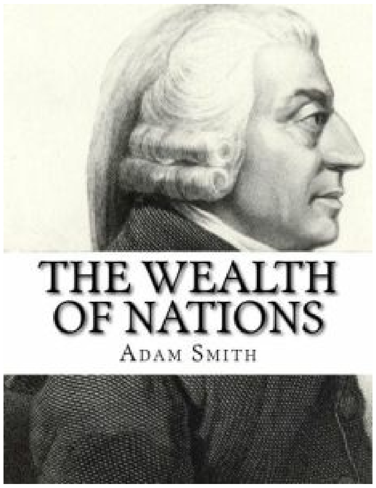

Book The Wealth of Nations

Adam Smith
CreateSpace, 1776
First Edition:1776
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Recommendation

BooksInShort believes that no serious economist can do without this exhaustive work, originally published in five volumes as *An Inquiry into the Nature and Causes of the Wealth of Nations*. This classic is a pragmatic and accessible milestone in the history of economics. Its author, Adam Smith, is woven into every economics textbook. However, Smith's theories, which today often are recounted mostly in fragments, frequently incorrectly, reveal their entire social and economic innovative power only in context. Smith burst onto the scene at a time when absolutist national states monopolized the world's precious metal reserves and tried to increase their own wealth through stringent export policies. These states were motivated by an entirely new concept about national wealth: that it stemmed from the work of the country's people, not from gold. Based on that idea, economic markets should balance themselves as if guided by an "invisible hand," impelled by each individual's self-interest. The state has to provide only an orderly framework and specific public goods and services. Even though Smith's image of idealized economic and social harmony may have developed a few cracks over the course of time, his ideas have inspired many well-known economists during the past 250 years, including David Ricardo, Vilfredo Pareto and Milton Friedman.

Take-Aways

- In 1776, Adam Smith laid the cornerstone of classic economics with his seminal work, *An Inquiry into the Nature and Causes of the Wealth of Nations*.
- He criticized mercantilism's economic intervention and rejects protective duties and other measures which hinder free trade.
- Mercantilism protects producers, but discriminates against consumers.
- Smith said that the efficient production of goods requires the division of labor.
- He believed that the exchange of goods requires public desire to trade and a market.
- The larger the market, the better the exchange of goods will function. Agreement between suppliers and customers creates the market price.
- Using accepted, durable currency as a means of exchange cuts transaction costs.
- A commodity's real value is the labor it represents; this real price does not fluctuate, whereas the nominal price is subject to change.
- The more freely people can act economically, the more productive they will be.
- Government should not interfere with economic events, but should provide only defense, legislation and specific public institutions.

Summary

Progress through Division of Labor

The division of labor has improved productivity enormously. Instead of an individual worker producing a product from beginning to end, production now can be divided into individual steps. For example, manufacturing one pin requires 18 different steps. An untrained worker may be able to produce only a few pins per day. However, if 18 workers each execute just one step, they can produce several thousand pins by the end of the day. In fact, the division of labor is one of the greatest achievements of progressive society. It developed because people have a natural propensity for exchanging goods. Each individual has different talents and, given the assistance of a barter economy, people can specialize: The baker bakes bread, the butcher supplies meat, and so on.

The Market and the Invention of Money

For trade to work, suppliers and consumers must have a market where they can meet. The size of the market has a direct influence on the scale of the division of labor: If the market is very small, specialization cannot function. In a small village, for example, nobody needs a porter; however, in a large city, porters are in demand. Where waterways exist, carts become unnecessary. Ships transport goods more quickly and more efficiently over greater distances, so trade gains momentum.

> "The division of labor, by reducing every man's business to some one simple operation, and by making this operation the sole employment of his life, necessarily increases very much the dexterity of the workman."

But better transport creates a problem for traders: What can they do if they are unable to find partners to trade with, other parties who want their goods? The invention of money as a means of trade solved this dilemma. At first, currency took the form of natural goods (for instance, cattle or salt) but, eventually, people started to use precious metals, which neither decayed nor lost value. To prevent fraud, states calibrated and officially embossed the precious metals, giving birth to coined money.

