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

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"Is [the *Wealth of Nations*] a defence of empire or repudiation of it? By a supreme artistry [Adam 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" (C.R. Fay 1956:107).

### Abstract

Adam Smith proposed three contradictory theories of the British Empire in the *Wealth of Nations*. The first view holds that the empire was created for merchants eager to monopolize 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 sustained military conflict with France.

How do we reconcile the incompatibility of Smith's three views of the British Empire? Smith provides little guidance. I argue that, to make sense of Smith's diverse views of the British Empire, we must recognize the persistent 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

How are we to understand Adam Smith's views about free trade, the value to Great Britain of her empire, and mercantilism? Most Smith scholars emphasize that Smith favored free trade, opposed mercantilism, and opposed the empire. Considerable passages can be adduced to

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support these contentions. Yet, Smith's views on these three issues are not so straightforward (as Palen 2014 suggests). As I will show, the difficulty arises because Smith proposed three distinct and somewhat contradictory theories of the British Empire in the *Wealth of Nations*.

In his first view – on which he places the most emphasis and relies on the strongest and often polemic rhetoric – Smith argued that the empire was based on rent-seeking by merchants eager to establish and maintain monopolies on the colonial trade, providing few benefits to Great Britain (*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' expensive defense. Most scholars follow Smith's emphasis (e.g., 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 empire as affording a non-incremental increase in the extent of the market, hence a non-incremental increase in the division of labor, specialization and exchange. The great division of labor, in turn, promoted the economic growth of *both* sides of the British Atlantic. 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 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, 18<sup>th</sup> century Britain was far richer and more industrialized because of the larger market and greater division of labor afforded by the colonies

(Winch 1965:9-11).<sup>2</sup> As the division of labor is the hallmark of Smith's theory of economic growth, adherents of Smith's first view cannot simply ignore or push it 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 world of sustained violent international conflict. Hont (2005,2015) argues that, 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.<sup>3</sup> Nonetheless, the cumulative weight of his many points from this perspective add up to a significant approach.

To give a sense that Smith presented three distinct sets of logics, I offer the following three quotations that represent Smith's different views,

"[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" (*WN* IV.vii.c.64-65:614-15).

"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).

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<sup>2</sup> Smith bitterly denigrates the European treatment of the native population (for example, *WN* IV.i.32:448 and IV.vii.c.80:626).

<sup>3</sup> 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).

Finally, with respect to the mercantile restrictions Smith elsewhere bitterly criticizes, Smith asserts:

“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).

How do we reconcile the incompatibility of Smith’s three 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?

I argue in this paper that, to understand the British Empire, we must work backwards through the three views. Economists largely ignore the problem of war and how it affects the desirability of various trade policies. The inattention to war may be reasonable when studying eras of sustained 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). This era of sustained military competition contrasts with the economists’ world which implicitly assumes sustained peace in which countries should maximize absolute gains.

International relations theorists demonstrate that a world of sustained rivalry is much more like a zero-sum game than is free trade in an era of international peace.<sup>4</sup> In particular, Powell (1991) demonstrates that countries engaged in sustained military rivalries will maximize their *relative* gains. Because the probability of winning wars is a positive function of resources,

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<sup>4</sup> Fearon (1995) and Powell (1991) are the international security theorists on whom I draw; see also Morrow et al (1998). Ekelund and Tollison (1981:\*\*), Ferguson (2003:20-21), and Hont (1988:6) emphasize the zero sum nature of economic competition in the era of military rivalry.

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 his arguments favoring free trade – Smith applauded Britain's navigation policies because these restrictions on trade enhanced Britain's military capacity.

The second view complements the third. The American colonies greatly expanded 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 aided Britain because they diminished France's military capacity.

Finally, to understand the first view, I suggest there exists a strong form and a weak form of the argument. The strong form asserts that the empire was solely for the benefit of merchants; the weak form, that merchants gained valuable privileges and rents due to Britain's protectionism, but they were not the sole or even the most important reason for empire. 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 number of seamen and the size of the British fleet in times of war (cites).

