



# 6

## Consequences on Economic Theory

### 6.1 Time and Economics

Finally, we will try to see how this applies to economics. Hume's economics is imbued with his cyclical vision of history and institutional Darwinism. The causes or ends of work, which arise from our passions, are three: pleasure, action and indolence. In Hume's theory, the usefulness of the object suggests the pleasure and convenience the owner is willing to promote, and he feels proud of the object's relationship with himself. The spectator sympathizes with this pride of the owner and with the pleasure promoted by the object. The sympathy produced in others makes the owner have an additional pleasure or esteem. This second reflection is secondary to the original pleasure; however, it becomes one of the most important recommendations of wealth and the main reason why we want it or esteem it in others.

But economic behaviour implies not only a desire to gratify desires, but a desire to have and seek desires, without which man would fall into languor.<sup>1</sup> The value of goods depends, according to Hume,

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<sup>1</sup>Lapidus in Ege and Igersheim (2012, 218).

on utility—only supply and demand affect prices—but, together with Hume’s doctrine of human behaviour, we could better call his theory “utility of labour”. If the vanity of the search for pleasure leaves a void in man, however, there is a genuine pleasure, work, so that other pleasures are a reward for the work done. Economic activity for Hume is intrinsically rewarding and the biggest obstacles to meeting the needs often generate an expansion of effort. Hume was transforming the mercantilist interpretation of the relationship between laziness and an excessive indulgence to pleasure. While the mercantilists considered the indulgence to pleasure like the pleasure for laziness, Hume takes it as a frustration, the attempt to compensate through pleasure the desire of liveliness that results from inaction.<sup>2</sup>

In some things, Hume followed mercantilist theory. For example, he held the belief that the increase in the tax burden increases the capacity of the individual to support it and the industriousness of workers, who want to maintain their previous standard of living. The lack of importance that Hume gave to the desire for gain as a work incentive, coupled with his claim that man intrinsically possesses a desire for action that takes him out of natural languor, led him to accept the mercantilist idea of an “optimal level of frustration”.<sup>3</sup>

For Hume, man is determined by circumstances and custom. In fact, Hume’s method is historical, because his concept of freedom prevents him from following a non-causal linearity. Although Hume introduces other perspectives, it is true that for him the historical perspective plays a dominant role. He was mainly recognized for his achievements as a historian.<sup>4</sup> But Hume is not so interested in the question of how the social order arises as, by relating history and psychology, what elements of human nature can contribute to demolish or maintain it, giving special importance to the role of selfishness and altruism in its maintenance.<sup>5</sup> It is a consequence of his philosophy based on the fear of

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<sup>2</sup>Rotwein (1970).

<sup>3</sup>Hume (1964c), *Of Money*.

<sup>4</sup>Teggart (1925, 87).

<sup>5</sup>Tasset (1999, 150).

disappearance of civil society by which he morally justifies the “existing” institutions. This historicity is posed in the form of an intergenerational transmission; therefore, history is descriptive and transmits ways of thinking and acting that one generation “imposes” on another. For example, Hume considered that misery and populousness are not due to nature, as in the later theory of Malthus, but to institutions.<sup>6</sup>

To analyse the relationship between historicity and economy, let us take the example of the interest rate. Hume tried to show that this was not a monetary phenomenon and that wealth is a cause, not a consequence, of its reduction. But due to his historical methodology and its concept of “habituated” freedom, he was more concerned to show that supply and demand are in themselves conditioned by the change in economic motivation caused by the development of trade. His theory of interest, in fact, proves that the phenomenon is reducible to changes in manners and customs, an argument that forces us to accept that the interest rate can be used as an instrument of economic policy.<sup>7</sup>

Likewise, in *Of Public Credit*, the historical and psychological perspective also predominates. Echoing Cicero, he makes a pessimistic prediction regarding the inevitability of the rise and fall of governments by excessive public debt, albeit optimistic about the inevitability of its resurgence.<sup>8</sup> Hume also offers a forecast for the period that follows the collapse that shows his cyclical vision of history. Men, forgetful of the past, make time and again the same mistakes and, seeking public admiration, enter a circle of power. Indeed, his theory of action by action, as well as the historical and psychological methodology and his institutional Darwinism, is embedded in all his writings.<sup>9</sup>

For Hume, on the other hand, the development of industry leads to greater mental development. Mandeville, Harris and Josiah Tucker; Ferguson and Hutcheson also highlighted the importance of the division of labour for development. For Hume, in *Of the First Principles*

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<sup>6</sup>Hume (1964c), *Of the Populousness of Ancient Nations*.

<sup>7</sup>Trincado (2005).

<sup>8</sup>Henderson (2010, 159).

<sup>9</sup>Paganelli (2012).

of *Government*, government is a result of a process of division of social labour in which a human group is specifically assigned the task of maintaining order and reciprocal cooperation.<sup>10</sup> Hume thinks it inadvisable to have a system of repression of the individual in favour of the collective, but he does look for a channelling and directing system towards interpersonal social passions. To do this, an élite must be constituted which, in addition to observing the rules of justice themselves, guarantee that others comply with them. Therefore, the maintenance of stability, especially in complex societies, requires the creation of an organizing and stabilizing order that has the essential function of providing incentives to individual behaviour, usually of short-sightedness, orienting it to long-term interests.<sup>11</sup> Thus, starting from its philosophical bases, Hume's treatment approaches a favourable vision of the role of government in society and in economy. However, the volubility of the image of merit, the mutability of human action, and the subjectivism of Hume's theory makes information about human action too uncertain for it to be easy to be imposed from the outside.

Adam Smith, on the other hand, tends to withdraw the historical and psychological influences of his treatment of the theoretical issues of economic policy. This is closely related to the Smithian idea of natural freedom. Smith's psychology is not so closely linked with his economic theory as in the case of Hume. Hume, with the historical and psychological method, tried to assess which social policies were the most acceptable according to the criterion of "utility" or survival. For Smith, natural liberty in the present is beyond the idea of utility. For that reason, he has an essential distrust of political decision-making.<sup>12</sup>

Smith considered his book on economics, *Wealth of Nations*, a continuation of his moral theory, developed in the *Theory of Moral Sentiments*. At the end of the 6th edition of the TMS he promises another book on law and government, and says that he has already partially made that promise with the WN. The economic man of the *Wealth of Nations*

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<sup>10</sup>Hume (1964d).