Natural Price and Market Price

However, the real value of a commodity is expressed in terms of what it costs to produce, not in terms of money. The value of each commodity equals the labor needed to create it. For example, if killing a beaver requires twice as much effort as killing a stag, then one beaver is worth two stags. The real value is the labor as expressed by the exchange rate.

> "All the different nations of Europe have studied, though to little purpose, every possible means of accumulating gold and silver in their respective countries."

Calculated this way, the value of a commodity does not fluctuate, since it always involves the same amount of labor. The labor is the real price of that commodity. The nominal price, however, can fluctuate, perhaps due to a decrease in the value of gold or silver, for example. Depending on whether a society is poor or wealthy, commodities develop typical – or natural – prices, which approximately equal their labor cost.

Supply and Demand

Usually, the seller of a commodity wants to make a profit. If the seller cannot realize a profit, he must sell his goods at the so-called purchase price – the amount he paid for them. Of course, he suffers the lost profit and the aggravation of knowing that he could have invested his money in other goods instead.

> "Labor, it must always be remembered, and not any particular commodity or set of commodities, is the real measure of the value both of silver and of all other commodities."

The market price is the price that a seller can actually achieve. It depends on the relationship between supply and demand in the market. If there is a large supply, prices will fall. Conversely, prices will rise if a commodity is in short supply. If supply and demand are balanced, the commodity probably will sell for its natural price. If a supplier can establish a monopoly, he can keep the supply of a commodity artificially low and, thus, get paid the highest price for it.

The Remuneration of Labor

Before land became private property and wealthy people accumulated large amounts of capital, the whole proceeds of a man's labor belonged to him. But, today, those who use property have to give part of the proceeds of their labor in exchange. This also applies to those who are employed by other people: The entrepreneur always retains part of the proceeds of his workers' labor. Of course, employers and employees can dispute the amount of remuneration, though it should never fall below the subsistence level. The labor market exists alongside the commodity market. If the demand for labor increases, suppliers will outbid each other to employ the best manpower.

Composition and Use of Capital

Before the division of labor, nobody needed capital or stockpiled supplies. When they got hungry, people went hunting. When they needed clothing, they used animal fur. But as soon as the division of labor was established, people had to stock necessities, such as raw materials for their work, and food and clothing for their families. Once people store goods, some of them will accumulate more goods than they need and will try to sell the surplus to generate revenue. Hence, it becomes their capital. Goods that are produced and sold are called "circulating capital." Machines, tools or property are called "fixed capital" or "capital assets."

> "What is the real measure of this exchangeable value; or, wherein consists the real price of all commodities?"

Except for that part of a country's wealth that is used immediately and doesn't produce a profit, the definitions that apply to individual capital also apply to national capital. A country's capital assets include its machinery, businesses, properties and even the skills of its citizens. The nation's circulating capital is comprised of all the money in circulation, its stock of supplies and its goods, whether they are semifinished or finished. Nations find it easier to produce and maintain monetary capital as paper money instead of gold and silver coins. Paper money is as efficient, convenient and secure as coinage, as long as its purchasing power remains stable.

The Demise of Agriculture

A natural order controls the use of capital. People who make a living from their labors in the fields should invest most of their wealth in agriculture. Trade and commerce or even foreign trade would, therefore, appear to be of secondary importance to them. But this order was turned around during the development of the modern

European states. At that time, foreign trade stimulated commerce and led to enormous improvements in agriculture. However, after the fall of the Roman Empire, the occupations of tilling the ground and husbanding animals began to falter in Europe. The marauders who destroyed the empire also destroyed the fertile trade between the cities and the rural population. In consequence, cities withered and farmers left their fields.

Freedom and Possession

Western Europe fell victim to poverty, and a few great landowners took possession of the fallow fields. The land lost its meaning as a way to insure an individual's livelihood and instead became a symbol of the landlords' power and protectionism. The farmers on this land became subordinate to their feudal lords, the landowners, in many ways: The landlords possessed the land, the seeds and the animals. Basically, the farmers were no more than slaves. And they worked just like slaves, that is, they never did more work than necessary. People only make an effort to ensure a rich harvest if they are going to enjoy the fruits of their labor. Every additional degree of freedom granted to the farmer leads to more productivity, a better harvest, and, in short, more wealth.

