THE ECONOMIC THOUGHT OF DAVID HUME

David Hume's views on economics are expressed in his Essays, Moral, Political and Literary, Part II (1752). He was a contemporary of Adam Smith and read Smith's The Wealth of Nations shortly before his death.[1] Some commentators have suggested that Hume exercised some influence over Smith's views on economics; others are not so sure. Hume's commentators over the last 200 years have emphasized his theory of knowledge, doctrine of causality and belief, theory of morals and historical writing. His views on economics have been relatively neglected.[2] The purpose of this essay is to summarize and clarify Hume's views on economics.

Commerce and Trade

Hume's essay "Of Commerce"[3] is an extension of his view of property rights. Just as government should not impair property rights, it should not impair commerce, which is the freedom to contract between consenting parties.[4] But Hume was not a 'pure' advocate of laissez-faire. He supported the infant industry argument:[5]

> A tax on German linen encourages home manufacturers, and thereby multiplies our people and industry. A tax on brandy encreases the sale of rum, and supports our southern colonies.[6]

The bulk of workers are employed either in argiculture or manufacturing. In the more primitive societies, almost everyone is employed in agriculture (husbandry), and as agricultural techniques are improved, the land becomes able to support more non-agricultural workers, including artisans and providers of luxuries as well as manufacturers. Some of these surplus (i.e., nonagricultural or manufacturing) workers are sometimes appropriated by the sovereign for use in the army or navy (OC 256), which prevents them from producing luxury goods and services, and leads to a different kind of state than would exist if their labor were not so appropriated. Increases in industry, the arts and trade generally increase both the power of the sovereign and the happiness of the people (OC 260). Trade is something that is mutually beneficial -- both parties gain. Hume spends a great deal of time refuting the idea that one nation's gain is another's trade loss.[7] Thus, trade is a win-win rather than a win-lose situation, as some modern-day mercantilists (such as Thurow [The Zero Sum Game] and Batra [The Great Crash of 1989])would have us believe.

Hume views everything in the world as purchased by labor, and sees labor as being caused by people's passions (OC 261). In modern language, one could say that wealth is produced either from physical or mental labor, and that it is individual incentive that causes the human action to begin in the first place. Of course, this view overlooks the fact that labor does not exist in a vacuum, but is mixed with land and perhaps capital (which can be seen as the result of accumulated labor). Exchange occurs when producers of a commodity produce more than they can consume. At that point, they trade their surplus for other goods and services (OC 261). In peacetime, the farmers' surplus goes toward the acquisition of manufactures or the cultivation of the liberal arts. In war, the surplus can go toward the support of an army or navy. The state becomes more powerful as it can produce increasingly beyond subsistence, what Hume refers to as employment beyond mere necessities (OC

262). But rather than encouraging the increase in state power by force, such increase is best accomplished by allowing individuals to produce as much as they want, which they will do automatically in the absence of coercion, and then appropriate part of the surplus:

> It is a violent method, and in most cases impracticable, to oblige the labourer to toil, in order to raise from the land more than what subsists himself and family. Furnish him with manufactures and commodities, and he will do it himself. Afterwards you will find it easy to seize some part of his superfluous labour, and employ it in the public service, without giving him his wonted return. Being accustomed to industry, he will think this less grievous, than if, at once, you obliged him to an argumentation of labour without any reward. (OC 262)

Countries that engage in foreign trade are more wealthy than those that do not. Imports furnish materials for new manufactured goods, and exports allow domestically produced goods that could not be consumed at home to be traded for foreign merchandise, thus increasing the power of the state as well as individual well-being. Foreign trade has historically preceded refinements in domestic manufacturing and luxury (OC 263). A corollary to this view is that population has a tendency to increase in countries where trade flows freely, and is reduced in less prosperous countries.[8] Hume disputes Montesquieu's thesis that world population has fallen since ancient times.[9] Hume's theory that population growth is checked by factors such as poverty was taken by later economists, such as Malthus.[10] Hume sees foreign trade as a way of increasing citizens' exposure to items that are not available at home, due to different soil and weather conditions, and thus increasing their well-being by making available products that are not available domestically. Thus, foreign trade increases the standard of living for the vast majority of the citizenry (OC 264).[11]

