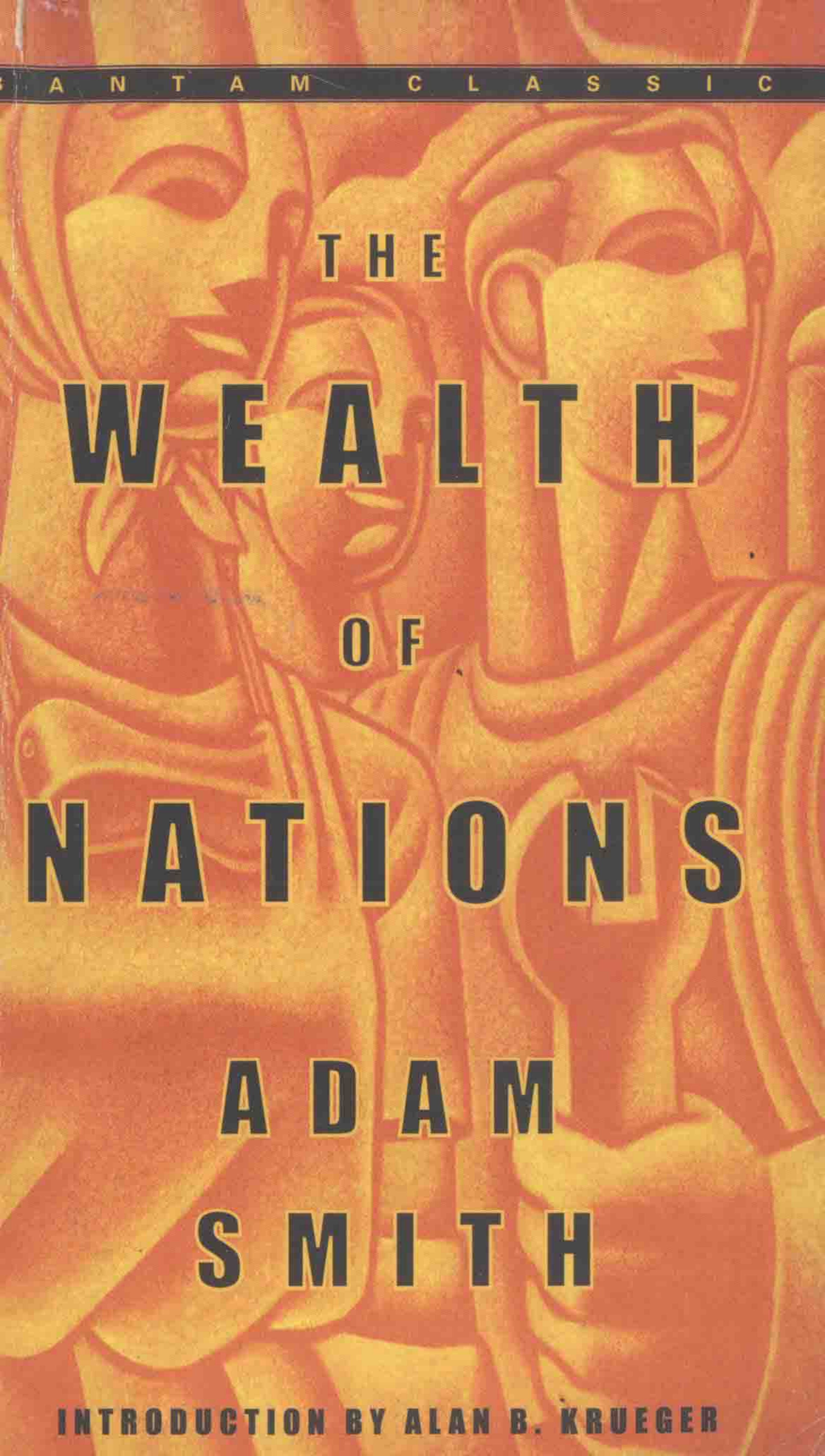

BANTAM CLASSIC

THE WEALTH OF NATIONS

ADAM SMITH

INTRODUCTION BY ALAN B. KRUEGER

THE WEALTH OF NATIONS

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Edited, with notes and Marginal Summary,

