TITLE:: Adam Smith and the Origin of Capitalism

SUBTITLE::

SOURCE:: Excerpt and condensation of Chapter 4 from <i>The Worldly Philosophers: The Lives, Times, and Ideas of the Great Economic Thinkers</i> by Robert L. Heilbroner, 7th ed., 1999.

TAGS:: Adam Smith, Smith, The Wealth of Nations, capitalism, market, markets, free market, system of perfect liberty, liberty and profit, self interest, competition

COUNTRIES:: Europe

YEARS:: 1776-1800

INTRO:: Robert Heilbroner's <i>The Worldly Philosophers</i> is a uniquely readable introduction to the lives and ideas of the great economic theorists of the last three centuries. The book has enlivened the study of economics for beginning students for more than 40 years.

Adam Smith published his <i>Inquiry into the Nature and Causes of the Wealth of Nations</i> in 1776, adding a second revolutionary event to that fateful year. A political democracy was born on one side of the ocean; an economic blueprint was unfolded on the other. But while not all Europe followed America's political lead, after Smith had displayed the first true tableau of modern society, all the Western world became the world of Adam Smith: his vision became the prescription for the spectacles of generations. Adam Smith would never have thought of himself as a revolutionist; he was only explaining what to him was very clear sensible, and conservative. But he gave the world the image of itself for which it had been searching. After <i>The Wealth of Nations,</i> men began to see the world about themselves with new eyes; they saw how the tasks they did fitted into the whole of society, and they saw that society as a whole was proceeding at a majestic pace toward a distant but clearly visible goal. In a word, a new vision had come into being.

What was that new vision? As we might expect, it was not a State but a System -- more precisely, a System of Perfect Liberty. Smith's vision is like a blueprint for a whole new mode of social organization, a mode called Political Economy, or, in today's terminology, economics.

The Laws of the Market

At the center of this blueprint are the solutions to two problems that absorb Smith's attention. First, he is interested in laying bare the mechanism by which society hangs together. How is it possible for a community in which everyone is busily following his self-interest not to fly apart from sheer centrifugal force? What is it that guides each individual's private business so that it conforms to the needs of the group? With no central planning authority and no steadying influence of age-old tradition, how does society manage to get those tasks done which are necessary for survival?

These questions lead Smith to a formulation of the laws of the market. What he sought was "the invisible hand," as he called it, whereby "the private interests and passions of men" are led in the direction "which is most agreeable to the interest of the whole society."

But the laws of the market will be only a part of Smith's inquiry. There is another question that interests him: whither society? The laws of the market are like the laws that explain how a spinning top stays upright; but there is also the question of whether the top, by virtue of its spinning, will be moved along the table.

To Smith and the great economists who followed him, society is not conceived as a static achievement of mankind which will go on reproducing itself, unchanged and unchanging, from one generation to the next. On the contrary, society is seen as an organism that has its own life history. Indeed, in its entirety <i>The Wealth of Nations</i> is a great treatise on history, explaining how "the system of perfect liberty" (also called "the system of natural liberty") -- the way Smith referred to commercial capitalism -- came into being, as well as how it worked.

Adam Smith's laws of the market are basically simple. They tell us that the outcome of a certain kind of behavior in a certain social framework will bring about perfectly definite and foreseeable results. Specifically they show us how the drive of individual self-interest in an environment of similarly motivated individuals will result in competition; and they further demonstrate how competition will result in the provision of those goods that society wants, in the quantities that society desires, and at the prices society is prepared to pay.

But self-interest is only half the picture. It drives men to action. Something else must prevent the pushing of profit hungry individuals from holding society up to exorbitant ransom. This regulator is competition, the conflict of the self-interested actors on the marketplace. A man who permits his self-interest to run away with him will find that competitors have slipped in to take his trade away. Thus the selfish motives of men are transmuted by interaction to yield the most unexpected of results: social harmony.

But the laws of the market do more than impose a competitive price on products. They also see to it that the producers of society heed society's demands for the quantities of goods it wants. Let us suppose that consumers decide they want more gloves than are being turned out, and fewer shoes. Accordingly the public will scramble for the stock of gloves on the market, while the shoe business will be dull. As a result glove prices will tend to rise, and shoe prices will tend to fall. But as glove prices rise, profits in the glove industry will rise, too; and as shoe prices fall, profits in shoe manufacture will slump. Again self-interest will step in to right the balance. Workers will be released from the shoe business as shoe factories contract their output; they will move to the glove business, where business is booming. The result is quite obvious: glove production will rise and shoe production fall.

Through the mechanism of the market, society will have changed the allocation of its elements of production to fit its new desires. Yet no one has issued a dictum, and no planning authority has established schedules of output. Self-interest and competition, acting one against the other, have accomplished the transition.

