AUSTRIAN APPROACH TO THE 3\textsuperscript{RD} DUTY OF THE
SOVEREIGN IN THE WEALTH OF NATIONS

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Austrian Approach to the 3\textsuperscript{rd} duty of the sovereign in the Wealth of Nations\textsuperscript{*}

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\textit{Abstract} Economists seem quasi unanimous about the fact that Adam Smith would have had the intuition of the existence of public goods and market failures. Musgrave-1985, among others, perfectly summarizes this widely held position in modern economic thought. In a normative sense, Smith would have entrusted their production to the government and their supply would constitute precisely the 3\textsuperscript{rd} duty of the sovereign in the Wealth of Nations. However, Smith – as Austrian economists since Menger – was mainly interested in the role of institutions in the economy. An institutional approach to the 3\textsuperscript{rd} duty of the sovereign - consisting in the establishment of property rights on public works and in the incorporation of joint stock companies - allows us to reconcile Smith thought with the laissez-faire tradition.

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There is a widely held belief in economic literature that Adam Smith would have had the
tuition of the existence of public goods and market failures. Smith would have entrusted
their production to the state and that would be precisely the 3rd duty of the sovereign in the
Wealth of Nations (WN here below). For example, Musgrave, among others, perfectly
summarizes this position in modern economic thought.¹

In 1927 Viner already stressed that in the WN the Scottish philosopher would have made
several exceptions to the laissez-faire tradition, contrary to the Theory of moral sentiments.²
While in the later the state was considered only as protector of individual rights, in the former
it would have become (with the 3rd duty) a supplier of public goods. Rothbard in his last book
expressed the same opinion.³

But it is possible to have an institutional interpretation of the 3rd duty in the WN which, as we
shall see, turns out to be much more compatible with laissez-faire. Since Menger, Austrians
have always been interested in the role of economic institutions (property rights, freedom of
contracts, etc.) and Smith had a similar approach to the role of the state.

The 3rd duty of the sovereign⁴ is presented in Book V of the WN. It consists in

"erecting and maintaining certain public works and certain public institutions, which it can
never be the interest of any individual or small number of individuals to erect and
maintain".⁵

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¹ Musgrave-1985.
² Viner-1927.
The contemporary reader may effectively have the impression that public works correspond
to public goods and that public institutions must be public sector or state enterprise. But our
argument is that for Smith these goods i) suffered from absence of property rights and ii)
needed great amounts of capital. Thus, in Section 1 we will discuss the property rights aspect
of public works in the WN. Section 2 will clarify the role of the sovereign in establishing
private joint stock companies in order to collect the vaste amounts of capital needed for their
supply. Finally, in Section 3, the case of education will be analysed from this point of view of
economic institutions.

1. Smith’s property rights approach to public works

The goods discussed in that part of the WN (bridges, canals, roads, education etc.) are often
classified in the economic theory as public goods à la Samuelson.\(^6\) The reasoning of public
goods theorists leads always to the conclusion of market failure. Thus, there would be
difficulties in financing these goods because the consumers who benefit from them cannot be
excluded and, therefore, don't pay their consumption: the state must intervene and produce
them. Retrospectively, this view seems to justify why Smith is discussing these goods in this
part of the WN, concerning the different roles of the sovereign.

Nevertheless, this interpretation appears incorrect and the notion of public works in Smith
has a sense quite different from the modern one of public goods. As West\(^7\) suggests it,
exclusion is almost always possible for Smith and consumers can, and ideally should, finance

\(^4\) The 1\(^{st}\) duty concerns defense and the 2\(^{nd}\), justice. In classical liberal tradition these
duties are generally considered as compatible with laissez-faire.
\(^5\) Smith-1976a, pp. 687-688.
the public work they use. Contrary to the theorists of public goods, Adam Smith was interested in the institutional aspect of their production.\textsuperscript{8}

In Smith’s view, the establishment of property rights on public works would allow the introduction of the price system in their production. With this introduction of price signals he had two main objectives: i) to exclude non-consumers from paying and ii) to allow the circulation of the information on these goods in order to supply them where needed.

