The Bicentenary Of The Wealth Nations: 1776-1976

A NOTE ON THE PRINCIPAL ASSUMPTIONS OF ADAM SMITH’S THEORY OF ‘SOCIAL’ RATHER THAN NARROWLY ECONOMIC INTEGRATION (*)

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1. INTRODUCTION

Adam Smith’s reputation as a major figure in history of economic analysis has been well-established. Although he is acknowledged as the founder of economics by many writers, this is still a debatable issue; but there is a general consensus among economists that his great work, An Inquiry into the Nature and Causes of the Wealth of Nations, is the first systematic and rather comprehensive treatment of all the major problems of economics. As Mark Blaug puts it:

«One cannot pretend the Adam Smith was the founder of political economy. Cantillon or Quesnay or Turgot have a better claim to that honor. But Cantillon’s Essai, Quesnay’s articles, and Turgot’s Refléxions are, at best, long pamphlets, dress rehearsals for a science, rather than the real thing. An Inquiry into the Nature and Causes of the Wealth of Nations is the first full-scale treatise on economics, containing as it does a solid core of production and distribution theory, followed by a review of the past in the light of these abstract

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principles, and concluding with a battery of policy applications, the whole of it permeated by the high theme of ‘the obvious and simple system of natural liberty’ towards which Adam Smith saw the world moving.» (1)

The Wealth of Nations was intended by Smith, the great philosopher and economist, to be a complete social philosophy, including political philosophy as well as economics; while this objective was, to a great extent, achieved, only the parts which dealt with economics are remembered. (2) Joseph A. Schumpeter calls it ‘epoch making original’ from standpoint of thought and policy, but claims that it «does not contain a single analytic idea, principle or method that was entirely new in 1776». (3) This negative - and rather extreme - view on Smith as analytic economist has been adopted, in a milder way, by most historians of economic thought; however, in a recent, original and stimulating study, Professor Samuel Hollander challenged it, reasserting the analytic primacy of the Wealth of nations. (4)

Even though some of its assumptions are open to severe criticism today, the impact of the Wealth of Nations has been so great that the 200th anniversary of its first publication has been celebrated in many parts of the world, — including in a country having a socialist economy — throughout the year 1976. (5) The purpose of this note is, on

(4) Samuel Hollander, The Economics of Adam Smith (Toronto; Univ. of Toronto Press, 1973). This is taken from the following review articles:
Laurence S. Moss, «The Economics of Adam Smith : Professor Hollander’s reappraisal» History of Political Economy, Adam Smith Bicentennial Issue, Vol. 8, No. 4 Winter 1976, pp. 564-574.
(5) Some of the meetings which have been devoted wholly, or partially, to the celebrations, reportedly, are as follows: History of Economic Society in Chicago, May 21st-23rd, 1976; History of Economic Thought Conference, Glasgow (Univ. of Glasgow) September 7th-9th, 1976; Society For the History of Social and Economic Thought, Japan, the Kanto branch meeting at Seijo Univ., Tokyo on May 22, and the Osaka City University meeting on May 29th; also the annual meeting of the same society at Kyushu University on November 6th-7th, 1976; the annual conference of the International Institute of Public Finance, in Edinburgh on September 6th-7th, 12th; Symposium at Massey College, at University of Toronto on March 9th; Adam Smith Seminar in Rio de Janeiro, Brazil, on Sept. 13th-17th; the 4th National Conference of the
this occasion, to review the principal assumptions of Smith's theory of 'social' integration with an evaluation of their historical and contemporary relevance. Due to the importance of the place he occupies in the development of our science, however, section II will briefly review Adam Smith's background — as a philosopher before he became an economist; section III will be dealing with his assumptions; sections IV and V will consider historical and contemporary relevance of these assumptions, respectively.

II. FROM SMITH «THE PHILOSOPHER» TO SMITH «THE ECONOMIST»

Adam Smith (1723 - 1790) studied the Classics, Mathematics and Philosophy under the philosopher Professor F. Hutcheson, at the University of Glasgow. (6) He was a distinguished student and was awarded a six-year scholarship to study at the Oxford University; following the three years at Glasgow, he studied six years at this university. After returning to Edinburgh he was soon offered a lectureship in English literature there. Smith was quite successful in his lectures. Then, his old university, Glasgow called him back named Professor of Logic in 1751; thus, his teaching career, that lasted thirteen years, began. The following year he was given the Chair of Moral Philosophy.

His lectures on moral philosophy at Glasgow University were divided into four parts: 1. natural theology; 2. ethics; 3. justice and jurisprudence; and 4. political economy. The second part dealing with ethics was developed into a book in 1759: The Theory of Moral Sentiments which established his reputation as an important philosopher.

