

Adam Smith's Ideas Applied to Today's Economy

Born in 18th-century Scotland, philosopher and political economist Adam Smith lived long ago, but his contributions to economic theory are still alive and treasured. "An Inquiry into the Nature and Causes of the Wealth of Nations", which he first published in 1776, covers a wide range of topics applicable to the United States economy today. "The Wealth of Nations", the shortened name by which the five-book, two-volume collection is most commonly recognized, is most famous for its discussion on laissez-faire economic policy. Because of his support of minimal government intervention, those who are not thoroughly educated in the ideas of Smith may tend to automatically associate him with conservative viewpoints when it comes to American politics. The depth of Smith's analysis runs much deeper than typical political talking points, however, and deserves greater consideration than a simple partisan label. Through comparing Smith's ideas on topics such as production, foreign trade, taxation, and different areas of government spending with current United States policies, one can begin to see how the state of America's economy lines up with Smith's ideal system and which changes Smith might suggest.

One of Smith's most well-known ideas is his concept of the "invisible hand" that guides supply and demand in an economy. This mechanism leads people to employ their capital in the manner that best serves their self-interest, which also often leads them to do what is best for society as a whole. The first way in which one accomplishes this is by conducting his business as close to home as possible (Smith, 1976, p. 454). The "home-trade" is preferred because transportation costs as well as risks incurred are lower. Hence, the individual is naturally inclined

to support domestic industry, which as a general rule increases the economy's revenue and level of employment. Next, Smith describes how the individual naturally seeks to enter the industry that can provide him with the opportunity for greatest profit (p. 455). Assuming all individuals act selfishly, in a way to maximize their own profits, they contribute to the maximization of revenue for the entire society. As Smith states, "By pursuing [an individual's] own interest he frequently promotes that of the society more effectually than when he really intends to promote it" (p. 456). According to Smith, when a government allows free markets and does not attempt to direct economic activity in order to promote the public interest, the optimal outcome will be reached. Individuals are able to judge which industries will serve them best in the long run better than "any statesman or lawmaker" (p. 456), and any advantages and disadvantages in a certain line of work are compensated via wage differences (p. 116).

The United States is not operating under a Socialist system; private property exists, and for the most part, people can work to create any business or enter any trade they want, provided they comply with federal and state laws. While Smith would appreciate that people in general have the freedom to choose any industry, whether or not he would agree with the extent of the United States' regulations is not explicitly answered in "The Wealth of Nations." Indeed, there are regulatory, government-run institutions that one could reasonably conclude that Smith would support in some circumstances, such as the Antitrust Division of the Department of Justice, which works to prevent monopolies and support more competitive markets through enforcing antitrust laws ("Antitrust Division"). However, even agencies like these that seek to preserve competition can be useless, according to Smith, who says that it is impossible to prevent meetings between people of the same trade while executing laws "consistent with liberty and justice" (p. 145).

It would be extraordinarily time-consuming to contrast Smith's writings with each and every relevant regulatory law and agency, but in beginning to compare the two, one can easily see that Smith would have problems with common practices in the United States today. In Part II of Book I, he discusses ways in which he believes that England's policies were disrupting "perfect liberty" and causing "inequalities" in employment. One of these ways was by "restraining the competition in some employments to a smaller number than would otherwise be disposed to enter into them" (p. 135). While Smith acknowledges that some employments require more education than others, he explained that England was requiring excessive amounts of apprenticeship for some types of employment. Some states arguably commit this same wrong in various instances; for example, in Texas, all new computer repair technicians are required to obtain a private investigator's license, which requires a Bachelor's degree in Criminal Justice or a three-year apprenticeship under a private investigator ("New Texas Law", 2008). Even though computers did not exist in Smith's time, it is safe to say that he would not support laws like this, which often put once-contributing members of society out of business.

