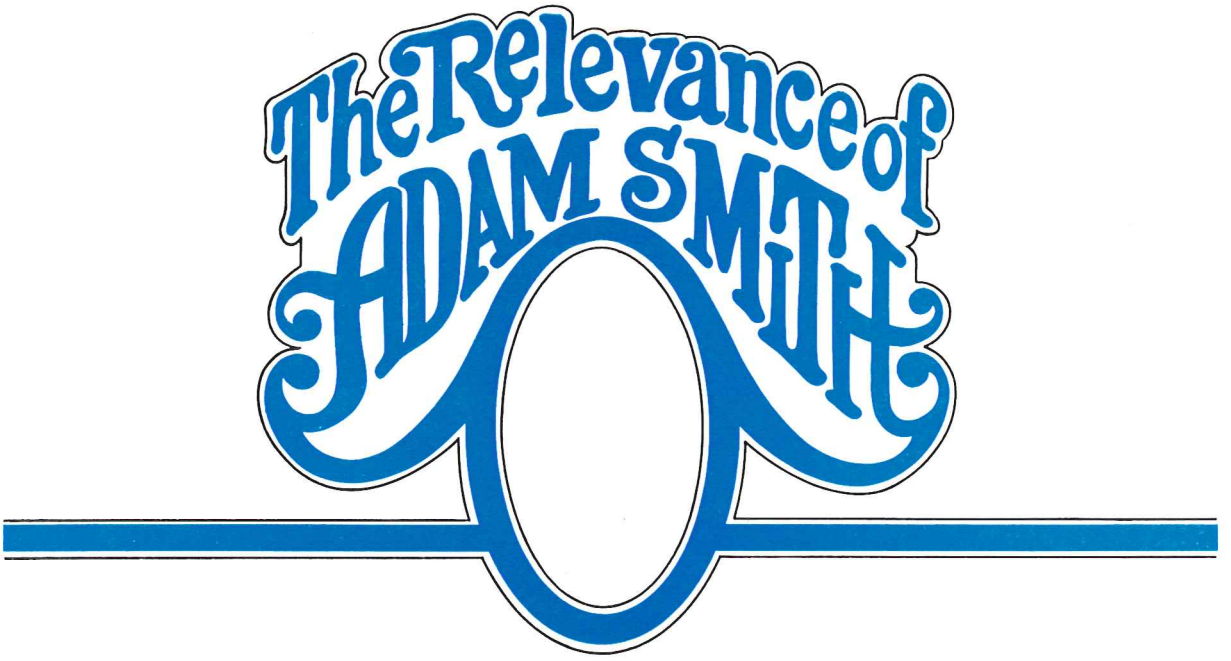
Federal Reserve Bank of Richmond

The Relevance of ADAM SMITH

Smith and the American Bicentennial

The Wealth of Nations,
contemporary economic issues
and classical policy prescriptions

FEDERAL RESERVE BANK OF RICHMOND



by

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Foreword

In observance of our nation's Bicentennial, the Federal Reserve Bank of Richmond is publishing this booklet on Adam Smith's **The Wealth of Nations.** The similarities between Smith's great treatise and our own Declaration of Independence are indeed striking. Both were published in 1776. Both were revolutionary documents, the one signaling the birth of a nation, the other the birth of the modern science of economics. Both were reactions to the heavy hand of the state, the one to the British Crown's interference with the right of economic and political self-determination, the other to mercantilistic controls on business enterprise. Both documents stress the importance of the individual in society, and both show great concern for individual liberty. Both Smith and the Founding Fathers shared the same vision of a good society, one that would allow maximum personal freedom while harnessing the powerful force of individual self-interest to the interests of society as a whole. Both addressed the problem of finding the institutional framework that would transform the vision into a reality. And that framework, too, is described in **The Wealth of Nations** as well as in the works of the Founding Fathers. Comprised of the free-market economic system and the political system of representative democracy, this framework established an environment within which economic progress, social harmony, and individual freedom and opportunity have flourished on a scale unmatched in history. As co-architect of this framework, which has provided much of the rationale of U. S. public policy over the past 200 years, Adam Smith deserves a place in the Bicentennial celebration.

The Relevance of Adam Smith

Smith and the American Bicentennial

A reflection on the sources of our intellectual heritage is an important part of the Bicentennial. Part of this reflection consists of reading the writings of the Founding Fathers. The Founding Fathers, however, were part of a larger group of men in North America and Western Europe who were discussing revolutionary ideas in political economy, science, and industrial organization. In the area of political economy, there is another bicentennial to celebrate in 1976. In 1776 Adam Smith published his monumental treatise, **An Inquiry into the Nature and Causes of the Wealth of Nations.** This booklet endeavors to show that any appraisal of the sources of our intellectual heritage must assign a major role to **The Wealth of Nations.**

Many of the Founding Fathers read **The Wealth of Nations.** Madison read it, and Alexander Hamilton borrowed heavily from it in his **Report on Manufactures.**[1] There are numerous references to Smith in the letters of Thomas Jefferson. Jefferson wrote in 1790 in a letter to Thomas Mann Randolph: ". . . in political oeconomy I think Smith's wealth of nations the best book extant . . . ."[2] He commented in 1816 in a prospectus for **Treatise on Political Economy** by Destutt de Tracy: "Adam Smith, first in England, published a rational and systematic work on Political oeconomy, adopting generally the ground of the Economists, but differing on the subjects before specified. The system being novel, much argument and detail seemed then necessary to establish principles which now are assented to as soon as proposed."[3]