<sup>11</sup>Tasset (1999, 234–235 and 247).

<sup>12</sup>Mueller (2014), who argues against Stigler (1971) or Rothschild (2002).

does not contradict the ethical man of the TMS.<sup>13</sup> But, de facto, Smith decided to detach the theories without performing cross-referencing, thereby failing to take advantage of the publishing success of both books. As Pack says, Smith's theological basis does not affect his economics either.<sup>14</sup> The fact that the value of goods depends, according to Smith, on the cost makes it objective enough so that he did not need to examine subjective psychological elements or lateral historical instincts. In Smith, the "natural" is opposed to the "historical". Although custom influences moral feelings, economics can disengage from them. Men are not determined by history or convention.<sup>15</sup>

Considering, as Smith does, the value of commodities as labour commanded is applying the moral term of empathizing sympathy or "having realized" to the economics' realm: when we say a person has discovered how much a thing is worth we are in effect speaking of its objective value, not of something subjective or relativistic related to his unaccountable pleasure. When the person realizes the value of something, he/she has sewn together for the first time the various relationships of ideas that will lead him to "realize" the meaning of each one of the minutes of work and experience required to produce an object.<sup>16</sup> As we have said above, in many cases the capacity for intuitive understanding is obstructed because really "we do not want to understand". There is a value that is difficult for people to keep in mind: the passing and harnessing of time, together with the power of saving and risking those savings.<sup>17</sup> Lastly, the landowner seeks, at least, the same income that is paid to his neighbours for their soil, with alternative uses. So, value is an institution defined in terms of institutional effort which commodities can command. It is a function of the sacrifice that the buyer avoids and imposes on others, which is therefore based on externality and attaches its importance to the spectator in economics also.<sup>18</sup> This spectator can

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<sup>13</sup>Grapp (1948), Macfie (1967), and Macfie (1959).

<sup>14</sup>Pack (1995) and Rothschild (2002).

<sup>15</sup>Griswold (1999, 349–354).

<sup>16</sup>Smith (1976b), WN I.vi.4–9, 65–68.

<sup>17</sup>Smith (1976b), WN II.iii.16–20, 337–339.

<sup>18</sup>Smith (1976b), WN I.v.1–3, 47–48.

be seen “in the mirror of the market” and is therefore something real and objective.<sup>19</sup> For instance, although it might not cause them any worries, we could calculate the productivity of the appropriation of the land by comparing the status of the lands in private hands with land not privately held.<sup>20</sup>

Ricardo thought that Smith had crossed the line into confusion between embodied and commanded labour.<sup>21</sup> But, for Smith, the labour embodied at the moment in which a commodity is created is already forgotten about. Value-cost requires paying attention to the market and is “a certain command... over all the produce of labour which is then in the market”.<sup>22</sup> The idea of value comes from the “labour which we exchange for what is supposed at the time [‘in the present’] to contain the value of an equal quantity”.<sup>23</sup> This implies that utility is not an exogenous pleasure that determines its value, but rather an endogenous one that depends on how it compares with other goods in the market. Thus, this makes economics abandon self-contemplation and subjectivity. Demand is not a function of price but the amount of a product that was able to be sold established after price determination.<sup>24</sup>

As against utilitarianism, for Smith men are not *homo economicus*. This term “economic man” was used by Bentham for the first time in the early nineteenth century when he describes action in maximization terms.<sup>25</sup> Afterwards, critics of John Stuart Mill stressed the idea.<sup>26</sup> But for Smith, people do not make judgements as a maximization of their subjectively defined ends; rather they try to better their condition or they reciprocate through the propensity to truck, barter and exchange one thing for another. In modern ethics, the concept of “homo reciprocans” has been forged to make a contrast with individual

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<sup>19</sup>Smith (1976b), WN I.xi.1–9, 160–162.

<sup>20</sup>Smith (1976b), WN III.ii.

<sup>21</sup>Ricardo (1817, 6–11).

<sup>22</sup>Smith (1976b), WN I.v.3, 48.

<sup>23</sup>Smith (1976b), WN I.v.2, 47–48.

<sup>24</sup>Urrutia (1983, 19).

<sup>25</sup>Stark (1954), *The Psychology of Economic Man*, 435.

<sup>26</sup>Mill (1836).

utilitarianism.<sup>27</sup> Besides, there is an emphasis made on intrinsic versus extrinsic motivation.<sup>28</sup> According to Adam Smith, regarding moral sentiments, we may reciprocate with an image of ourselves that represents what others may expect from our actions. Actually, as we have seen, for Smith, the search for utility is love of the system.<sup>29</sup> In addition, the rules of custom cannot be the basis of morality: as Smith says, a friend who thanks for obligation, as in a rule of religion that professes, although we approve, we will not appreciate it as much as if he did so because he truly enjoys the intimate feeling of companionship with us.

In some sense, the economic theories of Hume and Smith even rely on different “protagonists”. We could define the protagonist of Smith’s economic theory as the “ethical man” of Kierkegaard; that of Hume is the “aesthetic man”, according to the terminology of the aforementioned philosopher.<sup>30</sup> The ethical man assumes duties of a lifetime, which admit no exceptions. He is the prudent man of Smith, who does not value things for his individual whim but for what they “really are worth”, that is, for what they cost to society. However, the only goal of the “aesthetic man” is satisfaction and, to avoid pain and boredom, he always flies towards new satisfactions. According to Kierkegaard, it is a state of permanent dissatisfaction. The protagonist of Hume’s theory seeks activities that make him forget his melancholic state. He is an inactive man but, contradictorily, very active (or reactive), as he “works for the sake of working” as this gives him the privilege of not thinking. As the aesthetic is a momentary state, it seems to be a less solid basis for science. For that reason, Hume relies on statistical methods, as a theory based on the aesthetic man is necessarily bound to explain parallel and irregular states, in a certain way exceptional. Actually, Hume considered that the indeterminacy of human behaviour can make any political prediction impossible.<sup>31</sup> Any explanation is timeless or can be

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<sup>27</sup>Godelier (1999).

