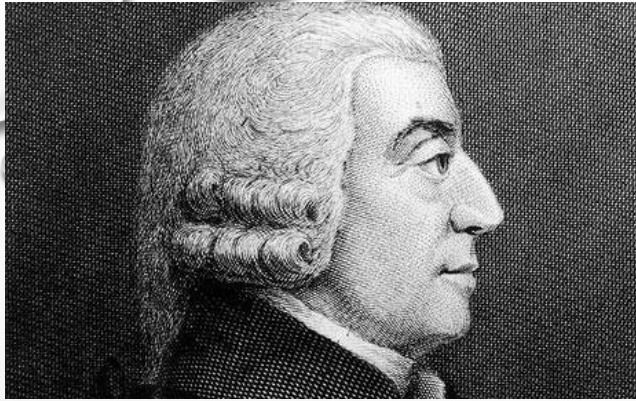


# READ

## **Adam Smith – a Primer**

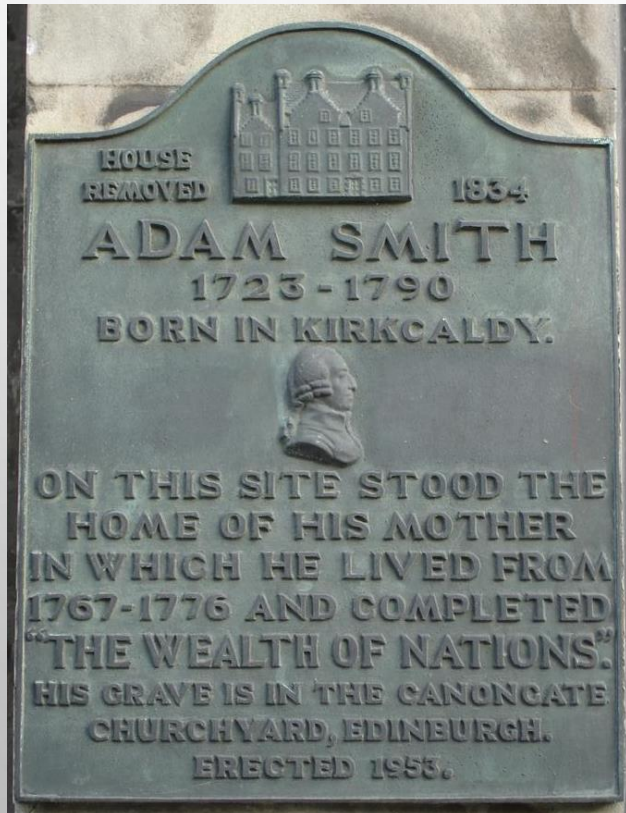
By Eamonn Butler

CHAPTER 3



# WHO IS ADAM SMITH?

- Adam Smith was born in 1723.
- He grew up in Scottish port of Kirkcaldy, which was a trading center, with ships landing fish, exporting coal from the local mines and bringing back scrap iron for the iron-working industry
- He saw things were changing; growing trade with the Americas, in commodities like tobacco and cotton, favored modern western ports like Glasgow over antiquated eastern harbors like Kirkcaldy.
- He went on to Glasgow University at the age of fourteen (quite a normal age at the time). Smith excelled, and won a scholarship to Balliol College, Oxford in 1740.



