

## **Adam Smith and *The Wealth of Nations***

**As the American Revolution began, a Scottish philosopher started his own economic revolution. In 1776, Adam Smith published *The Wealth of Nations*, probably the most influential book on market economics ever written.**

Born in 1723, Adam Smith was the son of a customs official in Kirkcaldy, Scotland. At 14, he entered the University of Glasgow and after graduating attended Oxford in England where he studied philosophy.

Smith became a professor of philosophy at Glasgow in 1751. He was active in the debating societies there and often argued for free trade.

In 1759, Smith published *The Theory of Moral Sentiments*. His book looked at human nature and ethics. At the beginning of the book, he stated that all people had the capacity to care about others. He pointed out that no matter how selfish a man might be,  
. . . there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.

But Smith also believed that people often acted in their self-interest, especially in economic matters. He contended, however, that this was not bad. He concluded that self-seeking individuals were “led by an invisible hand” that caused them to unintentionally act in ways that still benefited society.

In 1763, Smith quit his professorship at Glasgow and tutored the stepson of Charles Townshend, who later became Britain’s treasury minister in the years leading up to the American Revolution. Smith traveled to Paris with his student and met Voltaire and other philosophers involved in the French Enlightenment.

Smith also met the leading French economist, Francois Quesnay. Quesnay had devised a system called “Physiocracy” that he believed explained the source of national wealth. He took issue with the popular belief, known as mercantilism, that a nation’s wealth was its hoard of gold or silver. Quesnay believed a nation’s wealth came from its farm produce that circulated throughout the land, nourishing everyone. Quesnay’s innovative idea prompted Smith to begin to write his own book on economics.

In 1766, Smith moved to London. He worked as a researcher for Charles Townshend, who was then in charge of Britain’s finances. Townshend had to deal with the huge national debt that resulted from the Seven Years War. This war enabled Britain to seize all of French North America. Townshend wanted the American colonists to help pay down the war debt through such measures as a tax on tea.

Smith researched Britain’s credit and debt along with the history of colonization by ancient Rome. He also became acquainted with leading political figures such as Benjamin Franklin and Edmund Burke (an important British political writer and leader).

The following year, Smith returned home to Scotland to finish his book, a task that took him nine more years. During this period, he visited London several times and witnessed debates in Parliament on the growing American resistance to British rule.

Finally, in March 1776, Smith published *An Inquiry Into the Nature and Causes of the Wealth of Nations*. This massive work of almost 1,000 pages was based on his exhaustive research and personal observations. Smith attacked government intervention in the economy and provided a blueprint for free markets and free trade. These two principles eventually would become the hallmarks of modern capitalism.

### **“An Obvious and Simple System of Natural Liberty”**

When Adam Smith published his *Wealth of Nations* in 1776, Britain was just beginning to enter the Industrial Revolution. The first cotton-spinning factory had opened only a few years earlier. Increasingly, workers labored for pennies a day in factories and mines. Most employers believed that to get the poor classes to work, their wages had to be low, just enough to keep them from starving.

Smith began his book with a radical definition of “national wealth.” He rejected the old mercantilist definition of acquiring gold and silver. Nor did he fully accept the Physiocrat view that wealth consisted solely of the produce of a nation’s farms. Instead, Smith proposed that the wealth of a nation consisted of both farm output and manufactured goods along with the labor it took to produce them. To increase its wealth, Smith argued, a nation needed to expand its economic production. How could a nation do this? Smith thought the key was to encourage the division of labor.

Smith argued that workers could produce more if they specialized. He gave the example of a pin factory based on his real-life observations. One worker who did all the operations necessary to make a single pin, he said, could produce no more than 20 in one day. Ten workers could make 200 pins this way. If, however, the 10 workers each specialized in one or two of the pin-making operations—from drawing the wire to putting the finished pin on a paper card—they would work more efficiently. Smith estimated that these 10 workers could produce 4,800 pins per worker or 48,000 altogether in a day.

Smith argued that if all production could be specialized like the pin factory, workers could produce more of everything. Because humans naturally trade with one another, Smith reasoned, those involved in making one product will exchange it (or the wages they earn) for the goods produced by other workers. Thus, Smith concluded, “a great plenty diffuses itself through all the different ranks of the society.”

Smith did not just present a theory about increasing production and the wealth of a nation. He worked out exactly how this would occur by describing what he called the “free market mechanism” (see box).

Adam Smith described free markets as “an obvious and simple system of natural liberty.” He did not favor the landowner, the factory owner, or the worker, but rather all of society. He saw, however, self-defeating forces at work, preventing the full operation of the free market and undermining the wealth of all nations.