\textbf{1.1 Property rights and financing public works}

Smith’s first objective was to introduce the price system in order to avoid the financing of public works by any person who would pay unjustly because he is not using it. Let only the consumer pay:

"(it) seems scarce possible to invent a more equitable way of maintaining such works".\textsuperscript{9}

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

Unfortunately the Scottish philosopher doesn't consider private property rights on such goods but only on the tolls established on them. This incomplete property rights system leads to some inconsistencies in Smith's analysis and he doesn't resolve them clearly. He

\textsuperscript{7} West-1977.
\textsuperscript{8} Smith’s reasoning was very different from that of public goods theorists and much closer to that of Coase-1960 et Coase-1974.
\textsuperscript{9} Smith-1976a, p. 725.
was not consistent enough to go as far as to consider complete privatisation of these facilities. Thus, when he analyzes goods, such as canals or bridges whose maintenance is necessary to get the toll, they should be maintained, according to him, by private persons because it is in their interest to do it:

"In several different parts of Europe the toll or lock-duty upon a canal is the property of private persons, whose private interest obliges them to keep up the canal. If it is not kept in tolerable order, the navigation necessarily ceases altogether, and along with it the whole profit which they can make by the tolls. If those tolls were put under the management of commissioners, who had themselves no interest in them, they might be less attentive to the maintenance of the works which produced them."\(^{10}\)

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

"(the) tolls for the maintenance of a high road, cannot with any safety be made the property of private persons. A high road, though entirely neglected, does not become altogether impassable, though a canal does. The proprietors of the tolls upon a high road, therefore, might neglect altogether the repair of the road, and yet continue to levy very nearly the same tolls."\(^{11}\)

Adam Smith is confused because that possible neglect could serve as a pretext for the intervention of the state (through trustees and commissioners) in supplying road services:

\(^{10}\) Ibid., pp. 725-726.
\(^{11}\) Ibid., p. 726.
"It is proper, therefore, that the tolls for the maintenance of such a work should be put under the management of commissioners or trustees."\textsuperscript{12}

Though, such a solution is not an efficient one neither: Smith exposes at length and very critically all government failures, involved by such state intervention:

"In Great Britain, the abuses which the trustees have committed in the management of those tolls, have in many cases been very justly complained of."\textsuperscript{13}

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

"(…) if the tolls which are levied at the turnpikes should ever be considered as one of the resources for supplying the exigencies of the state, they would certainly be augmented as those exigencies were supposed to require."\textsuperscript{14}

So, when the state is entrusted to levy tolls, it can very easily increase them and make the trade more expensive. Thus, the state may turn out to be the cause for possible economic recession. The cases of public monopolies for post service and money

\textsuperscript{12} Ibid.  
\textsuperscript{13} Ibid.  
\textsuperscript{14} Ibid.
production must be understood in this perspective: even if there were public monopolies at the time of Smith, these works could finance themselves and therefore there is no reason to forbid competition and their private production.

1.2 Price signals and the production of public works

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

"When high roads, bridges, canals etc. are in this manner made and supported by the commerce which is carried on by means of them, they can be made only where that commerce requires them, and consequently where it is proper to make them."15

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

14 Ibid., p. 727.
15 Ibid. p. 725.
"(a) magnificent high road cannot be made through a desert country where there is little or no commerce, or merely because it happens to lead to the country villa of the intendant of the province (...). A great bridge cannot be thrown over a river at a place where nobody passes, or merely to embellish the view from the windows of a neighbouring palace: things which sometimes happen, in countries where works of this kind are carried on by any other revenue than that which they themselves are capable of affording."\(^{16}\)

What we see is that the meaning of public works is simply that these goods are consumed by several persons in common. There is no reference to non-rivalry or non-excludability as modern public goods theory pretends.

2. Capital markets and public institutions

A second problem is that public works needed lots of capital. That’s precisely the role of public institutions which are discussed in this part of the WN.

2.1 The legal nature of public institutions

Smith opposed public institutions to "private companies" or "private partnerships". It seems easy for modern readers to understand public institutions as government-run entities. But in the context of industrial organization at the time, public institutions had a different meaning for Smith. As a matter of fact, the very distinction between "public" and "private" is not based on the distinction between state property and private property, between government-run enterprises and private firms (see Table 1).

