War, Trade, and Mercantilism: 
Reconciling Adam Smith's Three 
Theories of the British Empire

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[The] maintenance of this monopoly [of the colonial trade] has hitherto been the principal, or more properly perhaps the sole end and purpose of the dominion which Great Britain assumes over her colonies... Under the present system of management, therefore, Great Britain derives nothing but loss from [this] dominion (Adam Smith Wealth of Nations IV.vii.c.64-65:614-15),

“As defence, however, is of much more importance than opulence, the act of navigation is, perhaps, the wisest of all the commercial regulations of England” (Adam Smith, Wealth of Nations IV.ii.29-30:464-65).

Is [the Wealth of Nations] a defence of empire or repudiation of it? By a supreme artistry [Smith] goes along with two contrasting points of view and leave us balanced on razor's edge, till the last word of the last sentence (Fay 1956:107).

Abstract

Adam Smith proposed two contradictory theories of the British Empire in the Wealth of Nations and hinted at a third. The first view holds that the empire was created for merchants eager to establish monopolies on the colonial trade. Smith concludes that "Great Britain derives nothing but loss" from the colonies. In the second view, Smith celebrates the European discovery of the new world, opening up non-incremental increases in division of labor, specialization and exchange. The empire thus fostered the economic growth of both sides of the British Atlantic, net of the costs of monopoly. Smith's third argument is the least developed. It holds that many mercantile restrictions had a direct purpose in improving Britain's security given its more than century-long military conflict with France.

How do we reconcile the incompatibility of Smith's three views of the British Empire? Smith provides too little guidance.

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I argue that, to understand the British Empire, we must view it from the perspective of a long-term military rivalry with France. Many of the navigation regulations were designed to advantage Britain vis-a-vis France. Smith argues, for example, that the harm to France from prohibiting trade in military stores more than compensated for the loss in wealth due to the restrictions. I demonstrate the logic of these claims using tools from modern political science.

1. Introduction

Adam Smith proposed two contradictory theories of the British Empire in the *Wealth of Nations* and hinted at a third. In his first view – and the approach on which he places the most emphasis – Smith argued that the empire was based on rent-seeking by merchants eager to establish and maintain monopolies on the colonial trade. As Smith suggests in the first head note, the “maintenance of this monopoly [of the colonial trade] has hitherto been the ... sole end and purpose of the dominion which Great Britain assumes over her colonies” (*WN* IV.vii.c.64-65:614-15). In this view, Great Britain would be much better off abandoning the American colonies than paying for the colonies’ defense. Most scholars follow Smith’s emphasis (Ekelund and Tollison 1981, 1997, Evensky 2015, ch 4, Koebner 1961:219-235, Stevens 1985:211, Winch 1996, Van de Haar 2013).

In the second view, Smith celebrates the European discovery of the new world, opening up non-incremental increases in division of labor, specialization and exchange, and hence the economic growth of both sides of the British Atlantic.\(^2\) In Smith’s words, “the discovery of America, and that of a passage to the East Indies by the Cape of Good Hope, are the two greatest and most important events recorded in the history of mankind... By uniting, in some measure, the most distant parts of the world, by enabling them to relieve one another's wants, to increase one

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\(^2\) Although Smith bitterly denigrates the European treatment of the natives (for example, *WN* IV.i.32:448 and IV.vii.c.80:626).
another's enjoyments, and to encourage one another's industry, their general tendency would seem to be beneficial” (*WN* IV.vii.c.80:626). In this view, Britain is far richer and more industrialized because of the larger market and greater division of labor afforded by the colonies (Winch 1965:9-11). As the division of labor is the hallmark of Smith's theory of economic growth, this second view cannot simply be ignored or pushed aside.

Smith makes a third argument concerning the military value of the empire to the metropole. In this approach, Smith argues that many mercantile restrictions improved Britain’s security given a dangerous world. As the head note suggests, Hont (2005,2015) argues that, in an international context of “the military and political survival of nations ... [bent] the logic of trade ... to the logic of war.” Part of the reason this view is by far the least well-known of Smith’s arguments is that Smith did not emphasize it, and his attention to it is scattered in the *Wealth of Nations* rather than being developed all at once.\(^3\)

How do we reconcile the incompatibility of Smith’s two well-known and one lesser-known views of the British Empire? And how do we make sense of British behavior, both in its mercantile policy and its sustained military rivalry with France? Was the British empire simply the product of interest group behavior biasing policy solely to further the private interests of merchants at public expense, as Smith sometimes suggests (and Ekelund and Tollison 1981 elaborate)?

I argue in this paper that, to understand the British Empire, we must work backwards through the three views. Economists tend to ignore the problem of war and how it affects

\(^3\) Cites to Smith. This view has a range of adherents in the Smith literature, including Hont (2005), Samuels (1973), and Viner (1948); see also Hirschman (1945).
desirable policies. Indeed, Smith rarely mentions war in his extensive treatment of the British empire in the *Wealth of Nations* IV.vii, "Of Colonies." In the first of the three sections of this chapter, "Of the Motives for establishing new Colonies," Smith does not mention that the North American colonies may have been an advantage in the on-going military competition with France. When Smith does mention war in this context, it is about the ability of the colonies to furnish men and revenue to the empire's cause (see, for example, *WN* IV.vii.c.11-13: 593-94).

