Adam Smith

An Inquiry into the Nature and Causes of the Wealth of Nations

Adam Smith was born in Kirkcaldy, Fife, Scotland in the spring of 1723. Little is known about his early life, but he was educated at the University of Glasgow and at Oxford. While he was a lecturer in Edinburgh in 1748, he met the Scottish philosopher David Hume who influenced his early thinking and with whom he corresponded until Hume's death in 1776. He was appointed Professor of Logic at Glasgow University in 1751, moving to the Chair of Moral Mhilosophy the following year. He resigned his position at the university in 1763 to act as tutor to the Third Duke of Buccleuch on an 18 month tour of France and Switzerland. During this time he had the opportunity to meet and engage with some of the leading political and economic thinkers of Europe. He returned to Kirkcaldy to complete the Wealth of Nations, which he published in 1776. In 1778 he accepted the position of Commissioner of Customs, a job he held until his death in1790.

CONTEXT

If there was such a thing as an economic "policy" governing the nations of Europe from the 16th through the early 18th centuries, that policy or approach was Mercantilism. It is probably claiming too much to say any coherent or examined "policy" directed thinking on economic matters. "Economics" was too much tied in with other interests. But developing alongside the growing nationalism and colonization of the period, mercantilism or rather those whose interests were tied with mercantile interests advocated government control over industry and trade to assure national wealth. This wealth was not intended to improve the lives of individual citizens but was a means of supporting the armies required in the on-going political conflicts. Laws at home favored the growth of industry at the expense of the laborers, and laws respecting the growing overseas colonies encouraged their exploitation for the support of the homeland.

Adam Smith's Wealth of Nations was the first major work to separate out economics as an independent field. Considered the founding work in what is now known as Classical Economics, it distinguished the study of economics from moral or political philosophy for the first time. Smith, one of the leading Scottish intellectuals of the 18th century, advocated entirely different approaches from those taken by the Mercantilists. He believed that when men were left free to pursue their own interests, they would respond to the natural economic forces of the market place more effectively and with more stimulation and better results than if efforts were controlled by the government. He called this principle the "invisible hand" and maintained that government efforts at control were inefficient and actually at odds with the operations of the market place. The Wealth of Nations introduced the concept of laissez-faire capitalism in the late 1700's, a concept gradually modified by history, largely in response to changes in social and political attitudes, but whose fundamentals still remain an integral part of economic theory in the 21st century.

SUMMARY

Introduction and Plan of the work:
In his Introduction, Smith defines the annual labor of a nation as the fund that supplies it with the necessities of life and consists in 1) the immediate produce of that labor; and/or 2) what is purchased with that produce from other nations. The proportion of this fund to the number of people who consume it indicates whether the nation is well or poorly supplied. This proportion is determined by 1) the skill and judgment with which the labor is applied and 2) the number of those employed or unemployed. He has divided his work into five books. The increase in the productivity of labor due to skill and judgment and what he calls the natural distribution of its produce are the subjects of Book I. Book II takes up the nature of capital stock, how it is accumulated, and how it is used. Book III considers the circumstances that have led nations to encourage the industry of towns over that of the country. Book IV reviews different economic theories and the policies they have given rise to. And finally Book V looks at the revenue needs of the commonwealth and how these needs can be met.

Book I; Chapter I: Chapter I deals with the increase in the productivity of labor as the result of the division of labor. The increase in productivity can be traced to the increase in skill of each workman; the time saved in transition from one job to another; and to the invention of machines allowing one man to do the work of many.

Chapter II: The principle that motivates the division of labor is found in human nature itself: "the propensity to truck, barter, and exchange one thing for another." Smith gives the example of a hunter skilled at making arrows who finds that he can get more meat by exchanging his arrows for someone else's venison than if he went hunting himself. Thus it is his own self-interest that motivates him to spend his time making arrows rather than hunting.

Chapter III: The advantages to the division of labor are limited by the size of the market. Some jobs naturally require a large market to exist, as a small market has no use for them (for example a porter). Even those jobs that are necessary in a small market (butcher, baker, carpenter, etc.) are more likely to be done by one man rather than be divided up among several when the market is small and isolated, as a family farm ten miles from the nearest neighbor or village would be. Smith points out that seacoast or riverbank areas are historically more likely to be centers of civilization and trade because water passage or transportation is so much more efficient than land carriage.

Chapter IV: Once the division of labor has been established, the need for some form of common currency arises. Smith reviews the various currencies that have been used in different eras and cultures. He discusses the choice of metal as the most widely acceptable and gives the history of coin. He distinguishes between "value in use" (water, for example, is highly valuable in use but is so common as to have little value for ex-change) and "value in exchange" (diamonds, which have little or no value in use but are highly valuable as a means of exchange because of their rarity) and proposes to examine how values are measured in the following chapter.