While there will be a certain amount of economic inequality between citizens, too great an amount of inequality weakens the state, and makes the poor less able to resist the economically strong (OC 265).[12] Hume's statement that "Where the riches are engrossed by a few, these must contribute very largely to the supplying of the public necessities" would seem to advocate some sort of graduated tax along the lines of that presently in place in most modern industrialized countries. Hume sees too great an income disparity as leading to an overconcentration of power, the further impoverishment of the poor and the discouragement of all industry (OC 265).

Labor was the source of value for Hume,[13] which was not an unusual position for economists to take at the time. Adam Smith and other economists of the Scottish School subscribed to the labor theory of value, and it was not until the 1870s that the marginal utility doctrine superceded the labor value theory. Hume is credited with anticipating the marginal utility school in one respect, however -- his hypothesizing a general state of economic equality.[14]

Hume's view of the relationship between geography and wealth is similar to that elaborated upon in Montesquieu's Spirit of the Laws.[15] People who live between the tropics have not attained art, civility, police enforcement of the law or military discipline, whereas these qualities are present in the temperate zones, at least to some extent, because of

> ...the warmth and equality of weather in the torrid zone, which render clothes and houses less requisite for the inhabitants, and thereby remove, in part, that necessity, which is the great spur to industry and invention .... Not to mention, that the fewer goods or possessions of this kind any people enjoy, the fewer quarrels are likely to arise amongst them, and the less necessity will there be for a settled police or regular authority to protect and defend them from foreign enemies, or from each other. (OC 267)

Monetary Theory

While Hume is not often referred to as a monetary theorist, he did have a few things to say about money, and of the things Hume had to say about economics, his monetary theories are perhaps the best remembered.[16] Thomas Mayer views Hume's monetary theories quite favorably, as having anticipated later monetary theory on an amazing number of issues, especially Hume's writings on the quantity theory, the Chicago transmission process, private sector stability, the vertical Phillips curve, which Hume originated, and preference for free markets. Also implicit are the irrelevance of allocative detail and the focus on the price level as a unit. Preference for reduced-form models and stable money growth also fit the whole tenor of Hume's discussion. Hume also rejected the monetarists' strong opposition to inflation.[17]

F.A. Hayek also views Hume's contributions favorably:

> ...Richard Cantillon and David Hume began the development of modern monetary theory. Hume in particular put the central point at issue by saying that, in the process of inflation, "it is only in this interval or intermediate situation between the acquisition

> of money and the rise of prices, that the increasing quantity of gold and silver is favourable to industry.[18]

And Milton Friedman writes:

> We have advanced beyond Hume in two respects only: first, we now have a more secure grasp on the quantitative magnitudes involved; second, we have gone one derivative beyond Hume.[19]

Robert Lyon asserts that Hume introduced two ideas into monetary theory that did not enter the mainstream of economic thought until Keynes: the concept of the importance of the variable of time in economic analysis, and Hume's emphasis on psychological factors as having an effect on money and trade.[20]

Hume's monetary theory has much in common with that of the modern Chicago School. For Hume, money is not one of the wheels of trade, but is the oil that allows the wheels of trade to roll more easily.[21] The actual quantity of money is unimportant, since prices are always proportional to the amount of existing money (OM 281). Yet a few pages later, Hume seemingly contradicts himself by stating that too large a quantity of money can be harmful in foreign trade (OM 283). Hume soon explains this seeming contradiction by pointing out that, as the quantity of money increases, domestic prices for labor and manufactures increase, and that, if the quantity of money in foreign countries does not also increase, prices in the foreign countries will remain lower than domestic prices, thus making domestic manufactures uncompetitive (OM 284, 286). Hume also refuted the notion that the supply of money will be depleted by trade.[22] Hume also points out that too large a quantity of money may be inconvenient to store and transport (OM 285), although this problem can be overcome by use of paper money (which Hume does not point out).