The inattention to war is less of a problem in eras of international peace and global trade. But it fails in fundamental ways as a means to understand behavior and policymaking in an era of sustained military rivalry. The British Empire arose and prospered in just such an era; namely, Britain’s sustained military rivalry with France from 1689 until 1815 (Findlay and O’Rourke 2007:247). International relations theorists demonstrate that a world of sustained rivalry is much more like a zero-sum game than is a world of international peace and free trade. In particular, Powell (1991) shows that countries engaged in sustained military rivalries will maximize their relative gains. Because the probability of winning wars is a positive function of resources, policies that are negative sum but which harm country one’s rival substantially more than it harms itself can be of great advantage. As I discuss below – and in direct contradiction to Smith’s arguments favoring free trade – Smith applauded Britain’s navigation policies because these restrictions on trade enhanced Britain’s military capacity.

The second view fits well with that of the third. The American colonies greatly expanded

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*4* Although this chapter is one of thirty-two in Smith's book, it is nearly ten percent of Smith's famous work, pp 556-641 of 947 (excluding appendices).

the division of labor in the Empire. The larger British economy, and hence British wealth, made Britain a more powerful military opponent. Similarly, policies denying trade with France in goods of great military value also made sense because they diminished France’s military capacity.

Finally, rent-seeking was an inevitable feature of British political economy given the immense size of expenditures – Britain spent on the order of GDP during the Seven Years’ War (1756-63) with France. Merchants and the trading economy were of substantial value to the British economy and its war efforts. And yet Smith’s second and third arguments directly contradict his statements that benefitting merchants was the sole goal and effect of the British Empire. For example, Smith emphasizes the monopoly aspects of British navigation acts, such as restrictions on foreign ships carrying trade to and from the Empire (cites), yet in other places he notes the obvious military advantage of these policies – they increase the size of the British fleet in times of war (cites).

In this paper, I make sense of these arguments by emphasizing the second and third as complementary and sensible arguments based on a sustained military threat. I reject the first view because it ignores the problem of international war.

This paper proceeds as follows. The next section discusses Smith's arguments about the costs of the empire and the influence of merchants in maintaining it. Section 3 turns to Smith's discussion of the benefits of empire. Section 4 discusses Smith's third approach emphasizing the logic of war. Section 5 provides an attempt to reconcile Smith’s three views, while section 6 develops the implications of this reconciliation. My conclusions follow.
Perhaps the most well-known argument from the *Wealth of Nations* is Smith’s advocacy of free trade. In this context, scholars have extensively studied Smith’s views on mercantilism and the British Empire. Smith’s first and more elaborate explanation for the empire focuses on rent-creation for merchants, private benefits at the collective expense. Emphasizing the costs of the empire, the literature largely characterizes Smith’s approach to the British mercantile system as abidingly negative. Smith’s emphasis in the *Wealth of Nations* fosters this conclusion, including his long, emphatic, and unambiguous closing paragraph. Indeed, Smith’s final sentence reads, “If any of the provinces of the British empire cannot be made to contribute towards the support of the whole empire, it is surely time that Great Britain should free herself from the expence of defending those provinces in time of war, and of supporting any part of their civil or military establishments in time of peace, and endeavour to accommodate her future views and designs to the real mediocrity of her circumstances” (*WN* V.iii.92:946-47). Smith’s oft-quoted phrase in a 1780 letter to Andreas Holt supports this account; in the letter, Smith refers to the *Wealth of Nations* as a “very violent attack I had made upon the whole commercial system of Great Britain” (*Corr*, letter 208 at 251). Evensky (2015:146) summarizes the view that Britain’s mercantile system did more harm than good. As he concludes, “In the name of national interest mercantilist policies have artificially drawn capital into the distant, slower, and less secure
colonial trade.”

In addition to the direct benefits and costs of the empire, Smith evaluates the effects of mercantile regulation, arguing that it is costly, negating the benefits of empire: “Even the regulations by which each nation endeavours to secure to itself the exclusive trade of its own colonies, are frequently more hurtful to the countries in favour of which they are established than to those against which they are established” (WN IV.vii.c.83-84:627-28).

Smith mentions numerous times that the American colonies bear no part in the expense of their defense and therefore provide nothing in return. In developing this logic, Smith belittles the benefits of the colonies to Britain. He draws two conclusions: first, the net benefits of the colonies are at best zero; and second, rent-creation, interest group influence, and monopolization explain why Britain sustains its costly and burdensome colonies (as Ekelund and Tollison 1981,1997 argue). According to Smith,

The maintenance of this monopoly has hitherto been the principal, or more properly perhaps the sole end and purpose of the dominion which Great Britain assumes over her colonies. In the exclusive trade, it is supposed, consists the great advantage of provinces, which have never yet afforded either revenue or military force for the support of the civil government, or the defence of the mother country. The monopoly is the principal badge of their dependency, and it is the sole fruit which has hitherto been gathered from that dependency. Whatever expence Great Britain has hitherto laid out in maintaining this dependency, has really been laid out in order to support this monopoly.

