# Adam Smith and "The Wealth Of Nations"

By Joy Blenman | September 7, 2016 — 4:53 PM EDT

What was the most important document published in 1776? The Declaration of Independence is the easy answer for Americans, but many would argue that Adam Smith's "The Wealth of Nations" had a bigger and more global impact.

On March 9, 1776, "An Inquiry into the Nature and Causes of the Wealth of Nations" (commonly referred to as simply "The Wealth of Nations") was first published. Smith, a Scottish philosopher by trade, wrote the book to upend the mercantilist system. Mercantilism held that wealth was fixed and finite and that the only way to prosper was to hoard gold and tariff products from abroad. According to this theory, this meant nations should sell their goods to other countries while buying nothing in return. Predictably, countries fell into rounds of retaliatory tariffs that choked off international trade. (For related reading, see: The Basics Of Tariffs And Trade Barriers.)

## The Invisible Hand

The core of Smith's thesis was that humans' natural tendency towardself-interest (or in modern terms, looking out for yourself) results in prosperity. Smith argued that by giving everyone freedom to produce and exchange goods as they pleased (free trade) and opening the markets up to domestic and foreign competition, people's natural self-interest would promote greater prosperity than with stringent government regulations. Smith believed humans ultimately promote public interest through their everyday economic choices. "He (or she) generally, indeed, neither intends to promote the public interest nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and 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," states Smith in "An Inquiry Into The Nature And Causes Of The Wealth Of Nations" (1776). This free-marketforce became known as the invisible hand, but it needed support to bring about its magic.

## What is the Effect of the Invisible Hand on the Government?

The automatic pricing and distribution mechanisms in the economy —which Adam Smith called an "invisible hand"—interacts directly and indirectly with centralized, top-down planning authorities. However, there are some meaningful conceptual fallacies in an argument that is framed as the invisible hand versus the government.

The invisible hand is not actually a distinguishable entity. Instead, it is the sum of many phenomena that occur when consumers and producers engage in commerce. Smith's insight into the idea of the invisible hand was one of the most important in the history of economics and remains one of the chief justifications for free market ideologies. The invisible hand theorem (at least in its modern interpretations) suggests that the means of production and distribution should be privately owned, and that if trade occurs unfettered by regulation, in turn, society will flourish organically. These arguments are naturally competitive with the concept and function of government.

The government is not serendipitous; it is prescriptive and intentional. Politicians, regulators and those who exercise legal force (such as the courts, police, and military) pursue defined goals through coercion. However, in contrast, macroeconomic forces— supply and demand, buying and selling, profit and loss occur voluntarily until government policy inhibits or overrides them. In this sense, it is more accurate to suggest that government affects the invisible hand, not the other way around.

However, it is the absence of market mechanisms that frustrates government planning. Some economists refer to this as the economic calculation problem. When people and businesses individually make decisions based on their willingness to pay money for a good or service, that information is captured dynamically in the price mechanism. This, in turn, allocates resources automatically towards the most valued ends.

When governments interfere with this process, unwanted shortages and surpluses tend to occur. Consider the massive gas shortages in the United States during the 1970s. The then newly-formed Organization of Petroleum Exporting Countries (OPEC) had cut production to raise oil prices. In response to this, the Nixon and Ford administrations introduced price controls to limit the cost of gasoline to American consumers. The goal was to make cheap gas available to the public.

Instead, gas stations had no incentive to stay open for more than a few hours. Oil companies had no incentive to increase production domestically. Consumers had every incentive to buy more gasoline than they needed. Large-scale shortages and gas lines resulted. Those gas lines disappeared almost immediately after controls were eliminated and prices were allowed to rise.

While it is tempting to say the invisible hand limits government, that wouldn't necessarily be correct. Rather, the forces that guide voluntary economic activity towards large societal benefit are the same forces that limit the effectiveness of government intervention.

# The Elements of Prosperity: According to Adam Smith

Boiling the principles Smith expressed regarding the invisible hand and other concepts down to essentials, Smith believed that a nation needed the following three elements to bring about universal prosperity.

