#### Primary Source 9.3

# ADAM SMITH, THE WEALTH OF NATIONS (1776): ON JOINT-STOCK COMPANIES<sup>1</sup>

Adam Smith (1723–90) was a Scottish author, philosopher, economist, and political thinker educated at the Universities of Glasgow and Oxford. His first major work, The Theory of Moral Sentiments (1759), propounded the idea that our moral sentiments emerge from feelings of sympathy toward others.

His masterwork, An Inquiry into the Nature and Causes of the Wealth of Nations (1776), revolutionized economic theory. As populations grow denser, he observes, producers of goods and commodities begin to exchange with others, gradually focusing on what they can produce most efficiently and profitably. As people specialize more, they produce more, raising the standard of living of themselves and of their societies. Since all members of society pursuing their self-interest will generally advance the general good, it is best for governments to leave economic activity to follow its natural course—via laissez-faire ("let it alone") policies—concentrating instead on defending society from external attack and from domestic criminality and by providing necessary social services.

In the passages below, Smith subjects joint-stock companies to critical analysis. Such firms, which in the typical European business practice of the time enjoyed government protection and monopoly trading rights, helped jump-start the early stages of economic expansion abroad. Over time, however, Smith believed that joint-stock companies in most business sectors could not compete successfully against partnerships, whose owners were far more committed to their firms' success. Regarding individual joint-stock companies, click here.

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## BOOK V. OF THE REVENUE OF THE SOVEREIGN OR COMMONWEALTH.

## CHAPTER I. OF THE EXPENSES OF THE SOVEREIGN OR COMMONWEALTH.

#### PART III.

Of the Expense of public Works and public Institutions.

ART. I.—Of the public Works and Institutions for facilitating the Commerce of the Society. And, first, of those which are necessary for facilitating Commerce in general.

. . .

Joint stock companies, established by royal charter or by act of parliament, differ in several respects, not only from regulated companies,<sup>2</sup> but from private copartneries.<sup>3</sup>

 $<sup>^1</sup>$  Adam Smith, *An Inquiry into the Nature and Causes of Wealth of Nations* (London: T. Nelson and Sons, 1852), 310–11, 316–18.

First, In a private copartnery, no partner, without the consent of the company, can transfer his share to another person, or introduce a new member into the company. Each member, however, may, upon proper warning, withdraw from the copartnery, and demand payment from them of his share of the common stock. In a joint stock company, on the contrary, no member can demand payment of his share from the company; but each member can, without their consent, transfer his share to another person, and thereby introduce a new member. The value of a share in a joint stock is always the price which it will bring in the market; and this may be either greater or less, in any proportion, than the sum which its owner stands credited for in the stock of the company.

Secondly, In a private copartnery, each partner is bound for the debts contracted by the company to the whole extent of his fortune. In a joint stock company, on the contrary, each partner is bound only to the extent of his share.<sup>4</sup>

The trade of a joint stock company is always managed by a court of directors. <sup>5</sup> This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand anything of the business of the company, and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such halfvearly or yearly dividend as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery. Such companies, therefore, commonly draw to themselves much greater stocks than any private copartnery can boast of. . . . The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers. 6 They have, accordingly, very seldom succeeded without an exclusive privilege, and frequently have not succeeded with one. Without an exclusive privilege they have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it.

. . .

When a company of merchants undertake, at their own risk and expense, to establish a new trade with some remote and barbarous nation, it may not be unreasonable to incorporate them into a joint stock company, and to grant them, in case of their success, a monopoly of the trade for a certain number of years. It is the easiest and most natural way in which the state can recompense them for hazarding a dangerous and expensive

<sup>&</sup>lt;sup>2</sup> Chartered business associations in which individual shareholders pursue separate business ventures all enjoying exclusive trading rights in specified lands.

<sup>&</sup>lt;sup>3</sup> Business partnerships.

<sup>&</sup>lt;sup>4</sup> This feature is called limited liability and served to draw vastly more capital into economic activity.