# WHO IS ADAM SMITH?



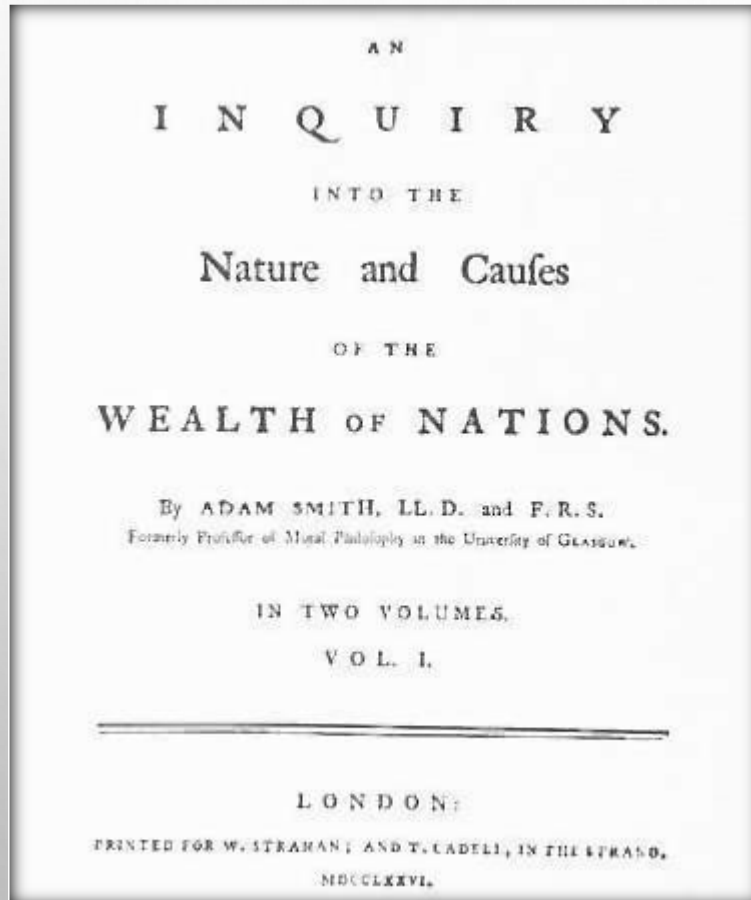
- The English education system did not impress him.
- Indeed, it gave him an important lesson on the power of perverse incentives.
- Oxford teachers were paid from large college endowments, not from students' fees. The 'pretence of teaching', and college life was contrived 'for the interest, or more properly speaking, for the ease of the masters'.
- Smith was able to educate himself in the classics, literature and other subjects from Balliol's world-class library.

# WHO IS ADAM SMITH?



- Smith was rewarded with the post of Commissioner of Customs in Edinburgh
- Many ideas from his thoughts such as trade liberalization, started making their way into public policy
- Later, Prime Minister William Pitt adopted Smith's principles in forging a trading pact with France and in implementing a widespread reform of the nation's tax system.
- From 1787 to 1789 he occupied the honorary position of Lord Rector of the University of Glasgow.
- He died in Edinburgh on 17 July 1790.

