

"You could read ten books on the subject  
and not glean as much information."

—DAVID BACH, author of the *New York Times* bestseller *The Automatic Millionaire*



# ECONOMY



**HOW  
OUR ECONOMY  
WORKS (AND DOESN'T WORK)**  
IN WORDS AND PICTURES

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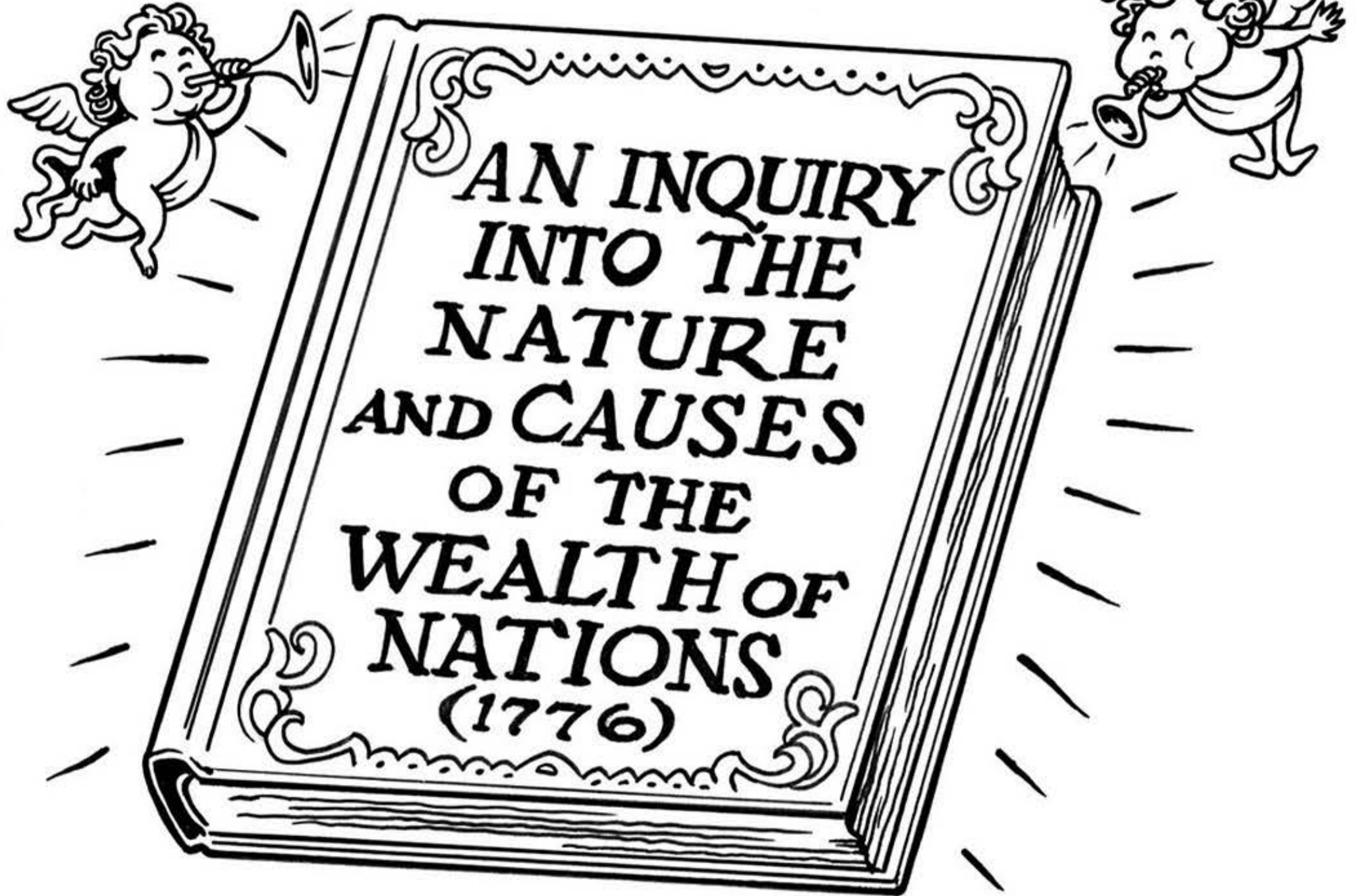
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## ADAM SMITH AND THE FREE MARKET

Smith's revolutionary work:



To Smith, one cause of wealth was the *division of labor*. He described a workshop where 10 workers made nothing but pins.