<sup>&</sup>lt;sup>5</sup> Called a board of directors in today's parlance.

<sup>&</sup>lt;sup>6</sup> That is, entrepreneurs.

experiment, of which the public is afterwards to reap the benefit. A temporary monopoly of this kind may be vindicated upon the same principles upon which a like monopoly of a new machine is granted to its inventor, and that of a new book to its author. But upon the expiration of the term, the monopoly ought certainly to determine; <sup>7</sup> the forts and garrisons. if it was found necessary to establish any, to be taken into the hands of government, their value to be paid to the company, and the trade to be laid open to all the subjects of the state. By a perpetual monopoly, all the other subjects of the state are taxed very absurdly in two different ways: first, by the high price of goods, which, in the case of a free trade, they could buy much cheaper; and, secondly, by their total exclusion from a branch of business which it might be both convenient and profitable for many of them to carry on. It is for the most worthless of all purposes, too, that they are taxed in this manner. It is merely to enable the company to support the negligence, profusion, and malversation<sup>8</sup> of their own servants, whose disorderly conduct seldom allows the dividend of the company to exceed the ordinary rate of profit in trades which are altogether free, and very frequently makes it fall even a good deal short of that rate. Without a monopoly, however, a joint stock company, it would appear from experience, cannot long carry on any branch of foreign trade. To buy in one market, in order to sell, with profit, in another, when there are many competitors in both, to watch over, not only the occasional variations in the demand, but the much greater and more frequent variations in the competition, or in the supply which that demand is likely to get from other people, and to suit with dexterity and judgment both the quantity and quality of each assortment of goods to all these circumstances, is a species of warfare of which the operations are continually changing, and which can scarce ever be conducted successfully without such an unremitting exertion of vigilance and attention as cannot long be expected from the directors of a joint stock company. The East India Company, upon the redemption of their funds, and the expiration of their exclusive privilege, have right, by act of parliament, to continue a corporation with a joint stock, and to trade in their corporate capacity to the East Indies in common with the rest of their fellow-subjects. But in this situation, the superior vigilance and attention of private adventurers would, in all probability, soon make them weary of the trade.

An eminent French author, of great knowledge in matters of political economy, the Abbé Morellet, <sup>10</sup> gives a list of fifty-five joint stock companies for foreign trade which have been established in different parts of Europe since the year 1600, and which, according to him, have all failed from mismanagement, notwithstanding they had exclusive privileges. He has been misinformed with regard to the history of two or three of them, which were not joint stock companies and have not failed. But, in compensation, there have been several joint stock companies which have failed, and which he has omitted.

The only trades which it seems possible for a joint stock company to carry on successfully without an exclusive privilege are those of which all the operations are capable of being reduced to what is called a routine, or to such a uniformity of method as admits of little or no variation. Of this kind is, first, the banking trade; secondly, the trade of insurance from fire, and from sea risk and capture in time of war; thirdly, the trade of

<sup>&</sup>lt;sup>7</sup> To come to an end.

<sup>&</sup>lt;sup>8</sup> Improper or corrupt behavior.

<sup>&</sup>lt;sup>9</sup> Employees.

<sup>&</sup>lt;sup>10</sup> André Morellet (1727–1819) was a French economist, author, and philosophe.

making and maintaining a navigable cut or canal; and, fourthly, the similar trade of bringing water for the supply of a great city.

Though the principles of the banking trade may appear somewhat abstruse, the practice is capable of being reduced to strict rules. To depart upon any occasion from those rules, in consequence of some flattering speculation of extraordinary gain, is almost always extremely dangerous, and frequently fatal, to the banking company which attempts it. But the constitution of joint stock companies renders them in general more tenacious of established rules than any private copartnery. Such companies, therefore, seem extremely well fitted for this trade. The principal banking companies in Europe, accordingly, are joint stock companies, many of which manage their trade very successfully without any exclusive privilege. The Bank of England has no other exclusive privilege except that no other banking company in England shall consist of more than six persons. The two banks of Edinburgh are joint stock companies without any exclusive privilege.