by Edwin Cannan

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INTRODUCTION

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NO BOOK has had more influence on economists' thinking and economic policy—and by extension on the world population's material well-being—than *An Inquiry Into the Nature and Causes of the Wealth of Nations* by Adam Smith. Skeptics of this claim might point out that many of the ideas in *The Wealth of Nations* can be traced to earlier thinkers and that Smith borrowed liberally from his French contemporaries. It has also become popular to find ancient Chinese philosophers who, unbeknownst to Smith, advanced related ideas two thousand years previously. Yet *The Wealth of Nations* has rightly earned its reputation as the founding work of modern economics. The genius of *The Wealth of Nations* lies in Adam Smith's abilities as a great synthesizer, great observer, and great storyteller. And most important of all, Smith was a great economic theorist. He saw economic behavior as primarily guided by the fundamental force of self-interest, and he conceived of the economy as a system in which regular patterns emerged from people interacting in markets on their own accord, without interference from outside authorities. Order, not chaos, would result if individuals were left to their own devices in Adam Smith's conception of the economy.

The notion that the social sciences, and economics in particular, can be studied like physics and chemistry, by breaking down human behavior into a small number of fundamental forces and modeling how individuals and organizations interact in such an environment, has survived and thrived to this day. What makes it work so brilliantly in Smith's hands is that Smith was a nuanced thinker. He was not nearly as doctrinaire a defender of unfettered free enterprise as many of his late-twentieth-century followers have made him out to be. He could—and often did—persuasively argue opposite sides of the same issue. He recognized that human judgment was not infallible. For example, he argued, "The contempt of risk and the presumptuous hope of success, are in no period of life more active than at the age at which young people chuse their professions" (p. 151). He also worried incessantly that giant corporations would come to dominate particular industries and, led by self-interest, use their influence with government to unfairly thwart their competitors and suppress the wages of their workers.

Nevertheless, Adam Smith could strip away complexity and focus on the fundamental forces at work, and he argued that such forces would conspire to produce the greatest common good under conditions of perfect liberty and perfect competition, without the actors involved intending this fortuitous result or even being aware of the role they played in bringing it about. Smith viewed competition as economically efficient: "Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of the society which he has in view. But the study of his own advantage naturally, or rather necessarily, leads him to prefer that employment which is most advantageous to the society" (pp. 569–570).

Central to Smith's thinking was the notion of equilibrium: the economy would reach a balance in which buyers and sellers, workers and firms, would have no incentive to change their economic behavior (i.e., quantities supplied or demanded) in light of the set of prices and wages that would be grounded out in the market by the pursuit of individuals' self-interest. "The proposition that resources seek their most profitable uses, so that in equilibrium the rates of return to a resource in various uses will be equal," the Nobel laureate George Stigler once wrote, "is still the most important substantive proposition in all of economics" (Stigler, 1976, p. 1201).

That Adam Smith would become the father of modern economics must have seemed rather improbable when he was born in 1723 in Kirkcaldy, a small town on the east coast of Scotland. (The exact date of Smith's birth is unknown. He was baptized on June 5, 1723.) His father, a well-to-do Scotsman also named Adam Smith, died before Smith was born. He was raised by his mother, a caring woman from a prominent family to whom he remained devoted throughout his life, with the help of his deceased father's friends (as specified in his father's will). Smith was a sickly infant and child, and he suffered from colic, an affliction normally confined to infants, throughout his entire life. His health prevented him from partaking in sports; instead, as a schoolboy he gravitated toward reading the classics and history. His contemporary and first biographer, Dugald Stewart, recounted that Smith was kidnapped by marauding vagrants when he was about three years old, and briefly held captive until rescued by his uncle, whom Stewart called "the happy instrument of preserving to the world a genius, which was destined, not only to extend the boundaries of science, but to enlighten and reform the commercial policy of Europe" (Stewart, 1793, pp. 2–3).

The adolescent genius attended university in Glasgow when he was fourteen years old, the normal age of matriculation early in the eighteenth century. At the time, Glasgow was a hotbed of the Scottish Enlightenment. In addition to housing a fine university, Glasgow was also a center for trade in livestock ("a continual fair or market" in Smith's words), which some biographers believe provided grist for his future economic theorizing. Smith was a dedicated and serious, if somewhat shy and awkward, student. He was fond of many of his teachers. In particular, his professor of moral philosophy, Francis Hutcheson, had a profound, "never to be forgotten" impact on Smith, and quite possibly served as a role model for his career.