# THE WEALTH OF NATIONS

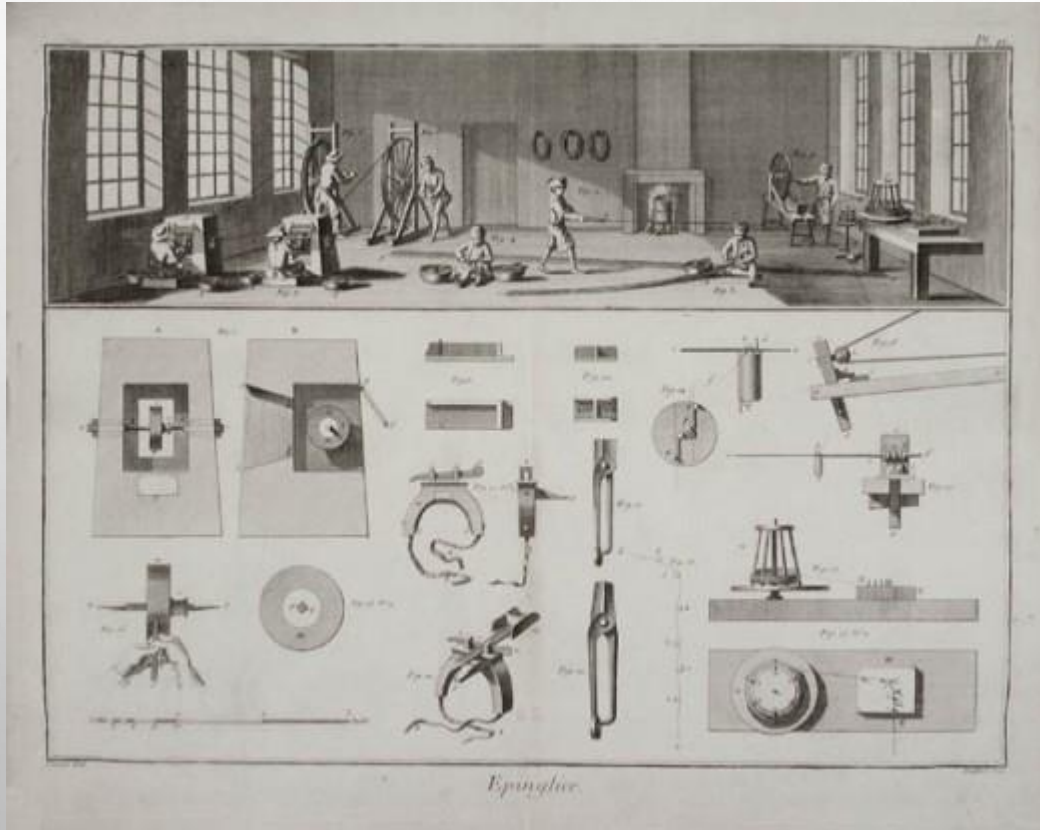


- Adam Smith wrote the *Wealth of Nations* partly to provoke politicians out of their policy of restricting and distorting commerce, rather than letting it flourish.
- He was also trying to create a *new science of **Economics***.

# THE WEALTH OF NATIONS: THEMES

- *Regulations on commerce are ill-founded and counterproductive.*
- *The real measure of a nation's wealth is the stream of goods and services that it creates.*
- *Productive capacity rests on the division of labor and the accumulation of capital.*
- *A country's future income depends upon this capital accumulation*
- *This system is automatic [But only when there is free trade and competition].*
- *Different stages of economic progress produce different government institutions.*
- *Competition and free exchange are under threat from the monopolies, tax preferences, controls and other privileges that producers are able to extract from the government authorities.*
- *Government must be limited.*

# PRODUCTION AND EXCHANGE



- Smith shows that the **division of labor** – labor specialization – generates enormous increases in output.
- Farmers specialize in raising crops or livestock: their land is consequently much better tended, and more productive, than if they had to spend time making all their household items too.
- Similarly, countries specialize by exporting the goods they produce best and importing the goods that others produce better
- The increased efficiency comes not just from the skill acquired when people do the same task many times.

# PRODUCTION AND EXCHANGE

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.<sup>3</sup>



- The division of labor harnesses the **cooperation** of many thousands of people in the production of even the most basic of everyday objects.
- This collaboration of thousands of highly efficient specialists is the source of developed countries' great wealth, and makes items such as woollen coats accessible even to the poorest.
- Smith calls '**that universal opulence which extends itself to the lowest ranks of the people**'.

# PRODUCTION AND EXCHANGE

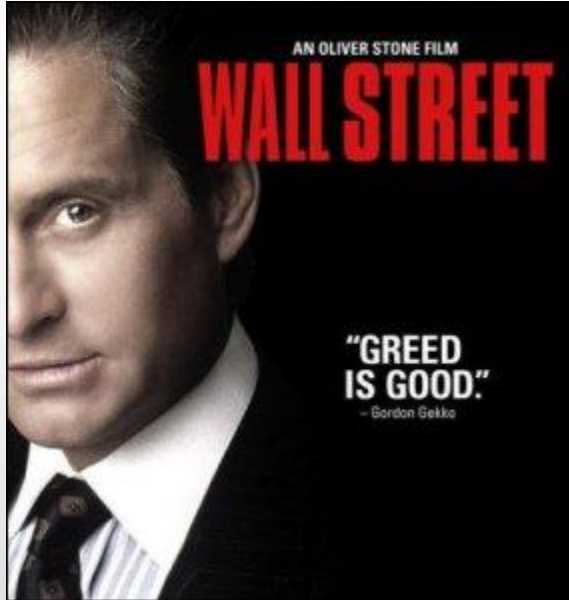
## The mutual gains from exchange

- The propensity to 'truck, barter, and exchange' is a natural and universal feature of human behavior.
- Each party proposes and accepts the bargain entirely in their own self-interest and not with the other side's welfare in mind. The exchange would not occur if either side thought themselves the loser by it.
- By exchanging, both sides get the goods they want for less effort than they would have to expend in making them for themselves. The benefit is mutual.
- **Wealth is not fixed, but is created by human commerce.** It was a groundbreaking idea.



