

WAR, TRADE, AND MERCANTILISM: RECONCILING ADAM SMITH'S THREE THEORIES OF THE BRITISH EMPIRE

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Abstract. Adam Smith proposed two contradictory theories of the British Empire in the *Wealth of Nations* and suggested a third. The first view holds that the empire was created for merchants eager to establish and maintain monopolies of 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 non-incremental increases the division of labour, 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 holds that many mercantile restrictions improved Britain’s security given its long-term military competition with France. How do we reconcile the incompatibility of Smith’s three views of the British Empire? Smith provides no guidance. I argue that, to understand the British Empire, we must view it from the perspective of a long-term military rivalry with France. Many 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 compensates the loss in wealth due to the restrictions. I demonstrate the logic of these claims using tools from modern political economics and political science.

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War and Military Competition, Great Britain vs France, Wars; 1689-1715.

JEL: B10, F10, F20

As defence...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.30, 464-65).¹

"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 leaves us balanced on razor's edge, till in the last word of the last sentence" (C.R. Fay 1956, 107).

1. Introduction

How are we to understand Adam Smith's multiple views about free trade, the value to Great Britain of her empire, and mercantilism? Most Smith scholars, especially economists, consider this question closed. These scholars view him as an unqualified champion of free trade, opposed to mercantile policies designed to create an empire largely to enhance merchant profits. Yet, Smith's views on the issues of trade, mercantilism, and empire are not so straightforward (as Palen 2014 suggests). I will show that the difficulty arises because Smith proposed three distinct and somewhat contradictory theories of the British Empire in the *Wealth of Nations*.² These multiple views force us to qualify Adam Smith's support of free trade, including the ways in which his approach pushes beyond the domain of modern economic theories of international trade.

Smith's first view reflects the dominant view in the literature just noted. In this account, 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). Great Britain would be much better off abandoning the American colonies than paying for the colonies' expensive defence. Most scholars follow this portion of Smith's emphasis; and he places the most emphasis and relies on the strongest and often polemic rhetoric in espousing this view.³

In the second view, Smith celebrates the empire as affording a non-incremental increase in the extent of the market, in turn creating a non-incremental increase in the division of labour, specialization and exchange. The greater division of labour 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

¹ Note: Abbreviations of Smith's work are placed just before the references.

² Adam Smith is known for "inconsistencies" on numerous topics in his corpus. As Sowell (1979:11) puts it, Smith "was little concerned with elegance, fine points, or with appearances of consistency... he was consistent in his use of terms throughout any given chain of reasoning, so that his conclusions were unaffected by his inconsistent use of terms between one set of reasoning and another." See also Coats (1975:218), Evensky (2005, 22-23; n42), and Viner (1927:221).

³ For example, see Evensky (2015, chapter 4), Koebner (1961, 219-35), Stevens (1985, 211), Van de Haar (2013), and Winch (1996). Ekelund and Tollison (1997, especially chapter 1 & 3) take a more nuanced and political view based on the idea of "rent-seeking" in an institutional setting.

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, 18th century Britain was far richer and more industrialized because of the larger market and greater division of labour afforded by the colonies (Winch 1965, 9-11).⁴ As the division of labour is the hallmark of Smith's theory of economic growth, adherents of Smith's first view cannot simply ignore or push this aspect of Smith's views aside.

Smith makes a third argument concerning the military value of the empire to the metropole. Instead of presuming a world largely characterized by international peace, as implicit in modern international trade theory, Smith assumes a world of violent, international competition and conflict. In this violent world, many mercantile restrictions serve a valuable purpose, namely, improving Britain's security. Hont (2005, 2015), long-time student of Adam Smith, argues 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 this survival required that "**the logic of trade was bent to the logic of war**" (Hont 2005, 5-6 emphasis added). By this, Hont meant that countries had to adjust trade policy to reflect whether the countries are at war. This approach is the least well-known of the three, and Smith gives it the least attention; further, he scattered this material across the *Wealth of Nations* rather than being developed all at once (see *WN* IV.ii.29-30, 464-65).⁵ Nonetheless, the cumulative weight of his many observations from this perspective adds up to a significant argument.

To give some credence to my contention that Smith presented three distinct sets of logics, I offer the following three quotations that represent Smith's different views. With respect to the first and view, Smith says,

"[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).

With respect to the second view, Smith says,

"The natural good effects of the colony trade, however, more than counterbalance 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

⁴ Smith bitterly denigrates the European treatment of the native populations (for example, *WN* IV.i.32:448 and IV.vii.c.80, 626).

⁵ Nonetheless, this third view has a range of adherents in the Smith literature, including Hont (2005), Samuels (1973), and Viner (1948). Grampp (1965, 40), for example, observes that "Smith ... wrote in favor of the Navigation Acts and other measures which increased the national power of Britain but diminished its real income." Hirschman (1945) provides a more general treatment of the effect of war on trade.