Chapter V: Smith establishes labor as the fundamental measure of the value of all commodities. Labor has two different components: the degree of hardship and the degree of ingenuity, and measuring either is difficult. Assigning a value to an item based on labor is an intelligible concept but not an obvious one, and so people have fallen to assigning value in terms of other commodities. Once money has been accepted as a means of exchange, it is used to determine value, the amount of money to be given or received for a particular item.

Value varies based on the availability or scarcity of an item and this applies not only to commodities but to currencies of exchange such as gold and silver as well. Smith defines two different values that can be applied to a commodity: the real value—the quantity of necessities or conveniences that can be purchased with it—and the nominal value—the quantity of money given for it. Smith goes into some detail on the reasons that values fluctuate and the implications or consequences of those fluctuations both immediately and over time. The last section of the chapter is a lengthy discussion of the use of coin and its devaluation over time.

Chapter VI: Three component parts determine the price of any commodity: rent, labor, and profit (rent being that part of the price that goes to the landlord; labor being that part that goes to the worker; and profit being that part that goes to the merchant, or those who provide the grain, lumber, etc.) The greater the division of labor involved in the final item to be sold, the greater number of rents, labor, and profits that participate in the final price. These components are easily distinguished when they belong to three separate men, the landlord, the worker, and the merchant; but when one man provides both land and materials, he may combine the rent he would receive from his own land and the profit he would receive on his materials, thus making it more difficult to distinguish the components of the final price.

Chapter VII: Smith distinguishes between the natural price of a commodity and the market price. The natural price reflects the average rate for rent, wages, and profit required to bring the item to market; and the market price is the actual price at which the item can be sold at market. The two may coincide or the market price may be either higher or lower than the natural price. Fluctuations in the market price are determined by how closely the quantity of an item offered at the market matches the actual (effectual) demand for that item. This is what we would call supply and demand. He establishes as a principle that over time the market price will always tend toward the natural price of the commodity.

Chapter VIII: Wages are what a laborer is paid for his work. From those wages must be deducted rent owed to the owner of the land he works and, in most cases, the profit due the master for advancing the laborer a living until the harvest (Note: it's important to remember here that by "wages," Smith doesn't mean what we usually do. By wages he means the value of a man's efforts. So, in the case of a farmer, his "wage" is the value of his harvest, what he is paid or receives from his efforts. With his "earnings," he must pay his landlord and pay for the materials he used, grain, lumber, livestock, etc. In the case of a factory laborer, the "rent" and "profit" would be deducted from the laborer's value be-fore he was paid). Wages are set by a contract between master and laborer, each one looking out for his own interest—the master to pay the smallest amount possible and the laborer to get the greatest amount possible. In any dispute between the two, the master has the advantage because he has behind him both his own ample supply of stock and the support of the law. The exception to this rule occurs when the need for laborers outstrips their availability so that the masters have to bid against each other to supply their need for workers. The opposite is equally true: when workers have to bid against each other for limited work, wages will fall.

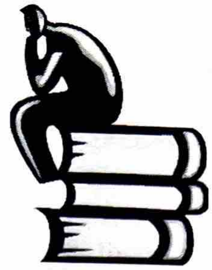
Wages tend to be consistent in any given location and time and they tend to reflect what is considered necessary to maintain a man. In addition to what is needed to maintain the laborer himself is added enough for him to take care of a family, thus assuring a continued supply of laborers.

The demand for laborers increases with the increase of national wealth. Smith spends the rest of the chapter in a discussion of the effects of dearth and plenty on the laborer, his personal habits—that is, his diligence or sloth—and his ability to raise a family.

Ch. IX: Competition and the general state of the economy both affect the profits of stock but in opposite ways. When competition develops, wages go up but the percent of profit that can be made on stocks goes down. Smith suggests that the rate of interest is a good barometer for the profits on stock. He points out that though both are components of price, high wages will not have as significant an impact on the price of a commodity as will a high profit.

Conclusion to Chapter XI: In his conclusion to the long chapter on the rent of land, Smith observes that the real rent of land increases with every improvement of society in general. The contrary is also true: anything that causes a reduction in the prosperity of the nation will result in a loss in the real rent of land, thus reducing the wealth of the landlord.

He concludes Book I with the observation that the price of the annual produce of a nation divides down between three orders of people: those who live by rent, those who live by wages, and those who live by profit. The prosperity of the first two, the landlords and the laborers, is tied to the prosperity of society in general. As a result, these two classes of people can be trusted to speak for the good of society. Smith adds the caveat that for different reasons neither of these two classes is likely to fully understand the good of society or how it relates to their condition. In contrast, the third class, those who live by profit, tend to prosper in poor countries and do less well in prosperous countries. The nature of their livelihood encourages an understanding of the economy, but because they are more concerned about their own interest than the interest of the society as a whole, their input cannot be trusted without first being examined "with the most suspicious attention."