<sup>28</sup>See Frey (1992) and Caruso (2012).

<sup>29</sup>Smith (1976a), TMS: 11: 1: 326–329.

<sup>30</sup>Kierkegaard (1965).

<sup>31</sup>Stewart (1977, 172–173) and Tasset (1999, 146).

reconstructed as timeless without loss of information.<sup>32</sup> According to Urrutia, an explanation requires the concept of equilibrium that makes us think of all reality as an “eternal present” (in his own words).<sup>33</sup> And, indeed, the long-term methodology of Smith moderates the fatigue and caprices of time, introducing us in a movement without friction.

## 6.2 Language and Economics

Their different concepts of language also affect Hume’s and Smith’s idea of the value of commodities.<sup>34</sup> As we have said, the final goal of Hume’s economics seems to be to explain “how a common world is created from private and subjective elements”,<sup>35</sup> which coincides with the goal of explaining the first formation of languages. Here Hume permeates his phenomenalist philosophy: man can only know the impressions perceived, which are subjective and changing. But the theory of perception by impressions, in social science, ends up defending an institutional Darwinism and suffers from the fear of the disappearance of civil society. It might seem that this relativistic view should advise caution in offering generalizations in economics. However, in contradiction to the alleged individual indeterminacy of passion, Hume affirms regarding the force of laws and government that the determination of politics over the passions of the masses leads to consequences almost as general and certain as those of mathematics.<sup>36</sup> In social sciences, he affirmed the law of large numbers and, thus, Hume says that what arises from the greatest number can be considered produced by certain causes.<sup>37</sup> Actually, Hume tried to show that there were habitual effects on the changing environmental forces that can be reduced to well-defined historical laws of behaviour. Schabas argues that for Hume phenomena such as money

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<sup>32</sup>Urrutia and Grafe (1982).

<sup>33</sup>See Urrutia (1983, 148).

<sup>34</sup>For language and Rhetoric in economics, see MacCloskey (1985, 1994) and Otteson (2002a).

<sup>35</sup>Tasset (1999, 182).

<sup>36</sup>Hume (1964a, 99, 288).

<sup>37</sup>Hume (1964a, 175).



and prices need to be related to the constitution of men, climates and soils.<sup>38</sup> The joining together of psychology and history would allow him to describe a human world, which the legislator had to leave intact so as not to produce revolutions that broke existing relations.<sup>39</sup> However, in Hume's explanations at certain times he seems to be giving primacy to the static point of view of the psychologist against the dynamic of the historian. In fact, the scholarship claims that the moral and political philosophy of Hume is mechanistic, uniformist and ahistorical. According to Black, the motives of action are always qualitatively the same, so history is nothing but an incessant repetition of the same.<sup>40</sup>

Adam Smith develops a discursive and demonstrative method in economics, based on logic, but away from the modelling, as models often try to obscure what can be easy. Smith says that the Physiocrats had followers because they were men "fond of paradoxes, and of appearing to understand what surpasses the comprehension of ordinary people".<sup>41</sup> Not even the existing data are very revealing, given that they require the process of language reductionism, whether encrypted or not. "I do not have much faith in political arithmetic and I do not intend to ensure the accuracy of this data",<sup>42</sup> Smith says about Charles Smith's calculation of the ratio between the average quantity of grains imported by Great Britain and the grains consumed. Neither does Smith consider mathematics useful: this science was not developed by a consideration of its usefulness, but because we admire its beauty or precision. According to Brady, Adam Smith also rejected the use of the mathematical laws of the calculus of probabilities and the classical interpretation of La Place and the Bernoulli brothers, and the personalist, subjectivist, psychological Bayesian approach used by neoclassical schools of thought. Adam Smith recognized that the mathematical concept of probability is not applicable, in general, in real-world decision-making.<sup>43</sup>

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<sup>38</sup>Schabas (2001).

<sup>39</sup>Hume (1964b, 292).

<sup>40</sup>Forbes (1975, 102).

<sup>41</sup>Smith (1980, 75).

<sup>42</sup>Smith (1976b, 577).

<sup>43</sup>Brady (2013).

That is to say, Smith uses a hypothetico-deductive method with an empirical testing; and for Smith, the economic dissertation does not necessarily seek utility, but the description of reality. West considers that Smith was addressing the constitution builders, but with his criticism of legislators, Smith shows that he was only in search for objectivity: he intended to address the general public to criticize the mercantile system and create confidence in freedom.<sup>44</sup> This, obviously, could be a basis for a critical stance of modern formalism in economics, which tries to remove the language of economics from common people's understanding to show off an unnecessary rhetorical difficulty.

It is evident, however, that there is a connection between *Lectures on Rhetoric and Belles Lettres* and the *Wealth of Nations*. Its attack on mercantilism was influenced by compositional conventions presented by Smith in the former.<sup>45</sup> There, the division of labour and the metaphor of the pin factory is a key literary metaphor of self-contained management.<sup>46</sup> It was a tiny tool that was a promise of progress and that has even been related to women's liberation, as allusions to pins and needles, sewing and knitting, tended to bear a negative relationship to the picture of domestic bliss which they evoke.<sup>47</sup> Arguments were used although sometimes it seems clear that rhetoric was against logical effects.<sup>48</sup> Also, the metaphor of the invisible hand took on a life of its own and now has little to do with Adam Smith's original meaning.<sup>49</sup>

### 6.3 Economic Growth

Hume's action in the economic sphere is based on three different motives: action for its own sake, habit and imitation. The first two, action and habit, can be considered constant in time. Therefore,

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<sup>44</sup>West (1976).

<sup>45</sup>Endres (1991).

<sup>46</sup>Harskamp (2010, 191).

<sup>47</sup>Harskamp (2010).