The Rise of the Cities

City dwellers attained freedom and independence a lot earlier than the rural population. Their protectors granted privileges to urban craftsmen and tradesmen by exempting them from bridge tolls, passage tolls, poll taxes and other dues. Citizens in the city were also "free" in another respect: They were able to elect a town council, merge into communities, and decide on their own who would inherit their goods and chattels. The city dwellers were allowed to erect walls and build up their defenses, while farmers lacked protection and were, therefore, at the mercy of any assault. And yet, the rise of the cities also benefited the rural population because the cities provided suitable markets for agricultural goods. City dwellers bought fallow land and cultivated it. They also spread the cities' order, laws and security to the surrounding villages.

The Flaws of the Mercantile System

The mercantile economic system includes two fundamentally flawed views. Nevertheless, various nations follow it almost blindly. First, a nation is considered wealthy if it owns large amounts of gold and silver. Hence, many countries make it their goal to accumulate enormous quantities of precious metal. To retain the nation's wealth, people were strictly prohibited from exporting these metals or, at least, high duties inhibited such exports. Fortunately, merchants made the British government understand that although they might first pay for goods with gold, reselling the goods to other countries brought even more gold back to England. Therefore, England removed export bans on precious metals.

> "The scarcity of money is not always confined to improvident spendthrifts. It is sometimes general through a whole mercantile town and the country in its neighborhood. Over-trading is the common cause of it."

The second flaw of the mercantile economic system involved maintaining a positive balance of trade. For example, the British consistently worked to export more than they imported. To serve this purpose here and elsewhere, merchants were not allowed to import any goods that their own country could produce or to bring in any goods from countries that had a negative balance of trade with their own nation. At the same time, states found various ways to foster exports:

- They granted reimbursements to exporters whose goods originally were subject to government duties.
- They provided subsidies for some trades.
- Special state trade agreements granted privileges for home country goods.
- States founded colonies where their merchants could have monopolies.

> "The wealth of a neighboring nation, however, though dangerous in war and politics, is certainly advantageous in trade."

This entire mercantile system is a deceptive, highly dangerous construct. It serves only producers and traders, and neglects consumers. In the end, consumers would benefit if local goods competed with imported products.

The Tasks of the State

The state's attempts to boost or restrict its economy in various sectors are damaging; Instead of promoting progress, they thwart it. The state's goal should be the free development of all market participants. As long as these participants comply with the laws and rules, they should be subject only to the free play of market forces. Of course, the state has specific tasks which private individuals can never fulfill. These tasks are:

- **National defense** – The state's first obligation is to protect its citizens from hostile assaults. Therefore, it must maintain an army or, at least, a militia.
- **Justice** – To enforce the rule of law and to prevent violence between citizens, the state has to provide courts, a judicial administration and police.
- **Public institutions** – The state has to take over all institutions where private individuals cannot expect to make a profit. These include schools and universities, churches, streets, bridges and channels.

> "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities."

The state depends on revenue from taxes to fulfill these tasks. Taxes on pensions, profits and salaries are permissible. The highest taxation principle is that taxes have to be assessed based upon a predetermined and logical rate of the citizen's means. The state can only tax that part of a person's income that was earned under the protection of the sovereign.

About the Author

Adam Smith, the son of a jurist, was born on June 5, 1723, in Kirkcaldy in Scotland. He learned moral philosophy from Francis Hutcheson, whose teachings combine the ideas of the philosophers John Locke and David Hume. After studying in Oxford and Glasgow, and teaching for some time, Smith was appointed professor of logic at Glasgow University in 1751, and professor of moral philosophy one year later. During this time, he was in close contact with David Hume, whose ethical and economic ideas influenced him substantially. In 1763, Smith left Glasgow for a two-year educational journey through France and Switzerland as a young duke's private teacher. From his encounters with the French physiocrats Turgot and Quesnay, Smith developed the idea for his main work, *The Wealth of Nations.* However, he did not finish and publish it until 1776. In 1779, Smith was appointed duty controller in Edinburgh, where he died on July 17, 1790. Shortly before his death, he ordered his friends to destroy all of his unfinished writings.