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8 For example, WN IV.vii.b.35:579; IV.vii.b.63:590; IV.vii.c.64:614-16; IV.vii.c.65:616; IV.vii.c.11-12:593; IV.vii.c.14:594; and IV.vii.c.2-26:598-99.

9 Smith continues, “The whole expence of this peace establishment was a charge upon the revenue of Great Britain, and was, at the same time, the smallest part of what the dominion of the colonies has cost the mother country. If we would know the amount of the whole, we must add to the annual expence of this peace establishment the interest of the sums which, in consequence of her considering her colonies as provinces subject to her dominion, Great Britain has upon different occasions laid out upon their defence. We must add to it, in particular, the whole expence of the late war, and a great part of that of the war which preceded it” (WN IV.vii.c.64:614-16). Smith repeats this conclusion elsewhere in WN: “The pretended purpose of [monopoly privileges] was to encourage the manufactures, and to increase the commerce of Great Britain. But its real effect has been to raise the rate of
Koebner (1961:234) labels Smith’s characterization of the monopolies as “scathing.”

Smith argues that the monopoly on trade with the colonies increases merchants profits; without the monopoly, colonization and trade would be less attractive, with lower quantities supplied. He also suggests that, because monopolization raises profits in the colonial trade, drawing capital away from other investments in Great Britain.¹⁰

Smith proposes the obvious remedy to the wrong-headed mercantile policies: Given this problem, the solution is clear “the natural system of perfect liberty and justice ought gradually to be restored ... The adjustment towards this ideal must be incremental so as not to create these ‘greater disorders’ (WN IV.vii.c.44:606).

In conclusion, Smith reports that, “A great empire has been established for the sole purpose of raising up a nation of customers who should be obliged to buy from the shops of our different producers, all the goods with which these could supply them” (WN IV.viii.53-54:661).

Based on the arguments presented in this section, it appears that Smith has little positive to say about the empire. As I have observed, the secondary literature seems to concur.

3. Evaluating the Net Value of the Colonies and Empire

To the British: The Benefit Side of the Ledger

In contrast to Smith’s seemingly clear assertions quoted in the previous section that Britain gained nothing from the American colonies, in a range of other discussions in the Wealth of Nations, mercantile profit” (WN IV.vii.c.64:616). And: "Under the present system of management, therefore, Great Britain derives nothing but loss from the dominion which she assumes over her colonies” (WN IV.vii.c.65:616).

¹⁰ "But whatever raises in any country the ordinary rate of profit higher than it otherwise would be, necessarily subjects that country both to an absolute and to a relative disadvantage in every branch of trade of which she has not the monopoly” (WN IV.vii.c.2-26:598-99).
of Nations, Smith provides equally clear assertions that the net benefits provided by the colonies were “not only advantageous, but greatly advantageous” (WN IV.iii.c.50:608-09; see also IV.vii.c.47:607-08). Smith discusses indirect but substantial sources of advantage to the metropole. These benefits arise from the great expansion of what he famously labeled “the extent of the market” and the subsequent increase in “the division of labor,” specialization, and exchange. In direct contradiction to his assertions quoted in section 2, Smith claims more than once that these benefits of empire exceed the costs of monopolies.

**Indirect Economic Benefits to Great Britain from the Colonies**

I have already quoted at length in the introduction Smith’s boldest statement of how the two sides of the British Atlantic benefit each other by relieving each other's relative wants. In brief, recall Smith argued that "By uniting, in some measure, the most distant parts of the world, by enabling them to relieve one another's wants, to increase one another's enjoyments, and to encourage one another's industry, their general tendency would seem to be beneficial" (WN IV.vii.c.80:626). Trade with America enriches Europe, Great Britain in particular: “The surplus produce of America, imported into Europe, furnishes the inhabitants of this great continent with a variety of commodities which they could not otherwise have possessed, some for conveniency and use, some for pleasure, and some for ornament, and thereby contributes to increase their enjoyments” (WN IV.vii.c.5:591).

The division of labor is one of Smith’s central elements of economic growth (WN I.iii:13-26). But, Smith famously argued, “the division of labor is limited by the extent of the market” (WN I.iii:31). Not surprisingly, when speaking of the benefits of the American colonies,
Smith emphasizes how the American colonies fostered a much larger market for British goods than otherwise. In a section of *WN* entitled, "Of the Advantages which Europe has derived from the Discovery of America" (*WN* IV.iii.c), Smith says that this source of benefits of the empire to the metropole arises in spite of the monopolization of aspects of America’s trade:

The natural good effects of the colony trade, however, more than counter–balance to Great Britain the bad effects of the monopoly, so that, monopoly and all together, that trade, even as it is carried on at present, is not only advantageous, but greatly advantageous. The new market and the new employment which are opened by the colony trade, are of much greater extent than that portion of the old market and of the old employment which is lost by the monopoly... If the colony trade, however, even as it is carried on at present is advantageous to Great Britain, it is not by means of the monopoly, but in spite of the monopoly (*WN* IV.iii.c.50:608-09).