<https://www.youtube.com/watch?v=5CrygjvyUPU>

# PRODUCTION AND EXCHANGE



Nobody but a beggar  
chooses to depend chiefly  
upon the benevolence of  
his fellow-citizens.

Adam Smith

## Father of Greed?

- By 'self-love' or 'self-interest', Smith does not imply 'greed' or 'selfishness'.
- His meaning is not some unpleasant readiness to gain by making others worse off.
- He stresses that '*sympathy*' for others is one of humanity's salient characteristics, and *justice* (not doing harm to others) is one of its fundamental rules.
- 'No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable.'

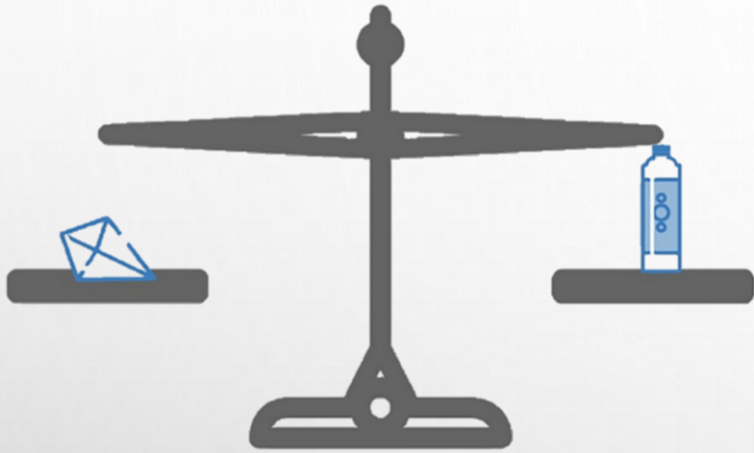
# PRODUCTION AND EXCHANGE



## WIDER MARKETS BRING BIGGER GAINS

- Only a 'great town' provides enough customers for porters,
  - For example; while scattered communities may be unable to support even specialist carpenters or stonemasons, forcing people to do more of these tasks for themselves.
- What extends the market is **money**!
- It helps in exchanging surplus.
- Without money, hungry brewers always had to search out thirsty bakers.

# PRODUCTION AND EXCHANGE



## THE INDEX OF VALUE

*'Paradox of Value'*

- Why something essentially useless (like a diamond) has a high 'value in exchange', when something vital (like water) has almost none?
- [Marginal utility theory: what is so rare (and demanded) has a great prize]