The other problem Smith had with England's policies was that they increased employment in other industries "beyond what it would naturally be" (p. 135). Smith's examples stressed government funding of educational programs that kept the labor market well-stocked with certain professions, but this principle of artificially increasing employment can be applied to other ways in which the United States government is intervening in economic activity. Currently, America's dairy industry is being heavily subsidized, and there is an income support program and a price support program ("Dairy Policy", 2014). First, the income support program provides monthly payments to farmers when milk prices fall below target amounts, putting downward pressure on milk prices. Conversely, the price support program keeps dairy prices artificially

high by guaranteeing that the government will consistently buy a certain amount of products, creating artificial demand that helps push prices upward. Smith would likely find these programs to be too complex and involved. He lists multiple concerns with subsidies, to which he refers as “bounties”, including their effect of weakening the value of money (p. 510). In his example, a bounty on corn would at first bring more money to the farmer, but as food prices rise, subsistence requirements and therefore labor costs increase, and no one is better off than before. While it may seem that the country is no better or worse off, according to Smith the country will actually become poorer overall as foreign goods become cheaper and in higher demand. Smith used the example of the herring industry in Scotland to describe additional consequences of subsidies, which could include people entering an industry solely to collect a bounty, unwise and inefficient decisions regarding production methods, and overproduction and waste of resources (pp. 520-521). Whether or not all of these issues are prominent in the United States today would require further research, but according to James (2006), the latter two have been problems in the dairy industry in recent years.

Further, Smith discusses the consequences of government regulations on foreign trade. Any regulations on prices of foreign goods are either “useless or hurtful” (p. 456). If the item produced at home is cheaper, the regulation is useless. If the good can be acquired cheaper from abroad, however, the regulation is harmful. Smith illustrates this concept on a smaller scale using the example of a family. If the master of that family is prudent, he does not try to make at home what he could purchase for less. If he is a tailor, for example, he does not attempt to make his own shoes. Likewise, a country should take advantage of the situations in which it can buy certain commodities cheaper from abroad than it would cost to produce them domestically. Relying on foreign producers for some goods allows a country to employ more resources in

industries in which it has the comparative advantage; in this way, trade will be advantageous to both parties (p. 458).

While free trade could put some domestic producers out of business, Smith recognizes that those workers could find employment elsewhere, and the benefits of free trade counteract this disadvantage. Lack of tariffs, duties, and other regulations facilitates a competitive environment, which helps prevent producers from charging excessive prices (p. 460). To use one of Smith's phrases, it fights the "wretched spirit of monopoly" (p. 461). The two circumstances in which Smith says that regulations are necessary are when an industry is vital to a nation's defense or when similar domestic goods have been taxed as well (pp. 463-465). Additionally, it may be beneficial for a country to place regulations on foreigners' goods in response to those foreigners taxing their goods first. This type of retaliation is only useful when it will lead to an agreement and loosening of those original regulations; otherwise, the retaliation will only prolong and increase total suffering (p. 468).

With \$195.6 billion in exports and \$238.6 billion in imports for September 2014 alone, the United States is definitely active in foreign trade (*U.S. International Trade*). Smith may have envisioned an ideal world with minimal regulations, where countries for the most part were led to produce mainly those goods in which they had a comparative advantage, but in reality, the system has become more complex. For any given industry, there are numerous rules and regulations that the United States and its trading partners follow in carrying out international business. While some of these may be necessary in Smith's view, it is likely that he would find many of them to be unwarranted. For example, since 1963, the United States has had a 25 percent tariff on foreign made trucks and commercial vans (Dolan, 2009). President Lyndon B. Johnson's driving reason behind this tax was to respond to Europe's high tariffs on America's

exported chicken. Since what is known as the “chicken tax” has now been in effect for over 50 years with no clear benefits, it is not probable that Smith would support this regulation- it has only “prolonged suffering.” Instead, Smith would say that the United States and European governments should take steps to gradually repeal these regulations, as immediate abolition of the tariffs could cause dramatic stirs in the involved countries’ economies. As foreign goods could be imported more freely, certain domestic industries (and employment in them) would suffer (p. 469). Smith very clearly summarizes his viewpoints on protectionist regulations at the end of Chapter II of Book IV: “Taxes imposed with a view to prevent, or even to diminish importation, are evidently as destructive of the revenue of the customs as of the freedom of trade” (p. 472). While there may be exceptions among the thousands of modern day tariffs and regulations currently acting as obstacles to foreign trade, overall, Smith would likely see today’s system as destructive and out of control.