<sup>48</sup>Peaucelle (2012).

<sup>49</sup>Kennedy (2009, 2011).

imitation must be the one that promotes the differential growth between historical stages, stimulating the spirit of enterprise or the imitative demand. Here we find a contradiction, given that Hume says that moral judgement depends on the agent's usual behaviour, which reminds us of the difficulty of directing attention to something new. In addition, imitation seems more of a consequence than a cause of action, since it needs a reflection on what it imitates. This objection is the same as the one made with the Humean concept of the self: certainly, the mirror of the self cannot be the self.

Then, the enjoyment of "pleasures" is for Hume an additional element of action that seems to be the consequence of the search for wealth. For instance, Hume treats imitation in the thread of the luxury controversy, typical of his time.<sup>50</sup> Desire for consumption operates as an instrumental end that makes economic activity a vehicle for the desire for action. Man wishes to gratify his desires, but this is because he enjoys the emotional excitement of having desires. So, contradictorily, he wishes not to gratify his desires because tranquillity is painful.

This implies another differential element between Hume and Smith: for Smith, the positive consequence of the creation of wealth is not that it increases the amount of "happiness" to which money gives access, but the very fact of the possibility of "breaking" the habit enjoying the feeling of curiosity and creation. "The progressive state is in reality the cheerful and the hearty state to all the different orders of society. The stationary is dull; the declining, melancholy".<sup>51</sup> Smith contrasts joy with melancholy, that is, curiosity towards the future to attachment to memory. As we have said, the feeling of joy in the economic area is based on the natural impulse of everyone to better their own condition, the means that normal man uses to get out of the state of "passivity" of the passions. But, as Bréban argues, adverse and prosperous events are only short-term shocks, so if in TMS an individual's level of happiness tends towards the one of his "ordinary state of happiness" (nowadays

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<sup>50</sup>Tufts and Thompson (1904).

<sup>51</sup>Smith (1976b), WN I.viii.43, 99.

we would say “hedonic adaptation”), short-term market prices also tend towards long-term natural prices.<sup>52</sup>

The impulse to better our condition does not seek the satisfaction of pleasure, but man tries to become the centre of attention for his wealth. “What interests us is vanity, not tranquillity or pleasure”.<sup>53</sup> This feeling also depends on the prideful image of having brought another over to one’s own side through verbal seduction,<sup>54</sup> something which is not always morally laudable. Although in WN Smith does not criticize the propensity to barter, in his *Lectures on Jurisprudence* he says that “To perform anything, or to give anything, without a reward is always generous and noble, but to barter one thing for another is mean”.<sup>55</sup> So, the impartial spectator does not necessarily approve of the causes of economic growth.<sup>56</sup> But the idea of a benevolent state is also an unconscious image that absorbs the energies of the anxious man and forces people into vicious circles.

For instance, capitalists “can never be multiplied so as to hurt the public, though they may so as to hurt one another”.<sup>57</sup> Besides, for Smith we want to improve our condition to maintain a social status,<sup>58</sup> sometimes based on a painful fear ratified by the stimulus of the spectator.<sup>59</sup> Nor is this worthy of praise: “An augmentation of fortune is the means by which the greater part of men propose and wish to better their condition. It is the means the most vulgar and the most obvious”,<sup>60</sup> but which is a consequence of the psychological need to break the habit and the excess of specialization, which leads to workers having ambition and encourages them to work more the higher the wages are. On occasion, competition

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<sup>52</sup>Bréban (2014).

<sup>53</sup>Smith (1976a, 124).

<sup>54</sup>Smith (1976b), WN I.ii.2, 25 and Fleischacker (2004, 90–95) on butcher/baker’s passage.

<sup>55</sup>Smith (1978), LJ 527.

<sup>56</sup>See Smith (1976b), WN II.iii, 42. For a different conclusion, Young (1997).

<sup>57</sup>Smith (1976b), II.V, 7.

<sup>58</sup>Smith (1976a), VI.ii.1.16–20, 224–226.

<sup>59</sup>See Lerner (1999) and Otteson (2002b).

<sup>60</sup>Smith (1976b, 341–342).

hurts workers when it obliges them to work to exhaustion<sup>61</sup> or leads them to suffer from “torpor of mind”.<sup>62</sup> Smith complains about the mercantile system’s “production for production’s sake”.<sup>63</sup> The ethic of work for work’s sake is contrary to the principle of prudence.<sup>64</sup> Nevertheless, continuous growth is necessary to unleash rivalry between captains of industry.

All these economic illusions allow us to feel a temporal continuity of time. For Smith only growth takes man out of the subsistence state; he considered that men are prudent, and their own nature leads them to have an idea of the future, the basis for illusion although illusion can also be deceptive. A rich country is joyful because, since subsistence is assured for all its inhabitants, creative capacity is released, not being frightened by subsistence crises. “The rich man consumes no more food than his poor neighbour... The desire of food is limited in every man by the narrow capacity of the human stomach”.<sup>65</sup> Then, in the WN, Smith gives up the idea of abundance that the State must “encourage” (which he defended in his *Lectures on Jurisprudence* of 1762–1766) to move on to the economic growth which the State must “allow”. The use of history allows Hume to introduce a long-term perspective; however, Hume continues to speak of wealth as a stock, not as a flow. China according to him is represented as one of the most flourishing empires in the world, although it developed little trade beyond its territories.<sup>66</sup> This contrasts with Smith’s consideration that China, despite its abundance, was poor, in a stationary state and with workers who earned low wages.<sup>67</sup> According to Smith, for the economy to overcome a situation of poverty it is not enough to have accumulated capital: we need a continuous growth that raises wages.<sup>68</sup> This is mainly based on his natural

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<sup>61</sup>Smith (1976b), WN I.viii.13, 84.

<sup>62</sup>Smith (1976b), WN V.i.f.50, 782.

<sup>63</sup>Smith (1976b), WN IV.viii.48–49, 660.

<sup>64</sup>Smith (1976b), WN I.viii.44, 100.

