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Adam Smith's *Wealth of Nations*:
The Legacy of a Great Scottish Economist[1]

Roy H Grieve

A Landmark in Social Science

Adam Smith – born in Kirkcaldy, professor at Glasgow, government official in Edinburgh – was one of the outstanding figures of the 'Scottish Enlightenment' which in the eighteenth and early nineteenth centuries made a brilliant contribution to the world's intellectual and artistic heritage. The publication in 1776 of his classic work *An Inquiry into the Nature and Causes of the Wealth of Nations* marks the coming of age of economics as an intellectual discipline. The *Wealth of Nations* presented a penetrating analysis of the capitalist industrial economy which was then taking shape in Britain. The book was an immediate success. It powerfully influenced public opinion, offered statesmen a programme of action and provided a body of ideas which formed the basis of development of economic theory for the next hundred years. It has worn well: the continuing relevance of Smith's essential principles is remarkable.

Box 1: Adam Smith, Philosopher

Adam Smith was born in 1723 in the 'little seaport town' of Kirkcaldy in Fife, posthumous child of the Comptroller of Customs. He was educated at the parish school and, 1737-40, at the University of Glasgow (the old College in the High Street) where 'his favourite studies were mathematics and natural philosophy, and the political history of mankind'. Proceeded on the Snell scholarship to Balliol College, Oxford, where he remained six years.

His academic career began with public lectures in Edinburgh, 1748. Elected professor of Logic at Glasgow, 1751, he transferred to the Chair of Moral Philosophy the next year. 'His reputation filled his classrooms; those branches of science taught be him became fashionable, and his opinions were discussed in the clubs and literary societies of Glasgow.' He resigned his Chair in 1764 to become tutor to the young Duke of Buccleuch, with whom he travelled on the Continent (making a stay at Versailles), 1764-66. On his return he retired to private life in Kirkcaldy and London in order to write and, after nearly ten years, published the *Wealth of Nations*. He was appointed a Commissioner of Customs at Edinburgh in 1778.

While the *Wealth of Nations* occupies a pre-eminent place in the history of economic thought, Adam Smith was much more than an economist. The *Wealth of Nations* was intended as but one chapter of a wide-ranging study of man in society. As a philosopher Smith sought to reveal the conditions of

[1] Chapter 4 (with slight modifications) in *Understanding the Scottish Economy*, K Ingham and J Love (eds.)1983. Oxford: Martin Robertson.

human progress, moral and intellectual, as well as material. His great project embraced, along with economics, ethics and psychology, law and politics. Of the four major works he planned, only two were given to the world. Prior to the *Wealth of Nations* the *Theory of Moral Sentiments* (1759) presented Smith's analysis of the basis of social behaviour. (The lines by Robert Burns, a great admirer of Smith's books,

O wad some Pow'r the giftie gie us
To see oursels as others see us

can in all probability be taken as the poet's rendering of the theme of the *Theory of Moral Sentiments*.) The manuscripts of treatises on law and on the progress of the arts and sciences, still 'on the anvil' at the time of his death, Smith caused to be destroyed.

Adam Smith was of a kindly and sociable disposition. While stories are told of his absent-mindedness, he was known also as a capable administrator. He remained a bachelor. The only likeness we have of him, apart from a little cartoon sketch, is the Tassie medallion portrait of 1787 – hold a current Royal Bank £1 note to the light.

He died in Edinburgh, 1790.

'Wealth' and the Means of Economic Progress

What, in the first place, does Smith mean by 'the wealth of nations'? The 'wealth of every nation' is defined, not as a hoard of gold and silver, but as an abundance of 'all the necessaries and conveniences of life which (the nation) annually consumes'. But we should not suppose that Smith equates the possession of material wealth with the *well-being* of society. The definition must be read in context: economic development is the subject of the *Inquiry*. Smith's purpose was two-fold: (a) to identify the sources of economic progress – of increase in the wealth of nations (as an escape for ordinary people from the privations and miseries of poverty); and (b), on the basis of that understanding, to determine the proper role of the state in relation to the economic order.

On what does this wealth, and its increase depend? With a given population, the quantity of 'necessaries and conveniences' which can annually be supplied to consumers must depend, as Smith indicates, on the number[2] (directly and indirectly) engaged in the production of these goods and services and on the productivity of their labour (output per man). The latter is the key factor: if standards of living are to rise, the productivity of labour must increase.