Smith is more specific with respect to empire’s effect on British (and European) commerce and manufacturing. He argues that the towns of Europe, as a consequence of the American colonies, serve a very large part of the world, whereas without the colonies, the towns were likely to be much smaller, serving a small, nearby territory and hence be smaller and poorer:

the commercial towns of Europe, instead of being the manufacturers and carriers for but a very small part of the world (that part of Europe which is washed by the Atlantic ocean, and the countries which lie round the Baltic and Mediterranean seas), have now become the manufacturers for the numerous and thriving cultivators of America, and the carriers, and in some respects the manufacturers too, for almost all the different nations of Asia, Africa, and America. Two new worlds have been opened to their industry, each of them much greater and more extensive than the old one, and the market of one of them growing still greater and greater every day.

The countries which possess the colonies of America, and which trade directly to the East Indies, enjoy, indeed, the whole shew and splendor of this great commerce (*WN* IV.vii.c.80-82:626-27).
Smith further argues that the growth of commerce and manufacturing indirectly improves European agriculture by increasing the demand for these products. “It is chiefly by encouraging the manufactures of Europe, that the colony trade indirectly encourages its agriculture. The manufacturers of Europe, to whom that trade gives employment, constitute a new market for the produce of the land; and the most advantageous of all markets; the home market for the corn and cattle, for the bread and butchers–meat of Europe; is thus greatly extended by means of the trade to America” (WN IV.iii.c.51ea, 609).11

Smith explained that the benefits of the larger market for the goods and produce did not flow on a one way street benefitting solely Great Britain. The Atlantic trade also benefitted the development of the American colonies. The foundation of American economic growth is British institutions, liberty in particular: “In every thing, except their foreign trade, the liberty of the English colonists to manage their own affairs their own way is complete” (WN IV.vii.b.51:584). “Plenty of good land, and liberty to manage their own affairs their own way, seem to be the two great causes of the prosperity of all new colonies” (WN IV.vii.b.16:572). The relative scarcity of labor in America implies high wages. These wages, in turn, “encourage population. The cheapness and plenty of good land encourage improvement, and enable the proprietor to pay those high wages. In those wages consists almost the whole price of the land; and though they are high, considered

11 Further, Smith’s argues, “Other countries, however, notwithstanding all the invidious restraints by which it is meant to exclude them, frequently enjoy a greater share of the real benefit of it. The colonies of Spain and Portugal, for example, give more real encouragement to the industry of other countries than to that of Spain and Portugal” (WN IV.vii.c.82:627).
as the wages of labour, they are low, considered as the price of what is so very valuable. What encourages the progress of population and improvement, encourages that of real wealth and greatness” (WN IV.vii.b.3:566). America has not only prospered, but grown faster than Great Britain, as was recognized by many of Smith’s contemporaries (cites: e.g., Pownall 1776?).

The faster economic growth in America led Smith famously to predict that the wealth of America would likely surpass that of Britain: “Such has hitherto been the rapid progress of that country in wealth, population and improvement, that in the course of little more than a century, perhaps, the produce of American might exceed that of British taxation” (WN IV.vii.c.79:625).

In short, Smith’s discussion of the gains from exchange emphasizes that the empire was a positive-sum game for both sides of the Atlantic. Further, as Fay suggests in the third head-note, Smith walks the “razor’s edge” between the first two views.

4. Smith’s Third View: The Military Benefits of Colonies

Smith suggested a third way to understand the value of Empire to Britain. This view builds on Smith’s second view, and it contradicts the first view. I advance it as the basis for our understanding Smith’s views of the British Empire. On numerous occasions

12 Ronald Coase relishes this observation in the context of Smith’s proposal for a fiscal union as the solution to the “conflict with America” (WN **; 1778) in which Parliamentary representation of Britain and the American Colonies would depend on their relative tax contributions. Coase (1977:323-25) explains the implications. If Smith's proposal of granting colonies representation in the British parliament proportional to their contributions to public revenues had been implemented before the outbreak of hostilities, "there would have been no 1776, ... America would now be ruling England, and we [in America] would be today celebrating Adam Smith not simply as the author of the Wealth of Nations, but hailing him as a founding father."
in the *Wealth of Nations*, Smith argued that the colonies provided valuable military benefits to the empire, exclusive of tax revenue or soldiers. His discussions of this topic are not as elaborate as his argument about the benefits derived from the increasing size of the market; and he scatters many of his remarks on this topic throughout the *Wealth of Nations*. Moreover, unlike the trenchant, even polemical, rhetoric Smith employed about the costs of the empire, his rhetoric about the military benefits contains frequent qualifications. Nonetheless, a coherent argument emerges when we consider Smith’s ideas on this topic as a whole.

Smith articulates the general principle underlying many specific instances, arguing that defense trumps opulence in trade policy (Hont 2005; Samuels 1973). Trade regulations that improve security may be beneficial to Great Britain even if they reduce wealth. In Smith’s words:

> If any particular manufacture was necessary, indeed, for the defence of the society, it might not always be prudent to depend upon our neighbours for the supply; and if such manufacture could not otherways be supported at home, it might not be unreasonable that all the other branches of industry should be taxed in order to support it. The bounties upon the exportation of British-made sail-cloth, and British-made gun-powder, may, perhaps, both be vindicated upon this principle (*WN* IV.v.a.36:522-23; see also IV.ii.23-24:563).