Hume (OM 286), like Montesquieu,[23] states that the increase in the general price level was caused by the inflow of gold and silver from the Americas, but notes that the price level increase was less, proportionately, than the increase in gold and silver.[24] Hume explains this nonproportional increase as due to a "change of customs and manners" (OM 292). Modern monetary theorists would ascribe it to a gradual increase in productivity.

Does money matter, or is it neutral? Some Chicago School economists of twenty years ago would have argued that money is all that matters. Yet some Keynesians would argue that money does not matter at all.[25] This subject has provoked a rich debate that continues to this day.[26]

For Hume, money does not matter as long as the quantity of money remains constant. "The greater or less plenty of money is of no consequence; since the prices of commodities are always proportioned to the plenty of money..." (OM 281).[27] Yet an increase in the quantity of money can increase trade, at least temporarily (OM 286), and a decrease can harm trade. Thus, it appears that Hume may be advocating a gradual, continual increase in the quantity of money (OM 287)[28] that is not much different from the position advocated by Friedman two centuries later.[29]

Hume's version of the quantity theory is the later, sophisticated theory, not the original, crude theory. In the original theory, it is assumed that a money supply increase seeps through the economy evenly and immediately so that relative prices remain constant while the price level increases. The later, more sophisticated theory to which Hume subscribes realizes that the money distribution is not instantaneous and even. Some individuals receive the new money first. They then use it to buy goods and services before the price level changes, so they buy at the old prices. A second group (which receives the money from the first group) then spends the money on other goods and services, and the process continues. Gradually, prices rise to reflect the increased quantity of money, but the early groups make their purchases at the lower price level, and each later group purchases at higher general levels until the new money works its way through the economy (OM 286). Hume sees this lag as beneficial, causing an increase in total industry and wealth because some individuals are able to buy more goods than before because they buy before prices rise (OM 286). Mises disagrees with Hume on this point, stating that

> ...those sections of the community that are the last to be reached by the additional quantity of money have their incomes reduced, as a consequence of the decrease in the value of money called forth by the increase in its quantity....[30]

> This increase in the stock of money ... results in no increase of the stock of consumption goods at people's disposal. Its effect may well consist in an alteration of the distribution of economic goods among human beings but in no case, apart from ... incidental circumstance[s] ... can it directly increase the total amount of goods possessed by human beings, or their welfare.[31]

Perlman disagrees with Mises' assessment of Hume's position:

> One of the most controversial passages in David Hume's economic essays is the

> one in which he discusses the transitory effects of a change in the quantity of money.... It was misinterpreted and criticized by both the Mills, and it has been variously interpreted and criticized by a large number of historians of thought ever since.[32]

> Both the Mills and Von Mises completely ignore the real wage effect considered by Hume. They interpret Hume as relying on the lags among different prices of commodities rather than the one between commodity prices and the money wage rate, which results in a change in the real wage rate.[33]

I believe the Mills/Mises'argument is correct, and that Perlman and Hume are wrong on this particular point. For example, if sailor John lands in England and spends the new gold he has just brought back from the new world on some basket of commodities, he can buy them at the old prices because the money has not yet had a chance to circulate throughout the economy, raising prices (because of the increased quantity of money now in circulation). But as the money continues to circulate, the general price level will rise to take account of the increased quantity of money. The last individuals who receive this money will receive it after prices have risen, and thus will not be able to buy as many commodities as if they had received the money earlier, before the general price rise.