## **Smith's Attack on Mercantilism**

In the 18th century, European nations practiced an economic system known as “mercantilism.” Each nation’s goal was to increase exports to its colonies and other nations, limit imports from them, and end up with a “favorable balance of trade.” A nation that exported more than it imported demanded the difference in gold and silver.

The mercantilist nations believed that the more gold and silver they acquired, the more wealth they possessed. Smith believed that this economic policy was foolish and actually limited the potential for “real wealth,” which he defined as “the annual produce of the land and labor of the society.”

European mercantilism depended on a web of laws, subsidies, special economic privileges, and government-licensed monopolies designed to benefit specific manufacturers and merchants. This system, however, inflated prices, hindered economic growth, limited trade, and kept the masses of people impoverished. Smith argued that the free-market system along with free trade would produce true national wealth, benefiting all social classes not just the privileged few.

In a major section of *The Wealth of Nations*, Smith attacked mercantilist trade practices. He insisted that what enriched European nations was not importing gold and silver but opening up new free-trade markets in the world. This trade, he wrote, further stimulated the division of labor, expanded the production of trade goods, and increased “the real revenue and wealth” of all.

Smith criticized how the British Parliament had passed laws that crippled free trade and hindered the expansion of national wealth. These laws imposed high import duties, gave subsidies to favored companies, and granted monopolies to powerful special interests like the East India Company.

These laws harmed society by limiting competition and keeping prices high. Such measures, Smith wrote, were “extorted from our legislature” and “written in blood” since they served the interest of only a small class of privileged manufacturers and merchants.

Smith reserved his greatest criticism for the British colonial empire. He concluded it was “hurtful to the general interest of society.” He focused especially on trade restrictions placed on the colonies in America.

Smith opposed mercantilist policies that required Americans to export certain products like fur pelts only to England. The Americans also had to ship their exports on British ships. Regulations prohibited transporting woolen products from one colony to another. Laws made it illegal for Americans to operate steel-making furnaces. Government-licensed monopolies like the East India Company held the exclusive right to sell goods like tea to the Americans.

According to Smith, these and hundreds of other restrictions benefited British special interests. But they slowed production and international trade, the sources of a nation’s

“real wealth.” To Smith, the mercantilist system was self-defeating and resulted from “the monopolizing spirit of merchants and manufacturers.” Their greed flowed from “an interest to deceive and even oppress the public.”

Smith concluded that to achieve economic growth and social betterment, Britain should sweep away its network of government economic privileges and restrictions. Let the “free market mechanism” operate on its own without government intervention, Smith advised.

### **Adam Smith and the Role of Government**

Adam Smith advocated a limited role for government. But he recognized significant areas where only it could act effectively.

Smith saw the first duty of government was to protect the nation from invasion. He argued that a permanent military force, rather than citizen militias, was necessary to defend any advanced society. Next, he supported an independent court system and administration of justice to control crime and protect property.

Smith favored “public works” to create and maintain an infrastructure to make easier the free flow of commerce. These works included such things as roads, bridges, canals, harbors, and a postal system that profit-seeking individuals may not be able to efficiently build and operate.

Even in 1776, at the beginning stages of industrialization, Smith recognized that repetitive factory jobs dulled the minds of workers. He said they became “as stupid and ignorant as it is possible for a human being to become.” Smith wanted all classes, even the poorest, to benefit from the free-market system. “No society can surely be flourishing and happy,” he wrote, when most of its people are “poor and miserable.”

Thus, remarkably for the time, Smith advocated the education of all youth. He believed there was little difference in intelligence between the poor and the rich. Only the social conditions of the poor held them in ignorance, he concluded. He called for a “little school” in every district, supported by public taxes and small parent fees. “An instructed and intelligent people,” Smith wrote, “are always more decent and orderly than an ignorant and stupid one.”

Smith wrote that paying taxes was “a badge, not of slavery, but of liberty.” By this, he meant that a taxpayer was an owner of property rather than the property of a master. Furthermore, Smith was an advocate of setting tax rates according to one’s ability to pay. Taxpayers, he argued, should pay “in proportion to the revenue which they respectively enjoy under the protection of the state.”

Smith believed in taxing property, profits, business transactions, and wages. But these taxes should be as low as possible to meet the public needs of the country. He also thought they should not be arbitrary, uncertain, or unclear in the law. Nor should they require home inspections that intruded into the private lives of individuals.

Smith criticized a large public debt, which, he observed, resulted mainly from wars. He believed that the mercantilists encouraged wars so that they could lend money at high interest to the government and exploit conquered lands. Smith viewed wars as “waste and extravagance,” producing a “perpetual” public debt that diverted money away from investment in new enterprises and economic growth. Public debt, Smith concluded, “has gradually enfeebled every state which has adopted it.”