This approach has important adherents in the literature. National security with respect to material of strategic value requires independence of foreign rivals who could withhold them.¹³ Viner (1948:282) elaborates: “In the seventeenth and eighteenth

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¹³ “[A]bout the beginning of the present century, in 1703, the pitch and tar company of Sweden endeavoured to raise the price of their commodities to Great Britain, by prohibiting their exportation, except in their own ships, at their own price, and in such quantities as they thought proper. In order to counteract this notable piece of mercantile policy, and to render herself as much as possible independent, not only of Sweden, but of all the other northern powers, Great Britain gave a bounty upon the importation of naval stores from America, and the effect of this bounty was to raise the price of timber in America, much more than the confinement to the home market could...
centuries, colonial and other overseas markets, the fisheries, the carrying trade, the slave trade, and open trade routes over the high seas, were all regarded, and rightly, as important sources of national wealth, but were available, or at least assuredly available, only to countries with the ability to acquire or retain them by means of the possession and readiness to use military strength.” Power is a function of the ability to mobilize resources useful in war. Students of international relations define it as the probability a country will triumph over a military rivalry (see Fearon 1995, Hirschman 1945, and Powell 1991).

Power relative to other countries in early modern Europe depended in large part on the military and financial capacities. Given the danger of war, national welfare depended not only on the division of labor and the size of the market, but a nation’s power relative to potential enemies. Hont (2005:15) explains how, under these circumstances, trade policy necessary became an instrument of security. States had no choice; the "aggressive acquisition of wealth was a mode of national self-preservation." Indeed it became an arms race. If one country failed to develop sufficient military and financial resources, others would gain an edge. Hont (2005:15) states the obvious. In the context of a sustained military rivalry, "national self-preservation depended on military strength."

Using this logic, many of Britain’s trade restrictions become more comprehensible. Smith observes that there seems to be cases in which “it will generally lower it; and as both regulations were enacted at the same time, their joint effect was rather to encourage than to discourage the clearing of land in America” (WN IV.vii.b.36:580).
be advantageous to lay some burden upon foreign, for the encouragement of domestick industry” (*WN* IV.ii.23-24:463). Consider a setting in which:

some particular sort of industry is necessary for the defence of the country. The defence of Great Britain, for example, depends very much upon the number of its sailors and shipping. The act of navigation, therefore, very properly endeavours to give the sailors and shipping of Great Britain the monopoly of the trade of their own country, in some cases, by absolute prohibitions, and in others by heavy burdens upon the shipping of foreign countries (*WN* IV.ii.23-24:463).

For example, Smith argues that fostering a larger fishing fleet produces a larger pool of sailors in the event of war. “To increase the shipping and naval power of Great Britain, by the extension of the fisheries of our colonies, is an object which the legislature seems to have had almost constantly in view. Those fisheries, upon this account, have had all the encouragement which freedom can give them, and they have flourished accordingly” (*WN* IV.vii.b.30:577-78). Deviations from free trade are valuable when their contribution to defense more than counterbalances the losses in trade (Hont 2005, Samuels 1973, and Viner 1948; see also *WN* IV.v.a.27:518). Smith employs a similar argument to rationalize subsidies to the carrying trade (*WN* II.v.30:371). Multiple forms of subsidies to shipping were valuable, in this view, because they enhanced Britain’s naval capacity, in turn, enhancing British security and wealth.

Turning to the comprehensive regulatory statutes governing trade in the empire, Smith explains that, because they contribute to British security, the acts of navigation are value to Britain. Speaking of Restoration England (1660-89), Smith declares that the navigation acts, “are as wise ... as if they had all been dictated by the most deliberate wisdom. National animosity at that particular time aimed at the very same object which
the most deliberate wisdom would have recommended, the diminution of the naval power of Holland, the only naval power which could endanger the security of England” (WN IV.ii.29:464). Magnusson (2007:56) reports that Thomas Mun, a mid-17th century mercantilist, argued that England was a “more or less constantly” at war with the Dutch, in which the Dutch naval superiority was able to drive away the British from valuable trading opportunities.

Smith continues this characterization of the navigation acts at length:

The act of navigation is not favourable to foreign commerce, or to the growth of that opulence which can arise from it. The interest of a nation in its commercial relations to foreign nations is, like that of a merchant with regard to the different people with whom he deals, to buy as cheap and to sell as dear as possible. But it will be most likely to buy cheap, when by the most perfect freedom of trade it encourages all nations to bring to it the goods which it has occasion to purchase; and, for the same reason, it will be most likely to sell dear, when its markets are thus filled with the greatest number of buyers. The act of navigation, it is true, lays no burden upon foreign ships that come to export the produce of British industry. Even the antient aliens duty, which used to be paid upon all goods exported as well as imported, has, by several subsequent acts, been taken off from the greater part of the articles of exportation. But if foreigners, either by prohibitions or high duties, are hindered from coming to sell, they cannot always afford to come to buy; because coming without a cargo, they must lose the freight from their own country to Great Britain. By diminishing the number of sellers, therefore, we necessarily diminish that of buyers, and are thus likely not only to buy foreign goods dearer, but to sell our own cheaper, than if there was a more perfect freedom of trade. As defence, however, is of much more importance than opulence, the act of navigation is, perhaps, the wisest of all the commercial regulations of England (WN IV.ii.29-30:464-65).

