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The Relevance of Adam Smith to Today's Problems

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During the past quarter century, economists have been devoting much of their energy to studies of the process of economic growth. Some have concentrated on the interplay of social, cultural, political, and economic forces that shape the destiny of developing nations. Others have sought to determine along empirical lines what part of the economic growth of industrialized countries may be attributed to improvements in education, what part to increases in the stock of capital, what part to scientific research, improvements of technology, and other factors. Still other economists have developed formal mathematical models to gain insight into the dynamics of a growing economy. The formidable literature generated by this research could be aptly assembled under the title of Adam Smith's treatise: An Inquiry Into the Nature and Causes of the Wealth of Nations.

In thinking about what I might say here today, I was led to reread passages of that celebrated work and to reflect once again on the legacy of Adam Smith to the field of economics. The Wealth of Nations is universally recognized as the first major exposition of modern economic thought. Adam Smith himself is commonly regarded as the father of political economy.

Yet it is a striking fact that the principles underlying the growth of national wealth and income, which was the central theme of his book, remained for many years a subordinate issue in the great works on economics.

The Wealth of Nations was, first and foremost, a theory of production. Smith's main interest was in the means by which a nation could use its resources of labor and capital most effectively, thereby increasing its output and improving the lot of its people. He examined in considerable detail also the principles underlying the distribution of output. But while this was a subsidiary theme of The Wealth of Nations, it became the primary concern of the classical economists -- David Ricardo, John Stuart Mill, Alfred Marshall, and others. About 150 years elapsed before economists again developed any substantial interest in the determinants of national output or national income; but it is hardly an exaggeration to assert that this has now become the central subject of scientific economics. Schumpeter, Mitchell, Robertson, Keynes, Kuznets, Roy Harrod, to name but a few of the great economists of recent times, have concentrated on this vital theme.

The contribution of Adam Smith to the formal body of economic theory is of towering proportions. Yet, it is less significant to the history of mankind than his influence on the

ways in which individual nations, both large and small, have organized their economic activities. Smith proposed a bold new venture in national policy -- the organization of economic life on the principle of free enterprise. He believed that governmental regulations were stifling economic growth in Great Britain and the rest of Europe; and that the abundant energies of people, particularly the British, would be released if these barriers to progress were swept away.

The importance of Smith's revolutionary ideas to the course of economic development in Great Britain and other parts of the Western world can be best appreciated by recalling the historical setting in which The Wealth of Nations appeared.

The economic policies and practices of England, France, and other European countries between the sixteenth and eighteenth centuries were governed by a loose body of principles known as mercantilism. In its popular conception, mercantilist doctrine is identified with protective measures for seeking a favorable balance of trade and an abundant supply of the precious metals. This characterization is correct as far as it goes, but it is incomplete. In fact, the mercantilist principles expounded in 1767 by another great Scotsman, Sir James Steuart, and widely practiced

in England during the preceding two centuries, revolved around a system of governmental regulation of nearly every aspect of economic life -- industrial output, agriculture, domestic and foreign trade, occupational choice, apprenticeship, prices, wages, labor mobility, and so forth. The direction of economic activity was considered to be the task of statesmen, who alone could guide the activities of businesses and individuals in ways that promote the national interest.

Mercantilism rendered service in its time by weakening some local monopolies and increasing the mobility of resources within a nation. It was nevertheless a crude economic and social philosophy, as it still is in its modern recrudescences. Smith recognized vividly its practical consequences -- an economy of limited enterprise, a vital people caught in a web of governmental controls, a nation missing its opportunity for innovation and greatness. The way out seemed entirely clear to him. Governments everywhere had to stop interfering with the economic decisions of individuals and businesses, so that free enterprise could become the great organizing principle of economic life.

The mercantilist form of economic organization, Smith reasoned, lacked a number of ingredients essential to satisfactory

growth of the wealth of nations -- ingredients that free enterprise would forthwith supply. Of these, three stood out in importance in his mind.

First, economic rewards had to be commensurate with the market value of the work that individuals performed and the risks they took in investing their capital. Smith believed -- as did the mercantilists -- that self-interest was a dominant force in human behavior. But he perceived a truth that had escaped the mercantilists -- namely, that a system of free enterprise could successfully harness individual motives to achieve national economic objectives.

Second, achievement of the progress of which a country was capable required active competition, including competition from abroad. Active competition, Smith believed, would lead to greater specialization of labor; it would encourage commercial application of technical and managerial knowledge; and, more important still, it would stimulate greater industry among businessmen and workers alike.