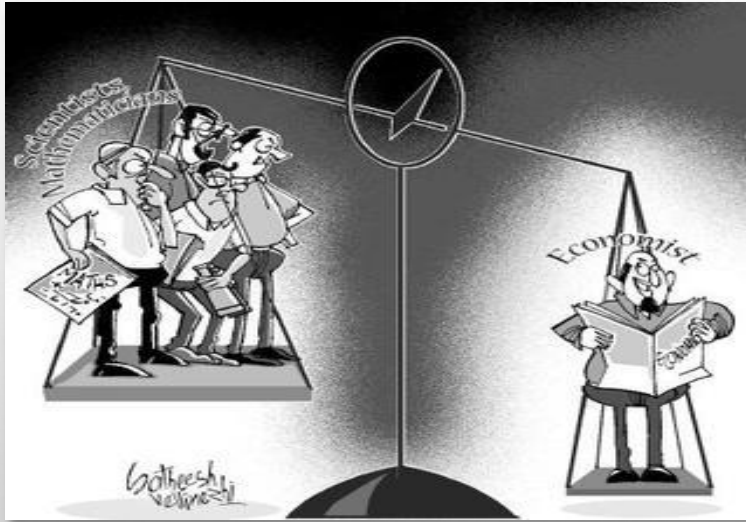


# PRODUCTION AND EXCHANGE

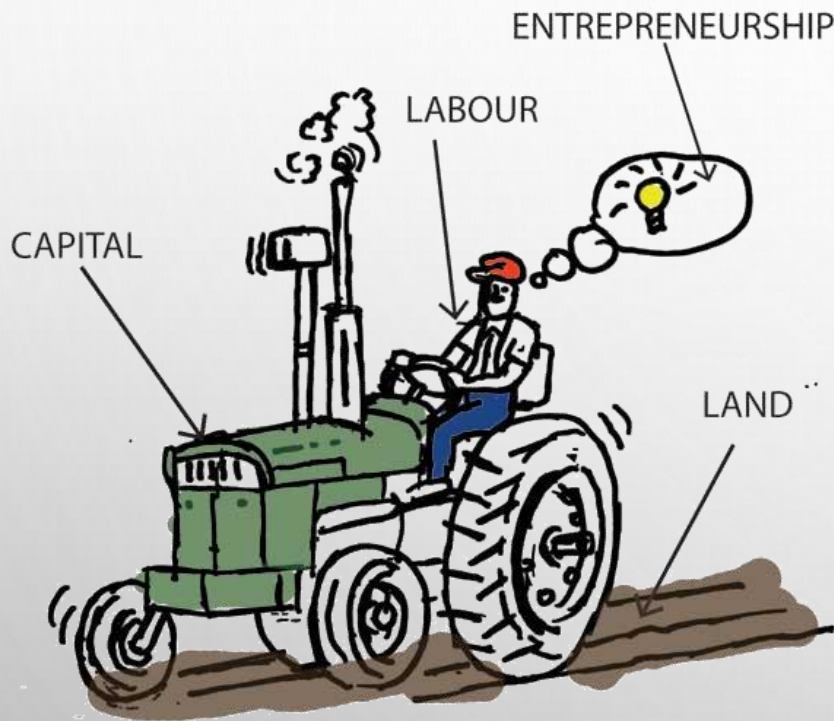
- **Value** originally must have reflected the **labour** put into the item's production
  - The ideal rate of exchange should reflect equal effort
  - *'It usually costs twice the labour to kill a beaver which it does to kill a deer, one beaver should naturally exchange for or be worth two deer'*.
  - Smith is actually trying to understand what today we see as a key economic measure, the **total costs of production**.
- If market price is higher than sellers' total production costs, they make a **profit**; if it is lower, they make a loss and sellers would withdraw.
  - High price would alert competitors that there are profits to be made; supply would increase and the market price would be bid down again.

# PRODUCTION AND EXCHANGE

- Why do wage rates actually differ?
- Some professions are...
  - hard or disagreeable (butchers are better paid than weavers)
  - seasonal (like bricklaying)
  - requiring great public trust (medicine)
  - costly to learn (the law) and the chance of real success might be slim (opera singers)



# PRODUCTION AND EXCHANGE



- Smith is leading us gradually to the realization that the **production, valuation and distribution** of the nation's **output** do not exist in isolation, but all take place simultaneously as interrelated parts of a functioning **economic system**
- A country's 'annual produce' resolves itself into rent, wages and profits, meaning that landowners, workers and employers are inevitably interdependent
- They are parts of a seamless system of flows in which goods are created, exchanged, used and replaced – and resources are put to their best use – all quite automatically

# PRODUCTION AND EXCHANGE



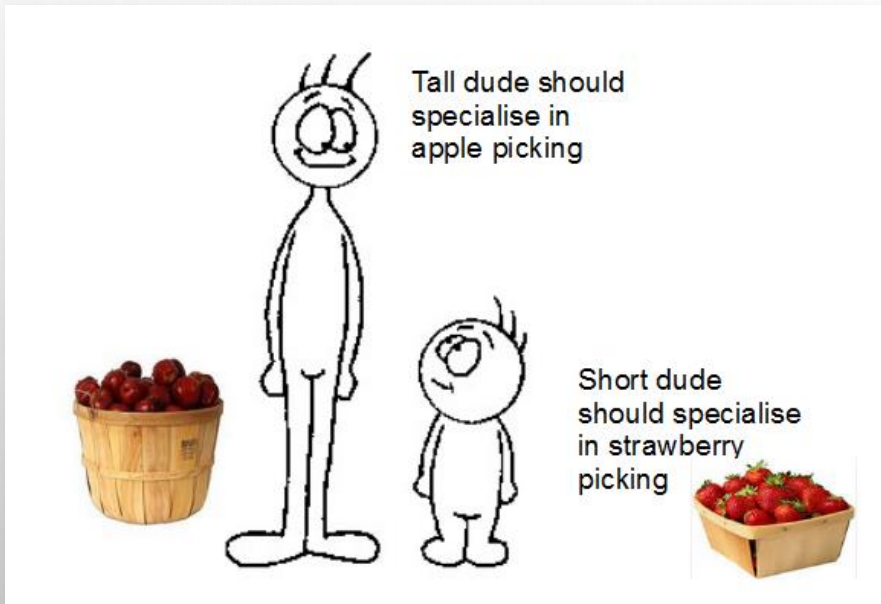
- To Smith, the only ‘real and effectual’ discipline over businesses is the fear of losing customers.
- A free market in which customers are sovereign is a surer way to regulate business behavior than any number of official rules – which so often produce the opposite of their avowed intention