One way to understand the logic of Smith’s third view is to make explicit a counterfactual implicit in Smith’s first argument and hence duplicated in the literature.

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14 The editors read this passage in the same way. In a previous passage with similar logic, they say with reference to this passage: “See below, IV.ii.24,30. In the latter reference, the Navigation Acts are defended on the ground that defence is of more importance than opulence” (n26, WN II.v.30:371).
Suppose Britain had voluntarily abandoned the American colonies so that it would be spared the exorbitant expense of the colonies' defense. Smith’s first view implies that abandoning the colonies would be hugely beneficial to Britain. But is this assertion plausible?

Neither Smith, when emphasizing the first thesis, nor the participants in the literature who advocate this view, appears to have thought through the counterfactual they have implicitly proposed. This counterfactual involves multiple assertions: (i) Britain would abandon the colonies; (ii) Britain would save the huge costs of defense, which America would then have to finance alone; and (iii) trade between the colonies and Britain would not change drastically – in particular the newly independent Americans would continue their extensive with trade Britain.¹⁵

This implicit counterfactual is an obvious one, but it is inadequate. The reason is the missing margin of violence. Optimal trade policy depends whether the international environment is one of peace and global trade or of war and military rivalry.

Drawing on Hont’s (2005:1-156) thesis of the “jealousy of trade,” I propose a second, more realistic counterfactual. Hont (2005: 5) explains that the “phrase 'jealousy of trade' refers to a particular conjunction between politics and the economy. It emerged when success in international trade became a matter of the military and political survival of nations.” Further, the term refers "to a pathological conjunction between politics and the economy that turned the globe into a theater of perpetual commercial war… It

¹⁵ Indeed, Smith advocated giving French Canada back to France and Florida back to Spain so that the Americans would feel surrounded and hence bound to ally – and continue trade with – Great Britain (Smith 1778:382-83).
implied that in modern politics the logic of trade was bent to the logic of war" (Hont 2005:6). To understand much of 18th century writing on trade, Smith included, we must understand it against the background of sustained commercial war.

Between 1689 and 1815, Britain and France were at war in more years than not; and in many of the years of peace, they were preparing for war (Hont 2005:24). If Britain were to abandon the American colonies, might not France spring to action? Suppose that, to capture benefits from the American trade, France had offered the Americans extensive privileges to ally with her against Great Britain. The new arrangement would hurt Britain in several ways. First, it would reduce Britain’s participation in – or even entirely exclude it from – the American market, including various naval stores and other commodities of high military value. Second, the extent of the British market would shrink considerably, reducing the division of labor and hence producing economic contraction, not growth. Third, the French would experience the increasing division of labor and subsequent economic growth, thereby gaining economic and financial power and potentially allowing it to triumph over the British.

Given its sustained military rivalry with France, Britain could not have been indifferent to the outcome implied by the second counterfactual. This logic implies that Smith's claim cannot be sustained; namely, that Britain had spent huge funds in the last war defending the colonies solely for the latter’s benefit.

To summarize Smith’s third argument, security and defense are legitimate ends of navigation policy and, further, that many of Britain’s trade restrictions can be interpreted as such. In this militarized environment, the gains from exchange from the colonial trade
made Great Britain far richer than otherwise. Its financial resources were therefore considerably larger than overwise.

5. Reconciling Smith’s Three Views: An Alternative Account of Mercantilism; Or, the Industrial Organization of Military Rivalrous, Early Modern European Empires

To make sense of Smith’s seemingly irreconcilable approaches to the British Empire, I first examine the logic of Smith’s assumptions underlying each argument; I then turn to modern international relations theory to provide a theoretical basis for my claims. The difference in the logic and conclusions between the first and third approaches reflects Smith’s use of two different assumptions about the international environment within which the British Empire sat. Put simply, Smith’s analysis in his “very violent attack” on British mercantilism presumes without explanation a counterfactual of global peace and free trade, and his “attack” measures the welfare losses of this system given this counterfactual.16

The long-term military rivalry of Britain and France contradicts Smith’s counterfactual of global peace and free trade. Because Smith’s counterfactual ignores the problem of a sustained military conflict, it is an inadequate standard from which to evaluate British policy given the on-going conflict with France. Smith acknowledges the

16 For example, “Though the encouragement of exportation, and the discouragement of importation are the two great engines by which the mercantile system proposes to enrich every country, yet with regard to some particular commodities, it seems to follow an opposite plan: to discourage exportation and to encourage importation. Its ultimate object, however, it pretends, is always the same, to enrich the country by an advantageous balance of trade. It discourages the exportation of the materials of manufacture, and of the instruments of trade, in order to give our own workmen an advantage, and to enable them to undersell those of other nations in all foreign markets: and by restraining, in this manner, the exportation of a few commodities, of no great price, it proposes to occasion a much greater and more valuable exportation of others (WN IV.viii.6-7:644).
military conflict in his third view. This logic of the on-going conflict with France therefore favors the third argument.