DRAWS  
OUT WIRE

STRAIGHTENS  
WIRE

SHARPENS  
POINT

PUTS  
HEAD ON

AND SO  
ON.

TOGETHER THEY MADE  
48,000 PINS A DAY—  
FAR MORE THAN  
TEN PEOPLE COULD  
MAKE IF EACH  
WORKED ALONE.

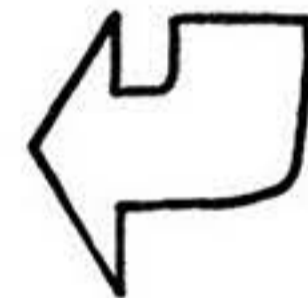
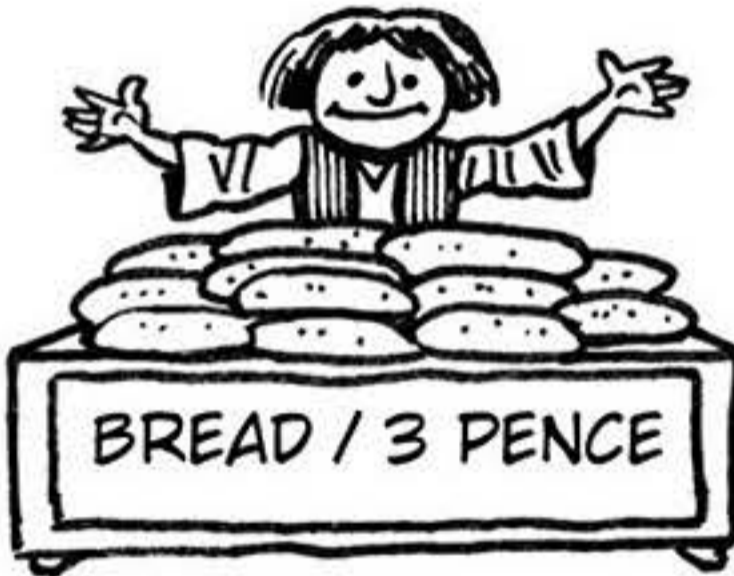
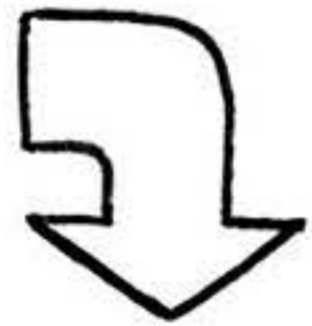
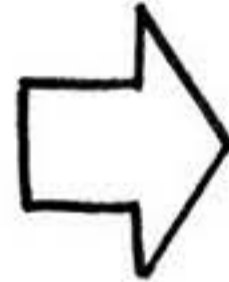


I CAN'T EVEN  
MAKE ONE!

The pin workshop had a clear organization— one person gave the orders.



BUT WHO GAVE THE ORDERS TO ALL THE PEOPLE WHO WORKED ON BIGGER TASKS, LIKE MAKING A LOAF OF BREAD?



Nobody did. Bakers didn't work because some Bread Planner told them to, or because they were saints who wanted people to be well fed. They worked because it was good for *them*.

"IT IS NOT FROM THE BENEVOLENCE OF THE BUTCHER, THE BREWER, AND THE BAKER, THAT WE EXPECT OUR DINNER, BUT FROM THEIR REGARD TO THEIR OWN INTEREST."



But if the baker cared only about himself, why didn't he do *this*?



BREAD / 10 PENCE

Smith's answer:

THE BAKER MIGHT *WANT* TO GOUGE, BUT IF HE TRIES, OTHER BAKERS, THINKING ONLY OF THEMSELVES, WILL STEAL HIS CUSTOMERS.



EVEN IF HE'S THE ONLY BAKER IN TOWN, HE CAN'T GET TOO GREEDY. IF HE STARTS MAKING CRAZY MONEY, OTHER PEOPLE WILL DROP WHAT THEY'RE DOING AND *HORN IN*.