# ACCUMULATION OF CAPITAL



- Mercantilists say that gold is durable and that the countries that export to us could viciously accumulate it over decades.
- Smith reminds us that:
  - Money is just a tool to facilitate exchange.
  - Foreign trade is a small part of total commerce
  - We stupidly exchange perishable commodities for such a durable one
  - We should not be so stupid to hoard gold and silver beyond their useful quantities.
  - An excess of inert metal is dead capital, and dead capital cannot make us rich

# ACCUMULATION OF CAPITAL



- When we restrict imports in the hope of preserving our gold and silver deposits, smith continues, it means that domestic consumers have less choice:
- They have to buy from home producers, rather than from a range of foreign producers whose goods may be better or cheaper
- The division of labour between trades, countries too should do what they are best at and exchange their surpluses
- ***Absolute advantage!***

# ACCUMULATION OF CAPITAL

- **Virtuous circle:** Specialization helps build greater surpluses, which in turn can be reinvested in new, dedicated, **labour-saving equipment**.
- As wealth expands, the whole nation becomes richer.
- One person (or one nation) does not have to become poorer in order for another to become richer
- The market economy is unparalleled at boosting national wealth, and this wealth diffuses right down to the poorest workers.
- The poor in the rich countries that adopt this system live better than the rich in the poor countries that do not.
- Countries make themselves better off if they do not try to remain self-sufficient or raise trade barriers against others

# ACCUMULATION OF CAPITAL

- However, this excluded '*unproductive labours*' where their work is consumed immediately, and does not produce revenue that can be reinvested
  - [like that of doctors, musicians, or lawyers]
- Ordinary people know that they must save and invest if they are to better themselves.
- Governments, however, have less focus on the importance of maintaining capital: their role is to spend on current services, not to invest in production.
- Almost the whole revenue of governments, observes Smith, is thus employed in maintaining unproductive hands.
- Big government may set nations back. But the market economy remains a powerfully robust system.

# ECONOMIC INSTITUTIONS

- The rise of commerce had separated economic from political power: and economic power is powerful
- A beneficial rule of law was brought about by groups of people who had not the least intention of serving the general public, but were mindful only of their own property and security

# TRADE RESTRICTION

The bounty to the white-herring fishery is a tonnage bounty; and is proportioned to the burden of the ship, not to her diligence or success in the fishery; and it has, I am afraid, been too common for vessels to fit out for the sole purpose of catching, not the fish, but the bounty.<sup>41</sup>

- Interventionism is not only irrational and expensive. It is also corrupting.
- British tariffs on foreign wine and beer, for example, are defended on the grounds that they reduce drunkenness.
- But Smith: it is still better if we can buy it more cheaply than we can brew it ourselves.
- As long as a country is producing more than it consumes, it is saving and adding to its capital.
- Such a country could still import more than it exports and nevertheless continue to produce surpluses and grow richer.

# TRADE RESTRICTION



- America's great asset is not silver or gold, but **land**. It is plentiful and cheap, and much labour is needed to realize its potential yield
- American agriculture is in fact so productive that labour remains affordable nonetheless.
- Britain has tried to make America 'a people of customers' with the policy of forcing America to trade only with the home country

# TRADE RESTRICTION

*"Consumption is the sole end  
and purpose of all production."*  
Adam Smith



- This was another example of mercantilist thinking, where producer interests dominate.
- This has drawn Britain's capital and enterprise away from more productive uses – depressing its prosperity along with America's, and leading to slower capital accumulation and therefore lower future incomes in both
- The policy instead has turned them from farmers into politicians

'Consumption is the sole end and purpose of all  
production;

And the interest of the producer ought to be attended to,  
only so far as it may be necessary for promoting that of the  
consumer.'