**Modern International Relations Theory**

I draw on the work of modern international relations theory to help adjudicate among Smith’s incompatible views of empire. This theory provides important insights into the optimal strategies countries should pursue during sustained military rivalries.

I begin with Fearon’s (1995) seminal answer as to why we observe war despite it being costly. Shouldn’t both parties to war be better off negotiating instead of fighting? Fearon explains that bargaining problems often prevent such agreements to avoid war. For example, asymmetric information problems often lead to different beliefs about relative capabilities of two potential military combatants. If party one believes it is much stronger than party two believes it is, then the largest bargain party one may offer party two can be *lower* than the lowest bargain party two would accept. In this setting, the two parties cannot agree to a bargain that prevents war. Asymmetric information problems can lead to an international environment where security is an omnipresent problem, as between Britain and France in the 18th century.¹⁷

Powell’s (1991) classic work on relative vs absolute gains provides additional insights into policies countries pursue in the face of international security problems (see also Hirschman 1945:9). Suppose there exists an exchange between two countries in

¹⁷ Similarly, problems with credible commitments can also make it impossible to implement a bargain that makes both parties better off.
which the first country captures twenty-five percent of the exchange, and the second country, seventy-five percent of the exchange. Should the first country enter this exchange? International trade economists, including Smith when advocating his first view, would say yes. Both countries are better off from the exchange even if the distribution of benefits is asymmetric.

Not so fast, however. Powell demonstrates that the answer to the question about the asymmetric exchange turns out to depend on the assumptions about security. If the international environment is peaceful with a very low threat of war – the typical assumption of international trade theory – then the answer is yes. Country one is better off with twenty-five percent of the gains irrespective of country two’s gains.

But if security and war are constant problems, and if the two countries are military rivals, then the exchange makes first country worse off. Because the exchange increases the power of country two relative to country one, the exchange raises the expected amount that country two can extract from country one in war (Powell 1991; see also Fearon 1995 and Hirschman 1945). This exchange enhances the relative military capacity of country two and is therefore a bad deal for country one. Hont (2005:23-24) reports that the famous 17th century French finance minister, Jean-Baptiste Colbert, relied on this logic: “Colbert's policy was to wage commercial war against Europe with any means at his disposal… [H]e wished to increase France's share of European shipping immediately, by physically destroying Dutch capacity if necessary.”

Smith mentions relative gains at *WN* IV.vii.c.16:594-95; in the next paragraph, he gives tobacco from Maryland and Virginia in illustration. In his discussion of Smith, Winch (1965:10-11) discusses relative gains. A related problem with trade with the enemy is that it can make a country vulnerable to holdup problems in the event of
Instead of engaging in trade with each other, each country in a military rivalry has strong security incentives to separate its economy from its enemy’s. The value of an empire in this setting is to expand the country’s economy, increasing the extent of the market and hence the division of labor and economic growth. Given a military rivalry, it may be optimal to build an empire that approximates free trade within – subject to military qualifications – while being closed to military rivals (on the latter, see *WN* IV.v.a.36:522-23).

As evidence of this view, consider the United States and its allies during the cold war era. This era is widely known for globalization and relatively free trade. Policies promoting free trade had one big exception, however: the deliberate prohibition of trade with the Communist Bloc of nations. In the context of this multi-generation conflict, the object of trade policy was to deny the Communist Bloc vital military supplies and the Smithian benefits of the division of labor in a far larger global market.

None of this argument implies an endorsement of mercantilism as a normatively attractive ideal. But it does suggest that the structure of trade relationships depends critically on whether the international environment is one sustained peace or military rivalry. Smith’s third argument of the military value of empire suggests that some trade restrictions may have large security benefits even if they come at the expense of “opulence.”

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19 Morrow, Siverson, and Tabares (1998) provide the best discussion of this topic, covering both the international relations literature and the economics literature on international trade.
To summarize the theory of empire in an international security environment of sustained military rivalry, countries have incentives to create trade barriers between empires. These trade barriers served several purposes:

1. (i) to deny the opponents valuable military inputs, a form of “raising rivals costs” (Salop and Scheffman 1983; Hirschman 1945);

2. (ii) to limit the size of the opponent’s market and thus restrict opportunities for the opponents economic growth through the division of labor, and specialization and exchange (Powell 1991; Hirschman 1945);

3. (iii) to limit the empire’s dependence on material that an opponent might deny them during war.

The value of colonies to the metropole can be quite high if the colonies substantially increase the division of labor and if they provide a cheaper and abundant source of scarce military supplies.

6. The Implications of a Sustained Military Rivalry for Evaluating the Net Value of the Colonies

In the presence of a sustained security threat from France, the colonies proved a valuable resource to Britain in several ways. They expanded the size of the market, immensely improving the division of labor and the gains from specialization. As Smith indicates, the two sides of the British Atlantic each gained through relief of their relative wants. The colonies also gained Britain a big source of investments, raising the return on investment to all of British capital. And the mercantile policies kept strategic goods out of French hands and limited the ability of the French to deepen their own division of labor through extensive trade and specialization with the American colonies.
Yes, the American colonies were expensive; and yes – as Smith complains – they did not contribute taxes to their defense. But they did contribute to the British economy and security in other ways. Any evaluation of the net value of the colonies to Britain must take all these components into account, not taxation alone. Unfortunately Smith never undertook this evaluation, leaving us with contradictory theses.