However, Hume and Mises agree on at least one point -- the rise in prices resulting from an increase in the quantity of money will not be strictly proportional to the amount of the increase. Hume reaches his conclusion based on experience:

> ...the alterations in the quantity of money, either on one side or the other, are not immediately attended

> with proportionable alterations in the price of commodities. (OM 288)

> ...the augmenting of the numerary value [of French money] did not produce a proportional rise of the prices, at least for some time. (OM 287)

Mises reaches his conclusion a priori, based on logic:

> The notion of a neutral money is no less contradictory than that of a money of stable purchasing power ... with the economic system which cannot be rigid, neither neutrality of money nor stability of its purchasing power are compatible.[34]

Hume recognizes another property of money[35] -- what Keynes would call "velocity."[36] Changes in the price level can come about by changing the quantity of money in circulation. Locking coins up in chests will cause prices to fall (OM 290). That the velocity theory is fallacious has been forcefully argued by Hazlitt.[37]

Another contribution Hume made to economic thought was to point out the distinction between money and wealth.[38] A nation's wealth is not determined by the amount of gold it has but by the goods and services it produces (OM). This argument refuted the mercantilists, who viewed gold as being wealth, and any loss of gold as being a loss of wealth.[39]

Another important aspect of Hume's monetary theory is his specie-flow doctrine, which first appeared in a letter to Montesquieu[40] and was later elaborated upon in Hume's "Of the Balance of Trade." The gist of this theory is that the amount of specie in every country tends toward an equilibrium, at the point where imports and exports are equal, caused by the interconnectedness of the price levels in the trading countries. As specie flows into one country, its price level increases, making costs higher and products less competitive on world markets. As specie flows out of other countries, the quantity of money falls, as do prices, making these countries more price competitive. The whole process is one of automatic balancing.

Hume has been criticized (for example, by Grubel) for not mentioning the effects of disturbances caused by wars and draughts, which Ricardo and Thornton tried to do.[41] Others have speculated that Adam Smith's rejection of Hume's specie-flow theory was because the theory was not sufficiently antimercantilist,[42] and that the theory is sufficiently unclear that it can be subject to several interpretations.[43] Several economists have accused the theory of being inconsistent in important respects[44] or downright false.[45]

Interest Theory

Before Hume, the common argument was that interest rates were determined by the supply of and demand for real capital rather than money,[46] or by the quantity of money in circulation -- that increasing the supply of money will keep interest rates low. But Hume, using his theory of human nature and historical examples, argues that low interest is the result of the growth of industry and commerce, which tends to increase the number of lenders and reduce the number of borrowers:

> High interest arises from three circumstances: A great demand for borrowing; little riches to supply that demand; and great profits arising from commerce: And these circumstances are a clear proof of the small advance of commerce and industry, not of the scarcity of gold and silver.

> Low interest, on the other hand, proceeds from the three opposite circumstances: A small demand for borrowing; great riches to supply that demand; and small profits arising from commerce.[47]

Böhm-Bawerk points out that this theory is an advance over existing theories, but that Hume's theory did not go quite far enough:

> In the literature of economic science we find the way very well prepared for this modification of the concept of capital. Indeed, it is virtually an accomplished fact in the works of Hume, who points out in one essay that the rate of interest by no means depends on the quantity of money available, but rather on the available supply of goods. The only thing lacking is for him to state in so many words that these "riches" or "stocks," as he calls them, are the "real capitals." It remained for Turgot to make that statement.[48]

Mises later refined Böhm-Bawerk's interest theory,[49] which was built upon the theories of Hume and Turgot. But even though Hume's interest theory is incomplete, it is still better than much of what was later written on the subject.[50]

Theory of Taxation and Fiscal Policy

Hume's theory of taxation is often compared to that of the French physiocrats, who argued that all taxation is ultimately shifted to land.[51] Hume challenges this view, and also calls into question the subsistence theory of wages and the view that entrepreneurial activity does not yield a surplus.[52] While raising taxes a little may increase the individual's incentive to work harder, thereby increasing national wealth, raising taxes too much will reduce the incentive to work harder, and may be harmful to the economy. Taxes have a tendency to shift to commodities, thereby raising prices and reducing consumption.[53] Hume is credited with reconciling the 'utility of poverty' views of his mercantilist predecessors with the later classical school arguments that a tax on labor will reduce its effective supply, by stressing the potential stimulating results of moderate taxes and the possible dangers of excessive tax rates.[54]