Smith’s views on subsidies and tariffs when it comes to regulating production and foreign trade suggest that he is not a zealous proponent of government spending and intervention. Smith recognizes the need for taxation, though, and gives four main guidelines for developing a nation’s tax system. First, “as nearly as possible”, each person should pay in taxes an equal proportion of the revenue they make under the protection of the government (p. 825). Next, the conditions of the tax each person owes should be certain; that is, the amount, time, and method of payment should be definite. Taxes should also be collected at a time that is convenient for the payer. For example, taxes on rents should be payable around the time rents are usually collected, and taxes on sales should be collected at the time of the transaction (p. 826). The fourth principle was that taxation should be done in an efficient way, carefully designed so that it does not create burden on the people in excess of the benefit received by the government. Some ways in which a

tax could have overall negative consequences are by requiring too many administrative and collecting costs, having different rates that give people incentive to be less productive, and providing inadequate punishment to those who try to cheat the system (p. 827).

The current tax system of the United States does not measure up to Smith's qualifications in multiple ways. First, not everyone pays the same rate when it comes to income tax; a progressive tax is in place, where tax rate rises as income increases (Erb, 2013). Smith's statement that an individual should contribute "in proportion" to his revenue gives no inclination that he would support a progressive tax. Rather, he would likely suggest a flat tax, where each person pays the same rate, regardless of income. While the time and method of payment does not leave much room for confusion, the amount that is to be paid, especially for income taxes, can be extremely difficult for the average person to determine, taking into consideration all exemptions, credits, and deductions. Whether or not Smith foresaw the emergence of tax accounting as a popular profession is unknown, but he certainly did not recommend such a complex system.

Certain characteristics of the United States taxation process violate Smith's fourth maxim as well. For example, tax evasion is a serious problem and is estimated to have cost the United States government \$345 billion in 2007 ("Tax Evasion: An Overview"). According to the U.S. Tax Code, punishment for tax evasion includes a fine of no more than \$100,000 and a prison sentence of no more than five years (26 U.S. Code § 7201, 2012). As Smith would say, this punishment may not be sufficiently rising "in proportion to the temptation" (p. 826). Steeper penalties might result in the risk outweighing the reward for those interested in trying to cheat the system. One more problem that Smith would have with current taxation procedures is their high administrative costs: in 2014, operating expenses for the Internal Revenue Service

amounted to over \$13.4 billion dollars and have been steadily increasing over the past 30 years (*U.S. Dept. of the Treasury*, 2014, p. 3).

Smith discussed his ramifications for collecting taxes in great detail, and he also gives guidelines as to how the government's revenue should be spent. In Book V, he lists three main areas in which the government faces expenses in order to carry out its responsibilities to society: national defense, the administration of justice, and public works and institutions. His analysis of the funding necessary to support national defense begins with describing various forms of society that require different amounts of support from the sovereign. The most advanced state of society will naturally require the most due to two reasons, beginning with the expansion of manufacturing industries (p. 694). In agriculture, a man's farm can be sustained by women, children, and others not suitable for war, but a man who works in manufacturing or another trade must rely on the government to support him while at war. Additionally, innovation in warfare techniques as well as increasingly complex wars that encompass greater amounts of time and land will naturally require more spending by the government. Hence, if a nation is to be successful in war, some men must serve in the army as their sole occupation, and the government can execute the division of labor that is necessary for each man to become a specialist in his role (p. 697).

Smith's justifications for national defense spending apply to the United States' military today, which has a budget of around \$618 billion for fiscal year 2014 (*Budget of the U.S. Government*, p. 194). This may on the surface seem to be a large amount, but Smith conveys the importance of a strong national defense through his writings, stating in Book V: "As it is only by means of a well-regulated standing army that a civilized country can be defended" (p. 706). He also discusses the increasing expenses as firearms and other weapons become more advanced,

and he believes that they are worth the higher cost in order to maintain a well-functioning army, stating: “In modern war the great [expense] of fire-arms gives an evident advantage to the nation which can best afford that expense” (p. 708). The U.S.’s 2014 Fiscal Budget gives a summary of some of the items being funded by the Defense portion of the budget, and they include investments to further develop crucial areas such as cybersecurity, combat aircrafts and vehicles, nuclear weapon complexes, and science and technology in general (*Budget of the U.S. Government*, p. 70). Each of these areas seeks to preserve the U.S. army as one of the strongest, most respected military forces in the world; therefore, Smith’s writings suggest that he would find the U.S.’s spending acceptable. He would likely advocate for a greater portion of the budget to go towards national defense, as defense spending only comprises about 16.4% of the 2014 federal budget (*Budget of the U.S. Government*, p. 194).