Italian Historians of Economic Thought, in Verona (Univ. of Verona) in October 1976; a special symposium and also a whole series of public lectures, discussions and round tables in the University of Belgrade during March 1976; The Harry Girwetz Memorial Lecture at the University of California, Santa Barbara on February 5, 1976. The lecture in the last meeting has been published as an article by its lecturer: Professor Henry W. Spiegel, «Adam Smith's Heavenly City» History of Political Economy, Adam Smith Bicentennial Issue, Vol. 8, No. 4 Winter 1976, pp. 478 - 492. The other meetings are reported in History of Economic Thought Newsletter, No. 17, autumn 1976.

(6) The materials used in presenting Adam Smith's life are taken from the following:
Bell, op. eit., pp. 150 - 162.
This book laid down the philosophical foundations of Smith's theoretical system developed in his later work, the Wealth of Nations.

The fourth part the Glasgow lectures was dealing with 'those political regulations which are founded, not upon the principle of justice, but that of expediency, and which are calculated to increase the riches, the power, and the prosperity of the state'. This part later became the nucleus of the Wealth of Nations. Smith travelled and lived in France two and a half years. He became acquainted with the leading French intellectuals and statesmen such as Quesnay, Turgot, Diderot, Voltaire and others. He began to work on the Wealth of Nations in Toulouse, France in 1764.

Smith completed and published the Wealth of Nations in 1776 while he was at the age of fifty-three. It went through five editions and was translated into French, German, Italian, Danish and Spanish during his lifetime. It has become a classic of economic liberalism and one of the greatest books ever written on economics.

III. THE PRINCIPAL ASSUMPTIONS OF ADAM SMITH'S THEORY OF 'SOCIAL' RATHER THAN NARROWLY ECONOMIC INTEGRATION

Adam Smith's theory of 'social', rather than narrowly 'economic' integration was based on principal assumptions that (1) there exists a natural order which is superior to man-made laws, (2) the fundamental motive for human conduct - or economic activity, is self-interest; and from the combination of the two, (3) let to itself, 'the free, unrestrained pursuit of self-interest' promotes the common good as well as the individual's good, thus leading to a harmony of interests within the framework of the natural order:

Smith had firm faith in the natural order. Under the influence of his teacher, Frances Hutcheson, he belonged to the naturalist school of philosophy whose main idea was to rely on 'what is natural as against what is contrived'. This implies a belief that there exists an inherent natural order and it is superior to any order artificially created by mankind. Thus, it is claimed that any wise social organization should act in harmony with the dictates of the natural order as nearly as possible. This meant different action and policy at different times and places;

however, the important idea, in essence, was «the superiority of natural over man-made law. (7)

Smith, the professor of moral philosophy and the author of 'The Theory of Moral Sentiments', saw six motives for human conduct: (1) self-love or self-interest, (2) sympathy, (3) the desire to be free, (4) a sense of propriety, (5) a habit of labor, and, (6) the propensity to truck, barter, and exchange one thing for another. (8) The most important and fundamental motive is self-interest. As the title of his main work implies, to him, economics concerns the wealth of nations, and economic activity lies in the pursuit of material wealth. What he did was to abstract economic life from other human activities and motives. Materialistic tendencies were dominant; to him «a man's character is determined by his environment; division of labor dominates character, rather than vice versa; and men are the pawns in a great machine-like game of nature». (9) The motive of self-interest of Smith's 'economic man' was emphasized as the driving force of all economic activity, being combined with other motives, of course. As he puts it:

«It is not the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our necessities, but of their advantages». (10)

The human motives, Smith believed, were so carefully balanced that the benefit of one man could not conflict with the good of others; thus there was a 'harmony of interests' resulting from 'free pursuit of self-interest'. Every man's activity to seek his own benefit would lead to the promotion of advantages of others as well as his own, even though he had no intention to do so. Again, it may be best to use his own words:

«Every individual necessarily labours to render the annual revenue 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. ... he intends only his

(8) Ibid., p. 146.
own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was not 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 society more effectually than he really intends to promote it. (11)

According to Smith, the only source of wealth is production resulting from labor and other sources. The wealth of a nation depends upon two things: 1. the productivity of labor; and, 2. the amount of productive labor. Division of labor and the introduction of machinery are two basic means by which production is increased. Division of labor is the principal cause of the increasing productivity of labor, and it depends upon the propensity to exchange which is one of the basic human motives. The propensity to exchange is the main cause for specialization. The degree of specialization, however, is limited by the extent of the market because large number of a given product cannot be sold in a small market.