And one final accomplishment. Just as the market regulates both prices and quantities of goods according to the final arbiter of public demand, so it also regulates the incomes of those who cooperate to produce those goods. If profits in one line of business are unduly large, there will be a rush of other businessmen into that field until competition has lowered surpluses. If wages are out of line in one kind of work, there will be a rush of men into the favored occupation until it pays no more than comparable jobs of that degree of skill and training. Conversely, if profits or wages are too low in one trade area, there will be an exodus of capital and labor until the supply is better adjusted to the demand.

All this may seem somewhat elementary. But consider what Adam Smith has done, he has found in the mechanism of the market a self-regulating system for society's orderly provisioning.

Does the world really work this way? To a very real degree it did in the days of Adam Smith. Business was competitive, the average factory was small, prices did rise and fall as demand ebbed and rose, and changes in prices did invoke changes in output and occupation.

And today? Does the competitive market mechanism still operate?

This is not a question to which it is possible to give a simple answer. The nature of the market has changed vastly since the 18th century. We no longer live in a world of atomistic competition in which no man can afford to swim against the current. Today's market mechanism is characterized by the huge size of its participants: giant corporations and strong labor unions obviously do not behave as if they were individual proprietors and workers. Their very bulk enables them to stand out against the pressures of competition, to disregard price signals, and to consider what their self-interest shall be in the long run rather than in the immediate press of each day's buying and selling.

That these factors have weakened the guiding function of the market mechanism is apparent. But for all the attributes of modern-day economic society, the great forces of self-interest and competition, however watered down or hedged about, still provide basic rules of behavior that no participant in a market system can afford to disregard entirely. Although the world in which we live is not that of Adam Smith, the laws of the market can still be discerned if we study its operations....

Smith's View of Economic Growth

"No society can surely be flourishing and happy, of which by far the greater part of the numbers are poor and miserable," he wrote. And not only did he have the temerity to make so radical a statement, but he proceeded to demonstrate that society was in fact constantly improving; that it was being propelled, willy-nilly, toward a positive goal. It was not moving because anyone willed it to, or because Parliament might pass laws, or England win a battle. It moved because there was a concealed dynamic beneath the surface of things which powered the social whole like an enormous engine.

For one salient fact struck Adam Smith as he looked at the English scene. This was the tremendous gain in productivity which sprang from the minute division and specialization of labor.

There is hardly any need to point out how infinitely more complex present-day production methods are than those of the 18th century. Smith was sufficiently impressed with a small factory of ten people to write about it; what would he have thought of one employing ten thousand! But the great gift of the division of labor lies in its capacity to increase what Smith calls "that universal opulence which extends itself to the lowest ranks of the people." That universal opulence of the 18th century looks like a grim existence from our modern vantage point. But if we view the matter in its historical perspective , it is clear that, mean as his existence was, it constituted a considerable advance.

What is it that drives society to this wonderful multiplication of wealth and riches? Partly it is the market mechanism itself, for the market harnesses man's creative powers in a milieu that encourages him, even forces him, to invent, innovate, expand, take risks. But there are more fundamental pressures behind the restless activity of the market. In fact, Smith sees two deep-seated laws of behavior which propel the market system in an ascending spiral of productivity.

The first of these is the Law of Accumulation. The object of the great majority of the rising capitalists was first, last, and always, to accumulate their savings.

But Adam Smith did not approve of accumulation for accumulation's sake. He was, after all, a philosopher, with a philosopher's disdain for the vanity of riches. Rather, in the accumulation of capital Smith saw a vast benefit to society. For capital -- if put to use in machinery -- provided just that wonderful division of labor which multiplies man's productive energy. Accumulate and the world will benefit, says Smith.

But here is a difficulty: accumulation would soon lead to a situation where further accumulation would be impossible. For accumulation meant more machinery, and more machinery meant more demand for workmen. And this in turn would sooner or later lead to higher and higher wages, until profits -- the source of accumulation -- were eaten away. How is this hurdle surmounted?

It is surmounted by the second great law of the system: the Law of Population.

To Adam Smith, laborers, like any other commodity, could be produced according to the demand. If wages were high, the number of workpeople would multiply; if wages fell, the numbers of the working class would decrease. Smith put it bluntly: "... the demand for men, like that for any other commodity, necessarily regulates the production of men."

If the first effect of accumulation would be to raise the wages of the working class, this in turn would bring about an increase in the number of workers. And now the market mechanism takes over. Just as higher prices on the market will bring about a larger production of gloves and the larger number of gloves in turn press down the higher prices of gloves, so higher wages will bring about a larger number of workers, and the increase in their numbers will set up a reverse pressure on the level of their wages.

And this meant that accumulation might go safely on. The rise in wages which it caused and which threatened to make further accumulation unprofitable is tempered by the rise in population. Smith has constructed for society a giant endless chain. As regularly and as inevitably as a series of interlocked mathematical propositions, society is started on an upward march. From any starting point the probing mechanism of the market first equalizes the returns to labor and capital in all their different uses, sees to it that those commodities demanded are produced in the right quantities, and further ensures that prices for commodities are constantly competed down to their costs of production. But further than this, society is dynamic. From its starting point accumulation of wealth will take place, and this accumulation will result in increased facilities for production and in a greater division of labor.