The value of the risk, either from fire, or from loss by sea, or by capture, though it cannot, perhaps, be calculated very exactly, admits, however, of such a gross estimation as renders it, in some degree, reducible to strict rule and method. The trade of insurance, therefore, may be carried on successfully by a joint stock company without any exclusive privilege. Neither the London Assurance, nor the Royal Exchange Assurance companies, have any such privilege.

When a navigable cut or canal has been once made, the management of it becomes quite simple and easy, and is reducible to strict rule and method. Even the making of it is so as it may be contracted for with undertakers at so much a mile, and so much a lock. The same thing may be said of a canal, an aqueduct, or a great pipe for bringing water to supply a great city. Such undertakings, therefore, may be, and accordingly frequently are, very successfully managed by joint stock companies without any exclusive privilege.

To establish a joint stock company, however, for any undertaking, merely because such a company might be capable of managing it successfully; or to exempt a particular set of dealers from some of the general laws which take place with regard to all their neighbours, merely because they might be capable of thriving if they had such an exemption, would certainly not be reasonable. To render such an establishment perfectly reasonable, with the circumstance of being reducible to strict rule and method, two other circumstances ought to concur. First, it ought to appear with the clearest evidence that the undertaking is of greater and more general utility than the greater part of common trades; and secondly, that it requires a greater capital than can easily be collected into a private copartnery. If a moderate capital were sufficient, the great utility of the undertaking would not be a sufficient reason for establishing a joint stock company; because, in this case, the demand for what it was to produce would readily and easily be supplied by private adventures. In the four trades above mentioned, both those circumstances concur.

The great and general utility of the banking trade when prudently managed has been fully explained in the second, book of this inquiry. <sup>11</sup> But a public bank which is to support public credit, and upon particular emergencies to advance to government the whole produce of a tax, to the amount, perhaps, of several millions, a year or two before it comes in, requires a greater capital than can easily be collected into any private copartnery.

<sup>&</sup>lt;sup>11</sup> See Primary Source 9.4.

The trade of insurance gives great security to the fortunes of private people, and by dividing among a great many that loss which would ruin an individual, makes it fall light and easy upon the whole society. In order to give this security, however, it is necessary that the insurers should have a very large capital. Before the establishment of the two joint stock companies for insurance in London, a list, it is said, was laid before the attorney-general of one hundred and fifty private insurers who had failed in the course of a few years.

That navigable cuts and canals, and the works which are sometimes necessary for supplying a great city with water, are of great and general utility, while at the same time they frequently require a greater expense than suits the fortunes of private people, is sufficiently obvious.

Except the four trades above mentioned, I have not been able to recollect any other in which all the three circumstances requisite for rendering reasonable the establishment of a joint stock company concur. The English copper company of London, the lead smelting company, the glass grinding company, have not even the pretext of any great or singular utility in the object which they pursue; nor does the pursuit of that object seem to require any expense unsuitable to the fortunes of many private men. Whether the trade which those companies carry on is reducible to such strict rule and method as to render it fit for the management of a joint stock company, or whether they have any reason to boast of their extraordinary profits, I do not pretend to know. The mine-adventurers company has been long ago bankrupt. A share in the stock of the British Linen Company of Edinburgh sells, at present, very much below par, though less so that it did some years ago. The joint stock companies which are established for the public-spirited purpose of promoting some particular manufacture, over and above managing their own affairs ill, to the diminution<sup>12</sup> of the general stock of the society, can in other respects scarce ever fail to do more harm than good. Notwithstanding the most upright intentions, the unavoidable partiality of their directors to particular branches of the manufacture of which the undertakers mislead and impose upon them is a real discouragement to the rest, and necessarily breaks, more or less, that natural proportion which would otherwise establish itself between judicious industry and profit, and which, to the general industry of the country, is of all encouragements the greatest and the most effectual.

<sup>&</sup>lt;sup>12</sup> Reduction.