The real or natural value of anything is measured by the labor which is spent in making it. If a man can buy something at less cost than the labor of making it himself, he buys it, giving in exchange something that the other person can buy at less cost (in terms of labor) than he can make it. This results in the mutual gain from specialization and trade. In an economy using money, the market price of a commodity is not always equal to the real value. The effective demand for a commodity sometimes exceeds the supply, which increases the price and brings some additional gain to the producer. However, this profitability will soon attract others to compete; it will draw labor and capital from other areas. As a result, the price is reduced in time, perhaps even below the real value; but there will be a tendency for the price of any commodity to approximate, the real value. When demand and supply are in equilibrium, the price will be 'the natural price'. In this way everybody will gain from a free market because each one will get what he wants at the lowest price.

In his view, then, the simultaneous satisfaction of desires of two individuals is made possible by exchange. In a simple system of natural liberty—that is, when all preferences and restraints are taken away—with men seeking their own interests only, the society will benefit as

well; productive resources will be used in accordance with consumers' wants. There will be an opulence with the increased productivity of labor and of the use of machinery, but each man ceases to be independent of others. Each man produces goods for the purpose of exchange, thus benefiting other members of community, in addition to himself, regardless of his intent. Money is paid for production and distribution as wages, profit and rent. By this mechanism of the market everybody shares in the increased product.

The market price tends to equality with the natural price; the natural price varies with the natural rates of wages, profit and rent which are three original sources of exchange value. The influence of institutional factors as well as the 'general circumstances of society'—i.e. whether the economy is stationary, declining, or expanding—are important in the level of each of them. Smith argued that, generally, wages and profits are inversely related. An increase in capital stock, by increasing competition among capitalists, tends to lower profits; but it increases demand for labor and raises wages. Wage level at any time is influenced by several factors peculiar to individual jobs: agreeableness, geographical situation, expected duration, the worker's knowledge about alternative employments, the terms of employment etc. The variations in wages would be above a lower limit: the minimum level required to keep the labor force in healthy and productive condition. A rise in wages above this subsistence level would be soon neutralized by an induced expansion in the size of population and of labor force. As wages rise, profits are reduced and vice versa; the worker shares his product with the owner of the capital and the landlord who gets rent.

Profit is defined as that part of value which the capitalist keeps for himself after paying the wages of his workers. Profits tend to decrease as a nation accumulates capital because more capital means more competition among industrialists. Thus in an expanding economy, businessmen would be more vigorous in pursuing their own advantage, suppressing their tendency to collusion and causing the profits to fall. Besides, it would be more and more difficult to find profitable investment opportunities in a given country. The rate of interest is determined by the rate of profit. As society becomes more wealthy profits fall.

Rent, in Smith's view, is a monopoly price. The quantity of desirable land is limited, and the people who own it can get something which is a payment neither for labor nor for capital. A great national wealth or high wages would result in a high rent. Tenants could be
forced to part with some portion of their product in excess of the natural wage for their labor. Thus, a rising share of the national product goes to landlords at the expense of profit recipients. However, the interests of landlords are not opposed to the interests of community because rents rise with the general increase of wealth. While high or low wages are the causes of high or low price, high or low rent is the result of it.

Smith argued that any interference with foreign trade as well as with domestic trade would diminish the welfare of the community. The rule, that one prefers to buy a good than making it himself at a higher cost, should also be applied to foreign trade; and no obstacles should be put in the way of importation of goods from abroad:

«What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.» (12)

He was also against any interference with free mobility of capital and labor among industries, or from industry to agriculture, or vice versa. Thus, Smith becomes «a champion of laissez-faire of even greater force than physiocrats...» (13) All regulations and restrictions concerning wages and various aspects of production should be abolished by the state. Free competition should be attained and maintained by it, because only competition is consistent with natural liberty. Moreover only perfect competition insures the promotion of common good by providing for the attainment of full rewards for the efforts of each individual. (14) Privileged positions and monopolistic rights should be destroyed and new ones should not be permitted.

According to Smith, the interests of workers and landlords coincide with the general interests of community. But it is not so with the interests of businessmen; they live by profit and their interests are opposed to those of society, since they gain high profits when competition is limited while increased competition and reduced profits benefit other classes of society. He was very suspicious of the business class who were ready and willing to sacrifice others' interests to promote their own:

(12) Ibid., p. 50 (quoted).
(14) Ibid., p. 149.
A Note On The Principal Assumptions Of Adam Smith's Theory

«People of the same trade seldom meet together, even for merriment and diversion, but conversation ends in a conspiracy against the public, or in some contrivance to raise prices.» (15)

How could they promote the general welfare, then? Through complete competition; they could not possibly enrich themselves continuously because extraordinary profits would attract other businessmen who would compete, and this competition would ripe out all excessive gains. Despite his suspicion for businessmen, however, his optimism about the harmony of interests was the result of his belief that privileged positions and monopolistic practices were possible only with the state support, and could not be sustained without it.