In the summer of 1740 Smith completed his studies at Glasgow and attended Balliol College at Oxford University in England. There he stayed for the next six years. Smith's experience at the elite Oxford campus was not as rewarding as his time spent at Glasgow, however. The Oxford tradition, which continues to this day, is to allow students more free time for self-instruction than is allowed in American colleges; certainly the dedication to teaching was less than what Smith was accustomed to at Glasgow. According to Ross (1995; p. 75), while at Oxford Adam Smith "reckoned that it is each man's interest to live as much at ease as possible, and if someone's rewards are the same whether he performs or does not perform an onerous duty, he will either neglect it or perform it as slackly as his superiors permit. . . . Thus, it came about, Smith argued, that the Oxford professors had given up even the pretence of teaching for many years." It may well be that Smith's Oxford experience ignited his belief in the virtues of competition.

Smith returned home to Kirkcaldy after leaving Oxford. It took him nearly five years to find a teaching position. In 1751, Smith was unanimously elected to the Chair of Logic at his former school, Glasgow University. He assumed the Chair of Moral Philosophy after another professor retired a year later. Revered as a popular and dedicated teacher of logic, rhetoric, and moral philosophy, Smith remained a professor at Glasgow University until 1764. Famously absentminded and overheard to talk to himself while he was alone, Professor Smith avidly played a card game known as whist (similar to bridge) in his leisure hours. He later described these years as "by far the happiest and most honourable period of my life" (Stewart, 1793, p. 112). He also assumed administrative positions, including Dean of Faculty in 1761.

While at Glasgow he published his first book, in 1759, *The Theory of Moral Sentiments,* a tract that explains human morality through the sentiment of sympathy. The book was well received—with high praise from Edmund Burke and David Hume, Smith's long-time friend—and established Smith's reputation as a man of letters. After gaining notoriety from *Moral Sentiments,* Smith was invited by Charles Townshend to become a travelling tutor to his stepson, the third duke of Buccleuch.

Perhaps growing weary of academic politics and restless in

Glasgow, and tempted by a generous stipend and promise of a pension, Smith left Glasgow in 1764 to become a tutor to the eighteen-year-old Buccleuch. Smith and Buccleuch embarked on a grand tour of France and Switzerland, taking up primary residence in Toulouse, France. They must have made quite a pair: the absentminded Smith with his broken French and his teenage charge, visiting the intellectual salons of Paris and Geneva. Serving as a private tutor left Smith with an unexpected amount of free time, every professor's dream. He used his time to befriend many of the great French intellectuals of the day, including d'Alembert, Turgot, Voltaire, and—most consequential of all—François Quesnay, author of *Tableau Économique*, an economic model of the flow of the macroeconomy.[1] Unfortunately, his time in France was cut short by the death of Hew Campbell Scott, the duke's brother, who had joined them for study.

Smith returned with the duke to London in the fall of 1766, and devoted the next ten years to researching and writing *The Wealth of Nations*, supporting himself on the annuity provided by the Duke of Buccleuch. Most of the time he spent in Kirkcaldy, with his mother, who lived to the age of ninety. Smith wrote a friend in 1780, "Upon my return to Britain I retired to a small Town in Scotland the place of my nativity, where I continued to live for six years in great tranquility, and almost in complete retirement. During this time I amused myself principally with writing my Enquiry concerning the Wealth of Nations."[2] What an amusement! The volume published in London on March 8, 1776, consumed nearly 1,100 pages, and drew extensively on modern and ancient history, philosophy, firsthand observation, published reports—all of which were marshaled to generate and support keen insights into economic theory.

The student who is about to read *The Wealth of Nations* for

[1]Smith had intended to dedicate *The Wealth of Nations* to Quesnay, but Quesnay died shortly before the book went to press.

[2]Letter to Andreas Holt quoted in Ross (1995; p. 227).

the first time is lucky. The book is eminently readable. Smith's clear, evocative writing style resembles that of one of his favorite authors, Jonathan Swift, author of *Gulliver's Travels*. His attention to detail and breadth of knowledge are remarkable. Economics is not the dismal science in Smith's hands.

The first chapter of *The Wealth of Nations* provides a vivid description of the division of labor, through a careful case study of a pin factory. Smith attributes the improvement in labor productivity, the key ingredient in economic growth, to an ever more specialized division of labor. "The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which it is anywhere directed, or applied," he observed, "seem to have been the effects of the division of labour" (p. 9). In modern terms, his discussion of the division of labor can best be thought of as a description of a production function. Assigning individuals more specialized tasks increases output per unit of input. Leaving the classroom and visiting the factory floor paid immeasurable dividends for Smith's analysis, a lesson that is often lost on modern economists.[3]

Probably the most famous (and selectively cited) passage in *The Wealth of Nations* concerns Smith's reference to the *invisible hand*. This reference occurs only once in the book, toward the end of the following long paragraph (p. 572):

> But the annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry, or rather is precisely the same thing with that exchangeable value. As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to rend the annual revenue

[3]It is worth noting, however, that the National Bureau of Economic Research has recently organized visits to factory floors in many industries to expose academic economists to the workings of the modern factory floor. These visits are appropriately called "pin factory" visits, in homage to Smith.