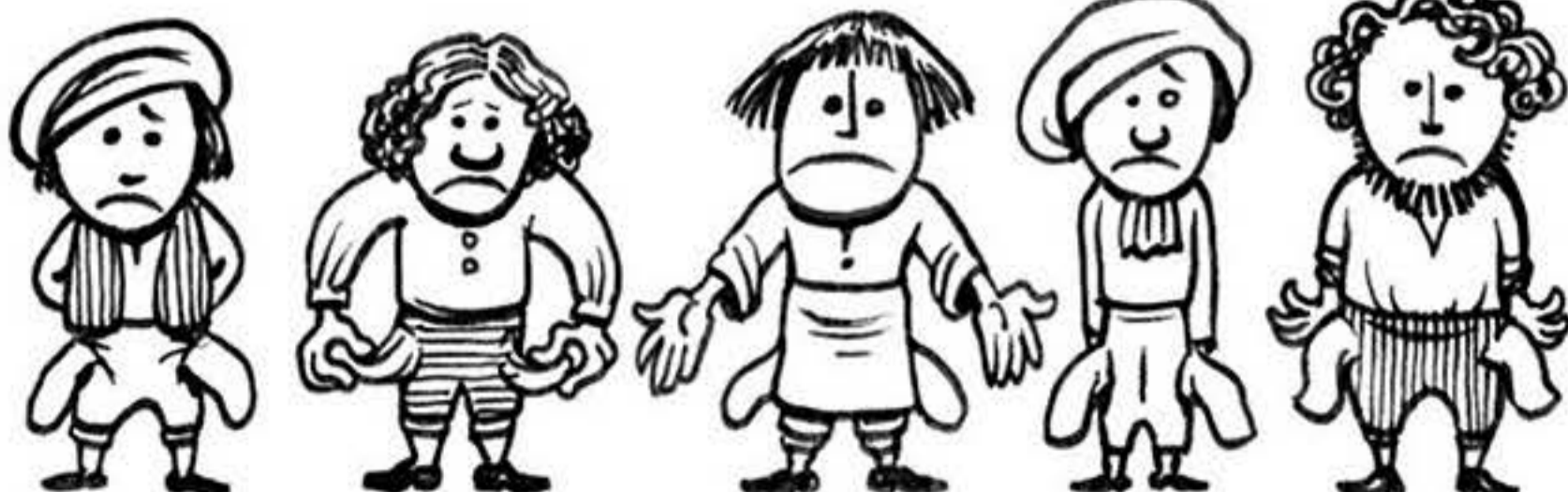
So in Smith's economy, *competition* kept everyone honest. Every baker—saint and greedhead alike—was led, "as if by an invisible hand," to sell bread at a fair price: high enough to pay for the baker's costs and work, low enough that others didn't steal the customers.



I WANT TO CHARGE MORE, BUT I CAN'T!



Speaking of costs, the baker's suppliers, workers, landlord, and lenders couldn't overcharge either, or the baker would go to their competitors. And so on.



So the price of a loaf of bread included the fair price of all the land, labor, and capital that went into it—in other words, the bread sold for its cost to society.

MORE OR LESS.



Here's the free market in *action*. Let's say there's a bad wheat harvest. The government could intervene...



Or it could do *nothing*. The price of wheat will rise, and then:

People will tighten their belts and substitute other foods.

Merchants will sell their stockpiles for a big profit.

Shippers will import more wheat to take advantage of the high price.



In other words, a *free market* organizes things, far more effectively than a human planner ever could. Imagine if a planner tried to arrange the supplies of modern New York City.



By *not* planning its supplies, New York has almost never had a shortage of anything (except space).

If buyers can't buy from whomever they want, if sellers can't set their own prices, or if wigmakers aren't allowed to become bakers, the system won't work right. So people must be left reasonably *free*.



So we're back to:

Laissez-faire!



But now we understand why:

PINS  
100 FOR  
A PENNY



- To *get*, people have to *give*—they have to sell something others want.
- If someone tries to charge too much, others will horn in until the price drops.
- So everything sells for roughly the cost of the land, labor, and capital it took to make the item.

IN OTHER WORDS, ITS COST TO SOCIETY.

If people *don't* buy a product, it means the product's not worth the cost of the resources used to make it. The seller goes out of business, freeing up the land, labor, and capital he was wasting.



LOVINGLY HANDCRAFTED  
PINS

1 FOR A  
PENNY

NO GREAT LOSS!

SO IN SMITH'S ECONOMY, THE **MARKET ITSELF** FIGURED OUT WHAT PEOPLE WANTED, AND HOW TO GET IT TO THEM MOST EFFICIENTLY, EVEN THOUGH EVERYONE **IN** THE MARKET WAS JUST TRYING TO MAKE A LIVING.

SMITH'S IDEA THAT THE MARKET CAN PROVIDE **ORDER** WITHOUT ANYONE GIVING **ORDERS** HAS BEEN THE CORE OF ECONOMIC THOUGHT EVER SINCE.