There are two means, says Smith, of increasing productivity: (a) by division of labour – the splitting up of complete operations of production into separate, specialist employments, and

[2] i.e. the 'number' usefully engaged in production - in proportion to the whole population of the nation.

(b) by the application of ‘machines and instruments’ which ‘facilitate and abridge labour’ and ‘enable one man to do the work of many’.

To supply labour with more and better equipment and to build up the infrastructure of the economy (facilities such as roads, bridges and harbours), means that capital accumulation has to be achieved. For that to be possible the economy must produce over a period of time (say, a year) more output than is required to replace the materials, equipment and subsistence of the workforce use up in the course of production in that period. The economy, that is to say, must be able to produce a *surplus* of output over what is necessary merely to maintain the existing level of production. Accumulation takes place when this surplus capacity is used to produce a net addition to the community’s stock of capital goods – when part at least of the surplus is ‘ploughed back’ in the form of investment rather than used up in current consumption.

Smith puts great stress on the virtue of saving. He hammers home the point that the growth potential of the economy will not be realized if its surplus production capacity is squandered on profligate consumption or wasted in maintaining an excessive number of ‘unproductive’ members of society.

Smith supposes that all resources made available by saving will (in the normal course of events) automatically be required for investment; no problem is anticipated with regard to entrepreneurs’ willingness to invest. Growth is envisaged as a self-sustaining, cumulative process, production capacity and demand for output expanding together. As costs fall, real incomes and purchasing power increase and markets widen; widening markets in turn induce through greater division of labour further improvements in productivity contributing in turn to rising output, incomes and demand.

The ‘Invisible Hand’ and the System of Natural Liberty.

Smith’s picture of economic growth is of a continuing process of increasing division of labour and investment, giving rise to progressively higher productivity and output. His vital insight is that this expansion is achieved not by means of any conscious overall plan, but is, as it were, the accidental by-product of individual actions motivated by individual self-interest. The dynamic of the system is ‘the uniform, constant and uninterrupted effort of every man to better his condition’, which he generally seeks to do by ‘the acquisition of a fortune’. It is the desire for ‘betterment’ - to ‘get on’ - that prompts saving rather than consumption. It is the striving of the individual entrepreneur, in his own particular sphere of operations, to exploit all possible opportunities of profit by improvement of productivity and extension of productive capacity, that drives the economy forward on the path of growth.

> (I)t is only for the sake of profit that any man employs a capital in the support of industry . . . As every individual, therefore, endeavours as much as he can 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 that 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. (Book IV, Chapter II)

The striking and famous metaphor of the 'invisible hand' vividly expresses the idea of a spontaneous, 'natural' tendency to order and harmony in economic affairs.

The 'invisible hand', operating through the pursuit of private profit, promotes the general expansion of the economy. It ensures also, at the level of particular markets and products, that the composition of output is consistent with the pattern of demand. Entrepreneurs will increase capacity and supply to markets where the relation of demand to supply is such that the going price offers an abnormally high profit. Conversely, they will abandon sectors where the price is too low to yield an acceptable return on capital. Thus as entrepreneurs, concerned only with their own profits, respond to price signals individual investment and production decisions are co-ordinated with each other and with final demand.

From this analysis of the economic mechanism Smith draws a conclusion of the first importance. His proposition is this: the most effective means of promoting economic progress is to establish

> the simple system of natural liberty (whereby) every man, so 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. (Book IV, Chapter IX)

The great merit of the system of natural liberty is that, in allowing the expression of natural forces, it harnesses independent initiative and effort, individual knowledge and experience to the public interest.

For this self-acting economic machine to function effectively, free movement of labour and capital should not be obstructed or diverted by restrictions and privileges such as comprised the Mercantilist system (See Box 2) of Smith's day. If the individual businessman knows best where his own particular interest lies, it is folly, Smith argues, for the statesman 'to load himself with a most unnecessary attention' by attempting to 'direct private people in what manner they ought to employ their capitals'. Free competition in the product markets, is however essential to protect the public interest. The state should not grant perpetual monopoly privileges (as the enjoyed by the East India and other great trading companies). Monopoly means restricted supplies and high prices, 'the highest that can be squeezed out of the buyers'. Smith has no illusions about the readiness of the capitalist to exploit the public if in a position

to do so. The ‘mean rapacity’ of merchants and manufacturers must be kept in check by the pressure of competition, which serves also as a spur to efficiency and progress.