Smith, who thought 'government' as the primary protector of private property, did not think that the existence of private property and its unequal distribution could and would result in disturbances of natural harmony. Even in the existence of great fortunes and income differences, he had no fear of oppression or exploitation; exchange was for equivalent things, and an invisible hand was very effective in promoting common good when individuals were in search for their own benefits and self-interest. The supreme beneficence of the natural order as against the inevitable imperfections of human institutions was emphasized by him in various ways. He argued that when all artificial preferences and restraints are taken away, «the obvious and simple system of natural liberty will establish itself». (16) The fundamental social force of self interest would, under the rule of reason which necessitates free competition, lead to a right reward for the efforts of labor, and also a share to all in the increased wealth brought about by the accumulation of capital and increased division of labor. Thus, a picture of social harmony prevails in economic liberalism of the great worldly philosopher Adam Smith whose primary goal was a political one: to shape policies in order to increase happiness of people, and changing the order of things to this end when he wrote 'The Wealth of Nations'.

(15) Oser, op. cit., p. 61 (quoted).
(16) Roll, op. cit., p. 146.
IV. HISTORICAL RELEVANCE

At the time Smith wrote, England was the most advanced country in the world, and industrial expansion was underway although he was not fully aware of the coming of industrial revolution yet. His main attack was on the unproductive members of community, particularly those privileged people whose existence set up the most formidable obstacles to the growth and expansion of industrial capitalism.

When he attacked protection and tariffs in foreign trade, he was serving to the interests of consumers as well, even though it was dictated by the interests of manufacturers. His attack on domestic monopolies and privileged positions created conducive conditions to further expansion of industry, while he was fighting 'the spirit of the corporation' or 'the propensity to combine and conspire'. Thus, his alleged defense of the interests of business class coincided with the defense of common good. In his advocacy of an extreme laissez faire attitude, the defense of industrialists themselves was not obviously aimed at. What he wanted to do was to destroy (and, to a great extent, succeeded) whatever remained of the antiquated mercantile system that put severe constraints upon the society's productive powers resulting from the ingenuity and venturesomeness of the new men who were building the new industrial age. (17) In this way, he was furthering the welfare of the whole community.

In short, emphasizing natural liberty and advocating economic and political liberalism for the existing social order, Smith was very successful in his time and in the immediate future. From this, it is possible to conclude, that his assumptions were relevant, but only partly and in the limited sense of the word; because he made the characteristics of his own day valid for all times, giving an universal explanation of his own contemporary social order as if it was not historically conditioned. Even in his time, another great English philosopher, Bentham, expressed the view-in his 'Fragment and Goverment', also published in 1776 - that the individual interest must be made to harmonize in order to produce happiness to the greatest number of people. (18) On the whole, a follower, David Ricardo agreed with Smith's system although the optimistic and socially harmonious elements were

(18) Ibid., p. 21.
weakened; but, his socialist followers were quick enough to point out the fact that it was becoming less and less adequate in the course of history with apparent conflicts of interests and resulting exploitation of poor in a world of laissez-faire.

V. CONTEMPORARY RELEVANCE

Smith's system was successful in representing an early phase of capitalism and was made the basis of the classical system. However, the inadequacy of the system became more and more apparent, and particularly with the Great Depression, the idea of smoothly-working and self-equilibrating capitalism ceased to be a realistic one. The author of the article «The End of Laissez-Faire» (19) John M. Keynes, was prescribing measures to save the system in a quite different form bringing the state into picture, in his later work, «The General Theory of Employment, Interest, and Money - 1936». In 1945 Keynes, in his defense of the Anglo-American financial arrangements, expressed the view that it was right to «combine the advantages of a freedom of commerce with safeguards against the disastrous consequences of a laissez-faire system which pays no regard to the preservation of equilibrium and merely relies on the eventual working out of blind forces». (20) There are, of course, still some economists in our time who see free competition and laissez-faire as the best of all possible worlds - even though there is none in the pure form - such as L. von Mises, (21) F. von Hayek, Lord Robbins and M. Friedman, but they are unlike Ricardo who «conquered England as completely as the Holy Inquisition conquered Spain». (22)

Obviously, whether the competitive market mechanism still works is a difficult question to answer; but the nature of the market has changed greatly during the past two-hundred years. With regard to the competition, John K. Galbraith has this to say:

(19) John Maynard Keynes, Essays in Persuasion, (New York: W. W. Norton and Company, 1963) pp. 312 - 322. We should note, however, that what Keynes attacked was the laissez-faire idea of the Neo-Classical economists because it was already taken over and incorporated in their system which replaced the classical model.