The intellectual spirit of **The Wealth of Nations** has much in common with the intellectual spirit existing in America at the time of the Revolution. Smith shared the egalitarian spirit of the Revolution. For example, he says:

> *The difference of natural talents in different men is, in reality, much less than we are aware of; and the very different genius which appears to distinguish men of different professions, when grown up to maturity, is not upon many occasions so much the cause, as the effect of the division of labour. The difference between the most dissimilar characters, between a philosopher and a common street porter, for example, seems to arise not so much from nature, as from habit, custom, and education.* (p. 15)[4]

Both Smith and American statesmen were trying to devise social systems in accord with the spirit of natural law. They believed that the principles of social organization conducive to harmonious relations among men and between men and their government are inherent in and may be deduced from the natural forces that motivate men's behavior. The Declaration of Independence refers to "the Laws of Nature." Smith believed that man's "disposition to

truck, barter, and exchange" would, given a policy of laissez faire, cause the self-interest of the individual to promote the larger interests of society.

Both Smith and early American statesmen were reacting against the doctrines of mercantilism, which justified direct and extensive control by the government over the market activities of individuals. Smith decried the Navigation Acts, which required that "all that part of the surplus produce of the English colonies . . . which consists in what are called enumerated commodities, can be sent to no other country but England." (p. 560) The Declaration of Independence condemns the King of Great Britain "for cutting off our Trade with all parts of the world." This reaction against the ideas of mercantilism resulted in a desire to limit the role of the government in the economy. During our Constitutional Convention efforts were made to give the Government broad powers to regulate the workings of the economy. It is significant that these efforts were defeated. The authority of the Federal Government to regulate the economy was limited to "the power to tax, borrow, regulate commerce, pass uniform bankruptcy laws, coin money, establish post offices and post roads, and grant patents."[5]

Of particular interest because of the Bicentennial of the American Revolution are Smith's observations about America. Published in 1776, they are insightful and prescient. The first passage contains Smith's recommendation for British policy toward its colonies. The second passage needs no comment:

> *To propose that Great Britain should voluntarily give up all authority over her colonies, and leave them to elect their own magistrates, to enact their own laws, and to make peace and war as they might think proper, would be to propose such a measure as never was, and never will be adopted, by any nation in the world. No nation ever voluntarily gave up the dominion of any province, how troublesome soever it might be to govern it, and how small soever the revenue which it afforded might be in proportion to the expence which it occasioned. Such sacrifices, though they might frequently be agreeable to the interest, are always mortifying to the pride of every nation, and what is perhaps of still greater consequence, they are always contrary to the private interest of the governing part of it, who would thereby be deprived of the disposal of many places of trust and profit, of many opportunities of acquiring wealth and distinction, which the possession of the most turbulent, and, to the great body of the people, the most unprofitable province seldom fails to afford. The most visionary enthusiast would scarce be capable of proposing such a measure, with any serious hopes at least of its ever being adopted. If it was adopted, however, Great Britain would not only be immediately freed from the whole annual expence of the peace establishment of the colonies, but might settle with them such a treaty of commerce as would effectually secure to her a free trade, more advantageous to the great body of the people, though less so to the merchants, than the monopoly which she at present enjoys. By thus parting good friends, the natural affection of the colonies to the mother country, which, perhaps, our late dissensions have well nigh extinguished, would quickly revive. It might dispose them not only to respect, for whole centuries together, that treaty of commerce which they had concluded with us at parting but to favour us in war as well as in trade, and, instead of turbulent and factious subjects, to become our most faithful, affectionate, and generous allies;* (pp. 581-2)

> *They are weak who flatter themselves that, in the state to which things have come, our colonies will be easily conquered by force alone. The persons who now govern the resolutions of what they call their continental congress, feel in themselves at this moment a degree of importance which, perhaps the greatest subjects in Europe scarce feel. From shopkeepers, tradesmen, and attornies, they are become statesmen and legislators, and are employed in contriving a new form of government for an extensive empire, which they flatter themselves, will become, and which, indeed, seems very likely to become, one of the greatest and most formidable that ever was in the world.* (pp. 587-8)

Major Themes in The Wealth of Nations

The central theme of **The Wealth of Nations** is the construction of a social order in which the individual, in pursuing his own self-interest, necessarily contributes to the general interests of society. Smith approaches this question pragmatically. For example, in the case of the postal service, Smith approved of government-operated enterprises. In general, however, Smith wanted to limit the role of government-run enterprises, not on doctrinaire grounds, but rather on the practical grounds that it is hard to design them so as to take account of the following observed phenomenon:

> *Public services are never better performed than when their reward comes only in consequence of their being performed, and is proportioned to the diligence employed in performing them.* (p. 678)

Of decisive importance to Smith in his design of the optimal social structure is his belief in the strength of individual self-interest. Properly channeled this force will steadily advance the common social interest. Much of the spirit of Smith's social prescriptions comes from his belief that this powerful force is most effectively taken advantage of by society when the individual is allowed a large amount of personal freedom to pursue his own economic betterment and is allowed to reap the rewards for such efforts:

> *The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations . . . .* (p. 508)

Again, for England Smith says that "the increase of its manufactures and agriculture" derives

> *. . . from the fall of the feudal system, and from the establishment of a government which afforded to industry the only encouragement which it requires, some tolerable security that it shall enjoy the fruits of its own labour.* (p. 238)

Through countless examples Smith makes clear that the private self-interest of the individual will promote the larger interests of society only if the most careful attention is given to the design of social institutions. Of the most fundamental importance is the impartial administration of justice:

> *Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.* (p. 862)

Furthermore, great care must be exercised to ensure that self-interest is not pursued in anti-social ways. A favorite theme of Smith is the prevalence of the desire of individuals to form monopolies:

> *People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.* (p. 128)

Adam Smith in 1976

The relevance of Adam Smith's ideas is best illustrated by demonstrating their continuing, extensive use in contemporary debates over public policy. The main part of this essay shows how Smith's ideas are used in contemporary public policy debates about monopoly and government subsidies and about centralized economic planning. A final section suggests reasons for the persistence of Smith's ideas. Throughout, the essay makes extensive use of quotations from **The Wealth of Nations** since the most effective expositor of Smith's ideas remains even today Adam Smith himself.