### 1.Enlightened Self-Interest

Smith wanted people to practice thrift, hard work, and enlightened self-interest. He thought the practice of enlightened self-interest was natural for the majority of people. In his famous example, a butcher does not supply meat based on good-hearted intentions, but because he profits by selling meat. If the meat he sells is poor, he will not have repeat customers and thus, no profit. Therefore, it's in the butcher's interest to sell good meat at a price that customers are willing to pay, so that both parties benefit in every transaction. Smith believed that the ability to think long-term would curb most businesses from abusing customers. When that wasn't enough, he looked to the government to enforce laws.

Extending upon self-interest in trade, Smith saw thrift and savings as important virtues, especially when savings were used to invest. Through investment, the industry would have the capital to buy more labor-saving machinery and encourage innovation. This technological leap forward would increase returns on invested capital and raise the overall standard of living.

### 2. Limited Government

Smith saw the responsibilities of the government being limited to the defense of the nation, universal education, public works (infrastructure such as roads and bridges), the enforcement of legal rights (property rights and contracts) and the punishment of crime. The government would step in when people acted on their short-term interests, and would make and enforce laws against robbery, fraud, and other similar crimes. He cautioned against larger, bureaucratic governments, writing, "there is no art which one government sooner learns of another, than that of draining money from the pockets of the people." His focus on universal education was to counteract the negative and dulling effects of the division of labor that was a necessary part of industrialization.

**3.Solid Currency and Free-Market Economy**

The third element Smith proposed was a solid currency twinned with free-market principles. By backing currency with hard metals, Smith hoped to curtail the government's ability to depreciate currency by circulating more of it to pay for wars or other wasteful expenditures. With hard currency acting as a check to spending, Smith wanted the government to follow free-market principles by keeping taxes low and allowing free trade across borders by eliminating tariffs. He pointed out that tariffs and other taxes only succeeded in making life more expensive for the people while also stifling industry and trade abroad. (For more on backing a currency with precious metal, read: The Gold Standard Revisited.)

## Smith's Theories Overthrow Mercantilism

To drive home the damaging nature of tariffs, Smith used the example of making wine in Scotland. He pointed out that good grapes could be grown in Scotland in hothouses, but the extra costs of heating would make Scottish wine 30 times more expensive than French wines. Far better, he reasoned, would be to trade something Scotland had an abundance of, such as wool, in return for French wine. In other words, because France has a competitive advantage in producing wine, tariffs aimed to create and protect a domestic wine industry would just waste resources and cost the public money.

## What Wasn't In "The Wealth Of Nations"?

"The Wealth of Nations" is a seminal book that represents the birth of free-market economics, but it's not without faults. It lacks proper explanations for pricing or a theory of value, and Smith failed to see the importance of the entrepreneur in breaking up inefficiencies and creating new markets.

Both the opponents of and believers in Adam Smith's free market capitalism have added to the framework setup in "The Wealth of Nations". Like any good theory, free-market capitalism gets stronger with each reformulation, whether prompted by an addition from a friend or an attack from a foe. Marginal utility, comparative advantage,entrepreneurship, the time-preference theory of interest, monetary theory and many other pieces have been added to the whole since 1776. There is still work to be done as the size and interconnectedness of the world's economies bring up new and unexpected challenges to free-market capitalism. (To read more about this evolution, check out:The History Of Economic Thought.)

## The Bottom Line

The publishing of "The Wealth of Nations" marked the birth of modern capitalism as well as economics. Oddly enough, Adam Smith, the champion of the free market, spent the last years of his life as the Commissioner of Customs, meaning he was responsible for enforcing all the tariffs. He took the work to heart and burned many of his clothes when he discovered they had been smuggled into shops from abroad. Historical irony aside, his invisible hand continues to be a powerful force today. Smith overturned the miserly view of mercantilism and gave us a vision of plenty and freedom for all. The free market he envisioned, though not yet fully realized, may have done more to raise the global standard of living than any single idea in history.

# ***Adam Smith & "The Wealth of Nations"***

1. Why did Adam Smith see economics and moral life as deserving of having different approaches?
2. What does the idea of "self-regulation of markets mean? Can you put this in terms of a social idea?
3. How does the "invisible hand" work?
4. Do you think the "invisible hand" is a perfect mechanism? Why or why not?
5. Is the United States a perfectly free market? Why or why not?