(20) Roll (1976) op. cit., p. 21. Italics are mine.

(21) Ludvig von Mises, a leading figure of the Austrian School of economics, died a few years ago.

«Competition which, at least since the time of Adam Smith, has been viewed as the autonomous regulator of economic activity and as the only available regulatory mechanism apart from the state has, in fact, been superseded.» (23)

Any part of the productive mechanism, (e.g. worker, or capitalist), was not strong enough to interfere with or to resist the pressures of competition in Smith’s time, but it is not so anymore. Labor unions developed as a countervailing power, and giant corporations are the dominant feature of the economy of the most advanced capitalistic country. Thus several factors have weakened the primary guiding function of the market as the growth of government intervention has also changed the scope of the market mechanism. However, the principles of self-interest and competition still provide basic rules of behavior that cannot be ignored entirely. The world in which we live, is quite different from that of Smith, yet «the laws of the market can still be discerned in it if we look beneath the surface». (24)

The fact that ‘we don’t expect our dinner from the benevolence of others but from their self-interest, and and we address ourselves not to their humanity, but to their self-love, and never to talk them of our necessities, but of their advantages’ can not be expressed better than did Adam Smith. Assuming a self-interest seeking individual, Smith created his ‘economic man’ which has been a basis for economic theory. As Dr. H. Schwartz indicates, this classic formulation of the importance of incentives is still true today as in 1776. (25) Also, Professor George J. Stigler, in a recent appraisal of Smith’s successes and failures, points out that his ‘overwhelmingly important triumph’ was that he put into the center of economics «the systematic analysis of the behavior of individuals pursuing their self-interests under conditions of competition» and calls it «the crown jewel of the Wealth of Nations». (26)

On the other hand, the assumptions that the existence of a natural order being superior to man-made laws. that the free pursuit of self-
interest leads to a harmony of interests within this natural order framework, have also served as the basis of economic theory; yet, as has already been pointed out, there has not been such a thing as a harmony of interests brought about by the free pursuit of self-interest. On the contrary, conflicting interests rather than a harmony of them can be counted on. Actually, apart from the assumption of self-equilibrating mechanism of the classical system which has not been justified, this point is an important factor in explaining why the state intervention has been, and, still is, needed in an increasing extent in the real world. These assumptions have an anti-state and anti-organization bias since in Smith's time the state or, sovereign as he calls it, could be characterized as an 'oppressor state'. (27) As Gunnar Myrdal argues, the philosophy of natural law and the assumption of a harmony of interests in society were based on an identification between 'what is' and 'what ought to be'; (28) or, in other words, they were quite idealistic rather than being realistic. The historical setting was conducive to such a thinking. As was noted earlier, Ricardo, the other classical economists, and of course, K. Marx and other socialists recognized the existence of conflicting interests in the course of history and heavily used them in their writings. (29) Today, even in the most capitalistic economies of the industrial Western countries, the state has an important role to play in framing and regulating economic activities. Inequalities and conflicting interests necessitate state interferences rather than interferences preventing the natural harmony of interests; in many cases, the conflicting interests make it compulsory for the state to interfere with, what Keynes calls the 'blind forces', since there has been a great change from the oppressor state of Smith's time towards the modern welfare state.


(28) Ibid., p. 138.

(29) Ibid., p. 139. Myrdal points it out: «To Marx, however, the society he saw was very far from ideal. He analyzed inner contradictions of the early capitalistic society around him. ...the notion of a stable equilibrium never came to fetter his mind. ...The doctrine of harmony of interests he criticized vehemently». Perhaps that is why W. W. Leontief calls Marx 'the great character reader of the capitalist system'. W. Leontief «The Significance of Marxian Economics for Present Day Economic Theory», American Economic Review Supplement March, 1938.
CONCLUSION

In summary, we may conclude that the assumptions and the system built on them by Adam Smith, the great exponent of the classical economics some two hundred years ago, have lost their relevance to a great extent in our time, but this does not diminish his great achievement. In fact, taking into consideration various factors that have been touched upon, perhaps we should agree with Professor Sir Eric Roll that, if Smith and Keynes both were alive today: «these two great thinkers, whose main works are one hundred and sixty years apart would find much common ground in respect to the broad principles that should guide the management of the economy» (30) with Smith inclining more towards the market forces.

(30) Roll (1976) op. cit., p. 22.