MONOPOLY AND GOVERNMENT SUBSIDIES: The principal theme set forth in **The Wealth of Nations** is that a country most effectively promotes its own wealth by providing a framework of laws that leaves individuals free to pursue the interest they have in their own economic betterment. This self-interest motivates individuals' "propensity to truck, barter, and exchange one thing for another" and thereby leads them to meet the needs of others through voluntary cooperation in the market place:

> *. . . man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and shew them that it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.* (p. 14)

Smith also argues that the harmony between private goals and larger socially desirable goals promoted by voluntary cooperation between individuals in the market place is interfered with by monopoly and government subsidies. In contrast to competition, monopoly and government subsidies cause individuals to devote either too few or too many resources to particular markets:

> *. . . the private interests and passions of individuals naturally dispose them to turn their stock towards the employments which in ordinary cases are most advantageous to the society. But if from this natural preference they should turn too much of it towards those employments, the fall of profit in them and the rise of it in all others immediately dispose them to alter this faulty distribution. Without any intervention of law, therefore, the private interests and passions of men naturally lead them to divide and distribute the stock of every society, among all the different employments carried on in it, as nearly as possible in the proportion which is most agreeable to the interest of the whole society.*
>
> *All the different regulations of the mercantile system, necessarily derange more or less this natural and most advantageous distribution of stock.* (pp. 594-5)

> *Every derangement of the natural distribution of stock is necessarily hurtful to the society in which it takes place; whether it be by repelling from a particular trade the stock which would otherwise go to it, or by attracting towards a particular trade that which would not otherwise come to it.* (p. 597)

Smith describes the actions of monopolists as follows:

> *The monopolists, by keeping the market constantly under-stocked, by never fully supplying the effectual demand, sell their commodities much above the natural price, and raise their emoluments, whether they consist in wages or profit, greatly above their natural rate.* (p. 61)

The "natural price" is "the lowest which the sellers can commonly afford to take, and at the same time continue their business." (p. 61) Today we would use the word "competitive" for "natural." The "effectual demand" is "the demand of those who are willing to pay the natural price of the commodity." (p. 56) Monopoly, as well as a governmentally subsidized activity, contrasts with a competitive market where a "commodity is . . . sold precisely for what it is worth, or for what it really costs the person who brings it to market." (p. 55)

The Wealth of Nations contains three general kinds of criticism of monopolies. The first is that the higher prices in a monopolized market reduce the welfare of consumers:

> *If . . . capital is divided between two different grocers, their competition will tend to make both of them sell cheaper, than if it were in the hands of one only;*

and if it were divided among twenty, their competition would be just so much the greater, and the chance of their combining together, in order to raise the price, just so much the less. Their competition might perhaps ruin some of themselves; but to take care of this is the business of the parties concerned, and it may safely be trusted to their discretion. It can never hurt either the consumer, or the producer; on the contrary, it must tend to make the retailers both sell cheaper and buy dearer, than if the whole trade was monopolized by one or two persons. (pp. 342-3)

In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. Their interest is, in this respect, directly opposite to that of the great body of the people. As it is the interest of the freemen of a corporation to hinder the rest of the inhabitants from employing any workmen but themselves, so it is the interest of the merchants and manufacturers of every country to secure to themselves the monopoly of the home market. (p. 461)

The second criticism of monopoly is that it engenders inefficient management:

Monopoly . . . is a great enemy to good management, which can never be universally established but in consequence of that free and universal competition which forces everybody to have recourse to it for the sake of self-defence. (p. 147)

The third criticism of monopoly is that it is inequitable because it increases arbitrarily the inequality in individuals' incomes:

. . . The policy of Europe occasions a very important inequality in the whole of the advantages and disadvantages of the different employments of labour and stock, by restraining the competition in some employments to a smaller number than might otherwise be disposed to enter into them. (pp. 118-19)

Monopoly has always been a contentious issue in debates on public policy in the United States. It is interesting to examine the way in which the ideas of Smith appear in current debates over monopoly. In general, proponents of government intervention in the market place argue that monopoly is endemic in capitalism and that its elimination requires significant intervention by the government in the market place. An opposing group argues that free markets effectively restrain monopoly power and that it is in fact government intervention in the market place that is chiefly responsible for monopoly. The first group assumes that large size, fewness of firms, and operation over an extensive geographic area automatically imply monopoly power and thus supports its position by citing the existence of industries dominated by a few large firms and the existence of multinational corporations. The opposing group supports its position by trying to show that where monopoly power exists it is made possible by particular governmental actions, e.g., in the United States by Federal milk marketing orders that fix the price of milk above what it would be otherwise, or FCC regulations restricting the growth of cable TV, thereby preventing competition with the established networks.