<sup>65</sup>Smith (1978, 194; 1976b, I.xi,c, 181; 1976a, 332–333).

<sup>66</sup>Hume (1964b, 296).

<sup>67</sup>See Dodds (2018).

<sup>68</sup>See Wood (1890).

price of labour theory with a rising secular trend.<sup>69</sup> It gives the short-term labour supply curve a positive slope.<sup>70</sup> Growth is based then on the ability to produce goods in a fluid way, which leads to an inflation of profits, which competes for workers, and deepens the system of distribution of wealth.

The difference between the two theories of Hume and Smith, then, is that the WN is a study of growth under the assumption that there is a natural desire for freedom; while for Hume man is determined by environmental forces. Hume raised the problem of growth from the sceptical perspective of the survival of society, while Smith's vision is more optimistic. Hume attempts to morally justify "existing" institutions from a certain fear of change; Smith, campaigns for freeing the maximum creative capacity of men.

For Smith, the wealth of nations requires that there be no oppression and that there is certain stability in property. Then, there will be a creative flow, which depends on work, physical and human capital and the institutions that preserve both. Wealth is not stock but institutional effort—labour that we do not need to do but that we may command from others. In this sense, labour from others is always positive for me, wealth of someone never entails the poverty of others if it is not used in terms of political power. Governments and institutions are responsible for poverty, not God or other people that are fond of living an active life.<sup>71</sup> Also, for the definition of economic growth, the difference between productive and unproductive work is fundamental: in underdeveloped countries, work does not contribute to the economic system reinforcing its self-sustainability and the elements that could be used as productive instruments in the future remain. Therefore, Malthusian mechanisms of procreation and death will appear.<sup>72</sup> Smith's growth occurs thanks to the increasing productivity result of the division of labour, with progress in one sector being a prerequisite for progress in others.<sup>73</sup>

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<sup>69</sup>Blaug (1985, 73–74).

<sup>70</sup>Marshall (1998).

<sup>71</sup>See Rodríguez Braun (1998) and Schoeck (1987).

<sup>72</sup>Prasch (1991).

<sup>73</sup>Reid (1987).

The greatest contrast between Hume and Smith lies in their different treatment of capital accumulation. Hume considers that growth depends on the intensity of the effective desire for savings from the feudal state with idle landlords and oppressed peasants to the mercantile economy of his own time.<sup>74</sup> Hume's preference for the middle class is evident in his work. He argues that the best position in life is the middle class, given that the rich are lost between pleasures and the poor among needs. Classes are understood as psychological categories of their members. The middle class is the best position to be able to acquire virtue, wisdom and happiness. The active middle class is the most useful. Lords, landowners, are indolent and seekers of pleasure; peasants are ignorant and unambitious and traders or middle class can be frugal and active. Trade is positive because of its sociological effect of creating the middle class and therefore economic development. The new merchants rival the old nobility. Foreign trade makes the pleasures of luxury known and, making the desire for a better way of life emerge, it takes men out of their indolence by desire for emulation.<sup>75</sup>

Then, Hume treats the spirit of the age as a differential element of historical periods, while Smith seems to consider it universal, and he does so even in the parts of the analysis that are related to historical sequence. So, his historical analysis consists more in an exemplification of his deductive theories than in the facts of which he pretends to induce his theories, the opposite of Hume's methodology. Smith bases the motivation of economic action on an inborn propensity to truck, and he does not look for that motivation in historical analysis. He assumes a persistence of an industry spirit and argues that the first development of trade is achieved after an institutional break. In what appears to be a rejection of Hume's position on universalist grounds,<sup>76</sup> Smith argues that there is no reason why all groups are not always equally frugal, because people are based on a

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<sup>74</sup>Skinner (1993).

<sup>75</sup>History of England 4, 384. See Wennerlind (2002).

<sup>76</sup>Rotwein (1970, 109). See also Hayek (1963) and more recently Berry (1997, 68–70).

universal, continual, and uninterrupted effort to better their own condition. It is this effort, protected by law and allowed by liberty to exert itself in the manner that is most advantageous, which has maintained the progress of England towards opulence and improvement in almost all former times, and which, it is to be hoped, will do so in all future times.<sup>77</sup>

There are cases in Smith where general history is important, for example, on the issue of public debt or free trade, but even in this case, he does not refer to historical influences. In the same way, although his monetary theory contains historical material, it is of an analytical nature and he does not develop, like Hume, a discussion of the development of a monetary economy. So, it is necessary to adjust the legislation to the interests and temperament of the times, but habits and prejudices are presented only as a hindrance.<sup>78</sup> This is quite important given that, for example, for Smith, we can predict that the absence of an ethic of hard work, frugality and reinvestment is not the cause of underdevelopment. As Bauer says, these attitudes are not a guarantee of development if they are expressed in a political economy that systematically hampers the accumulation of capital.<sup>79</sup>

## 6.4 Money Issues

A final, and paradigmatic, debate between Hume and Smith is the money issue.<sup>80</sup> For Smith, the confusion between stock and flow arises from the false identification between wealth (purchasing power) and an increase in the amount of money. Two main issues show how Hume and Smith's money theories contrast: the specie-flow mechanism and

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<sup>77</sup>Smith (1976b, 345): Book II: Chapter III. This argument is to be found in different places of the WN 99, 139, 285, 341, 374–375, 405, 454, 455, 540, 674, 718.

<sup>78</sup>Smith (1976b, 573): Book IV: Chapter V.

<sup>79</sup>See Harris (1983, 379).

<sup>80</sup>See Trincado (2005).



the question of bank-notes issuance. Briefly, Smith neglected to refer to Hume's specie-flow mechanism because, although at first this self-regulating system was intended to refute the mercantilist defence of money accumulation, finally Hume had to defend the non-neutrality of money. Hume argued for the "non" neutrality of money and arbitrated new ways of artificial incentive to action. As Humphrey says, in Hume's case, non-neutrality of money is due to the inflexibility of some prices creating an additional real expenditure in a short-run inflation context, as unemployed labour is willing to work at present wages.<sup>81</sup> With regard to note issuing, Smith proposed free-banking, whereas Hume, in the last analysis, defended the existence of a public bank that should restrict issuance. According to Smith, the overissue of money is due in general to the action of government. Money reduces transaction costs, but it only does so if it rises above circulation channels, as a way of allowing—not forcing—economic creation. Currency competition is the only means of being able to choose for trustful currencies. Smith's libertarian philosophy has, therefore, a determining influence on moulding his monetary theory.