### **Applying *The Wealth of Nations* to the World**

Recognizing that the American colonists were victims of Britain’s mercantile policies, Smith advised Parliament to let the American colonies peacefully go their own way. For the sake of maintaining a monopoly of trade, he argued, the colonies had cost the British people much more than they had gained. In the case of the Americans, Smith declared that denying “a great people” the freedom to pursue their own economic destiny was “a manifest violation of the most sacred rights of mankind.” He urged Britain’s rulers to awaken from their imaginary and wasteful “golden dream” of empire.

We know Adam Smith today as the father of *laissez faire* (“to leave alone”) economics. This is the idea that government should leave the economy alone and not interfere with the “natural course” of free markets and free trade. But he was mainly thinking about the government granting special economic privileges to powerful manufacturers and merchants. To Smith, these mercantile monopolists and their allies in Parliament were the great enemies of his “free market mechanism.”

In *The Wealth of Nations*, Smith only glimpsed the impact of the Industrial Revolution in Britain and later the United States. He did not foresee the development of huge corporate monopolies that suppressed competition without the need for government licenses. He did not imagine the brutal working and living conditions suffered by masses of men, women, and children. Thus, he never fully addressed the issue of whether government should intervene in the economy to prohibit such things as corporate monopolies and child labor.

Adam Smith did not write any other books. He died in 1790, well regarded by all who knew him. By this time, the British prime minister, William Pitt “The Younger,” was adopting Smith’s economic principles as government policy. Thus began the revolution of modern free market capitalism that dominates world economics today.

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### **Adam Smith's "Free Market Mechanism"**

*The following is a simplified version of the economic system Adam Smith believed would emerge once governments ended their oppressive mercantilist policies.*

1. A man builds a cloth-making factory, hires workers, and divides their labor into many specialized operations. The factory owner is motivated by self-interest, profit, maybe even greed.
2. Others, however, are also building factories to make and sell cloth. They all have to compete for the money of the buyers whose self-interest is to buy cloth at the best price.
3. Buyers bid up the price of the cloth when the supply of cloth is low and their demand for it is high. But when there is an oversupply, the buyers can pick and choose and refuse to purchase high-priced cloth. The factory owners then have to reduce their prices to attract more buyers. Economists call this the "law of supply and demand."
4. Additional innovative divisions of labor, maybe brought on by new machinery, motivate others to invest in more factories. But they must compete to hire more workers. The "law of supply and demand" applies here, too, and wages go up.
5. Higher wages lengthen the lives of workers and their children. The population grows, which increases the supply of workers. Wages then stop rising. But, soon another division of labor wave occurs, producing more economic growth and the need for even more workers. Wages go up again. The cycle repeats itself.
6. Families now can afford to buy (demand) more cloth and lots of other products. The factory owners make more profits. Everybody wins and society as a whole improves.
7. The cloth factory owner never intended to improve society; he just wanted to make money for himself. But his self-interest, as if "led by an invisible hand," resulted in the betterment of all. As Adam Smith himself put it, "By pursuing his own interest he frequently promotes that of the society more effectively than when he really intends to promote it."

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### **For Discussion and Writing**

1. Explain Adam Smith's ideas about human self-interest and the "invisible hand." Do you agree with him? Explain.
2. What did Adam Smith mean by the phrase "wealth of nations"?
3. Contrast Adam Smith's "free market mechanism" with mercantilism.
4. What economic problems was Smith addressing in his day? What economic problems face modern society?

## **For Further Reading**

Heilbroner, Robert L. *The Worldly Philosophers, The Lives, Times, and Ideas of the Great Economic Thinkers*. rev. 7th ed. New York: Simon & Schuster, 1999.

Smith, Adam. *An Inquiry Into the Nature and Causes of the Wealth of Nations*. Great Books of the Western World, vol. 39. Chicago, Ill.: Encyclopaedia Britannica, Inc., 1952.

## **A C T I V I T Y**

### **Adam Smith and Government Interventions in the Economy**

1. Do you think Adam Smith would agree or disagree with the following government interventions in the economy today?
  - anti-monopoly laws
  - child-labor laws
  - minimum-wage laws
  - inheritance taxes
  - Social Security
  - North Atlantic Free Trade Association (NAFTA)
2. Form six small groups to each investigate one of the above interventions.
3. Use your textbook and school library resources to find out about the intervention you are investigating. Use quotes and other evidence from the article to decide what position Adam Smith would likely take on the intervention.
4. Each group should then report to the class its conclusion along with supporting evidence.