Adam Smith and "The Wealth Of Nations" (The Birth of Classical Economics)

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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. Adam Smith is considered by many to be the father of **classical economics**.

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 overturn the mercantilist system. Mercantilism, the common economic system in Western Europe at the time, believed that wealth was fixed and finite and that the only way to prosper was to keep as much gold as you could and place tariffs on products from other countries. According to this economic theory, nations should sell their goods to other countries while buying nothing in return. Understandably, the result was that countries placed more and more tariffs on goods from each other, substantially reducing international trade.

The Invisible Hand

This free-market force of everyone acting for their own financial self-interest, and thus incidentally helping the whole market grow, became known as the **invisible hand**. The core message of Adam Smith's book, The Wealth of Nations, was that people’s natural tendency toward self-interest (what you might call looking out for yourself) ultimately leads to wealth and 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 heavy government regulations. Smith believed humans ultimately promote public interest through their everyday economic choices - even though their “selfish” behavior doesn’t intend to help anyone else!

Smith said, *“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.”*

Group 1 Side B

The **invisible hand** is not actually a thing on its own. Instead, it is the sum of many factors that occur when consumers and producers buy, sell, and trade. 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 theories. The **invisible hand** theory suggests that the means of production and distribution (such as factories and trucks) should be privately owned, and that if trade occurs without heavy government regulation, over time, society will do well and prosper all on its own. These arguments are naturally competitive with the concept and function of government.

Government does not act randomly. It is acts in intentional and planned ways. Politicians, regulators and those who exercise legal force (such as the courts, police, and military) often meet their goals by forcing (or enforcing) their rules upon businesses and consumers. In contrast to that, macroeconomic forces — supply and demand, buying and selling, profit and loss — occur voluntarily *until* government policy changes their natural course. In this sense, it is more accurate to suggest that government affects the **invisible hand**, not the other way around.

Classical economists believe that when governments interfere with the natural economic 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 naturally!

Group 2 Side A

The Elements of Prosperity: According to Adam Smith

Adam Smith believed that a nation needed the following *three* elements to bring about universal prosperity:

1. Enlightened Self-Interest

Smith wanted people to practice thrifty spending, hard work, and enlightened (smart and aware) 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 prevent 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 believed that spending carefully and not wastefully, as well as saving were important virtues, especially when savings were used to invest. Through investment, the industry would have the capital (money) to buy more labor-saving machinery and encourage innovation. This technological leap forward would increase financial returns on invested capital to those saving through investment and raise the overall standard of living.

2. Limited Government

Smith saw the responsibilities of the government as 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, complicated governments.

> *Smith wrote, "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 balance the people against the negative and dulling effects of the division of labor in industrialized factories (the concept that workers doing just one thing all day are more productive than workers who help with the whole business as farmers would have).

Group 2 Side B

3. Solid Currency and Free-Market Economy
The third element Smith proposed was a solid currency (money). This, he said, should be used along with free-market principles. By backing currency with hard metals such as gold, Smith hoped to curtail the government's ability to depreciate money by simply making and 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 holding back industry and trade abroad.

Smith's Theories Overthrow Mercantilism
To show his opinion about the negative influence of the tariffs commonly used in Mercantilism, Smith used the example of making wine in Scotland. He pointed out that good grapes could be grown in Scotland in greenhouses, but the extra costs of heating would make Scottish wine 30 times more expensive than French wines. It would be far better 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 the sales of wine in France would just waste resources and cost the public money.

The Bottom Line
The publishing of "The Wealth of Nations" was a turning point in economics and history. It marked the birth of modern capitalism and the beginning of the classical economic theory as we know it today.

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