The view of the world suggested in **The Wealth of Nations** is that monopoly power cannot persist without the assistance of government. The specific examples of monopoly that Adam Smith attacked required the police power of the state for their maintenance. These monopolies were of three kinds. One kind of monopoly depended upon the mercantilistic system of laws which England used to monopolize trade with its colonies: "Monopoly of one kind or another, indeed, seems to be the sole engine of the mercantile system." (p. 595) Another kind arose from the monopoly power granted guilds (referred to by Smith as corporations), which allowed them exclusive rights to produce a given commodity:

The exclusive privilege of an incorporated trade necessarily restrains the competition, in the town where it is established, to those who are free of the trade.

To have served an apprenticeship in the town, under a master properly qualified, is commonly the necessary requisite for obtaining this freedom. The bye-laws of the corporation regulate sometimes the number of apprentices which any master is allowed to have, and almost always the number of years which each apprentice is obliged to serve. The intention of both regulations is to restrain the competition to a much smaller number than might otherwise be disposed to enter into the trade. The limitation of the number of apprentices restrains it directly. A long term of apprenticeship restrains it more indirectly, but as effectually, by increasing the expence of education. (p. 119)

The government of towns corporate was altogether in the hands of traders and artificers; and it was the manifest interest of every particular class of them, to prevent the market from being overstocked, as they commonly express it, with their own particular species of industry; which is in reality to keep it always understocked. (p. 124)

A final kind of monopoly depended upon tariffs and quotas that prevented foreign producers from competing with domestic producers:

The superiority which the industry of the towns has every-where in Europe over that of the country, is not altogether owing to corporations and corporation laws. It is supported by many other regulations. The high duties upon foreign manufactures and upon all goods imported by alien merchants, all tend to the same purpose. Corporation laws enable the inhabitants of towns to raise their prices, without fearing to be under-sold by the free competition of their own countrymen. Those other regulations secure them equally against that of foreigners. (p. 127)

Competitive markets restrain monopoly because the above-average profits associated with the exercise of monopoly power attract new producers who increase output and thereby lower prices:

When by an increase in the effectual demand, the market price of some particular commodity happens to rise a good deal above the natural price, those who employ their stocks in supplying that market are generally careful to conceal this change. If it was commonly known, their great profit would tempt so many new rivals to employ their stocks in the same way, that, the effectual demand being fully supplied, the market price would soon be reduced to the natural price . . . . Secrets of this kind, however, it must be acknowledged, can seldom be long kept; and the extraordinary profit can last very little longer than they are kept. (p. 60)

Monopolists can preserve their favorable position only if the government prevents potential competitors from entering the monopolized activity:

The exclusive privileges of corporations, statutes of apprenticeship, and all those laws which restrain, in particular employments, the competition to a smaller number than might otherwise go into them, have the same tendency . . . . They . . . may frequently, for ages together, and in whole classes of employments, keep up the market price of particular commodities above the natural price, and maintain both the wages of the labour and the profits of the stock employed about them somewhat above their natural rate.

Such enhancements of the market price may last as long as the regulations of police which give occasion to them. (pp. 61-2)

Free markets make the formation of monopoly difficult because monopoly requires the adherence of all actual and potential sellers in a market. Self-interest makes achievement of such adherence difficult because each seller has an incentive to undercut the monopoly price in order to increase his share of the market. Monopoly power is increased or made possible if enforced by the government. In the following passage Smith refers to the guilds, or corporations, of his day:

An incorporation . . . makes the act of the majority binding upon the whole. In a free trade an effectual combination cannot be established but by the unanimous consent of every single trader, and

it cannot last longer than every single trader continues of the same mind. The majority of a corporation can enact a bye-law with proper penalties, which will limit the competition more effectually and more durably than any voluntary combination whatever. (p. 129)

Smith's ideas appear in current public debate over monopoly. Advocates of deregulating the transportation and communications industries by eliminating or reducing the power of Federal regulatory agencies argue that these agencies promote monopoly by limiting the entry of new firms and by fixing prices for all producers. Government regulations enforced upon all firms in an industry have the effect of allowing producers to eliminate competition and to raise prices. At the same time, lack of competition reduces incentives for efficient production.

Monopoly can occur in labor as well as product markets. The craft unions of today, for example, resemble the guilds of Smith's time. Today unions are universally accepted as permanent institutions in our society; nevertheless, there is continual debate over the extent to which government should use legislation as a means of increasing or limiting the monopoly power of unions. Is it legitimate to use minimum wage laws to protect unions from competition of lower-wage nonunion labor? Should the government deny welfare payments to striking workers? Should Congress give all state and municipal employees collective bargaining rights and the right to strike? Is it desirable to use the Davis-Bacon and Walsh-Healy Acts to set union rates for contractors involved in Federal construction work, thereby limiting the ability of nonunion labor to compete with union labor by offering their labor at a lower wage rate? Should Congress permit common situs, that is, on-site, picketing by one union where several unions and subcontractors are at work?