BUT IT SOMETIMES SEEMS THAT PEOPLE SPEND MORE TIME **REVERING** ADAM SMITH THAN **READING** HIM. SMITH HAD **OTHER** THINGS TO SAY, THINGS THAT HAVE BEEN LARGELY FORGOTTEN. LET'S LOOK AT SOME OF THEM.



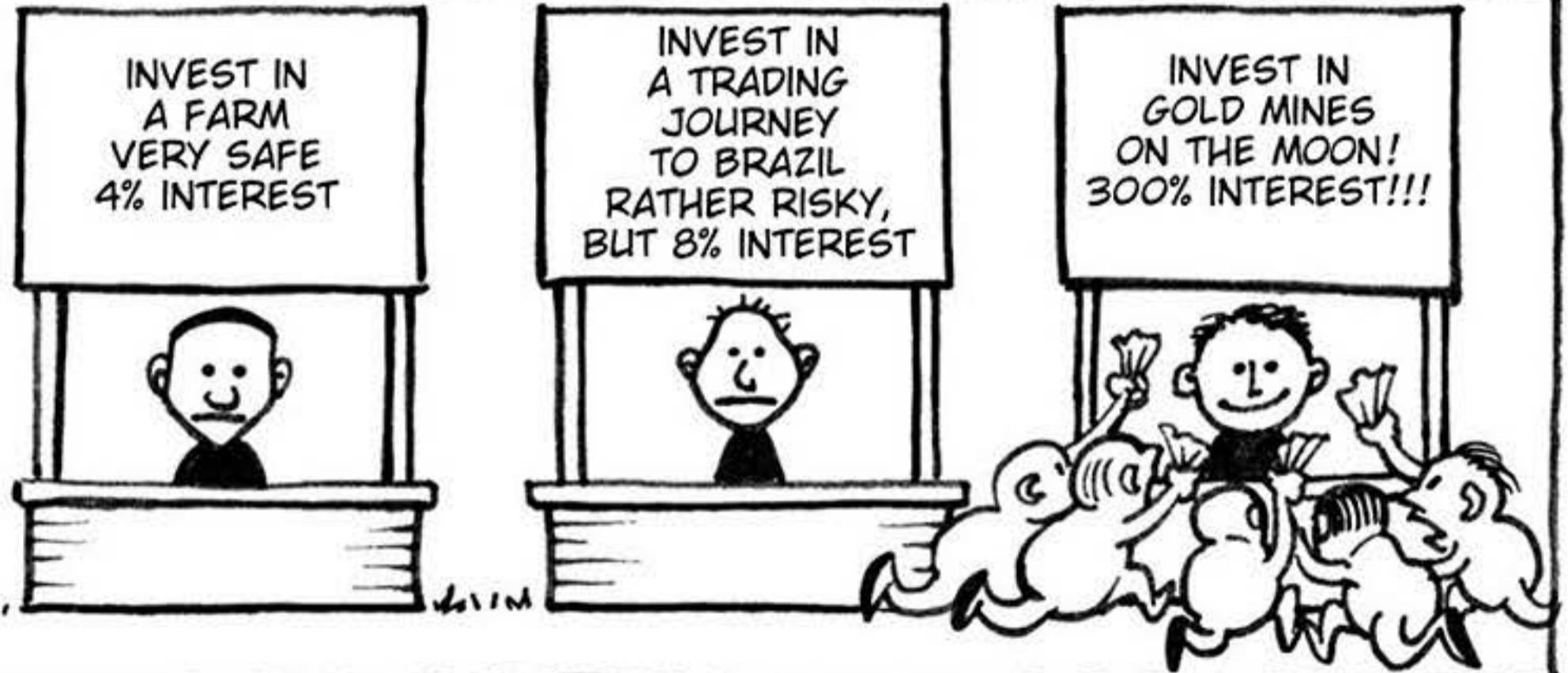
THE LIMITS OF THE MARKET

Adam Smith was never dogmatic; he knew markets weren't perfect. Markets won't enforce laws, protect borders, or provide *public goods*, such as street cleaning, that everyone wants but nobody has much incentive to provide.



For that matter, Smith thought government should favor war-related industries so they would be around if war came, protect wage workers (because they had less bargaining power than employers), keep banks honest, issue patents, protect new industries until they were on their feet, cap the interest rate, control disease, establish education standards (so brain-dead *jobs* like the ones in the pin workshop didn't turn workers into brain-dead *people*), and even provide public amusements.