Smith’s brief description of a nation’s responsibilities in administering justice focuses mainly on the measures needed in order to prevent corruption, and the basic structure of the United States legal system reflects some of Smith’s key recommendations. First, the U.S. Constitution establishes a judicial branch separate from the executive power. Smith believed this to be important for two reasons, the first being that the executive power has too many other responsibilities that would prevent him from giving the administration of justice the “undivided attention” it deserves (p. 722). On average, the U.S. Supreme Court hears between 100 and 150 of the 7,000 cases it is asked to review each year (“About the Supreme Court”); the President would not have time to make decisions about that many cases without sacrificing due process of law. Smith also saw the need for separation of powers in order that “what is vulgarly called politics” would not interfere in the proper administration of justice (p. 722). Even if the executive power is considering the best interests of the state at all times, Smith says that this

mindset could cause them to sacrifice the rights of an individual. He proceeds to explain why this is unacceptable: “Upon the impartial administration of justice depends the liberty of every individual, the sense which he has of his own security” (pp. 722-723). The Constitution features the Bill of Rights, specifically designed by the Founding Fathers in order to preserve basic rights and freedoms of all American citizens, and the Supreme Court and judicial system still seek to uphold this document today.

Smith would surely approve of the U.S.’s preservation of its citizens rights, and he would also likely favor the way in which judges are compensated. Much of his analysis on the administration of justice focuses on ensuring that judges are unbiased and thorough in their work. He suggests that judges be paid after deciding cases, in accordance with how much time they spend deliberating a case, to give them incentive to exercise due “diligence” (p. 719). While the Supreme Court justices are not paid by the hour, they are on a fixed yearly salary, which Smith lists as a viable option rather than being paid in “presents”, which could theoretically serve as bribes (p. 718). Smith emphasizes that the payment of a judge’s salary should not be influenced by the goodwill of the executive power, nor should the executive power be able to remove him at any time (p. 723). While these characteristics are true of the Supreme Court, the way in which justices are chosen would likely not be supported by Smith. Justices are appointed by the President and confirmed by the Senate (“United States Courts”), but this clearly conflicts with Smith’s idea that the judicial branch should be as independent of executive power as possible (p. 723). While Smith would not fully agree with the structure of the United States judicial branch, he would agree with the government’s involvement in providing funding for judges’ fixed salaries and with the separation of powers in place.

Smith defines a third and final category of essential government expense as that of “public Works and public Institutions” (p. 723). This type of spending is necessary in order to provide for goods and services that are extremely advantageous to society as a whole but too expensive to be created and maintained by individuals and the private sector. In the first article of this chapter, Smith discusses the development and upkeep of a nation’s infrastructure. Naturally, as a nation expands economic activity and becomes more technologically advanced, it will encounter greater expenses in maintaining works such as roads, bridges, canals, and harbors (p. 724). Smith explains that tolls are the fairest and most convenient way to fund these structures and routes, especially when travelers pay in proportion to the weight of their vehicles. He warns against setting toll rates too high, however, as they could potentially have negative consequences such as discouraging travel and increasing prices of goods due to higher transportation costs (p. 728). His other main guideline regarding infrastructure was that it is best maintained and overseen by local and provincial administration. Listing several examples of situations he had witnessed in London, he concluded that repairs were most promptly and efficiently executed when the needed revenue was collected mainly from those affected by the improvements (p. 731).

The U.S. Department of Transportation has a budget of \$76.6 billion for Fiscal Year 2014, along with an additional \$50 billion for new transportation investments (*DOT Budget Highlights*, p. 1). With state and local governments still having the majority of control and responsibility for infrastructure, the federal government’s additional spending and intervention in infrastructure may seem to be redundant from a viewpoint like that of Smith. However, not every item in the budget necessarily conflicts with Smith’s idea that most infrastructure decisions should be left to local and provincial administration. For example, many of the investment

portions are directed to maintaining safety throughout airways and to enhancing airport efficiency (p. 11). Benefits from improvements in areas such as these are difficult to pinpoint to one specific area; therefore, Smith might see that nationally gathering revenue is the fairest way to fund these types of projects.