# ROLES OF GOVERNMENT



- Civil government, so far as it is instituted for the security of property, is in reality instituted for the defence of the rich against the poor, or of those who have some property against those who have none at all.
- The power to tax allows it to build up enormous resources, but it has much less incentive to manage its property as efficiently as would a private individual.

# ROLES OF GOVERNMENT

- Smith believes that the market economy can function and deliver its benefits only when its rules are observed – when property is secure and contracts are honored.
- 1: The maintenance of **justice** and **the rule of law** are therefore vital.
- 2: **Defence**. If our property can be stolen by a foreign power, we are no better off than if our own neighbours steal it.
- 3: 'the duty of erecting and maintaining 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'.
- These comprise **infrastructure projects** that facilitate **commerce** and **education**, which helps make people a constructive part of the social and economic order

# ROLES OF GOVERNMENT



- If the main benefit is local and the cost cannot be recovered by tolls, a local tax is best
- London taxpayers should pay for paving and streetlights in London

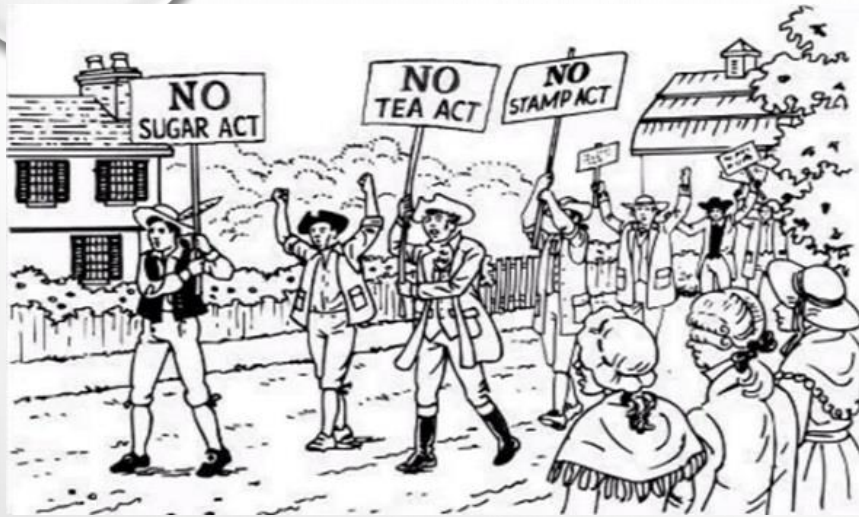
# ROLES OF GOVERNMENT



- The division of labour may have undesirable social consequences.
- The daily focus on repetitive tasks inevitably narrows people's views and interests.
- Smith insists that education is needed to correct it.
- Education should focus on the labouring poor, who suffer most.
- But while the state might pay for school buildings, it should not pay the whole of teachers' wages.
- If teachers rely on fees from students, their performance will be that much sharper.

# PRINCIPLES OF TAXATION

- **First**, people should contribute in proportion to the income that they enjoy under the security of state protection.
- **Second**, taxes ought to be certain, rather than depend on the arbitrary decisions of tax officers.
- **Third**, tax should not be inconvenient to pay.
- **Fourth**, taxes should have minimal side effects:
  - They should be cheap to collect;
  - They should not hamper industry and enterprise;
  - They should not be so onerous as to encourage evasion, such as smuggling;
  - They should not require 'frequent visits and the odious examination of the taxgatherers'.



# TAXATION

- Smith says that people should pay tax in proportion to their income, but wants the rich to pay 'something more than in that proportion'
- A tax on companies is unwise, for example, because – as he observes with great insight – the capital on which our income depends is highly mobile
- He opposes taxes on consumption, but supports a tax on luxuries (including things that we would think rather basic today, such as poultry)

# THE WEALTH OF NATIONS TODAY?

- Smith's world was very different to ours, of course, before the industrial revolution changed everything.
- He did not forecast
  - The joint-stock companies
  - The rise of union power,
  - The problems of industrial pollution
  - Fiat money inflation
- The Wealth of Nations still leaves us with a powerful set of solutions to the worst economic problems that the world can throw at us.
- The free economy is an adaptable and flexible system