Those arguing against legislation that would increase the monopoly power of unions employ the arguments set forth by Smith. Smith argued that any form of monopoly raises the price of the associated product:

[An] increase of competition would reduce the profits of the masters as well as the wages of the workmen. The trades, the crafts . . . would all be losers. But the public would be a gainer, the work of all artificers coming in this way much cheaper to market. (p. 123)

Smith also argues that unions decrease the number of workers in the unionized sector and increase the number in the nonunionized sector. The effect is to raise wage rates in the unionized sector and to lower wage rates in the nonunionized sector, thereby effecting a transfer of income from nonunionized to unionized workers and promoting a less equal distribution of income:

. . . the policy of Europe, by restraining the competition in some employments to a smaller number than would otherwise be disposed to enter into them, occasions a very important inequality in the whole of the advantages and disadvantages of the different employments of labour . . . . (p. 129)

It frequently happens that while high wages are given to the workmen in one manufacture, those in another are obliged to content themselves with bare subsistence. The one is in an advancing state, and has, therefore, a continual demand for new hands: The other is in a declining state, and the super-abundance of hands is continually increasing. . . . the workmen could easily change trades with one another, if . . . absurd laws did not hinder them. . . . and their wages would neither rise too high in the thriving, nor sink too low in the decaying manufacture. (pp. 134-5)

Smith also criticizes unions on the grounds that they prevent the nonunion worker from working wherever he desires:

The property which every man has in his own labour, as it is the original foundation of all other property, so it is the most sacred and inviolable. The patrimony of a poor man lies in the strength and dexterity of his hands; and to hinder him from employing this strength and dexterity in what manner he thinks proper without injury to his neighbour, is a

plain violation of this most sacred property. It is a manifest encroachment upon the just liberty both of the workman, and of those who might be disposed to employ him. As it hinders the one from working at what he thinks proper, so it hinders the others from employing whom they think proper. To judge whether he is fit to be employed, may surely be trusted to the discretion of the employers whose interest it so much concerns. (pp. 121-2)

An issue related to the subject of monopoly in labor markets is licensing requirements in certain trades and professions. The publicly stated reason for licensing in the professions is that it insures quality work and protects the consumer. Free market proponents note that the requirements that must be met in order to receive a license are generally set by the profession itself. They then argue that given this privilege, the members of a trade or profession naturally act in their own self-interest by limiting entry. Taxicab owners, beauticians, plumbers, and members of other trades allegedly limit through licensing requirements the number who practice their profession. Critics of government-sponsored licensing arrangements use the ideas of Smith when they argue that consumers, not members of a given trade, should decide who is able to provide competent service:

The pretence that corporations are necessary for the better government of the trade, is without any foundation. The real and effectual discipline which is exercised over a workman, is not that of his corporation, but that of his customers. It is the fear of losing their employment which restrains his frauds and corrects his negligence. An exclusive corporation necessarily weakens the force of this discipline. A particular set of workmen must then be employed, let them behave well or ill. It is upon this account, that in many large incorporated towns no tolerable workmen are to be found, even in some of the most necessary trades. If you would have your work tolerably executed, it must be done in the suburbs, where the workmen, having no exclusive privilege, have nothing but their character to depend upon, and you must then smuggle it into the town as well as you can. (p. 129)

As described earlier, Smith disapproved of government subsidies for the same general reasons that he disapproved of monopolies. He comments as follows on subsidies to the fishing industry:

Something like a bounty upon production, however, has been granted upon some particular occasions. The tonnage bounties given to the white-herring and whale-fisheries may, perhaps, be considered as somewhat of this nature. They tend directly, it may be supposed, to render the goods cheaper in the home market than they otherwise would be. In other respects their effects, it must be acknowledged, are the same as those of bounties upon exportation. By means of them a part of the capital of the country is employed in bringing goods to market, of which the price does not repay the cost, together with the ordinary profits of stock. (p. 484)

These same arguments are still used today by critics of government subsidies to special groups such as the maritime industry and exporters.

CENTRALIZED ECONOMIC PLANNING: During the Depression an important debate began about the need for some form of national economic planning in order to achieve commonly shared long-run goals. The ideas of Smith have always played a prominent role in this debate.

Smith in **The Wealth of Nations** argues that the attainment of socially desirable goals is best achieved not through centralized economic planning, but rather through planning by each individual using the detailed knowledge of his particular situation, with the separate plans of all individuals coordinated by the impersonal discipline of prices determined in the market place. Smith's preference for the second type of planning is shown in the following passage:

The uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful

enough to maintain the natural progress of things toward improvement, in spite both of the extravagance of government, and of the greatest errors of administration. Like the unknown principle of animal life, it frequently restores health and vigour to the constitution, in spite, not only of the disease, but of the absurd prescriptions of the doctor. (p. 326)

Smith argues that government administrators cannot possibly possess the detailed information necessary in order to plan the economic activities of individuals:

. . . the law ought always to trust people with the care of their own interest, as in their local situations they must generally be able to judge better of it than the legislator can do. (p. 497)

The advantage of competitive markets is that decisions are made by the individuals with the requisite knowledge:

Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest in his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society. (p. 651)

Smith viewed the governments of the major countries of his day as wasteful and inefficient. In contrast, according to Smith, individuals because of their desire to better their condition are more likely to be frugal and to oversee carefully their expenditures. With respect to individuals, Smith observes:

With regard to profusion, the principle which prompts to expence, is the passion for present enjoyment; which, though sometimes violent and very difficult to be restrained, is in general only momentary and occasional. But the principle which prompts to save, is the desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb, and never leaves us til we go into the grave. . . . Though the principle of expence, therefore, prevails in almost all men upon some occasions, and in some men upon almost all occasions, yet in the greater part of men, taking the whole course of their life at an average, the principle of frugality seems not only to predominate, but to predominate very greatly. (pp. 324-5)

The contrast with the behavior of government is striking:

Great nations are never impoverished by private, though they sometimes are by public prodigality and misconduct. (p. 325)