\(^{16}\) Ibid.
Table 1: Institutional aspects of the distinction « public / private » for Smith

<table>
<thead>
<tr>
<th>Type of institution</th>
<th>Type of responsibility</th>
<th>Type of entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>« Public »</td>
<td>Limited liability</td>
<td>Corporate Legal Bodies (Artificial Persons)</td>
</tr>
<tr>
<td>« Private »</td>
<td>Unlimited liability</td>
<td>Natural Persons (Partnerships of natural persons)</td>
</tr>
</tbody>
</table>

It is based on a legal distinction between big private corporations and small private, most of the time family, firms. The essential difference between them was twofold.

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

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

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

"in a private copartnery, each partner is bound for the debts contracted by the company to the whole extent of his fortune. In a joint stock, on the contrary, each partner is bound only to the extent of his share."\(^{17}\)

\(^{17}\) Ibid., pp. 740-741.
In this perspective, contrary to members in partnerships, "no member (of the joint stock companies) can demand payment of his share from the company; but each member can without their consent (of the other members), transfer his share to another person, and thereby introduce a new member."\(^\text{18}\)

Thus, the third duty of the sovereign was supposed to allow the constitution of private joint stock companies, an institution whose existence was entirely dependent on the state. Modern legal procedures which allow their easy creation didn't exist at the time. As West wrote: "The key historical fact is that in Smith's time large groups of individuals were so hindered by the absence of an appropriate variety of legal instruments with limited liability that much needed capital markets were blocked".\(^\text{19}\) That remained the case until the mid 19th century, when legislation was enacted to make their creation easier, with the Joint Stock Company Act in 1844, the Limited Liability Act in 1855 and with the comprehensive Companies Act in 1862.\(^\text{20}\) Before that legislation there were 165 canal acts submitted to Parliament between 1758 and 1803 just in order to build canals.\(^\text{21}\)

### 2.2 Advantages and inefficiencies of public institutions in Smith’s view

It is in discussing the 3rd duty that Smith analyzes the advantages and inefficiencies of joint stock companies. They didn’t fare well in the opinion of writers at the time. Even the Scottish economist advised against their establishment because of their exclusive and monopoly privileges usually granted by the sovereign (being thus detrimental to competition and

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\(^\text{18}\) Ibid., p. 740.
\(^\text{19}\) West-1977, pp. 6-7
\(^\text{21}\) Ibid., p. 40.
consumers in his view). The managers of such companies might also neglect to run them well because they were managing the shareholders' capitals and not their own.

"The directors of such companies, however, being the managers rather of other people's money than that of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."²²

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

Despite these inconveniences, when economic activity required great amounts of capital, the sovereign had to accomplish his 3rd duty by establishing or incorporating private (that is "public" in the Smithian framework) joint stock companies, without exclusive privileges. How could he know which concrete situation required or not such an act from his part? Smith gives some indications:

"The only trades which it seems possible for a joint stock companies to carry on successfully, without an exclusive privilege, are those, of which all the operations are capable of being reduced to what is called a Routine, or to such a uniformity of method as admits of little or no variation."²³

²² Ibid., p. 741.
²³ Ibid., p. 756.
Two other requirements can be found in the next pages of the WN:

i) the trade must have greater utility than the utility other trades commonly have;

ii) the trade must require "greater capital than can easily be collected into a private copartnery". Smith concludes "(if) a moderate capital was sufficient, the great utility of the undertaking would not be a sufficient reason for establishing a joint stock companies; because, in this case, the demand for what it was to produce would readily and easily be supplied by private adventurers." 24

2.3 Examples of the role of public institutions

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

Thus according to Smith, "the insurers should have a very large capital. Before the establishment of the two joint stock companies for insurance in London, a list, it is said, was laid before the attorney-general, of one hundred and fifty private insurers who had failed in the course of a few years." 25 As we have just emphasized the first ones are also private insurers in modern economics’s terminology.

Banking is another activity of this kind. A very interesting anonymous paper attributed to Smith was discovered a few years ago by Gherity 26 where the distinction between public and

24 Ibid., p. 757.
25 Ibid.
26 Gherity-1993.
private banks is made very clear. For example, concerning the two "public banks" in Edinburgh.