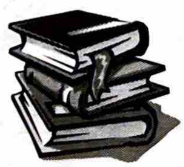


Things to Think About

1. Smith's Wealth of Nations is considered to be the classic statement or expression of laissez-faire economics. The term comes from the French expression, "Laissez- faire la nature": let nature take its course. It describes an economic system in which government takes a hands-off or more restrained approach in directing the economic life of the nation on the assumption that the natural economic forces will work to the good of society in the long run. In his work, Smith is clearly weighing the advantages of men when they are left to to act freely on their own self-interests as against men when they are forced to do things against their will and in the service of some abstract theory of state or nation. Smith offers a very different view of the state and the role of government than the views of many other thinkers. Do you think Smith's views are closer to Plato or Aristotle? To Locke or Hobbes? To Hamilton or Jefferson?

2. In the field of political economy, there is a recognized dichotomy between individualism and collectivism. Individualism emphasizes the freedom and rights of the individual over the state, while collectivism maintains just the opposite. Smith clearly favors individualism, while Hegel, as well as Kant, favor collectivism. Why do you think Rationalism would tend to endorse collectivism and Empiricism (which is Smith's background) would tend toward individualism?

3. Although today he is mainly viewed as a proponent of the free market competition that favors entrepreneurs, Smith originally saw himself as a champion of the lower classes and set out to write the book in response to the aggressive intervention of governments on behalf of merchant interests at the expense of the poor (see VIII, 36). Smith apparently believed that the best way for a nation to combat poverty is for the poor to have the opportunities to work so that they can begin to earn their own wealth, and the government should not intervene on behalf of businesses in the free market. The government should let businesses be competitive and productive in the free market, and thereby they will need the work of the poor to develop and prosper.



Study Questions

1. Smith describes the tendency of men towards a division of labor as a propensity in them to "truck, barter, and exchange one thing for another." What is the motive that explains this propensity in human nature (Ch. 2, 3)?

2. According to Smith, what geographical feature is most likely to influence the development of civilization (Ch. 3)?

3. What was the "Fair of Troyes" and what is its relevance to Smith's discussion of money (IV, 10)?

4. In discussing the value (the price) of all commodities, what does Smith say was the original currency used to determine the value available for exchange (Ch. V, 2)?

5. What are the three components that go into the price of a commodity (Ch. VI)?

6. What is effectual demand and what role does it play in establishing market price (Ch. VII, 8)?

7. What is the formula that is used in determining the necessary wage for a worker (Ch. VIII, 15)?

8. How are wages a barometer of the state or condition of a nation's economy (Ch. VIII, 27)?

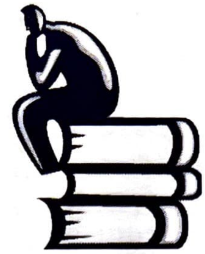
9. In Chapter IX, Smith steps out of his academic mode and makes a judgmental comment on behavior he has observed. What is his judgment and who is it directed against (Ch. IX, 24)?

10. Smith makes the point that neither landlords nor laborers have a good understanding of the economy or how their own prosperity is linked to it, while the merchants and manufacturers are likely to have a good understanding. What reasons does he give for this disparity (Ch. IX,.8-10)?

11. Smith uses the image of "an invisible hand" guiding the decisions of men participating in the market place. In what way does this image encourage man in the use of his natural "rational" abilities? In what ways could it be construed as undermining them, encouraging in man a "passive" response to economic realities?

Questions on Language and Form

1. Smith is making a didactic presentation on Economics, a subject that has caused the eyes of more than a few beginning students to glaze over. But in spite of the complexity of the subject and the unfamiliarity of much of the vocabulary, the Wealth of Nations is in many ways a primer and is readily accessible to the new student. What characterizes the structure and development of the whole is its simplicity and logical coherence. There is a clear coherence to the whole and an obvious logic in the movement from one chapter to the next. What is the whole and how would you describe the ordering principle of the chapters, the movement from one to another?



Reflection Questions

1. In Chapter VIII Smith deals with wages. In considering the effects of poverty on the laborers, he observes the high rate of mortality among their children. Reread paragraphs 38-40, and write a brief reflection responding to them.

2. While you have read only a very brief selection from Smith's major work, you have read enough to characterize the system he is describing. How would you characterize it? That is, how does it function as a whole? How do the parts function in relation to one another? Would you call this an organic system or a mechanistic system?

3. Smith uses the image of "an invisible hand" guiding the decisions of men participating in the market place to make decisions that unknowingly serve the common good. Do you think that this is simply an image or do you think that Smith's theories assume either a natural law operating in the world or the action of some guiding Providence? Is this "invisible hand" the benevolent hand of God, or is it the "invisible hand" of selfishness? "On average," is it better to have less government or more in the economic affairs of men?