. . . though the profusion of government must, undoubtedly, have retarded the natural progress of England towards wealth and improvement, it has not been able to stop it. . . . In the midst of all the exactions of government, . . . capital has been silently and gradually accumulated by the private frugality and good conduct of individuals, by their universal, continual, and uninterrupted effort to better their own condition. It is this effort, protected by law and allowed by liberty to exert itself in the manner that is most advantageous, which has maintained the progress of England towards opulence and improvement in almost all former times, and which, it is to be hoped, will do so in all future times. . . . It is the highest impertinence and presumption, therefore, in kings and ministers, to pretend to watch over the oeconomy of private people, and to restrain their expence, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. They are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expence, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will. (pp. 328-9)

Adam Smith is especially critical of the government planning he observed in France. The French government, following mercantilistic

policies, assumed that the wealth of the country could only be increased through central direction of the economy. Government planning in France was personified by Colbert, "the famous minister of Lewis XIV. . . . a man of probity, of great industry and knowledge of detail; of great experience and acuteness in the examination of public accounts . . . . ":

> *That minister had unfortunately embraced all the prejudices of the mercantile system, in its nature and essence a system of restraint and regulation, and such as could scarce fail to be agreeable to a laborious and plodding man of business, who had been accustomed to regulate the different departments of public offices, and to establish the necessary checks and controuls for confining each to its proper sphere. The industry and commerce of a great country he endeavoured to regulate upon the same model as the departments of a public office; and instead of allowing every man to pursue his own interest his own way, upon the liberal plan of equality, liberty and justice, he bestowed upon certain branches of industry extraordinary privileges, while he laid others under as extraordinary restraints.* (pp. 627-8)

Opponents of government planning today do little more than repeat the arguments of Smith.

One form of government planning occurs when the government uses subsidies to influence the investment decisions of private individuals. The extent to which government should influence the direction of private investment is the subject of much current debate. For example, it has been argued in the United States that the reserve requirements of a bank should be adjusted according to the kinds of loans the bank makes. Investments should be judged not solely according to their profitability, but rather according to a set of social priorities defined by Congress.

Adam Smith argues that the wealth of a country is most effectively enhanced by a government policy that makes no attempt to influence how private individuals or businesses allocate their savings. A country's wealth is increased most if savings go to those investments with the highest rate of return. Individuals are led to choose these investments in the pursuit of their own self-interest:

> *. . . it is only for the sake of profit that any man employs a capital in the support of industry; and he will always, therefore, endeavour to employ it in the support of that industry of which the produce is likely to be of the greatest value . . . .*
>
> *But the annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry . . . . As every individual, therefore, endeavours . . . to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.* (p. 423)

This example is a specific illustration of Smith's general argument that given the proper institutions, society most effectively promotes its own larger interests by leaving individuals free to pursue their own self-interest:

> *Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of the society, which he has in view. But the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society.* (p. 421)

Again, planning by individuals is preferable to planning by the government:

> *What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evi-*

dent, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it. (p. 423)

Modern opponents of governmental attempts to influence the allocation of private investment use the arguments of Smith. For example, on the basis of these arguments, they criticize special government efforts to promote housing. In the United States such efforts include income tax deductions for interest payments on mortgages, higher legal interest rate ceilings on time deposits at savings and loan institutions than at banks, and subsidies to finance housing as through the FHA, Ginnie Mae, Fannie Mae, and VA programs. They also criticize tax laws that tax income from capital at differing rates, thereby causing savings to flow from more to less productive investments. Examples of such laws are the corporation income tax, which taxes income from capital generated in the corporate sector but not in the non-corporate sector, and capital gains taxes, which accord differential treatment to ordinary and capital gains income from capital.

The Wealth of Nations also discusses issues that arise out of the variant of national economic planning in which the government instead of the market place determines the distribution of income. Today some amount of governmental redistribution of income is universally accepted through the graduated income tax, welfare, unemployment compensation, and so on. The current issue in public policy debate is whether the recent growth of the role of the government in determining the distribution of income should be limited or allowed to continue. Individuals who emphasize the importance of allowing the market place instead of government to be the principal arbiter of the distribution of income argue that weakening the relationship between labor and the receipt of the rewards for that labor dulls incentives and thereby retards the growth of the economy. This argument is made repeatedly by Adam Smith.

A constant theme in **The Wealth of Nations** is the importance of maintaining a strong relationship between work and the rewards for work. With regard to wage earnings, Smith says:

The wages of labour are the encouragement of industry, which, like every other human quality, improves in proportion to the encouragement it receives. (p. 81)

That security which the laws in Great Britain give to every man that he shall enjoy the fruits of his own labour, is alone sufficient to make any country flourish . . . . (p. 508)

Smith even has an amusing story about the effect of a change in the arrangements for rewarding labor on the motivation of soldiers:

We do not reckon our soldiers the most industrious set of people among us. Yet when soldiers have been employed in some particular sorts of work, and liberally paid by the piece, their officers have frequently been obliged to stipulate with the undertaker, that they should not be allowed to earn above a certain sum every day, according to the rate at which they were paid. Till this stipulation was made, mutual emulation and the desire of greater gain, frequently prompted them to over-work themselves, and to hurt their health by excessive labour. (p. 82)

With regard to profits, Smith argues against social arrangements which interfere with the

. . . 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. (p. 716)

These sentiments recur in a quote in which Smith describes as the most important cause of England's prosperity its:

. . . equal and impartial administration of justice which renders the rights of the meanest British subject respectable to the greatest, and which, by securing to every man the fruits of his own industry, gives the greatest and most effectual encouragement to every sort of industry. (p. 576)

Why Have Smith's Ideas Persisted?