Third, a pricing mechanism was needed to allocate resources among competing uses, in accordance with the wants of consumers. Free markets, Smith argued, generate price and wage adjustments which result in a use of resources

that is consistent with the prevailing pattern of consumer and business demands, and thus solve problems that governmental rules cannot handle.

This was an exciting new doctrine of enormous significance for economic and social organization in the European states, and also for the emerging nations of North America. Under the influence of the revolution in commerce and industry that got under way during the eighteenth century, many businessmen and artisans had found the intricate governmental regulations of their conduct needlessly burdensome, and they not infrequently reacted by ignoring or circumventing them. Smith's philosophy of free enterprise thus appeared at a time when political leaders as well as men engaged in commerce were ready to reexamine accepted doctrines. The lucidity and dignity of Smith's prose, the authority of his scholarship, and the cogency of his reasoning hastened the appeal of his work to intellectuals and the new merchant class. Before many years passed, The Wealth of Nations became the most influential guide to economic reform in his own country. Adam Smith's influence, however, did not stop there.

If my reading of history is anywhere near the mark, developments over the past two centuries have demonstrated

beyond serious doubt the essential validity of Smith's theory of production. Where free enterprise has flourished, nations have prospered and standards of living have risen -- often dramatically. Where detailed governmental regulation has repressed individual initiative and stifled competition, economic growth has been hampered and the well being of the people has generally suffered.

The outstanding example of economic progress under a system of free markets is provided by the United States. The standard of living enjoyed by the people of my country has been, and still is, the envy of the world. The rate of economic growth in many countries has of late exceeded that of the United States, and thus the disparity of living standards -- at least among the industrial nations of the world -- has been shrinking. This is a heartening development. Yet, the fact is that per capita output in the United States is still far above that of any other country. For example, the gross national product per person in the United States is some 20 per cent higher than in Sweden or Canada -- the two closest nations in terms of per capita output, and it is about twice as high as in the more advanced socialist countries -- such as the Soviet Union and Czechoslovakia. You may recall that Premier Khrushchev predicted in the late 1950's that the per capita output of the Soviet Union would equal or surpass

that of the United States by 1970. This forecast proved to be an idle boast by a political leader who had not yet arrived at a mature understanding of the mainsprings of economic progress.

The standard of living that we enjoy in the United States reflects more than our system of economic organization. Rapid development of the American economy was fostered also by our rich endowment of natural resources and our vast expanse of fertile lands. Our free institutions and opportunities for self-advancement attracted to our shores millions of venturesome individuals from all over the world. The people who came were industrious and highly motivated, and they often brought with them useful technical skills and educational accomplishments. However, other countries also have been blessed with rich natural resources and with people of unusual educational and technical achievements, and yet have not managed to find the path to rapid economic development.

The key to the economic progress of the United States, I believe, is therefore to be found in our institutions, which by and large have permitted anyone in our midst to choose his occupation freely, to work for himself or for an employer of his choice, to produce whatever he chose, to benefit from the fruits of his individual effort, and to spend or to save or to invest as he deemed proper;

Under the economic system that has flourished in the United States, the natural thing for individuals and businesses to do is to plan for the future, so as to be in a position to take advantage of the opportunities that continually become available in a growing and prosperous economy. This feature of a free enterprise system, and its crucial role in fostering economic development, is seldom appreciated by advocates of centralized planning. Planning for economic growth in the United States and other free enterprise economies -- unlike that of socialist nations -- is a mass activity pursued by literally millions of producing and consuming units, each looking to a better future and striving to attain it. Over the years, our business firms have become accustomed to planning their investments in plant and equipment, their inventories, their advertising programs, their labor policies, their financing requirements. More important still, they now plan on a vast scale the development of new products and new methods of production by conducting extensive research and development programs. Our families, meanwhile, have remained eager to provide for a better life in the future, and therefore find themselves planning for a new home, for a good education for their children, and for reasonable comforts in the years of their

retirement. Americans work hard to realize their goals, and they are enterprising enough to search out or to create new opportunities.

The present condition of the economy of the United States thus provides impressive evidence of the essential truth of Smith's theory of production. Individual initiative, properly compensated, has been the dynamic force behind the growth of a mighty nation. And market forces, operating in a competitive environment, have served to harmonize the plans of millions of economic units, thereby fostering the national welfare.