My purpose in this paper is to make sense of these seemingly contradictory perspectives by emphasizing that Smith's second and third approaches are complementary and sensible arguments based on a sustained military threat. As to the first view, I accept its weak form while rejecting its strong form because the latter ignores the problem of sustained violent international conflict. As I quote Smith below, war trumps trade (cites).

This paper proceeds as follows. The next three sections discuss Smith's three views of empire: arguments about the costs of the empire and the influence of merchants in maintaining it (section 2); Smith's discussion of the benefits of empire (section 3); and drawing on international relations theory in political science to interpret Smith's third approach emphasizing the logic of war (section 4). In section 5, I propose a reconciliation of Smith's three views, while section 6 develops the implications of this reconciliation. My conclusions follow.

## **2. Evaluating the Net Value of the Colonies and Empire To the British: The Cost Side of the Ledger**

Smith's advocacy of free trade is among the most well-known arguments from the *Wealth of Nations*. In this context, scholars have extensively studied Smith's views on mercantilism and the British Empire.<sup>5</sup> Smith's first and most 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

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<sup>5</sup> See, e.g., Benians (1925), Coats (1975), Evensky (2015,ch 4); Hont (2005, 2015,ch 6), Kennedy (2010,ch11, Keobner (1961,\*\*), Palen (2014), Phillipson (2010,ch 1), Skinner (1996, 2009), C. Smith (2009,ch\*\*), Tribe (2006), Van de Haar (2013), and Winch (1965).

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).<sup>6</sup> Evensky (2015:146) summarizes the view that Britain's mercantile system did more harm than good: "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 sufficiently costly as to negate 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 to Britain in return for colonial defense.<sup>7</sup> In

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<sup>6</sup> Ekelund and Tollison (1981, 1997) provide one of the most comprehensive analysis of Smith's ideas and especially British practice from this perspective (see also Evensky 2015,ch4).

<sup>7</sup> 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.

developing this logic, Smith belittles the indirect benefits of the colonies to Britain. He draws two conclusions: first, the net benefits of the colonies to Britain 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). I have already quoted the passage in which Smith argues that the, “maintenance of this monopoly has hitherto been the ... sole end and purpose” of the British empire.”<sup>8</sup> Koebner (1961:234) aptly labels Smith’s characterization of the monopolies as “scathing.” Smith proposes the obvious remedy to the wrong-headed mercantile policies: “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” (*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 bulk of the secondary literature concurs.

### **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 unambiguous assertions quoted in the previous section that Britain gained nothing from the American colonies, in numerous discussions in the *Wealth*

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<sup>8</sup> (*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 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).

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 stands as one of Smith’s central elements of economic growth (*WN* I.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

from this perspective, Smith emphasizes how the American colonies afforded 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 explains that this source of benefits of the empire to the metropole arises in spite of the monopolization of aspects of America's trade (as quoted above in the introduction). "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" (*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 and other colonies, serve a very large part of the world. Without the colonies, the towns were likely to be much smaller, producing a more limited selection of goods, and serving a small, adjacent territory. Hence the towns would 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 Baltick 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).<sup>9</sup>

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: “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). “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). 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 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 Smith and many of his contemporaries (cites: e.g., Pownall 1776?).

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<sup>9</sup> 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).

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).<sup>10</sup> 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.

#### **4. Smith’s Third View: The Security Benefits of Empire**

Smith suggested a third way to understand the value of Empire to Britain. This view builds on Smith’s second view. It also contradicts Smith’s first view, which fails to account for sustained military competition. I advance this third view as the foundation for understanding Smith’s views of the British Empire. In a surprisingly large number of passages in the *Wealth of Nations*, Smith argued that the colonies provided valuable military benefits to the empire, wholly apart from the colonies’ provision of tax revenue or soldiers. His discussions of this topic are not gathered into one sustained argument, in contrast to his argument about the benefits derived from the increasing size of the market. Moreover, unlike the trenchant, even polemical, rhetoric Smith employed about the costs of the empire, his rhetoric about the security benefits is more measured.