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).

Finally, with respect to British mercantile restrictions that he elsewhere bitterly criticizes, Smith make the assertion noted in the first headnote:

“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 behaviour, both in its mercantile policies and its sustained, 125-year military rivalry with France?

I argue 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, although this has begun to change after many Americans have begun to worry about our dependence on potential adversaries. The inattention to war may be reasonable when studying eras of sustained international peace and global trade. But it fails in fundamental ways to help us understand behaviour and policymaking in an era of sustained military rivalry. The British Empire arose and prospered in just such an era; namely, Britain’s sustained, multi-generational 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 international trade theory which implicitly assumes sustained peace in which countries maximize absolute gains. Consider a major trade agreement between two countries that grants one party five times the amount gained by the second. In Smith’s first view, because the agreement makes both better off, it is desirable.

In contrast, international relations theorists demonstrate that a world of sustained military rivalry is more like a zero-sum game than in contrast to an era of free trade and international peace.⁶ Using a variant of a standard bargaining model, 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, a major trade agreement between two military rivals that grants one side five times the gain of a rival adversely alters the expected value of fighting in favour of the first country. Further, this perspective implies that 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 – in contrast to his arguments favouring 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 labour in the Empire. The larger British economy, and hence British wealth, made Britain a more powerful military opponent, ultimately bankrupting France, leading to the French Revolution. Similarly, policies, such as the Navigation act, denying trade

⁶ I draw on Fearon (1995) and Powell’s (1991) foundational papers in international security; see also Morrow, Siverson, and Tabares (1998); Ferguson (2003, 20-21); and, and Hont (1988, 6) who emphasize the zero-sum nature of economic competition in the era of sustained military rivalry.

with France in goods of great military value, aided Britain because they diminished France's military capacity (Logan 2005, 207-08).

Finally, to understand the first view, I suggest that we distinguish between a strong form and a weak form of the free-trade 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 on war. In the Seven Years' War (1756-63) with France, Britain spent around £100 million, on the order of estimated GDP.⁷ 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 (WN II.v.30, 370-71), 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 (WN IV.ii.30, 464-65).

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 conflict. As I quote Smith in the headnote and other passages below, war sometimes trumps free trade.

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); I then discuss Smith's third approach, drawing on models from international relations theory in political science that emphasize 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.⁸ Smith's first and most elaborate explanation for the empire focuses on rent-creation for merchants, producing private benefits at the collective expense. Emphasizing the costs of the empire, the literature largely

⁷ On estimates of GDP, see Broadberry, Campbell, et al. (2015); and for public expenditures on war, see Mitchell (1988, Table "Public Finance 2," 578-80).

⁸ See, e.g., Benians (1925), Evensky (2015, chapter 4); Hont (2005, 2015 chapter 6), Kennedy (2010, chapter 11), Magnussen (2007), Palen (2014), Phillipson (2010, chapter 1), Skinner (1996, 2009), Tribe (2006), Van de Haar (2013), and Winch (1965).

characterizes Smith's approach to the British mercantile system as abidingly negative. Smith's emphasis in the *Wealth of Nations* fosters this conclusion, including his long, emphatic, and unambiguous closing paragraph. Indeed, Smith's final sentence reads, "*If any of the provinces of the British empire cannot be made to contribute towards the support of the whole empire, it is surely time that Great Britain should free herself from the expence of defending those provinces in time of war, and of supporting any part of their civil or military establishments in time of peace, and endeavour to accommodate her future views and designs to the real mediocrity of her circumstances*" (*WN* V.iii.92, 946-47).

Smith's oft-quoted phrase in a 1780 letter to Andreas Holt supports this account; in the letter, Smith refers to the *Wealth of Nations* as a "very violent attack I had made upon the whole commercial system of Great Britain" (*Corr*, letter 208 at 251).⁹ 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 high expenses of their defence and provide nothing in return to Britain.¹⁰ In 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-seeking, interest group influence, and monopolization explain why Britain sustains its costly and burdensome colonies (as Ekelund and Tollison 1981, 1997 argue).¹¹ 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.

⁹ Ekelund and Tollison (1981, 1997) provide one of the most comprehensive analyses of Smith's ideas and especially British practice from this perspective (see also Evensky 2015, chapter 4).

¹⁰ 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.

¹¹ (*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).

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 of Nations*, Smith provides equally clear assertions that the net benefits afforded 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 labelled "the extent of the market" and the subsequent increase in the division of labour, 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.

3.1. 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 the specialization and exchange, Smith's division of labour, of the empire resulted in a non-incremental change in British income and wealth (*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 labour stands as one of Smith's central elements of economic growth (*WN* I.i-iii, 13-26; see also Hollander 1973, 208-10). Smith famously argued that "the division of labour 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 despite 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 old market and of the old employment which is lost by the monopoly" (*WN* IV.iii.c.50, 608-09).