The validity of Smith's views have been reaffirmed time and again during the past two or three decades. By the end of World War II, for example, a large part of the industrial plant of Germany had been destroyed and the confidence of its people shattered by the collapse of the German nation and its division into two separate political entities. The postwar recovery of the economy of West Germany, operating under conditions of free enterprise, has nevertheless been spectacular. Its per capita output is now among the highest in the world, and its products are exported to every corner of the globe. East Germany, on the other hand, installed a centrally-managed system, and its economy floundered for a number of years.

Economic growth in East Germany appears to have perked up of late, but its per capita output is still well below that of West Germany.

The postwar record of economic progress in countries such as Israel and Japan, which encourage individual initiative and private enterprise, is even more striking. In a mere quarter of a century, the Israelis have managed to transform a desert into a flourishing modern nation. Japan is also poorly endowed with natural resources and its large population is crowded into a small area; its economy has nevertheless grown swiftly. Currently, the production of Japan is exceeded only by that of the United States and the Soviet Union. Since 1960, the real gross national product of Japan has more than tripled, and it is still rising much faster than in any other major industrial country.

The Japanese economic miracle has received universal acclaim. The achievements of other Asian countries that give large scope to free enterprise -- Thailand, South Korea, Taiwan, Singapore, and Hong Kong -- are not as widely known. Yet, all these countries experienced average yearly increases in real per capita output ranging from 5 to over 8 per cent during the decade of the 1960's.

The Crown Colony of Hong Kong might indeed serve as a monument to Adam Smith, for nowhere in the modern world have his economic principles been followed more closely. You may recall that Smith, in his discussion of the benefits of foreign trade, noted that a nation would be most likely to profit from foreign commerce if its trading partners were rich, industrious, and commercial nations. Lacking geographical neighbors that fit this description, Hong Kong took advantage of advances in transportation and communication that have made it possible to trade profitably on a world-wide basis. In 1972, over three-fourths of Hong Kong's exports -- largely manufactured goods -- went to Europe and North America. And the value of its total exports apparently exceeded that of Mainland China, whose population is perhaps 200 times as large as that of Hong Kong.

In Latin America, the highest rate of economic growth of any nation at the present time is enjoyed by Brazil, whose economic system has moved closer in recent years to the principles of Adam Smith. Decisions as to the direction of investment are now left largely to the business community; foreign investments are encouraged; individuals are free to choose the line of work that best suits their talents, and to enjoy the rewards accorded by the market to successful

performance. This system of economic organization, aided by the great natural and human resources of Brazil, is producing excellent results. The rate of growth of Brazilian production has been 9 per cent or more in each of the past 5 years; last year, in fact, real output in that country rose more than 11 per cent.

Lively competition, individual incentives, and a pricing mechanism to allocate resources are as important to the growth of national wealth now as they were in the Great Britain of the eighteenth century. That fact, I believe, is gaining recognition beyond the boundaries of what we loosely call the Free World. In recent years, the socialist countries of Eastern Europe have begun to reconsider their earlier policy of guiding the course of their complex economies through central planning and detailed regulation of most aspects of economic life. They have begun to ponder whether the production of some unwanted goods or obsolete machines might not reflect the failure of prices to signal changes in consumer or business demands; whether more rapid technological progress might be encouraged by providing industrial managers with stronger incentives for taking risks; whether workers would increase their productivity if more opportunities became available to improve their own lot and that of their families through greater individual effort.

In most of these countries, pockets of free enterprise have indeed remained, and they have provided the socialist authorities with some dramatic examples of the vitality of Adam Smith's theory of production. In the Soviet Union, for example, individuals are allowed to cultivate small agricultural plots and to retain or sell the produce they raise. Yields per acre on these small pieces of land are typically far higher than on the huge and highly mechanized collective farms. In 1962, for example, small private farms constituted only 3 per cent of the total acreage cultivated in the Soviet Union, but they accounted for a decisive part of the meats, milk, eggs, vegetables, and fruit produced and consumed in the country -- in fact, for over a third of the country's total agricultural production. The Soviet people have literally been kept alive by free enterprise in their household agriculture, and the significance of this fact cannot have escaped their attention entirely.

In some, if not all socialist countries, doctrinaire adherence to centralized planning and regimentation of economic life is gradually being displaced by a more flexible administration of the economic system. Wider scope for decision making is being given to individual factory managers; monetary incentives related to economic performance are becoming more common;

a larger role is being assigned to prices in the allocation of resources. Notable examples of this trend may be found in Yugoslavia and Hungary, where significant efforts have been made in recent years to accelerate economic development by moving toward a more flexible, less centrally-directed form of economic organization. In the Soviet Union, also, a reform of the industrial structure is currently underway, aiming among other things at decentralization of research and development programs.