Hume's essay "Of Public Credit" discusses the advantages and disadvantages of public credit. One advantage is to give the sovereign a new source of funds, which merchants would otherwise dissipate or divert to land. But the development of a securities market reduces the rate of profit, lowers commodity prices, causes consumption to expand and encourages technical innovation.[55] He defends this position in a letter to Montesquieu,[56] who was of the opinion that there are no advantages to public debt.[57]

Hume points out several disadvantages of public debt. For one thing, it shifts industry to London, while the burden of paying for the public credit shifts to the countryside, which may not be equitable.[58] Second, public credit carries all the disadvantages of paper currency, including the removal of better money (silver and gold) from circulation (Gresham's Law) and a tendency to increase the general price level.[59] The tax burden will also increase, as the credit has to be paid, and increasing the tax burden will either increase the price of labor or lead to oppression. Foreigners could acquire a portion of the public debt, thereby somehow gaining some control or advantage over the people or industry. Income from those who hold the public debt (the idle rich) encourages them to lead an idle and inactive life. In one of the more interesting passages of this essay, Hume refutes the notion that public debt is not harmful because we 'owe it to ourselves'. Two hundred years later that argument was resurrected by Keynes and used by Roosevelt to justify massive (for that time) deficit spending.[60]

The Significance of Hume's Economics Today

Hume's contributions to the history of economic thought are many and varied. While his observations were casual compared to those of other economists of the time (such as Smith), it is amazing how much he was able to perceive about the economic system and its various interconnected parts such as money, interest, taxes and international trade. He was one of the first eighteenth-century thinkers to break free (but not completely free) of the mercantilist fallacies (many of which are still subscribed to today by leading politicians and even some economists). Hume is viewed as a precursor of Adam Smith, and it is said that some of the seeds Hume sowed eventually blossomed in Smith's Wealth of Nations.[61] Hume's refutation of the balance of trade fallacy is still one of the best, and is well worth reading.

Hume's best economic perceptions are in monetary theory, and it is in this area that he is best remembered today. Subsequent theorists have climbed upon Hume's shoulders to advance and refine various aspects of his monetary theory. Hume was one of the first to clearly distinguish the difference between money and wealth, a problem mercantilists had been grappling with for several generations. His quantity theory was extremely perceptive for its time and, although now two hundred years old, is better and more in keeping with reality than some present day theories advanced by post-Keynesians. His specie-flow theory, tied in with international trade, is still worth reading, and was unsurpassed for at least a generation.[62]

His writings on the double-sided beneficial effects of unrestricted trade could be profitably read by our present-day protectionists in congress, although his defense of the infant industry leaves much to be desired (it should be noted that some modern politicians are still advocating the argument that infant industries need protection, so perhaps Hume's argument is not that much outdated today, even though it is as incorrect now as it was when he advanced it 200 years ago). His interest theory, although advanced for its time, has been superceded. His theories of public credit have some things in common with Wicksell and Buchanan. His tax theory reconciles the mercantilist 'utility of poverty' theory with the classical school view that taxing labor is counterproductive. Although Hume refutes the theory that raising the tax on labor will lead to increased labor productivity, this fallacious view is still being taught in some universities today, especially by progressive tax advocates. His theories of population and the effect of geography on economy make for interesting reading and are viewed as a milestone in the empirical treatment of pre-Malthusian population questions.[63] In his essay on population, Hume refutes the widespread view that population had been declining since ancient times. Hume's general scepticism is perhaps best seen in this essay.

Arkin suggests that students of economic thought may some day pinpoint the beginning of modern economics as 1752, the year the first edition of Hume's Political Discourses appeared, rather than on the present generally accepted date of 1776 -- the year Adam Smith's Wealth of Nations was published.[64] But I think Arkin overstates the importance of Hume's place in the history of economic thought. While Hume's contributions are many and varied, they are not as important as those of Smith, whose ideas also gained immediate widespread recognition, whereas Hume's economic ideas were basically ignored until well into the nineteenth century, perhaps because his economic views were overshadowed by his works on history and philosophy.