Logically, the sustained Anglo-French rivalry favors Smith’s third view and weighs heavily against Smith’s first view. In a dangerous and insecure world, failure to fight off France, potentially leading to a world dominated by France, would mean far greater restrictions on British trade, much smaller size of markets with far more limited division of labor and the gains from specialization and exchange. Even worse, dominance of France might also involve existential issues – was a French military dominance of Britain out of the question, were Britain not to have spent so much on security?

None of this analysis appears in Smith, nor in modern economics (but see Findlay and O’Rourke 2007 and Magnusson 2007). Smith in his first view and modern economics generally both ignore problem of international violence (Fearon 1995, Morrow et al 1998, North, Wallis, and Weingast 2009, and Powell 1992). And yet violence was a reality (Hont 2005 and Viner 1948). Further this violence required that mitigating violence be an active margin of public decisionmaking. Analysts who ignore violence therefore systematically miss an important and rational motivation for decisionmaking. By ignoring violence, these analysts can neither explain why states make their policies – here colonial policy and mercantilism – nor can they appropriately evaluate the normative value of policies to mitigate violence, which appear to economists as mere market intervention.
7. Conclusions

Smith’s contradictory statements about the value of the empire to Britain are hard to reconcile. The literature largely follows Smith’s lead, either mentioning the costs and the benefits of empire but emphasizing the former over the latter; or barely mentioning the second, thus emphasizing the first by default. The main verdict in the literature follows Smith’s rhetorical emphasis on the costs of empire.

Yet, as I show, Smith’s discussion of the costs of empire assumes away the problem of war and security, presuming a counterfactual of global peace and free trade from which to judge the impact of mercantilist restrictions. The presumption of peace and global free trade underlying Smith’s first view meant that Smith failed to see how his policy recommendations based on his normative standard, free trade would have left Britain more vulnerable, less competitive, and hence worse off in its long-term military rivalry with France. In the presence of sustained security risk, the appropriate counterfactual is not idealized global free trade, but one where the Americans allied with the French, excluding the British from American trade. Unilateral free trade risked French hegemony on the continent and over the Atlantic.

Smith’s second view of empire recognizes the benefits from the empire’s immense division of labor. In direct contradiction to his first approach, Smith’s second approach emphasizes that the great benefits of empire arise despite the costs of mercantile regulations and the costs of monopoly.
Finally, I emphasize a third view, one complementary to the second. This view emphasizes the military benefits of the British Empire in a world of hostile military competition with France. In this approach, Smith says that navigation regulations that make Britain more secure are worth their costs in “opulence.” Britain’s military rivalry with France led, rationally, to forms of mercantilism: Build an empire that approximates free trade and a common market within; but with strong barriers to trade across empires. Missing the problem of violence leads economists – both Smith and modern ones – to misinterpret British navigation regulations.

Drawing on international relations theory, I discuss how the optimal trade policies with respect to empires in a world with considerable security threats differ from those in a world of global free trade. These policies, often reflected in theories of mercantilism, appear to economists who ignore violence as costly market intervention that should be removed. In terms of this paper’s emphasis on sustained military rivalries, removing these restrictions unilaterally would not make Britain better off because it would have Britain more vulnerable to France.

In a world of violence and security threats, the American colonies contributed in numerous ways to the larger wealth and security of Great Britain: they enlarged the “extent of the British market” and hence division of labor; they raised the returns on British investment; and they kept strategic materials away from military rivals. More importantly, the British empire had two direct effects with respect to France: it prevented France from participating in the gains from major portions of the American trade, thus restricting the “extent of the French market” and its division of labor; and it prevented an
American-French alliance that might exclude the British from the American market. In a world of military rivalries, British mercantile policies provided substantial benefits to the metropole.

Having provided a means to sort out Smith’s three contradictory views on the British Empire, I end with an obvious question, why did Smith propose such different views? A satisfying answer is beyond the scope of this paper; but some suggestive observations are in order.

Viner’s (1928) discussion of Smith’s contradictions emphasizes his polemics and his strong advocacy of particular policies, such as free trade. Viner explains Smith’s contradictions on this basis (see Coats 1975**). Smith may have employed a strong rhetorical position as a means of emphasizing that an alternative structure of the empire, including greater emphasis on policies of free trade rather than monopolies, would better serve Britain’s interests.

Smith wrote the *Wealth of Nations* in the post-Seven Years’ War era. This war eliminated the French threat to the British colonies (but not the French threat to Britain). Because the security threat to the empire had dramatically fallen, the value of global free trade had risen. Appositely, Magnusson (2007:46) dates the last English work on mercantilism as James Steuart’s *Principles of Political Economy* (1767), just following the Seven Years’ War. Smith hoped the *Wealth of Nations* would influence the direction of reform, perhaps justified by the change in the empire’s security environment. Is this observation, consistent with the third view, a mere coincidence? Or is it part of the
subtext underlying Smith’s positive discussions of the empire over the previous century juxtaposed to his normative ambitions for free trade in the post-Seven Years’ War era?

**References**