In the developing nations, too, a trend is evident towards wider acceptance of Adam Smith's theory of economic development. A decade or two ago, many of these countries were seeking to rush headlong into heavy industry, bypassing the development of agriculture and light industry for which their resource base and their technical skills were better suited. Barriers to imports were created to speed industrial development, while one industry after another was saddled with restrictions and regulations that made competition in world markets extremely difficult. Political leaders in these countries had become so fascinated with the thought of rapid industrialization that they not infrequently ended up by creating industrial temples, rather than efficient and commercially profitable enterprises.

Some costly lessons have been learned, and some ancient truths rediscovered, from this experience. Of late, developing countries have been reconsidering the benefits of agriculture and light industry as paths to economic progress. More of the developing countries are now encouraging private foreign investment, and practically every nation is seeking ways to raise productivity, open new markets, and foster a spirit of enterprise among its people.

Policy makers across the world thus keep coming back to the principles enunciated by Adam Smith some 200 years ago. A contemporary reader of The Wealth of Nations cannot escape being impressed with the vigor of Smith's analysis and its relevance to the world of today. Yet, he will also be struck, I believe, by the fact that nations are nowadays concerned with economic problems that were hardly foreseen in his great treatise on political economy.

While Adam Smith was at work on The Wealth of Nations, another enterprising Scotsman, James Watt, was still struggling to perfect the steam engine. Today we split the atom to augment the supply of electricity, and we send men on fantastic voyages to the moon. With the progress of science, the proliferation of industry, and the spread of urbanization, the interdependence of economic activities has greatly increased. Opportunities for

conflict between private and public interests have therefore grown in importance. Adam Smith, to be sure, was not unaware that such conflicts could occur. Contrary to a widespread impression, he put fences around free enterprise -- for example, by arguing in behalf of certain restrictions on free trade, by recognizing the need for governmental maintenance of roads, harbors, and similar public works, and even by accepting statutory ceilings on interest rates as a contribution to the general welfare. Adam Smith, however, had no need to concern himself with pollution of air or water, or with urban blight, or with depletion of energy sources, or with insistent political pressures for better education, improved health care, more recreational facilities, and a host of other things that have led to extensive governmental involvement in the economic life of industrialized nations.

The business cycle of modern times, especially in nations that practice free enterprise, has given special impetus to the enlargement of governmental responsibilities. Experience over many years had demonstrated that active competition serves to coordinate individual plans and thus enables markets for specific commodities to function, on the whole, in satisfactory fashion. However, experience also taught us that while competition is a

good cure for overproduction in a specific market, it is a very inadequate cure when a shortage of demand develops simultaneously in many markets. In such a case, business activity as a whole will slump, the flow of incomes will be checked, and unemployment will spread; in short, the nation will experience a business recession. On the other hand, when demand becomes excessive in many markets simultaneously, the general level of prices will rise and this too will bring economic troubles.

In recent decades, therefore, governments have sought to stimulate the general level of economic activity at certain times, and to restrict it at other times, by a flexible use of their monetary and fiscal policies. Of late, a new phenomenon -- a disconcerting rise in the price level even in the absence of excess aggregate demand -- has troubled various industrial countries. This development has led some governments to intervene directly in wage and price decisions in the hope of achieving simultaneously both full employment and general price stability.

We thus face problems today with which Adam Smith did not concern himself. Economic life keeps changing, and each generation must face anew the central problem with which

he dealt so boldly -- that is, how best to draw the line between private and governmental activities in the interest of augmenting the general welfare. As we go about this task, we cannot be blind to the imperfections of market processes or to the abuses of market power by business firms or labor organizations. But we also cannot afford to neglect Adam Smith's warning, of which recent experience provides ample illustration, that governments not infrequently create new problems, besides wasting resources that could have been put to effective use by private citizens or business firms.

In the course of my career, both as a student and as a public official, I have found it necessary to revise my ideas about the proper role of government in specific economic matters. Experience is a demanding teacher, and my respect for it has led me at times to favor governmental actions that I abhorred in my youth. My confidence in the basic advantages of free enterprise remains, however, unshaken. I continue to believe, as Adam Smith argued so cogently, that when a nation's economic activity is organized on the basis of free enterprise, men and women will by and large employ their talents in ways that enrich and strengthen the nation's economy. More

important still, it is only by avoiding excessive concentration of power in the hands of government that we can preserve our individual liberties and have the opportunity to seek personal fulfillment with full dignity.

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