All in all, Hume ranks only a notch or so below Adam Smith in his perceptions of economic reality in the eighteenth century. Hume's contributions to economic thought are especially impressive when it is considered that only a small proportion of his total writings are devoted to economics. Had Hume devoted as much time to economics as had Adam Smith, we might now be referring to Hume as the father of modern economics rather than Smith.

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3. David Hume, "Of Commerce," in Essays Moral Political and Literary, Part II, 1777 edition. Reprinted by Liberty Classics (Indianapolis, 1987) with an apparatus of variant readings from the 1889 edition by T.H. Green and T.H. Grose, pp. 253-267. Further references will be cited as 'OC' followed by the relevant page number(s).

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6. David Hume, "Of the Balance of Trade," in Essays Moral Political and Literary, p. 324.

7. David Hume, "Of the Jealousy of Trade," in Essays Moral Political and Literary, p. 327-331.

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15. Montesquieu, op. cit., Books XIV-XVIII.

16. Marcus Arkin, "The Economic Writings of David Hume - A Reassessment," in Joseph J. Spengler and William R. Allen (eds.), Essays in Economic Thought: Aristotle to Marshall (Chicago: Rand McNally, 1960), p. 146.

17. Thomas Mayer, "David Hume and Monetarism," Quarterly Journal of Economics 95 (August, 1980), p. 89.

18. F.A. Hayek, Choice in Currency: A Way to Stop Inflation, Occasional Paper No. 48, (London: The Institute of Economic Affairs, 1976), p. 23, quoting Hume's "Of Money."

19. Milton Friedman, "25 Years After the Rediscovery of Money: What Have We Learned?: Discussion," American Economic Review 65 (May, 1975), pp. 176-179, as cited by Thomas Mayer, "David Hume and Monetarism," Quarterly Journal of Economics 95 (August, 1980), p. 89.

20. Lyon, op. cit., p. 457.

21. David Hume, "Of Money," in Essays Moral Political and Literary, p. 281. Further references will be cited as 'OM' followed by the relevant page number(s).

22. David Hume, "Of the Balance of Trade," pp. 308-326.

23. Montesquieu, op. cit., Book XXII.

24. OM 292; David Hume, "Of Interest," in Essays Moral Political and Literary, p. 296.

25. Dietrich K. Fausten, "The Humean Origin of the Contemporary Monetary Approach to the Balance of Payments," Quarterly Journal of Economics 93 (November, 1979), p. 658.

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Dunnikier, "Letter from Oswald to Hume (October 10, 1749)," in Rotwein *op. cit*., pp. 190-196. (Also in *Selections from the Family Papers Preserved at Caldwell* (Glasgow, 1854), vol. I, pp. 93-107.)

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32. Morris Perlman, "Of a Controversial Passage in Hume," *Journal of Political Economy* 95: 2 (April, 1987), p. 274.

33. *Ibid*., p. 277.

34. Ludwig von Mises, *Human Action*, third revised edition, (Chicago: Regnery, 1966), pp. 418-419.

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45. Bernard Semmel, "The Hume-Tucker Debate and Pitt's Trade Proposals," *Economic Journal* 75 (1965), pp. 759-770.

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48. Eugen von Böhm-Bawerk, *Positive Theory of Capital* (volume 2 of *Capital and Interest*) (South Holland, IL: Libertarian Press, 1959), p. 19. First published in 1889 as *Positive Theorie des Kapitales*.

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50. Arkin, *op. cit*., p. 147; J.M. Low, "The Rate of Interest: British Opinion in the Eighteenth Century," *The Manchester School of Economic and Social Studies* 22:2 (May, 1954), as cited in Arkin, p. 157, note 18.

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55. David Hume, "Of Public Credit," in Essays Moral Political and Literary, pp. 353-354.

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61. Arkin, op. cit., p. 142.

62. Ibid., p. 147.

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