith provides an assessment of labor markets far from the textbook idealization.

Surprisingly, however, the results of centralized wage setting in Scandinavia come closer to the outcomes in the idealized textbook description. First of all the union movement insists on 'equal wages for equal work' eliminating the wage differentials between homogenous workers. Secondly, centralization of wage bargaining takes wage setting out of the hands of the unions representing relatively high-paid workers and puts wage setting in the hands of leaders of the union movement as a whole, which includes almost everyone. This encompassing nature of the union movement (strongly emphasized by Mancur Olson, 1990) implies a strong commitment to full employment, implying that the average wage costs are constrained by a preferences for low unemployment.

As a consequence, close to full employment combined with an almost uniform wage for similar workers (the textbook result) are more realistic under quite opposite assumptions to those that dominate the textbooks. Employers may also gain from higher aggregate profits by reducing wage inequality relative to the wage schedule associated with decentralized bargaining and even relative to the wage schedule associated with a real competitive labor market where employers set wages unilaterally (as demonstrated in Moene and Wallerstein 1997).

**Efficiency and equity:** In Scandinavia the main concern of unions and employer associations was not equality, but rather macroeconomic efficiency by way of encouraging structural change through investment in good modern jobs. Equal pay for equal work achieved exactly that and became the first step towards the coordinated wage bargaining that was institutionalized in the 1950s. This policy is the most dramatic instance of union-sponsored wage equalization in the world. In both Norway and Sweden, an ambitiously egalitarian wage policy was adopted by the central blue-collar confederation and pursued steadily for decades. Solidaristic bargaining, as the policy was named, called for the equalization of workers' pre-tax income by eliminating or reducing the wage differentials that existed between plants within the same industry, between industries, between regions and ultimately between occupations. (Moene and Wallerstein 1995, 1997).

**Equalizing growth:** Wage compression does in fact stimulate innovation and economic growth, as firms with advanced new technologies do not have to pay excessive wage premiums. While wage inequality operates as though high-productivity firms are taxed and low-productivity firms are subsidized as wages adjust to local conditions, wage compression works in the opposite way: it is as though high-productivity firms are subsidized and low-productivity firms are taxed. As a result, wage equality implies that inefficient firms close down earlier as newer and more productive firms enter, contributing to the process of structural change that Schumpeter (1942) called "creative destruction".[2] In terms of the small model in section 3, low $p$ enterprises are destructed as more high $p$ enterprises are created.

The main beneficiaries from solidaristic bargaining are to be found in the tails of the income distribution, among low-paid workers and capitalist employers; the losers are high-skilled middle-class workers. Solidaristic bargaining was initially supported by important actors opposed to redistribution. The efficient and innovative enterprises gained from wage setting with small wage differentials. A compressed earnings distribution was supported by a coalition between numerous workers and influential capital owners. Such concurrent interests, typically categorized as alliances of ends against the middle, may explain the viability of the Scandinavian model and why it is associated with

[2]See also Moene and Wallerstein 1995, 1997, and 2001.

high economic growth.

All in all the Scandinavian experience shows how obstacles to rapid modernization can be removed by equalizing opportunities, power and pay in a way that resembles Smith's claim of progress through equity.

# Free Adam Smith

In *Wealth of Nations* Adam Smith is openly impressed by capitalists' achievements, but not about their motives. In his *Theory of Moral Sentiments* from 1759 he had already warned "[o]f the corruption of our moral sentiments, which is occasioned by this disposition to admire the rich and the great, and to despise or neglect persons of poor and mean condition."(p 84) Finishing *Wealth of Nations* 17 years later one might wonder whether he failed to follow this impartial spectator who was looking over his shoulder, scrutinizing every sentence he wrote.

He did not fail. *Wealth of Nations* is much more pro poor, pro labor, and pro majority interests than both conservatives and radicals today are willing to see. Freeing Adam Smith from his ideological captivity by the right and the left would enable a better discussion of how markets and social policies can be fruitfully combined to the benefit of majority of workers; those with incomes below the mean. In my view it is the political left that holds the key. It should abandon the false proposition that markets and free trade cannot complement social interventions, strong unions and a generous welfare state in an egalitarian development path.

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