This is no business cycle that Smith describes. It is a long-term process, a secular evolution. And it is wonderfully certain. Provided only that the market mechanism is not tampered with, everything is inexorably determined by the preceding link. A vast reciprocating machinery is set up with all of society inside it: only the tastes of the public -- to guide producers -- and the actual physical resources of the nation are outside the chain of cause and effect.

But observe that what is foreseen is not an unbounded improvement of affairs. There will assuredly be a long period of what we call economic growth but the improvement has its limits. In the very long run, well beyond the horizon, he saw that a growing population would push wages back to their "natural" level. Growth would come to an end when the economy had extended its boundaries to their limits, and then fully utilized its increased economic "space."

Smith did not see the organizational and technological core of the division of labor as a self-generating process of change, but as a discrete advance that would impart its stimulus and then disappear. For all its optimistic boldness, Smith's vision is bounded, careful, sober -- for the long run, even sobering.

No wonder, then, that the book took hold slowly. It was not until 1800 that the book achieved full recognition. By that time it had gone through nine English editions and had found its way to Europe and America. Its protagonists came from an unexpected quarter. They were the rising capitalist class excoriated for its "mean rapacity." AII this was ignored in favor of the great point that Smith made in his inquiry: let the market alone.

In Smith's panegyric of a free and unfettered market the rising industrialists found the theoretical justification they needed to block the first government attempts to remedy the scandalous conditions of the times. For Smith's theory does unquestionably lead to a doctrine of laissez-faire. To Adam Smith the least government is certainly the best: governments are spendthrift, irresponsible, and unproductive. And yet Adam Smith is not necessarily opposed to government action that has as its end the promotion of the general welfare.

Government's Economic Role

Smith specifically stresses three things that government should do in a society of natural liberty. First, it should protect that society against "the violence and invasion of other societies. Second, it should provide an "exact administration of justice" for all citizens. And third, government has the duty of "erecting and maintaining those public institutions and those public works which may be in the highest degree advantageous to a great society," but which "are of such a nature that the profit could never repay the expense to any individual or small number of individuals."

Put into today's language, Smith explicitly recognizes the usefulness of public investment for projects that cannot be undertaken by the private sector -- he mentions roads and education as two examples.

What Smith is against is the meddling of the government with the market mechanism. He is against restraints on imports and bounties on exports, against government laws that shelter industry from competition, and against government spending for unproductive ends. These activities of the government all bear against the proper working of the market system. Smith never faced the problem that was to cause such intellectual agony for later generations of whether the government is weakening or strengthening that system when it steps in with welfare legislation.

The Danger of Monopoly

The great enemy to Adam Smith's system is not so much government per se as monopoly in any form. The trouble with such goings-on is not so much that they are morally reprehensible in themselves -- they are, after all, only the inevitable consequence of man's self-interest -- as that they impede the fluid working of the market. Whatever interferes with the market does so only at the expense of the true wealth of the nation.

In a sense the vision of Adam Smith is a testimony to the 18th-century belief in the inevitable triumph of rationality and order over arbitrariness and chaos. Don't try to do good, says Smith. Let good emerge as the by-product of selfishness.

Smith was the economist of pre-industrial capitalism; he did not live to see the market system threatened by enormous enterprises; or his laws of accumulation and population upset by sociological developments fifty years off. When Smith lived and wrote, there had not yet been a recognizable phenomenon that might be called a "business cycle." The world he wrote about actually existed, and his systematization of it provides a brilliant analysis of its expansive propensities.

Yet something must have been missing from Smith's conception. For although he saw an evolution for society, he did not see a revolution -- the Industrial Revolution. Smith did not see in the ugly factory system, in the newly tried corporate form of business organization, or in the weak attempts of journeymen to form protective organizations, the first appearance of new and disruptively powerful social forces. In a sense his system presupposes that 18th-century England will remain unchanged forever. Only in quantity will it grow: more people, more goods, more wealth; its quality will remain unchanged. His are the dynamics of a static community; it grows but it never matures.

But, although the system of evolution has been vastly amended, the great panorama of the market remains as a major achievement.

For Smith's encyclopedic scope and knowledge there can be only admiration. <i>The Wealth of Nations</i> and <i>The Theory of Moral Sentiments,</i> together with his few other essays, reveal that Smith was much more than just an economist. He was a philosopher-psychologist-historian-sociologist who conceived a vision that included human motives and historic "stages" and economic mechanisms, all of which expressed the plan of the Great Architect of Nature (as Smith called him). From this viewpoint, <i>The Wealth of Nations</i> is more than a masterwork of political economy. It is part of a huge conception of the human adventure itself.