In Hume's time, literature on monetary issues had both mercantilist and classical elements: the intrinsic desirability of money was key, but an increase in the quantity of money was considered to be a cause of inflation. Hume, at first, shows a preference for the classical view. But, as soon as he introduces his historical method and concentrates on the monetary meaning of a greater population and industry, or on the change of habits related with them, he ends up defending money productivity. Hume officially formulates his quantitative version of the specie-flow mechanism in *Of the Balance of Trade*. The famous argument posits that the quantity of metal in different trading nations tends automatically to an equilibrium in a gold standard. It is through the effects on the price level and the following increase or decrease in exports and imports. Hume's thinking was based on three assumptions: that the quantity of money is a determining factor in establishing the price level; that the volume of exports and imports affects internal and external

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<sup>81</sup>Humphrey (1991).

relative level prices; and that the difference between the international balance of payments between nations must be paid for in metal. These three assumptions combined develop the theory of a self-regulating system of international distribution of cash that completely weakens the mercantilist objective of seeking gold as wealth.

But, although Hume attached great importance to the mechanism part of the doctrine, from the outset he linked the argument with the question of economic growth. Hume considered price levels to be determined by the proportion of metals “with respect to” industry and capacities in the long run (by industry, Hume meant the level of economic development). He did not deny that the withdrawal of metal would be negative for a country, and he objected to the use of paper money because gold and silver would be in danger of being lost. What he intended to solve was a problem of causality: an increase in population and not the prohibition of imports is the cause of the growth of the quantity of money; but if we manage to increase the quantity of money, we could, at least in the short term, increase wealth through alterations in relative prices. If an increase in the quantity of money affects prices of some sectors more than that of others, it would encourage transactions and credit and increase demand for money, that is to say, its rate of circulation. The adjustment theory stops making sense if the new metal accumulates. In a letter to Oswald, Hume says:

I never meant to say that money, in all countries which communicate, must necessarily be on a level, but only on a level proportioned to their people, industry and commodities... I agree with you, that the increase of money, if not too sudden, naturally increases people and industry, and by that means may retain itself; but if it do not produce such an increase, nothing will retain except hoarding.<sup>82</sup>

Hume intended to demonstrate his vital cycle of wealth theory that foresaw a limit to the possibilities of growth. As with other subjects he tackles, he sought the psychological and moral elements that could contribute to demolishing society to defend the conservation of the ones

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<sup>82</sup>Letter from Hume to Oswald, November 1, 1750, in Rotwein (1970, 197–198).

that help to maintain it, in this case giving importance to the role of the selfishness of a rich country that wants to hoard all wealth. The wealthy country, with the greatest demand and increasing prices, loses its leadership over poor nations with decreasing prices. Answering Josiah Tucker, Hume says in a letter to Lord Kames, March 4, 1758:

All the advantages which the author insists upon as belonging to a nation of extensive commerce, are undoubtedly real... The question is whether these advantages can go on, increasing trade in infinitum, or whether they do not at last come to a ne plus ultra.<sup>83</sup>

Hume specifies among these disadvantages the high price of provisions and labour, which enables the poorer country to rival the industry of the rich country. This is presented as a generalized law of growth and decadence that governs relations between all commercial nations. As Hume assures that growth opportunities will pass through one nation to other, he considers the result as “a happy concurrence of causes” that maintains international distribution of specie in an equilibrium.

But in *Of Money*, Hume comments further and more authoritatively on the emphasis of monetary process on economic growth. He takes his argument on economic development a step further to discuss the importance of the transformation from a barter economy to a monetary economy, achieved by increasing specialization and exchange. It was not the quantity of money but the more generalized use of money that should “enter into every transaction and contract”<sup>84</sup>—and the change in people’s habits, that increased the wealth and power of the state. Hume bases this idea on two arguments. Firstly, the more the money is distributed, the larger the proportion of total expenses that could be collected as taxes. This is because the capacity to increase taxes tends to vary inversely with the tax charge on each taxpayer. Second, when we replace barter with a money economy, the quantity of commodities that arrive on the market increases; either the same commodities circulate

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<sup>83</sup>Letter from Hume to Lord Kames, March 4, 1758, in Rotwein (1970, 200).

<sup>84</sup>Hume (1964c), *Of Money*: II: I: 317.

more (diminishing demand and the need for money) or the demand for money for making transactions increases. Thus, if the quantity of money remains the same, the general price level will be reduced by the greater quantity of commodities circulating. In a more developed economy, the sovereign will be better supplied not only because he can extract taxes in cash from his taxpayers, but also because he can buy and make more payments with the money he receives.

Hume also accepts the role played by exchange rates in the adjustment process. So, he establishes the arguments based on the demand for money. In this case, demand could be increased by supply regardless of the influence of a growth in supply on commerce, activity and employment. For instance, the metal flow in Western European countries since the discovery of the American mines was multiplied by a general expansion of industry because the process of exchange led to a greater quantity of money. In the intermediate period before money circulates to all the echelons of State and has its full effect in all the ranks, monetary expansion has two beneficial effects. The first is on employment. The analysis contains a detailed relation of the transmission effect in an economy enjoying full employment of resources. Hume shapes step by step the way in which the increase in the quantity of money, assuming that it initially reaches the hands of the employer, increases the demand for labour if wages have not increased, and increases employment and the output of the economy as a whole.<sup>85</sup>

Although significant, this effect is not the most important for Hume, who stresses more the sociological influence of the growth of the supply of money, which affects the “spirit of industry” in a mechanical and determinist way. Before the increase in the labour wage, money will accelerate the diligence of individuals in response to a greater demand of markets. This artificial incentive can spark individuals to action. Hume’s analysis, in short, is like the more recent literature that shows the causal relations between pecuniary incentives and the development of a monetary economy. Hume concludes that the quantity of money is

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<sup>85</sup>Hume (1964d, 313), *Of Money*.

not important for the happiness of the state, but it is important that the magistrate keeps it going.<sup>86</sup> This looks like the attitude of mercantilism that sought beneficial inflation. Hume's argument maintains the "utility of labour" mercantilist theory of value. In the end, the greater quantity of money is important. Nevertheless, Hume is showing that inflation is harmful, unlike the beneficial spirit of industry that it creates in the long run.