In the other main portion in his chapter about expenses in public works and institutions, Smith emphasizes the importance of education in a civilized society. One of his main arguments supporting the need for education is that lack of intellectual exertion eventually leads a person to become “as stupid and ignorant as it is possible for a human creature to become” (p. 782). This type of person is then unfit for war or any profession other than the simple tasks to which he has grown accustomed over the course of his life. Without government intervention, Smith says, the poor class of a nation will fall into this state. For a small expense, however, the public can provide access to education to all people and prevent this from happening (p. 785). While the public will not necessarily derive a considerable advantage from instructing the poor, by not leaving them “uninstructed”, a nation’s people are more likely to be more orderly and respectful of superiors (p. 788).

Having established the importance of a publicly organized education system, Smith describes how this system should be set up in order to maximize its value. He believes that the government should establish schools in each district, with masters’ salaries only partially funded by the public. The rest of a teacher’s salary would come from the small fees paid by students’ families. By establishing competition between masters to attract students and thereby increase one’s salary, this solves the problem of masters “neglecting their business” and not devoting sufficient effort to educating students (p. 785). Earlier in the chapter, Smith says that the exertion of a worker in any profession is always in proportion to the pressure that is put on them to make

that exertion (p. 759). This principle also applies to another threat to good education that he mentions, which is similar but not identical to the concept of tenure today. Smith was concerned that if students have no involvement in choosing their professors at a college, and these professors are appointed and essentially protected by the head of the college, then these professors will lose incentive to work hard (p. 765).

There are multiple aspects and current issues in education in the United States that could be considered in relation to Smith's analysis, such as Common Core standards, content of curriculum, and the public versus private debate, but this paper's analysis will focus mainly on the topics previously discussed: funding in general and instructor accountability. The U.S. government does provide funding for public education, but most education policy is decided at state and local levels ("U.S. Dept. of Education: Laws and Guidance"). Public school students in grades one through 12 do not pay tuition, and while Smith would appreciate the fact that all people, regardless of income, have access to education, he believed that everyone should pay a small fee in order to help pay the teachers' salaries. The main problem that Smith would likely see in U.S. education today is the lack of incentive for teachers to perform their duties with appropriate diligence. Teachers are on fixed salaries, and 40 states have teachers unions that are members of the American Federation of Teachers (AFT), the nationwide coalition of state teachers unions ("AFT: State and Local Websites").

There may be various advantages and disadvantages that arise from unions, but Smith would likely disagree with the activity of AFT, as the organization has been quite vocal in opposing laws that aim to establish procedures that objectively evaluate schools and teachers based on student performance (Bidwell, 2014). Union members typically argue that standardized test scores in areas such as English and Math are not indicative of a teacher's performance and

that therefore, government funding of a school should not be influenced by these scores. By eliminating such standardized testing, these union members say that states would be less inclined to lower their educational standards, and teachers would have more freedom to teach outside the test questions and focus on developing students' skills such as critical thinking, real-life applications, and working collaboratively. Smith does show support for giving teachers some freedom in establishing curriculum. Referring to the question of who should decide course content, he states: "An extraneous jurisdiction of this kind, besides, is liable to be exercised both ignorantly and capriciously" (p. 761). Since government officials do not generally have experience with teaching, Smith says that it would be difficult for them to understand what exactly should be taught. However, as mentioned previously, Smith was definitely in favor of holding instructors accountable, and since their salaries in the U.S. do not depend on how many students they attract, there should be measures in place to give them incentives to perform well. Standardized tests address that very issue, and they also encourage the teaching of math and sciences, which Smith states are vital areas of knowledge applicable to most trades (p. 786).

This paper only focused on several characteristics of America's economic activity, but "The Wealth of Nations" contains a plethora of topics applicable to the nation today. It would be interesting to investigate and attempt to determine Adam Smith's stance on other current issues such as health insurance, immigration, and the national debt. However, in beginning to compare United States policy with Smith's famous work, it is evident that there are some aspects of America that Smith would applaud and others that he would change. Economic and government policy is complex; the answers to a nation's problems are often not clear-cut or obvious, and even carefully constructed solutions like those of Smith could have downfalls. Smith has both critics and supporters, but regardless of one's view of his analysis, it is undeniable that "The

Wealth of Nations” is one of the most influential economic writings in history and will continue to be relevant and useful for years to come.

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