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<sup>10</sup> Ronald Coase seems to relish 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 America would gain representation in Parliament; and 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."

Nonetheless, a coherent argument emerges when we draw together as a whole Smith's discussions on this topic.

Smith articulates the general principle underlying many specific instances in the third of three quotes in the introduction: the trade restrictions embodied in the navigation acts were valuable because defense trumps opulence in trade policy (*WN* IV.ii.29-30:464-65; see also Grampp 1965:40, 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. This is known as the "hold-up problem" (Klein, Crawford, and Alchian 1979; Williamson 1985) in which one party has far more bargaining leverage over a second because it (the first party) can threaten to withhold valuable goods or services. Smith illustrates this point with the example of tar and pitch which England had obtained from Sweden. But in 1703, the Swedish firm producing this important naval material withdrew it, limiting supplies to Britain and forcing her to transport the material in Swedish ships.<sup>11</sup> Viner (1948:282) elaborates: "In the seventeenth and

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<sup>11</sup> "[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

eighteenth 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.”<sup>12</sup> Military power is a function of the ability to mobilize resources useful in war.

Modern 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). As Powell (1991) demonstrates, in the presence of sustained military conflict, states rationally maximize relative, not absolute power.

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, its competitors would gain an edge. In the context of a sustained military rivalry, "national self-preservation depended on military strength" (Hont 2005:15).

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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).

<sup>12</sup> 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).

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 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).

Smith explained that deviations from free trade are valuable when their contribution to defense more than counterbalances the losses in trade (Hont 2005, Powell 1991, Samuels 1973, and Viner 1948; see also (*WN* IV.v.a.27:518). I have already mentioned fisheries. 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 (1660-88), 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 at this time was "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 characterizes the navigation acts at length:

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).<sup>13</sup>

## **5. Reconciling Smith’s Three Views: An Alternative Account of Mercantalism; Or, the Industrial Organization of Sustained Military Rivals among Early Modern European Empires**

To understand the logic of Smith’s third view, I make explicit a counterfactual implicit in Smith’s first argument and duplicated in the literature. Suppose Britain had voluntarily abandoned the American colonies, believing 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?

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<sup>13</sup> 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). Hont (2015:125) also agrees: “The right alternative was a sensible foreign policy, here meaning the preservation of Britain a blue-water power secured by the Navigation Acts (which Smith thought were measures of real republican genius and had been England's salvation) in conjunction with non-intervention in foreign land wars, while still acting as an offshore adjudicator of Europe's balance of power.”

Neither Smith, when emphasizing the first thesis, nor the participants in the literature who advocate Smith's first interpretation of Smith on the British Empire, appears to have thought through the counterfactual they have implicitly proposed. This counterfactual involves multiple hidden presumptions of questionable merit: (i) Britain would abandon the colonies; (ii) Britain would save the huge costs of defense, which America would then have to finance alone; and most importantly (iii) trade between the colonies and Britain would not change drastically – in particular the newly independent Americans would continue their extensive trade with Britain.<sup>14</sup>

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. 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). In a world of free trade – Smith's first thesis – advocating giving up Florida and Canada to manipulate America would be unnecessary and irrelevant.

Drawing on Hont's (2005:1-156) discussion 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

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<sup>14</sup> In discussing Britain's foreign policy (the Navigation Act's preservation of Britain's sea power and adjudicating the balance of power in Europe), Hont (2015:125) questions Smith's dubious presumptions: "Smith thought that these two activities could be financed from the profits off foreign trade, tapping into mercantile profits and using emergency powers if war made it necessary. This idea assumed, of course, that international trade took place in the great mercantile republic of mankind under rules of neutrality, allowing commerce to continue even during war." Whatever Smith's hopes for free trade during its many wars with the Dutch followed by those with the French, they did not match reality.

term refers "to a pathological conjunction between politics and the economy that turned the globe into a theater of perpetual commercial war... **it implied that in modern politics the logic of trade was bent to the logic of war**" (Hont 2005:6 emphasis added). To understand much of 18th century writing on trade, Smith included, we need some background about sustained commercial war.<sup>15</sup>

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 economic and military implications of the second counterfactual. Smith's claim that Britain had spent huge funds in the last war defending the colonies solely for the latter's benefit cannot be sustained. Security and defense are legitimate ends of navigation policy, and many of Britain's

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<sup>15</sup> Although Smith does not use the phrase, "jealousy of trade," he clearly understood the concept. Hume discussed the concept in his essay of that title (Hume 1752).