> 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 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. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

Smith's specific point is that restrictions on imports, supported by merchants and manufacturers in some industries, work to the advantage of those industries but not to the general good of society.

Many liberal and conservative economists have interpreted Smith's reference to the invisible hand broadly, as indicating his commitment to the idea that individual exchange in the marketplace inexorably leads to the greatest good for society. Emma Rothschild challenges this commonplace twentieth-century interpretation, suggesting that "Smith did not especially esteem the invisible hand" (Rothschild, 2001, p. 116). She even goes so far as to suggest that Smith used the famous metaphor as an ironic joke, in the tradition of Jonathan Swift. She does not dispute that Smith was a great defender of individual freedom. She also acknowledges that the ideas that individuals' actions have unintended consequences and that these unintended consequences sometimes promote the public good permeate *The Wealth of Nations*. The thrust of her argument is that, interpreted in the context of the late eighteenth century and Smith's other writings, he would be skeptical of the twentieth-century elevation of the invisible hand to the central concept of his thinking. This conclusion is partly speculative and has enraged critics, but there can be little doubt that Smith's faith in the power of an invisible hand has been exaggerated by modern commentators. He persistently worried that merchants and manufacturers, pursuing their own self-interest, would orchestrate government regulation and patronage to their advantage, knocking the benevolent invisible hand off course. This worry applies with equal force to contemporary politics as well. Moreover, Rothschild emphasizes that Smith used the metaphor only once in *The Wealth of Nations*, applied it rather narrowly, and presented it with more than his usual number of caveats and qualifications.

To be sure, Smith worried about the encroachment of government on economic activity. And his concerns were directed at least as much toward parish councils, church wardens, big corporations, guilds, and established religious institutions as to the national government; after all, these institutions were part and parcel of eighteenth-century government. He was nonetheless frequently tolerant of government intervention when the aim was to reduce poverty. For example, concerning labor regulation, Smith passionately argued, "When the regulation, therefore, is in support of the workmen, it is always just and equitable; but it is sometimes otherwise when in favour of the masters" (p. 195). He also saw a tacit conspiracy on the part of employers "always and everywhere" to keep wages as low as possible.

Smith was a Rawlsian before the philosopher John Rawls, proclaiming: "No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they who feed, clothe and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, clothed and lodged." (pp. 110–111)

He clearly had a big heart and much compassion for the disadvantaged. This generated inevitable conflict in his own thinking. One must decide how much efficiency should be sacrificed to improve the lot of those who feed, clothe, and lodge the rest of society, if that is a goal of economic policy. The answer is not easy for one individual, nor universally accepted across individuals. Smith wrestled with this dilemma. As a consequence, some of Smith's arguments were at times ambiguous or in conflict, despite his precise prose. In fact, at the turn of the nineteenth century Adam Smith's arguments were invoked by Samuel Whitbread in favor of a minimum wage and by William Pitt against it.

A similar conflict arises concerning progressive taxation, meaning a tendency for tax rates to rise with an individual's income. Smith favored low taxes and argued that subjects "ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities" (p. 1043). This sounds like a flat tax. Yet he also argued, "It is not very unreasonable that the rich should contribute to the public expence, not only in proportion to their revenue, but something more than in that proportion" (p. 1065). Indeed, Smith supported a tax on luxury carriages, anathema to the idea of a flat tax.

Smith also supported universal government-financed education—not for reasons of efficiency or redistribution, but because he believed the division of labor destined people to perform monotonous, mind-numbing tasks that eroded their intelligence. His economic policy had social and moral objectives, not just the maximization of national income. Smith was very much a product of the Enlightenment.

In *The Wealth of Nations* Smith describes people as usually rational decision makers, although sometimes seduced by "romantic hopes" to disregard the dangers inherent in their decisions. In a very real sense, the origin of "behavioral economics," an emerging field in economics that questions whether individuals act rationally to maximize their individual utility, can be traced back to Adam Smith.