Box 2: Mercantilism

‘Mercantilism’ (or in Smith’s language ‘the Mercantile system’) denotes the long-established system of national economic management practised by the states of Europe, Britain included, in Smith’s time. Governments sought through extensive and detailed intervention – in the form of tariffs and subsidies, monopoly charters and other specific regulations – to shape the pattern of national trade and industry. For each country the object was (incompatibly) the same – to maximise exports and minimise imports of manufactures so as to achieve a surplus on the balance of trade and therefore an inflow of the precious metals.

Smith regarded the Mercantilist programme as misconceived in both object and method. He saw it as indicative of a failure to appreciate the possibility of mutual gains from international division of labour, specialization and trade, and of want of understanding of the operation of the ‘invisible hand’. The effects of the system, he believed, were to favour sectional interests at the expense of the community in general and, by standing in the way of individual enterprise, to retard economic progress.

Wages and Profits

In Smith’s account of the distribution of national output amongst the members of society, capitalists, workers and landlords confront each other as rival claimants to shares of the national cake. What each class gets (in profits, wages or rent) depends on its bargaining strength. The propertied classes have the advantage over the workers.

> What are the common wages of labour depends everywhere upon the contract made between two parties, whose interests are by no means the same. . . . It is not, however, difficult to foresee which of the two parties must, upon all ordinary occasions, have the advantage in the dispute, and force the other into compliance with their terms. . . . A landlord, a farmer, a master manufacturer, or a merchant, though they did not employ a single workman, could generally live a year or two upon the stocks which they have already acquired. Many workmen could not subsist a week . . . and scarce any a year without employment. In the long-run the workman may be as necessary to his master as his master is to him: but the necessity is not so immediate. (Book I, Chapter VIII)

Smith makes no bones about it – distribution depends on ‘muscle’ – on the ability of each class to shoulder aside competitors for a share of national income. While the balance of power has changed, one way and then the other, since Smith’s time, his treatment of distribution in terms of social relations and market power (*not* in terms of the social contribution of the parties concerned) remains valid today.

Despite the conflict between labour and capital over the division of current output, paradoxical as it may seem, a coincidence of interests does exist in the capitalist economy. Profits on capital are necessary to the workers as well as to the capitalists themselves. Profit provides both incentive and means to the capitalist to undertake investment. Investment creates employment and is essential for economic growth, which in time raises the living standards of all members of the community.

The Duties of the State

In advocating the system of natural liberty and mounting his 'very violent attack' on the Mercantilist system of state regulation, Smith was arguing with great force that the state should not seek to do what would be better done by private enterprise. It must, however, be emphasised that Smith at the same time requires a positive contribution from the state. He regards that contribution as of vital importance for economic progress and social welfare. The primary function of the state is to ensure security of person and property (without which, incidentally, enterprise could not flourish). But that is not all: certain economic and social obligations, complementary to the system of natural liberty, are laid by Smith upon the state. These fall into two broad categories.

Intervention to foster economic development. Intervention is recommended to create conditions under which the driving force of *individual* self-interest may most effectively advance the *general* interest.

It is the duty of the state

> [to erect and maintain] certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain, because the profit could never replay the expenditure to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.
>
> (Book IV, Chapter IX)

As instances of essential works which may require public provision, roads, bridges, harbours, canals and street lighting are mentioned. The quoted passage neatly expresses the notion of market failure on account of externalities: social and private interest fail to coincide because the reward of the private agent does not fully reflect the benefit (or cost) of his action (or inaction) to the community as a whole. The maintenance of roads is a case in point: Smith argues that responsibility cannot safely be left in private hands as remuneration (from tolls) would be independent of efficient performance. Smith observes also that administrative means must be devised to make sure that public agencies such as road authorities, not subject to effective discipline through the market, perform in accordance with the community's interest.

Smith does not draw a rigid line between appropriate spheres of public and private activity. Take the case of canals. Although he allows that these may be made and maintained by private enterprise, they are nevertheless listed as possible state undertakings. Or notice his comments on the postal service: he is quite happy, simply because the business is well-conducted, that it should be in public hands. It is the adequate provision and efficient operation of necessary facilities, rather than the matter of ownership itself, that are important to Smith.

Certain actions by the state which may, within the framework of natural liberty, promote progress are approved. Special privileges may be awarded, but temporarily, to companies opening up particularly risky markets; likewise patent rights may be granted to encourage innovation. Some mention is made of tax measures to influence individual decisions. Most unexpected perhaps is that Smith approves of the imposition of a maximum rate of interest. (This rather drastic intervention in the market is said to favour productive borrowers against spendthrifts, thereby promoting investment.)