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 otherwise.

### **Modern International Relations Theory**

To help adjudicate among Smith's incompatible views of empire, I draw on modern international relations theory. 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. The paradox is that both parties to a war are 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 offer 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 18<sup>th</sup> century.<sup>16</sup>

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 a possible exchange between two countries in which the first

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<sup>16</sup> Similarly, problems with credible commitments can also make it impossible to implement a bargain that makes both parties better off.

country captures twenty-five percent of the exchange's value, while the second country captures seventy-five percent. Should the first country enter this exchange? International trade economists, including Smith when advocating his first view, 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 asymmetric exchange makes first country worse off. Because the exchange increases the power of country two relative to country one, the exchange raises the probability that country two will defeat country one in war. Country two can therefore extract from country one in negotiations (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 17<sup>th</sup> 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.”<sup>17</sup>

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<sup>17</sup> 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) also 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 war (Hirschman 1945:\*\*); and can provide the enemy with valuable military resources that it might not be able to obtain otherwise. In this environment of sustained military rivalry, combatants are led to structure an empire differently from that in a world of global free trade without war.

Instead of engaging in trade, 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. 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.<sup>18</sup> In the context of this multi-generation conflict, the object of the United States' 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 optimal structure of trade relationships depends critically on whether the international environment is one of sustained peace or military rivalry.

To summarize: the theory of empire in an international security environment of sustained military rivalry holds that countries have incentives to create trade barriers between empires.

These trade barriers served several purposes:

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

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<sup>18</sup> 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.

2. 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. 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. Conclusions

In the presence of a sustained security threat from France, the American colonies proved a valuable resource to Britain. They expanded the size of the British market, immensely improving the division of labor and the gains from specialization on both sides of the British Atlantic. As Smith indicates, the two sides of the British Atlantic each gained considerable relief of their relative wants (*WN* IV.vii.c.80:626). The colonies also expanded the set of investments, raising the return on investment to all of British capital. And the British 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 and a much smaller size of markets with a 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?

The full implications of the sustained military Anglo-French rivalry appears in neither Smith nor in modern economics (but see Findlay and O'Rourke 2007, Magnusson 2007, and Samuels 1974). Smith in his first view – as with modern economics generally – ignores problems of international violence (Fearon 1995, Morrow et al 1998, North, Wallis, and Weingast 2009, and Powell 1991). And yet sustained, violent conflict was a reality for 18<sup>th</sup> century Britain (Hont 2005 and Viner 1948). The persistent French threat required that security had to be an active margin of public decisionmaking. Analysts who ignore violence therefore systematically miss an important and rational motivation for decisionmaking with respect to empire, colonies, taxation, and trade. Therefore these analysts can neither explain why states make their policies – here colonial policy and mercantilism – nor appropriately evaluate the normative value of policies to mitigate violence, which appear to economists as mere market intervention.

Although Smith's contradictory statements about the value of the empire to Britain are hard to reconcile, the literature largely ignores this problem, nearly exclusively focusing on Smith's first view emphasizing free trade. 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 of 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 that contradicts the first view while complementing 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 diminished "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. 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 security threats from violent international conflict, the American colonies contributed in numerous ways to the larger wealth and security of Great Britain wholly apart from taxation: 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 (see also Coats 1975:224, Fleischacker 2004:16ff, and Grampp 1965:15). 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 (1756-63) era. This war eliminated the French threat to the British colonies (but not the French threat to Britain as Napoleon would prove). 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), immediately 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. Consistent with the third view, is this observation 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?

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