Smith examines this argument further with respect to empire's effect on British (and European) commerce and manufacturing. He argues that the towns of Europe, because 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 smaller, adjacent territory:

“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 splendour 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).¹²

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. America not only prospered, but grew faster than Great Britain, as Smith and many of his contemporaries recognized (e.g., Pownall 1776, Rodriguez Braun 1992). The faster economic growth in America led Smith famously to predict that the wealth of America would likely surpass that of Britain in a century: “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).¹³ 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.

¹² Further, “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).

¹³ 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” 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.”

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, an omnipresent feature of the early modern European environment. 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 to help finance their defence. 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. Nonetheless, a coherent argument emerges when we draw together Smith's discussions on this topic.

Smith articulates the general principle underlying many specific instances in the third of three quote in the first headnote: the trade restrictions embodied in the navigation acts were valuable because defence trumps opulence in trade policy (*WN* IV.ii.29-30, 464-65; see also Grampp 1965, 40; Hont 1988, 6; 2005; and 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 otherwise 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 sailcloth, and British-made gunpowder, may, perhaps, both be vindicated upon this principle" (*WN* IV.v.a.36, 522-23; see also IV.ii.23-24, 563).

This logic of security 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" in economics (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 that the second can do without only at great expense. Smith illustrates this point with the example of tar and pitch which England had formerly obtained from Sweden. 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.¹⁴ Viner

¹⁴ "[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

(1948, 282) elaborates: “*In the seventeenth and 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.*”¹⁵ 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). Powell (1991) demonstrates that, 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 their military and financial capacities. Given the danger of war, national welfare depended not only on the capital accumulation, the division of labour, 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).

Applying 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 domestic 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 security more than counterbalances the losses in trade (Hont 2005, Powell 1991, Samuels 1973, and Viner 1948; see also *WN* IV.v.a.27, 518). Smith employs a similar argument to rationalize subsidies to the carrying trade (*WN* II.v.30, 371). Multiple forms of subsidies to shipping were valuable, in this view, because they enhanced Britain’s naval capacity, in turn, enhancing British security and wealth.

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 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).

¹⁵ 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).

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 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).¹⁶

5. Reconciling Smith’s Three Views: An Alternative Account of Mercantilism: 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’ defence. Smith’s first view implies that doing so would be hugely

¹⁶ The Glasgow edition editors of *WN* – Campbell, Skinner, and Todd – read this passage similarly. They say with reference to this passage: In WN IV.ii.24,30, the “Navigation Acts are defended on the ground that defense 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.”

beneficial to Britain. But is this assertion plausible? If we rely on modern trade theory, the answer is yes.

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. The counterfactual involves multiple hidden presumptions of questionable merit: (i) Britain would save the huge costs of defence, which America would then have to finance alone; and (ii) trade between the colonies and Britain would not change drastically. In particular, the newly independent Americans would continue their extensive trade with Britain.¹⁷

This implicit counterfactual is an obvious one. Yet, because it misses the margin of violence, it is inadequate. Optimal trade policy depends on whether the international environment is one of peace and global trade or of war, military rivalry, and trade restrictions on empire. As additional evidence to support my thesis, 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 advocating giving up Florida and Canada to manipulate America would be unnecessary and irrelevant to American and British trade.

Drawing on Hont's (2005, 1-156) discussion of the "jealousy of trade," I propose a second, more realistic counterfactual. To understand much of 18th century writing on trade, Smith included, we need some background about sustained commercial war.¹⁸

We now know that, 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 (Finlay and 'O'Rourke 2009, 247, Hont 2005, 24; North and Weingast 1989). 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 subsidies and privileges to ally with her against Great Britain. The new arrangement would hurt Britain in several ways. First, it would have reduced Britain's participation in or even entirely excluded from the American market, including various naval stores and other commodities of high military value that had been protected by the Navigation acts. Second, the extent of the British market would have shrunk considerably, reducing the division of labour and hence producing economic contraction, not growth. Third, the French would experience the increasing division of labour and subsequent economic growth, thereby gain economic and financial power and potentially allowing it to triumph over the British.

¹⁷ 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.

¹⁸ Although Smith does not use the phrase, "jealousy of trade," he clearly understood the concept. Smith's good friend, David Hume, discussed the concept in his essay of that title (Hume 1752).

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 Seven Years War (1756-63) defending the colonies solely for the latter's benefit cannot be sustained. Security and defence are legitimate public goods enhanced by navigation policy, and many of Britain's trade restrictions can be interpreted as such. In this militarized international environment, the gains from exchange from the colonial trade made Great Britain far richer than otherwise. The fiscal and military resources on which Britain could draw were therefore considerably larger than it would have been without its American colonies.