"Cap the interest rate" was a big one. Smith understood that if the reward gets too big, investors forget the *risk*.



With the interest rate capped, Smith expected people to take reasonable risks but avoid wild gambles.





Smith didn't just think interest should be low; he thought the same about *profit*. Smith thought that high profits were *bad*, because you couldn't have high profits and high wages at the same time.



High wages weren't just in workers' interest; they were in *society's* interest, because almost everyone *in* society was a worker. That's still true today: If your income comes from the work you do, and not from rent or profit, *you're* a worker.



Which brings up a point so basic that it can be hard to see.



"NO SOCIETY CAN SURELY BE FLOURISHING AND HAPPY, OF WHICH THE FAR GREATER PART OF THE MEMBERS [THE WORKERS] ARE POOR AND MISERABLE."

So when capitalists followed their self-interest and paid low wages, that was *bad* for society.



Same if they raised prices: when prices rose, *real wages*—not the money itself, but what the money would buy—fell.

HIGH PRICES AND LOW WAGES ARE THE SAME DAMN THING!



That's one reason Smith liked free markets: in a free market, capitalists compete for workers, which raises wages.

They also compete for customers, which lowers prices.



But even back in Smith's day, *big* capitalists could *escape the market*.

For one thing, they could *take over* a market.



"PEOPLE OF THE SAME TRADE SELDOM MEET TOGETHER, EVEN FOR MERRIMENT AND DIVERSION, BUT THE CONVERSATION ENDS IN A CONSPIRACY AGAINST THE PUBLIC, OR IN SOME CONTRIVANCE TO RAISE PRICES."

Even worse: Big capitalists had enough political *power* to push for laws establishing *subsidies* and *protective tariffs* that guaranteed high profits.

Those laws were bad for society, but who understood that? Not the tired, uneducated worker. Or for that matter, the *government*, much of the time.

IN A WORD, *MERCANTILISM*.



SO ADAM SMITH DIDN'T EXACTLY THINK GOVERNMENT WAS DANGEROUS TO THE FREE MARKET. HE THOUGHT THE DANGER WAS BIG CAPITALISTS *TRICKING* GOVERNMENT INTO DOING THEM FAVORS.

Which brings us to the big *forgotten message* of *The Wealth of Nations*:



It's worth reading in Adam Smith's own words.

"THE PROPOSAL OF ANY NEW LAW OR REGULATION OF COMMERCE WHICH COMES FROM [CAPITALISTS] OUGHT ALWAYS TO BE LISTENED TO WITH GREAT PRECAUTION, AND OUGHT NEVER TO BE ADOPTED, TILL AFTER HAVING BEEN LONG AND CAREFULLY EXAMINED, NOT ONLY WITH THE MOST SCRUPULOUS, BUT WITH THE MOST SUSPICIOUS ATTENTION. IT COMES FROM AN ORDER OF MEN, WHOSE INTEREST IS NEVER EXACTLY THE SAME WITH THAT OF THE PUBLIC, WHO HAVE GENERALLY AN INTEREST TO DECEIVE AND EVEN TO OPPRESS THE PUBLIC, AND WHO ACCORDINGLY HAVE, UPON MANY OCCASIONS, BOTH DECEIVED AND OPPRESSED IT."

Smith had a bit of a *problem* with big capitalists.



"THE MEAN RAPACITY, THE MONOPOLIZING SPIRIT OF MERCHANTS AND MANUFACTURERS, WHO NEITHER ARE, NOR OUGHT TO BE, THE MASTERS OF MANKIND..."

And for good reason. Britain's economy was freer than France's (Smith thought that was why Britain was richer), but it was still riddled with regulations, subsidies, protections, and especially *government-enforced monopolies*.

A *monopoly* is when there's only *one* seller in a market. With no competition, the monopolist can—and will—overcharge.

For instance, in Smith's day only the giant East India Company could trade with Asia.

OUR MONOPOLY *ENCOURAGES* US TO TRADE WITH ASIA!



THAT MAKES NO SENSE! IF THE ASIA TRADE PAYS, WHY KEEP PEOPLE OUT OF IT? IF IT DOESN'T, WHY ENCOURAGE IT?

The very *existence* of the East India Company was an interference in the market—the EIC was a government-created entity called a *corporation*.

FOREWORD BY DAVID BACH  
INTRODUCTION BY JOEL BAKAN

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