One reason for the persistence of Smith's ideas is that they describe how to attain a goal assumed to be socially desirable not just by Smith but also by many individuals today. The first two sentences in **The Wealth of Nations** assume the social desirability of maximizing per capita income:

The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniencies of life which it annually consumes, and which consist always either in the immediate produce of that labour, or in what is purchased with that produce from other nations.

According therefore, as this produce, or what is purchased with it, bears a greater or smaller proportion to the number of those who are to consume it, the nation will be better or worse supplied with all the necessaries and conveniencies for which it has occasion. (p. lvii)

Contemporary defenders of Smith's ideas argue that this goal is compatible with another goal widely held to be socially desirable, lessening the inequality of the distribution of income. The larger the size of a country's income, the more there is to redistribute through the graduated income tax or through direct payments to the poor. Smith's defenders also argue that the goal of lessening the inequality of the distribution of income does not invalidate his criticisms of specific kinds of government intervention in the market place, such as government subsidies or governmentally enforced monopolies. Such forms of intervention are characterized as clumsy or crude ways to redistribute income and liable to abuse. Critics of such intervention claim that in practice they are used to redistribute income from the general public to the politically influential. An arbitrary redistribution of income is not a valid justification of a particular piece of legislation or regulation:

To hurt in any degree the interest of any one order of citizens, for no other purpose but to promote that of some other, is evidently contrary to that justice and equality of treatment which the sovereign owes to all the different orders of his subjects. (p. 618)

Another reason for the persistence of Smith's ideas is that they describe the motivation behind the market behavior of individuals in a way many still believe to be apt today. This motivating force is of course self-interest. Others have reacted strongly to characterizing individual behavior in these terms. Some of the adverse reaction is mitigated by a different choice of words, e.g., individuals may be characterized as motivated by a desire to improve their standard of living or to provide better for their families. Some of the adverse reaction derives from a need by individuals to see themselves in a way that they regard as worthy. Asked to describe their own motivations, they think in terms like "benevolence," not "self-interest." Yet other individuals might agree with the characterization of Smith but would prefer to have individuals motivated by forces other than self-interest. They feel that if institutions could be changed, loftier and nobler motivations would emerge to order social relations.

A final cause of adverse reaction to Smith's characterization of human behavior in terms of self-interest is simply the result of a misunderstanding of what was of concern to Smith in **The Wealth of Nations**. Smith believed that the wealth of a nation increased because of advances in the division of labor and the concomitant extension of markets. Smith describes the almost incomprehensible complexity of such markets in a "civilized" country in the following small excerpt from a much larger passage on the subject:

Observe the accommodation of the most common artificer or day-labourer in a civilized and thriving country, and you

will perceive that the number of people of whose industry a part, though but a small part, has been employed in procuring him this accommodation, exceeds all computation. The woollen coat, for example, which covers the day-labourer, as coarse and rough as it may appear, is the produce of the joint labour of a great multitude of workmen. The shepherd, the sorter of the wool, the wool-comber or carder, the dyer, the scribbler, the spinner, the weaver, the fuller, the dresser, with many others, must all join their different arts in order to complete even this homely production. How many merchants and carriers, besides, must have been employed in transporting the materials from some of those workmen to others who often live in a very distant part of the country! (p. 11)

The contrast between the number of individuals with whom a person interacts in the market place and in his personal life is striking:

In civilized society he [man] stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons. (p. 14)[6]

Smith in **The Wealth of Nations** is concerned with the first kind of interaction, that between individuals in the market place. What else but self-interest could organize relations of such size and complexity? Self-interest in the market place, however, is perfectly compatible with the dominance of praiseworthy motives in an individual's relations with his family and friends.

Much of **The Wealth of Nations** is devoted to describing how differing institutional arrangements affect human behavior. Because many today accept the importance Smith attached to self-interest as the motivating force in individuals' relations outside their circle of friends and family, his observations remain relevant to them. There is of course no need for a person interested in the design of institutions to be a believer in laissez faire to find these observations interesting or perceptive. Smith was interested in designing institutions so that self-interest would promote the general interest. Conversely, he was interested in how institutions could put self-interest at variance with the general interest.

As the following passages show, unfortunate institutional arrangements have produced unfortunate results in the past. The reader may decide whether the same arrangements would produce the same results in the present day. The first passage refers to the practice of raising revenue by requiring the payment of a sum of money from persons seeking redress in court:

This scheme of making the administration of justice subservient to the purposes of revenue, could scarce fail to be productive of several very gross abuses. The person, who applied for justice with a large present in his hand, was likely to get something more than justice; while he, who applied for it with a small one, was likely to get something less. (p. 675)

In Smith's day law clerks were paid according to the number of pages they wrote:

It has been the custom in modern Europe to regulate, upon most occasions, the payment of the attornies and clerks of court, according to the number of pages which they had occasion to write; the court, however, requiring that each page should contain so many lines, and each line so many words. In order to increase their payment, the attornies and clerks have contrived to multiply words beyond all necessity, to the corruption of the law language of, I believe, every court of justice in Europe. (p. 680)

A more serious example of how Smith felt institutional arrangements affected behavior is found in his discussion of the East India Company. Smith argued that as a result of the monopoly granted to the Company, its members destroyed the wealth of the governed countries in the pursuit of their own self-interest. This result, however, was caused by unfortunate institutional arrangements, not because of the bad character of those in charge of the Company:

I mean not, however, by any thing which I have here said, to throw any

> *odious imputation upon the general character of the servants of the East India company, and much less upon that of any particular persons. It is the system of government, the situation in which they are placed, that I mean to censure; not the character of those who have acted in it. They acted as their situation naturally directed, and they who have clamoured the loudest against them would, probably, not have acted better themselves.* (pp. 605-6)

Smith's intellectual legacy consists of more than numerous prescriptions for problems in public policy: it consists also of a way of looking at problems. Smith made explicit his view of what motivates the behavior of individuals, i.e., their "propensity to truck, barter, and exchange one thing for another" to satisfy their "own necessities," and he used this framework to interpret all market behavior. Given this view of what motivates the market behavior of individuals, Smith could draw implications about the effects on behavior of different kinds of institutions. Smith examined the validity of these implications through the meticulous observation of great numbers of examples of market behavior drawn from his own day and from history. Smith more than anyone else helped to make economics into a special discipline or science.

It is appropriate to note that this empirical approach to understanding how the world works, an approach developed to a significant extent by Smith, is the very approach that will decide the degree to which his particular policy prescriptions remain relevant today. Smith's particular policy prescriptions may be modified or abandoned, yet his approach to resolving public policy problems will remain important. For example, modern critics and defenders of Smith's laissez faire policy prescriptions characterize the organization of markets today in contradictory terms. The following brief description of the views of each group that follows is intended to suggest that there are plausible arguments to support either view. A resolution of these conflicting views will necessarily have to be made through careful, systematic study of the actual organization of markets, i.e., through the scientific approach by Smith.

Smith viewed the market place, free of government interference and governmentally supported monopolies, as a place where individuals voluntarily exchange goods and services among each other as a means of promoting their mutual welfare. Critics of Smith often dismiss his policy prescriptions for limiting the role of the state in the market place by asserting that this world of competitive markets no longer exists. The market place is now characterized by great concentrations of power in the hands of a small number of large corporations. Exchange is no longer mutually advantageous trade between individuals; it is an exploitive exchange between great concentrations of power and weak individuals. The intervention of the government is considered necessary to redress the relative weakness of the individual. For example, one author writes in a recent article advocating increased government planning:

> *. . . we are all uncomfortably aware that the economy itself has become very different from the one described in the textbooks. Highly concentrated sectors exist in which large corporations and unions have fortified themselves against the normal influences of market forces. About a third of the gross national product passes through the hands of the federal, state and local governments. The laws of supply and demand do not operate uniformly across the competitive sector, the concentrated sector and the government sector. That elegant optimizing machine described by Adam Smith, which has been a source of deep intellectual and moral satisfaction to ten generations of economists, no longer corresponds to reality.*[7]

Supporters of Smith's policy prescriptions challenge this description of the market place. They argue that a concentrated industry is not necessarily noncompetitive; fewness of firms may reflect only economies of scale in production. The steel industry, for example, must compete with foreign imports and with industries whose products can be used in place of steel, such as aluminum and concrete. Fur-

thermore, while the growth of unions and government may have reduced competition, other forces in the meantime have increased competition. The costs of information and transportation have decreased sharply.

The cost to the consumer of acquiring information on the prices of competing products has decreased because of increased access to advertising via TV, radio, newspapers, and magazines. The advent of the car has reduced the cost of comparative shopping. The market itself responds to the demand for increased information caused by the development of technologically complex products. Firms specializing in the dissemination of information (such as brokers giving investment advice, travel agencies, publishers of magazines on cars or boats, consumer product rating agencies, and so on) arise. If the demand exists, producers sell a joint product of a commodity and a warranty. Probably more important, some producers and middlemen for any given product have an incentive to make investments in their reputations by consistently providing reliable products. If a consumer ignorant of electronics wants to buy a pocket calculator, he has the opportunity to buy a name brand computer from a store that sells only quality merchandise. The cost of shipping goods has decreased, so that in any market of moderate size a producer of almost any commodity is liable to find himself in competition with commodities from any part of the world. American labor markets are characterized by high mobility caused by workers looking for advantageous job opportunities. The kind of careful analysis of markets performed by Smith might well show that markets are significantly more competitive today than in Smith's day.

Conclusion

One difficulty with defending the present day relevance of Smith is that his ideas have become so thoroughly absorbed into our intellectual heritage that they are no longer identifiable as having originated with Adam Smith. It is hoped that this booklet will contribute to a recognition of the relevance of Smith's ideas by pointing out the remarkable number of them still used in current debates over public policy.

Footnotes

[1] Edward G. Bourne, "Alexander Hamilton and Adam Smith," **The Quarterly Journal of Economics,** 3 (April 1894), 328-44.

[2] Millicent E. Sowerby, **Catalogue of The Library of Thomas Jefferson** (Washington, D. C.: The Library of Congress, 1953), V. III, 438.

[3] **Ibid.,** p. 438. The Economists were a school of French thinkers on political economy.

[4] Page references are in parentheses and refer to the Canaan edition of **The Wealth of Nations** in the Modern Library Series, Random House, New York, 1937.

[5] William D. Grampp, **Economic Liberalism** (New York: Random House, 1965), V. I, 128.

[6] This paragraph and the relevance of the quotation were suggested by Ronald Coase in a lecture delivered at the University of Virginia on April 2, 1976.

[7] Myron E. Sharpe, "Planning: The Unpleasant Debate," **Business Economics,** 11 (January 1976), 32.