Intervention to prevent injustice and suffering. State intervention is required also to prevent the injustice and suffering to which the system of natural liberty could give rise.

Smith affirms that the state is obliged to restrain and protect when the unfettered pursuit of individual self-interest threatens the safety or rights of others. A specific instance of state regulation (prohibition of the issue of banknotes of small denomination) gives occasion to an emphatic statement of principle.

> Such regulations may, no doubt, be considered as in some respects a violation of natural liberty. But these exertions of the natural liberty of a few individuals, which might endanger the security of a whole society, are, and ought to be, restrained by the laws of all governments. . . . The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of the banking system which are here proposed. (Book II, Chapter II)

State activity of a welfare character is required by Smith. He demands state action to prevent the undesirable social effects he fears will otherwise be associated with economic progress. He is greatly concerned that increasing division of labour and specialization will do serious damage, intellectual, spiritual and physical to working people.

> The man whose whole life is spent in performing a few simple operations . . . generally becomes as stupid and ignorant as it is possible for a human creature to become. . . . The uniformity of his stationary life naturally corrupts the courage of his mind . . . It corrupts even the activity of his body. . . . His dexterity at his own particular trade seems in this manner to be acquired at the expense of his intellectual, social and martial virtues. But in every improved and civilized society this is the state into which the labouring poor, that is, the great body of the

> people must necessarily fall, unless government takes some pains to prevent it. (Book IV, Chapter I, Part III)

For the common people a system of compulsory, subsidized parish schools (on the Scottish model) must be set up throughout the country. For the good of body and spirit the government should 'take proper pains' to support the practise of military exercises. To counter extreme and gloomy doctrines, the state ought to encourage the study of science and philosophy and the provision of public entertainments and exhibitions, thus to 'amuse and divert', inspiring 'gaiety and good humour'.

It may be noted that Smith, while recognizing that the state itself would derive benefit from such welfare policies, is explicit that, even were that not so, social problems would 'deserve the most serious attention of government'.

Activities of the State in the Present Day[3]

In the two centuries that have passed since publication of the *Wealth of Nations* circumstances have change – economic conditions are very different and social attitudes have altered. In Britain today the state plays a much larger part than envisaged by Smith at the dawn of the industrial era.

Smith was very conscious of the damage that monopoly could inflict on the public interest. He seems, however, to have taken the view that, were Mercantilist privileges eliminated, the problem of monopoly would disappear. He believed (mistakenly, as is now evident) that large joint-stock companies would not, except in special circumstances, survive in competition with smaller and, as he thought, more efficient owner-managed enterprises. But developments of technology and organisation have led in many industries to concentration of power and the consequent need for measures to constrain monopolistic behaviour in the private sector. Utilities (gas, electricity, railways, etc) and other key industries (coal, steel) have been nationalized, partly for practical, partly for doctrinaire reasons. (Nationalization, incidentally, brings a problem perceived by Smith – that of ensuring the satisfactory performance of a *public* monopoly.) State acquisition of 'lame ducks' to ensure their survival has further extended the nationalized sector.

In Smith's time trade unions were prohibited by law. Today labour monopolies in key sectors possess great economic and political power. Wage-push inflation and the 'external' costs of strike action contribute problems unknown in the eighteenth century. Intervention in collective bargaining by means of incomes policy and through arbitration may be defended as necessary to protect the general interest.

[3] *Author's note (2013): It will be recalled that this paper was written in 1982, since which date the British economy has undergone quite drastic changes, not unconnected with some highly doctrinaire policy measures.*

Many instances of conflict between the interests of society and the private pursuit of profit have become apparent. Smith's principle of protective legislation has found widespread application – in respect, for instance, of product standards, conditions of work, public health and the environment.

Smith certainly took a positive view of state intervention and public spending for welfare purposes. The provision of state-subsidized education which he so urgently recommended is, however, no more than a first step in the direction of a general welfare programme. On the subject of poverty and the possibility of its relief by transfer payments, the *Wealth of Nations* is surprisingly silent. The explanation may be that Smith accepted great disparities in conditions of life as inevitable and looked to economic growth rather than transfers as affording the better prospect of improvement to the poorest members of society. The post-war Welfare State is the product of a different distribution of political power and of different perception of what should, and could, be done. Today welfare outlays – in the form both of direct public provision of services (health, education) and of transfer payments (to the elderly, the sick, families, the unemployed) form a substantial portion of public spending (see Table 1).