Finally, in the conclusions of the essay *Of the Balance of Trade*, Hume sought to justify the rejection of paper and his support of metal money as a precaution against serious alterations in money's value and, as money is for Hume the measure of all goods, in wealth. In effect, Hume showed his disagreement with the excessive extension of bank notes. But finally, he says: "We observed in Essay III ["Of Money"] that money, when increasing, gives encouragement to industry, during the interval between the increase of money and rise of the prices. A good effect of this nature may follow too from paper-credit; but it is dangerous to precipitate matters".<sup>87</sup> As the growth of paper-money affects exchanges and purchasing power parity and displaces metals, which are not necessary to circulate goods and go abroad reducing reserves, Hume, in principle, does not recommend the use of paper money. But, later, he changes his mind saying "it must, however, be confessed, that, as all these questions of trade and money are extremely complicated, there are certain lights, in which this subject may be placed, so as to represent the advantages of paper-credit and banks to be superior to their disadvantages".<sup>88</sup> He continues by asserting that it is not to be doubted that the creation of banknotes makes metal leave a country but he doubts that the advantages of metals are so important they cannot be offset by the growth of industry and credit due to the right to use paper money and bank credits.<sup>89</sup> "But", he concludes, "whatever other advantages result from these inventions, it must still be allowed that, besides

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<sup>86</sup>Heimann (1953, 45).

<sup>87</sup>Hume (1964c, 337), *Of the Balance of Trade*: II: V: Footnote 2.

<sup>88</sup>Hume (1964c, 338–339), *Of the Balance of Trade*: II: V.

<sup>89</sup>Hume (1964c, 339–340), *Of the Balance of Trade*: II: V.

giving too great facility to credit, which is dangerous, they banish the precious metals...<sup>90</sup> Finally, he trusted hierarchy to reduce transaction costs, as he said that there is no better bank than a public bank that keeps all the money it receives, and that never increases the quantity of money in circulation.<sup>91</sup> Certainly, the emphasis Hume places on historical processes in his monetary theory was, not only its most general element but also its only sound characteristic.

Adam Smith neglected to refer to Hume's specie-flow mechanism precisely because not introducing money into his analysis allowed him to maintain the central argument of his work, that is to say, that labour (not money) is the cause of progress and growth.<sup>92</sup> As Smith suggests, "Mr. Hume's reasoning (about the specie-flow mechanism) is exceedingly ingenious. He seems however to have gone a little into the notion that public opulence consists in money".<sup>93</sup> Smith was only worried about real variables in the long run. He did not distinguish between the effects of growth on the quantity of money in prices or on activity because he did not want to defend that artificial incentives could spark a person to action. According to Smith, money is "like" a capital that makes commodities move: he says that a money increase is a net income decrease.<sup>94</sup> So, ideally, a nation should develop commerce with the minimum quantity of money possible.

Smith preferred to present a monetary conception of balance of payments which neither includes the flow-specie mechanism nor the quantitative theory of money. Thus, according to Humphrey,<sup>95</sup> Smith laid the foundations of the modern balance of payments theory. Self-regulation of the market, however, continues to be the basis of the system, one of the three lessons driven by Smith's theory according to Amartya Sen (the others are the adequacy of the profit motive as the

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<sup>90</sup>Hume (1964c, 340), *Of the Balance of Trade*: II: V.

<sup>91</sup>Hume (1964d, 312), *Of Money*: II: I.

<sup>92</sup>Petrella (1968).

<sup>93</sup>Smith (1978, 507), *LJ* (B): 253.

<sup>94</sup>Smith (1976b, 371–376), *WN*: II: II.

<sup>95</sup>Humphrey (1981).

basis of rational behaviour and the adequacy of self-interest as socially productive behaviour).<sup>96</sup>

The monetary theory of balance of payments predicts that an eventual growth in the quantity of metal (not depending on the greater production of mines) does not affect prices, but temporarily causes a balance of payments deficit that diminishes until it disappears, that is to say, affects the quantity of reserves or the rate of exchange and discount of bills of exchange (although that could mean greater profits and investment in the short run). In fact, Smith objects to the accepted maxim of his time that the growth in convertible paper money necessarily increases the monetary price of commodities. In a gold-standard situation, the quantity of gold and silver withdrawn from circulation always equals that of the paper added, so paper money does not necessarily expand the total amount in circulation.

According to Smith, Hume was not correct in his statements as “In 1751 and in 1752, when Mr. Hume published his *Political Discourses*, and soon after the great multiplication of paper money in Scotland, there was a very sensible rise in the price of provisions, owing, probably, to the badness of the seasons, and not to the multiplication of paper money”.<sup>97</sup> Inflation is due to real causes, not to monetary ones. As Smith says, if mine production increases regarding that of other goods, then, like every other good, the price of gold will fall in a gold standard. Only the cost of production of goods affects relative value, taking the costs of production as the institutional effort that the good is able to command. So, if the quantity of money that can be annually employed in whatever country is determined by the value of annually consumable goods that circulate within the country; and, if production diminishes, money will be sent abroad in metal and used to buy goods, as it lacks national employment. “The exportation of gold and silver is, in this case, not the cause, but the effect of its declension, and may even, for some little time, alleviate the misery of that declension”.<sup>98</sup>

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<sup>96</sup>Sen (2011, 259).

<sup>97</sup>Smith (1978, 418), WN: 2: 2.