He thought the market was ubiquitous and uniquely human, writing: "The propensity to truck, barter and exchange one thing for another . . . is common to all men, and to be found in no other race of animals" (p. 22). He would undoubtedly be shocked to discover that twentieth-century economists have found that animals such as rats and pigeons respond to economic incentives in laboratory settings, and generally seem capable of displaying consistent economic behavior. Nevertheless, the documented pressure for market activity to develop in virtually all human environments, from Communism to prisoner-of-war camps, does seem a remarkable human tendency. Constraints can be imposed on a market, but the rise of a market seems virtually unavoidable.

Smith's keenest observations on the operation of markets pertained to the labor market. In chapter X he established the idea of *equalizing differences*: "The whole of the advantages and disadvantages of the different employments of labour and stock must, in the same neighborhood, be either perfectly equal or continually tending to equality" (p. 138). This has become the fundamental equilibrium concept of modern labor economics, animating the theory of compensating differential for work amenities and the theory of human capital. He proposed five reasons why wages differ in different employments: (1) "The wages of labour vary with the ease or hardship, the cleanliness or dirtiness, the honourableness or dishonourableness of the employment." (2) "The wages of labour vary with the easiness and cheapness, or the difficulty and expence of learning the business." (3) "The wages of labour in different occupations vary with the constancy or inconstancy of employment." (4) "The wages of labour vary according to the small or great trust which must be reposed in the workmen." (5) "The wages of labour in different employments vary according to the probability or improbability of success in them" (pp. 140–147).

The first, third, and fifth reasons can be thought of as compensating differentials: in a market with perfect mobility and full information (at least on the margin), undesirable attributes of particular employments will be counterbalanced by higher wages to recruit a sufficient number of workers into those professions. The second reason is a straightforward statement of equilibrium in human capital theory. The fourth explanation, while consistent with compensating differentials, is probably more appropriately considered a forerunner of efficiency wage theory, where workers are paid a wage premium to ensure their trust. As Smith highlighted, trust is not an issue when it comes to self-employed workers; imperfect monitoring and shirking are not a problem when a worker is his or her own boss.

While one must resist judging eighteenth-century philosophers from the standpoint of twenty-first-century morality and experience, given Smith's keen insights into the labor market and his vigorous defense of individual liberty, his meek stand on slavery must be considered a disappointment. Smith observed that "The experience of all ages and nations, I believe, demonstrates that the work done by slaves, though it appears to cost only their maintenance, is in the end the dearest of any. A person who can acquire no property, can have no other interest but to eat as much, and to labour as little as possible. Whatever work he does beyond what is sufficient to purchase his own maintenance, can be squeezed out of him by violence only, and not by any interest of his own" (p. 493). This analysis implies that slavery would be less profitable than wage labor, a situation that cannot persist for long in equilibrium. Yet slavery showed no tendency to abate by peaceful means in the southern American colonies. Moreover, Smith argued that the decision of the Quakers in Pennsylvania to free their slaves implied that they must have been few in number, for, "Had they made any considerable part of their [the Quakers'] property, such a resolution could never have been agreed to" (p. 494). And Smith's argument that the cost of slave labor was unexpectedly dear is inconsistent with his conclusion that sugar plantations, which heavily used slave labor, were more profitable than corn cultivation, which was not produced with much slave labor in the English colonies. In any event, Smith did not enunciate a principled stand against slavery, an odious deviation from perfect liberty.

Adam Smith foresaw the potential for the American colonies to become a great economic power in *The Wealth of Nations*. It is doubtful that he foresaw the influence that his work would have on the development of America, however. While Smith corresponded with Benjamin Franklin, and may well have met him in Scotland or England, his influence on the founding fathers was far-reaching. Samuel Adams, Thomas Jefferson, James Madison, and Alexander Hamilton all studied *The Wealth of Nations*. Madison, in particular, was persuaded by Smith's work to argue for full religious liberty in *The Federalist Papers*. A couple of years ago, my research assistant, Melissa Clark, discovered that George Washington also owned a copy of *The Wealth of Nations*, by noticing his signature on the table of contents to the fourth edition of the book, published in January 1789 and currently housed in Princeton University's Firestone Library.[4]

Smith was fifty-three years old when *The Wealth of Nations* was first published.[5] He had moved to London to oversee the final stages of publication of the book and to be with his dear friend David Hume at the end of Hume's life. Smith remained in London for two years after the publication of the book. In 1778 he moved back to Scotland, having been appointed commissioner of customs for Edinburgh, serving on the board his father had served on. Still a bachelor, he lived quietly with his mother and a maiden cousin in a pleasant stone house, and he looked after the nine-year-old son of another cousin. Adam Smith died in Edinburgh on July 17, 1790. Ironically, Smith was disappointed that he had not accomplished more in his lifetime. In all likelihood, he died firmly believing that *The Theory of Moral Sentiments* was his most important and influential work (Ross, 1995, p. 177).