"established by authority, the proprietors are no further bound, than to the amount of their respective shares of the bank-stock: whereas every partner of a private banking-company, is not only bound to the amount of the stock advanced, but is further liable to the whole extent of his fortune, for every obligation that is contracted. Thus the establishment by authority makes a difference very material in favour of the bank-proprietor, and as material against the public. The proprietors in all events risks no more than the stock he trades on, (...) whilst a private banking company, uncovered by any such legal protection, is obliged to interpose the whole estates, real and personal, of every of its members, in satisfaction of its engagements to the public."²⁷

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

3. Education as public good

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

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

<table>
<thead>
<tr>
<th>Institutions of education</th>
<th>Private or domestic education (good of private consumption)</th>
<th>Public education (good of collective consumption)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private institutions</td>
<td>Private institutions</td>
<td>Public institutions (incorporated entities)</td>
</tr>
<tr>
<td>(Families / private teachers)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Families cover all the costs (in money or in time spent)</td>
<td>Direct financing (Students or families pay directly the teachers)</td>
<td>Direct and/or third party financing (students, private donors, foundations, rent of land, money interest, state subsidies etc.)</td>
</tr>
</tbody>
</table>

*We have to include in the category “public institutions” the state system of education (the French system).

On the other hand, public institutions (schools, colleges, universities etc.) as incorporated bodies are opposed to private teachers (natural persons) who work on their own account.

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

Ibid., pp. 277-278.
"Those parts of education, it is to be observed, for the teaching of which there are no public institutions, are generally the best thought. (...) Were there no public institutions for education, no system, no science would be taught for which there was not some demand; or which the circumstances of the times did not render it, either necessary, or convenient, or at least fashionable to learn."^28

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

"A private teacher could never find his account in teaching (...) a science universally believed to be a mere useless and pedantick heap of sophistry and nonsens. Such systems, such sciences, can subsist no where, but in those incorporated societies for education whose prosperity and revenue are in a great measure independent of their reputation, and altogether independent of their industry."^29

Smith didn’t not have such a good opinion of public institutions in education. As in the case of other public works, he tried to introduce the price system. For him the payment of the teachers should have been made mainly by direct consumers of education. Smith was clearly in favor of a system in which the professors were paid directly by the students (without third payers).

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^29 Ibid., pp. 780-781.
"The institutions for the education of the youth may, in the same manner, furnish a revenue sufficient for defraying their own expenses. The fee or the honorary which the scholar pays to the master naturally constitutes a revenue of this kind."\(^{30}\)

However, the education system at the time may also be financed by third parties: by private donors or by private foundations (that is collective incorporated entities and, so, public institutions also in Smith’s view) through scholarships, bursaries etc. Adam Smith writes:

"(...) sometimes the public, and sometimes the piety of private founders have established many pensions, scholarships, exhibitions, bursaries etc.\(^{31}\) Some elements may be found in a similar quote about what "public" means: it’s about "the charitable foundations of scholarships, exhibitions, bursaries etc.\(^{32}\)"

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

– in some, the professors were paid mainly by the students (Scotland);

– in others by the revenues of rent (Oxford), or by the money interest of a sum given by private donors, by charitable foundations, or by the sovereign;

– Smith is aware that education could also be financed by state subsidies. That was the case for state universities in France at the time. But that was for him the worst solution.

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

\(^{30}\) Ibid. pp. 758-759.

\(^{31}\) Ibid., p. 146.
“Whoever has attended for any considerable time to the administration of a French university, must have had occasion to remark the effects which naturally result from an arbitrary and extraneous jurisdiction of this kind”.33

Conclusion

Modern private joint stock companies and private universities and colleges would be considered public institutions by Smith. He didn’t invent the public goods concept and didn’t make the state responsible to supply them. This sheds a new light on the third duty of the sovereign, which is essentially a constitutional duty of property rights attribution and incorporating limited-liability companies in order to bring about a better functioning of the market process. Finally, in this perspective the 3rd duty turns out to be also much more compatible with the classical liberal laissez-faire tradition.

References:


32 Ibid., p. 762.
33 Smith-1976a, p. 762.