<sup>98</sup>Smith (1976b, 436–437), WN: 2: 3.

In disagreement with Hume's arguments, Smith defends the creation of bank notes, a cheaper means of exchange than metal.<sup>99</sup> If money is "like" a capital, if its production is made cheaper, the means of production is made cheaper, and the bank system becomes more productive. Smith also points out problems with bank-note issuance: for him, trust, and the fact that bank notes have a fixed purchasing power, as they are a measure of value, is very important.<sup>100</sup> National safety will be threatened if most of the money is issued in the form of paper or if there is a risk of a bank crisis.

But for Smith, the excessive issue of bank notes is due in general to the hierarchical action of government that imposes notes of legal tender. Although it is in the direct interest of the State to achieve monetary and bank stability, synonymous with its own stability, the State seeks to obtain a short-term profit, damaging itself in the long run. For that reason and based always on the necessary convertibility of notes to metal, Smith defended free banking, the formula developed in Scotland in the eighteenth century. In this case, different currencies, convertible by law, competed to obtain public trust, the means by which Smith thought possible to avoid excess issuing.<sup>101</sup> As the general price level is determined through the costs of production of gold relative to other goods—which constitutes its "natural price"—, Smith's analysis of substitution of specie with paper money makes his banking theory a part of his economic growth theory. A state monopoly of the issue of notes always leads to the excess of money. Public bank stability depends on that of the State, but this same advantage creates an excess of trust in the issuing of those notes of obligatory acceptance. "It acts, not only as an ordinary bank, but also as a great engine of state. In those different operations, its duty to the publick may sometimes have obliged it, without any fault of its directors, to overstock the circulation with paper money".<sup>102</sup> Conversely, the interest of private banks is to create confidence in its notes since, if they did not, they would

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<sup>99</sup>Smith (1976b, 377), WN: 2: 2.

<sup>100</sup>Smith (1976b, 377), WN: 2: 2.

<sup>101</sup>Smith (1976b), WN: II: II.

<sup>102</sup>Smith (1976b, 320), WN: II: II.



not be accepted or they would be continually replaced by gold, an additional cost for the bank that needs to maintain more metal in its coffers to satisfy eventual demands.<sup>103</sup> In consequence,

The only method to prevent the bad consequence arising from the ruin of banks is to give monopolies to none, but to encourage the erection of as many as possible. When several are established in a country, a mutual jealousy prevails... Even tho' one did break, every individual (would) have very few of its notes.<sup>104</sup>

Government protection of a system of regulated banks is also a greater source of potential instability. Smith criticizes the relief programmes during bank crises. Banks take an excessive risk because they assume the central bank will save them, bailing them out of the difficulty. The memory of bankruptcy or the possibility of bankruptcy is the only risk deterrent. Instability even has serious effects in the long run, as it affects credibility and expectations:

When any alteration is made one does not really know how much of the new coin is equal to a certain value; this necessarily embarrasses commerce. The merchant won't sell but for a very high price, being afraid of losing, and the purchaser for the same reason will not give but a very low one... It is also productive of a great deal of fraud.<sup>105</sup>

Moreover, currency devaluation reduces public faith, and nobody will lend any sum to the government, or bargain with it, as he perhaps may be paid with one half of it.<sup>106</sup> On the other hand, neither is it necessary for the State to control issuing. It is true that at a certain moment there is a correct quantity of money to satiate the "circulation channel"

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<sup>103</sup>Smith (1976b, 387–389), WN: II: II.

<sup>104</sup>Smith (1978, 505), LJ (B): 251.

<sup>105</sup>Smith (1978, 505), LJ (B): 251.

<sup>106</sup>Smith (1978, 502), LJ (B): 243: 502.

of transactions, but in most cases the growth of the quantity of money is a consequence, not a cause, of wealth. Cabrillo says that Smith did not understand the idea of demand for money or monetary balance, as the speed of circulation of money did not play a significant role in his theory, in spite of the importance that Cantillon had attributed to that concept.<sup>107</sup> But, as we see, this is really part of Smith's argument: it is not the demand for goods that affects supply but the greater division of labour, the accumulation of capital and the reduction in cost of raw materials. In the case of commodity "money" (the utility of which is to promote the circulation of other commodities), the supply of commodities determines the demand for commodities, and this, the supply of and demand for money. When money is understood as something like a real bill, the channel of circulation demands a sum of it high enough to fulfil circulation and never demands more.

As Méndez argues, increasing the quantity of notes is always beneficial as it cuts down the cost of issue "while it does not exceed the reserves available".<sup>108</sup> But, in Smith, over issuing of notes is possible, making us lose gold. When we overissue, if the lesser difficulty occurs, or there is a delay in payments, the alarm it would create will necessarily intensify the run on gold and the Central Bank will need to be continually coining and paying for the tax for coining. This happened at the beginning of the eighteenth century when John Law's actions led to a State crisis after having persuaded the French government to overissue money, as "he thought it would be a great convenience, as the government then might do what it pleased, raise armies, pay soldiers, and be at any expense whatever".<sup>109</sup>

Nevertheless, Smith proposes monetary reform to reduce transaction costs in a metallic system, saying that the issue of notes of a certain small quantity should not be allowed as a way of preventing circulation between dealers and consumers, who require little sums that move

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<sup>107</sup>Cabrillo (1976, 34).

<sup>108</sup>Méndez (1988, 83).

<sup>109</sup>Smith (1978, 515), LJ (B): 271.

quickly, be realized with notes. But he needed to justify this proposal of legislation, which “is a manifest violation of that natural liberty which it is the proper business of law, not to infringe, but to support”.<sup>110</sup> Smith concludes that if bankers are restrained from issuing any circulation bank notes, or notes payable to the bearer, for less than a certain sum and if they are subjected to the obligation of an immediate and unconditional payment of such bank notes as soon as presented, “their trade may, with safety to the publick, be rendered in all other respects perfectly free”.<sup>111</sup>

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<sup>110</sup>Smith (1976b, 416–417), WN: II: II.

<sup>111</sup>Smith (1976b, 423), WN: II: II.

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