If scholarship is to be judged by its impact on future generations, then there is no question that *The Wealth of Nations*

[4]Smith made no alteration save adding an acknowledgment in the fourth edition. The fifth edition, published later in 1789, was the last Smith revised himself.

[5]Perhaps by coincidence, the most influential subsequent works in economics were published by men of approximately the same age. John Maynard Keynes was fifty-three in the year *The General Theory of Employment, Interest and Money* was published; Karl Marx was forty-nine when *Das Kapital* was published; and Milton Friedman was forty-five when *A Theory of the Consumption Function* was published and fifty-one when *A Monetary History of the United States* was published (written with Anna J. Schwartz, who was forty-eight). So much for the idea that economists are past their peak productivity before middle age.

remains an unparalleled success. Indeed, most of postwar economics can be thought of as an effort to determine theoretically and empirically when, and under what conditions, Adam Smith's invisible hand turns out to be all thumbs. The modern theory of information economics highlights that the first welfare theorem, which holds that in a competitive equilibrium no one can be made better off without making someone else worse off, does not apply if information is imperfect or asymmetric. Likewise, unattended externalities (i.e., spillovers from a private transaction that affect more than those parties directly involved in the transaction) mean that government intervention can improve a laissez-faire equilibrium. Transaction costs and irrational decision making could also reduce the economy from peak efficiency. And the exercise of noncompetitive market power, such as collusion among employers in the product or labor market, can reduce the efficiency of a market economy, as Smith warned.

The challenge for modern economists has been to quantify the importance of deviations from the benchmark model of perfect liberty that Smith provided, and to determine whether alternative government would in some sense produce better results than the status quo. This is very much an agenda that Adam Smith laid out. It is testimony to the slow progress of economic science and the prescient genius of Adam Smith that his conception of equilibrium remains at the forefront of economics, some 225 years later. I suspect Smith would also be proud that *The Wealth of Nations* continues to have a profound influence on scholars in fields outside of economics, especially in philosophy, history, and sociology.

RECOMMENDED READINGS

Heilbroner, Robert L. (Ed.) *The Essential Adam Smith*. London: W.W. Norton and Company, 1987. Contains important essays as well as key excerpts from Smith's longer works, including *The Wealth of Nations*. Selected personal correspondences are also included.

Heilbroner, Robert L. *The Worldly Philosophers*. New York: Simon & Schuster, 1999. A classic text on the history of economic thought and the men who shaped it. In addition to a substantial section on Adam Smith, this book discusses the lives and ideas of Karl Marx, John Maynard Keynes, David Ricardo, and others.

Hollander, Samuel. *The Economics of Adam Smith*. Toronto: University of Toronto Press, 1973. Develops and analyzes the economic models that underlie and are implied by Smith's writings.

Malloy, Robin Paul and Jerry Evensky. (Eds.) *Adam Smith and the Philosophy of Law and Economics*. Dordrecht: Kluwer Academic Publishers, 1994. A collection of essays from such academic disciplines as law, legal history, economics, and philosophy that explores Adam Smith's contribution to the philosophy of law and economics.

Rae, John. *Life of Adam Smith*. New York: Augustus M. Kelley, 1965. Originally published in 1895, this was the first large-scale biography of Adam Smith. The 1965 reprint contains a helpful *Comprehensive Guide to John Rae's Life of Adam Smith* by Jacob Viner that outlines Smith's life and points out errors and omissions in Rae's original work.

Ross, Ian S. *The Life and Times of Adam Smith*. Oxford: Clarendon Press, 1995. A well-researched biography of Smith's life from birth to death. Ross focuses on the events of Smith's life and the people he was in contact with, and discusses how these events and people may have shaped Adam Smith's philosophical views.

Rothschild, Emma. *Economic Sentiments: Adam Smith, Condorcet and the Enlightenment*. Cambridge, MA: Harvard University Press, 2001. A reinterpretation of the ideas of Adam Smith and the Marquis du Condorcet that emphasizes the interconnections between their views of economics and