Smith did not specify the maintenance of full employment as one of the duties of the state. He simply did not envisage a problem of general unemployment. The possibility that total demand for output might be insufficient to induce employers to take on all available labour was not envisaged. While, to the modern reader with the benefit of hindsight, it may seem a weakness of the *Wealth of Nations* that aggregate demand is too readily assumed to 'look after itself', Smith could hardly have been expected to have foreseen that instability of demand and employment would become a serious social and economic problem: in fact the pattern of major cyclical fluctuations in the British economy dates from later - the 1780s or 1790s. Only in 1936 did J M (later Lord) Keynes's epoch making *General Theory* establish that there was no sound basis for faith that the economy naturally tends to a state of full employment. The practical implication is that the government is obliged to manage, by use of fiscal and monetary instruments, the level of aggregate demand in the interest of full employment.

Finally, a fundamental question presents itself. Two hundred years ago Britain was on the way to becoming the world's leading industrial power. Does the present British problem of competitive weakness and 'de-industrialization' suggest that a broad industrial strategy, as operated by France and Japan, could usefully supplement the 'invisible hand' by shaping the context in which investment decisions are made? (We ask 'supplement' not 'supplant': the problems experienced in the Soviet Union and Eastern Europe with systems of command planning demonstrate the dangers of attempting to dispense altogether with the services of the 'invisible hand'.)

Table 1: Two centuries of public spending in Britain

Public spending, 1770 (as percentage of national income)

Debt charges	3.7
Defence	3.0
Civil List	0.7
Other civil government	0.7
Poor relief (estimate)	1.0
County expenditures (jails, vagrants, constables, bridges, etc	0.1
Total public spending	9.2
Total (excluding defence and interest)	2.5

The growth of public spending (by central and local government, excluding public corporations) as percentage of GNP

	1890	1910	1938	1955	1974
Social services (incl transfers)	2	4	11	16	25
(Transfers)	(1)	(1)	(7)	(7)	(15)
Other civil and defence	7	9	19	21	19
Total public spending	9	13	30	37	44
Total (excl defence and int)	5	8	17	23	35

Two Lessons for Today

The *Wealth of Nations* propounds a forceful case for economic freedom – for liberation of enterprise from the constraints of 'the Mercantile system'. But Smith's advocacy of the system of natural liberty should not be understood as dogmatic prescription of *laissez-faire*, of a 'hands-off' stance of government in relation to economic and social affairs. It is as a *means* of achieving society's objectives that non-intervention may –under some circumstances - be judged proper, not as an *end* or virtue in itself.

Smith is alert to the possibility that the 'invisible hand' can on occasion fail the public interest. He is open-minded in allowing that when such failure occurs, judicious government

intervention may achieve a better outcome for the community. He lays particular responsibilities on the state in answer to particular economic and social problems he has identified; he is practical rather than doctrinaire. Commonsense and compassion characterize his discussion. To Smith, social suffering is not something to be tolerated helplessly as the immutable result of natural forces.

An ideal economic system, as envisaged by Smith, would yield society the benefits of individual initiative and effort while at the same time involving the state in correcting the deficiencies of private action and in safeguarding the interests of the community in general. To decry government intervention and public spending as inherently 'bad' (or to assert with equal dogmatism that public ownership and central planning are necessarily 'good') would be quite contrary to the spirit of the *Wealth of Nations*. A balance of individual and collective responsibilities is required. We may not that Smithian lesson.

Smith's ideal is, in principle, as relevant in the twentieth as in the eighteenth century. The practical question that concerns us today is this: what 'division of labour' between the state and the natural economic mechanism will, in the circumstances as they exist, best serve the community's interest? It is the manner in which Smith tackled the question of the role of the state, rather than the specific answers he gave in 1776, that is of direct present relevance. (The particular duties he recommended of the state do not go as far as required by present conditions.) Smith, as we have seen, judged the appropriate functions of the state in the light of the problems that were apparent to him. It is evident that no detailed specification of its duties, which would be universally applicable, can be formulated. Smith's handling of the issue of intervention implies that, in any particular circumstances, what is required of the state must be a matter of judgement – by an informed, compassionate and open mind – and not of dogma. That again is a lesson we may take from the *Wealth of Nations*.

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