5.1. 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 wars 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 (i.e., party one), 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 18th century.¹⁹

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). Recall the example above about the exchange in which one country gains one-third of what a second country gains. Should the first country accept the trade deal? Presuming peace, 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! Powell demonstrates that the answer to the question about the asymmetric exchange depends on the assumptions about security. If the international environment is peaceful with a very low threat of war, the typical implicit assumption of international trade theory, then the answer is yes. Country one is better off with its share of the gains irrespective of the size of country two's gains. In contrast, if security and war are constant problems – for example, if the two countries are long-term military rivals – then the asymmetric exchange may make the second 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

¹⁹ Similarly, problems with credible commitments can also make it impossible to implement a bargain that makes both parties better off.

extract more from country one in negotiations (Powell 1991; see also Fearon 1995, Hirschman 1945, and Morrow, Siverson, and Tabares 1998). This exchange enhances the relative military capacity of country two and is therefore a bad deal for country one.²⁰ Hont (2005, 23-4) reports that the famous 17th century French finance minister, Jean-Baptiste Colbert, relied on this logic: “Colbert's policy was to wage commercial war against Europe with any means at his disposal... [H]e wished to increase France's share of European shipping immediately, by physically destroying Dutch capacity if necessary.”²¹

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 labour 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 last point, 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 as an era of globalization and relatively free trade. Globally, tariffs generally fell during this era. Policies promoting free trade had one big exception, however: the deliberate prohibition of trade with the Communist Bloc of nations.²² Why did they do that? 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 labour 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);
2. to limit the size of the opponent's market and thus restrict opportunities for the opponents economic growth through the division of labour, and specialization and exchange (Powell 1991; Hirschman 1945);

²⁰ Technically, the answer involves how the exchange changes p , the probability that country 2 wins a fight against country 1 (and hence the probability that country 1 wins is $1-p$). If the trade lowers p to $p' < p$, the expected value of trade can be negative.

²¹ Smith mentions relative gains at *WN* IV.vii.c.16, 594-95; in the paragraph that follows this, 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.

²² 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.

3. to limit the empire's dependence on strategic materials that an opponent might deny them during war.

Smith's second and third views, the value of colonies to the metropole can be quite high if the colonies substantially increase the division of labour 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 economic and strategic resource to Great Britain. They expanded the size of the British market, immensely improving the division of labour 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 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 labour through extensive trade with the American colonies.

The British paid heavily to protect their American colonies. Although Smith complains in his first view that the colonies did not contribute taxes to their defence, the colonies did contribute to the British economy and security in other, important ways. Any evaluation of the net value of the colonies to Britain must take all these components into account, not on taxation alone.

Logically, the sustained Anglo-French rivalry favours 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 that country would mean far greater restrictions on British trade, a much smaller size of its markets, and therefore a more limited division of labour and hence lower economic growth. Even worse, dominance of France raises existential issues – might France have come to dominate Britain were Britain not to have spent so much on security? Therefore, Smith's complaints that the Americans did not contribute taxes for their defence is far less credible.

The full implications of the sustained military Anglo-French rivalry appears in neither in Smith nor in the modern neoclassical economics of trade.²³ Although free trade may be optimal in a world of sustained peace, in periods of sustained military competition, this result seems false. As we have seen, Smith in his first view seems to ignore problems of domestic and international violence. Yet Great Britain faced sustained, violent conflict throughout the 18th century (Hont 2005 and Viner 1948). The persistent French threat required that security had to be an active margin of public decision-making.

Although Smith's inconsistent statements about the value of the empire to Britain are hard to reconcile, the social science literatures largely ignore this problem, nearly

²³ On this point, see for example Findlay and O'Rourke (2007), Magnusson (2007), and Samuels (1973).

exclusively focusing on Smith's first view emphasizing free trade; historians have for at least a century focused on the first two views (see, for example, Benians 1922 and Palen 1979). Smith's discussion of the costs of empire implicitly 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. This presumption 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 militarily competitive, and hence worse off in its long-term military rivalry with France. In the presence of sustained security risks, the appropriate counterfactual is not idealized global free trade, but one where the Americans allied with the French, partially or wholly excluding the British from American trade. Unilateral free trade by Britain risked French hegemony on the continent, over the Atlantic, and control over a (formerly British) America.

Smith's second view of empire recognizes the benefits from the empire's immense division of labour. 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 hostile world. 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.

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 of peace. Removing these restrictions unilaterally would not make Britain better off because this policy change would have Britain more vulnerable to France. 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 labour; 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 limited France's participating in the gains from major portions of the American trade, thus restricting the extent of the French market and its division of labour; and it prevented an American-French alliance that might exclude the British from the American market.

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 the rise of Napoleon would prove).²⁴ 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.

²⁴ I observe that Napoleon attempted to exclude Britain from trade with the European market.

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Abbreviations for Smith's Ouvre

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