

Adam Smith on Management

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Abstract

This paper summarizes the management perspective found in the two major works of Adam Smith. The pioneer of classical economics, Smith was also an early management scholar. He de-emphasized nationalistic competition, advocated a consumer-oriented viewpoint and stressed the importance of economic growth. Having rejected the concept of the state as economic prime mover, Smith found that the responsibility for economic growth lay with the leaders and managers of business enterprise. He proceeded to analyze their behavior in his classic study of the early factory system. Smith's analysis covered management issues which still plague business, and some of his observations, particularly those concerning worker motivation and corporate top management, remain as meaningful as they were in the 18th century.

Introduction

Adam Smith was a visionary social system builder and also a pioneer management theorist. His two masterworks, *The Theory of Moral Sentiments* (TMS) and *An Inquiry into the Nature and Causes of the Wealth of Nations* (WN), were published in 1759 and 1776 respectively, during the early stages of Britain's process of industrialization. His ideas had great impact in his own time and continue to be relevant to such current issues as trade protection and industrial policy, and also to business management. He is often cited, frequently incorrectly, or out of context. Although Adam Smith is most remembered today for his economic theory, he had a long and wide-ranging academic career and lectured on jurisprudence, philosophy, and other subjects as well as political economy. The social system that he constructed was more than an economic theory; it was a comprehensive model of the workings of society including a model for business management. Smith believed that economic growth directed by a functioning market system and facilitated by appropriate government institutions, was the

key to a nation's wealth and the well being of its citizens. Because growth was dependent on the effective employment of productive resources, Smith saw that management played a crucial role and therefore he analyzed management concepts at length. Some management issues that he discussed remain unresolved, however his observations and recommendations continue to be worth studying.

This article is a review, from a management perspective, of Adam Smith's thought as revealed in WN and TMS. We first examine the economic and management environment in which Smith wrote. Then, following a synopsis of Smith's model of political economy, we summarize his views on various facets of management. Finally, we present Smith's conclusions regarding the roles of government and business. It is our contention that the originality, penetrating observation, and timelessness which characterize Adam Smith's writing on management, and the influence that his thought continues to exercise, make him the true father of management scholarship.

The Economic Environment

Adam Smith was an academic, but his writing in WN was directed at policy issues of the day. By the mid-1700's, the need for a new political-economic theory was clear. Europe's dynastic and colonial wars had created crises in public finance. Governments needed revenues; therefore they needed to promote taxable national wealth. The prevailing economic precept followed by all of the European powers was what came to be known as mercantilism, which held that national wealth was a function of the stock of resources (specifically gold and silver) that a sovereign could draw upon, and was created primarily by a foreign trade surplus. A classic argument for mercantilism in the 17th century was made by Thomas Mun, who wrote that:

The ordinary means therefore to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule: to sell more to strangers yearly than we consume of theirs in value.¹

The trade surplus would be collected from foreign countries in gold or silver. The acquisition of precious metals, like the conquest of territory, was a zero-sum game, so a nation must ensure that its resources were put to the most efficient use and that the corresponding designs of its neighbors were frustrated. Among competing nations with similar levels of productivity, a trade surplus would ultimately have to be paid for by the ordinary citizens, whose standard of living would be reduced so that the king could build up a stock of treasure. Nations, said Mun, must strive for self-sufficiency. They must promote exports, and discourage imports. In this way, the frugality of the people will enrich the king and thereby increase the wealth of the nation. Wealth was the means by which national power was projected, and it was to be the property of the ruling class and not the ordinary citizen. Mercantilist doctrine was well developed by the early 17th century, when Sir Edwin Sandy's, speaking in the English House of Commons, blamed widespread unemployment on an outflow of money caused by imported consumer goods.²

To varying degrees, every European nation applied this concept, and it remains the theoretical foundation of modern protectionism. Mercantilism in Europe led to protective tariffs, subsidy and regulation of domestic manufacturing, and trade wars, which not infrequently resulted in shooting wars.³ England's trade with the other European powers during the 1700's has been characterized as "essentially a form of undeclared warfare."⁴ By the mid-18th century, mercantilist national policy continued in force but the theory behind it had come under attack. Hume, for example, recognized that one nation's prosperity need not come at the expense of its neighbors; he argued that economic progress is a process of national improvement and not a struggle against others.⁵ Furthermore, along with the French Physiocrats, Hume saw that a nation's production, rather than its stockpile of money and precious metals, was the source of its wealth.⁶ The Physiocrats, unfortunately, defined production in artificially narrow terms that excluded all but the extractive industries. Adam Smith built on the free trade

foundation erected by the Physiocrats, but he did not accept their dismissal of manufacturing as unproductive.

The Management Environment

Accompanying the late 18th century need for a new economic framework was a need for management expertise. In the English textile industry of the 16th and 17th centuries, the handicraft system had given way to the domestic or putting-out system of production in which self-directed manufacturing laborers worked at home and were paid on a piece-work basis by an entrepreneur. With the development of the steam engine and other capital-intensive means of production, it became necessary to centralize work. The factory system was born as a result of the need to assemble many workers together in one workplace housing the production equipment, which was now owned by the capitalist entrepreneur. The factory system required more sophisticated methods of allocating and planning capital investments, organizing production processes, and directing workers. Thus, the rise of the management function was of crucial importance in the industrial revolution; North has argued that increased management involvement in the production process was a more direct cause of the rise of the factory system than technological advances.⁷

Labor was an immediate problem in the new factories -- recruitment, training, and motivation of the work force posed difficult challenges. The concept of a repetitive job requiring punctual attendance and close supervision was alien to a population accustomed to the more irregular cadence of agricultural life. Reward systems, punishments for infractions, and attempts to instill new cultural patterns were implemented with varying degrees of success, as they are today.⁸

The New Paradigm

Adam Smith was intrigued by the new factory system and saw how expanded markets and greater labor specialization could lead to a higher standard of living for all

citizens. He constructed a model in which the material well being of the consumer was the goal; wealth was defined not as the government's cache of treasure, or as the strength of a nation's business organizations, but as the productive power of labor. As Smith observed,

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it.⁹

Smith believed that a nation was better or worse off depending on the per capita produce available to its population. This in turn depended primarily on productivity,¹⁰ a responsibility of management. Growth was the engine that augmented per capita output, therefore living standards, as the demand for labor increased and wages were bid up. Without growth, market competition would force wages down to subsistence levels. As an example case, Smith explained that lack of growth was why 18th century China, a seemingly wealthy country, could not provide more than a minimum subsistence level of existence to its population.¹¹ Although some business executives might welcome such a plentiful supply of cheap labor, Smith recognized that the interests of the businessmen were often counter to those of the nation. He weighed in on the side of the common man, stating that

No society can surely be flourishing and happy, of which the far greater part of the members are miserable and poor. It is but equity, besides, that they who feed, clothe and lodge the whole body of the people, should have such a share of the produce of their own labor as to be themselves tolerably well fed, clothed and lodged.¹²

Smith presented a new paradigm which argued that if individual initiative and self-interest were given a relatively free hand by the state, then as citizens worked in an interdependent manner toward their private goals, the entire economy would grow in a socially optimal manner. He argued that individuals are motivated by personal interest, therefore when given the liberty to pursue their own ends, will seek out the best

opportunities that they can find. They will charge the highest possible price for their efforts, but are held within a reasonable range by the prospect of competition. He viewed the price mechanism as assigning society's assessment of the value of any endeavor, hence the market leads people to undertake activities that are worthwhile. In Smith's system, the government should play a minimal role in the economy because as individuals seek to maximize their own gain, they will actively search out those activities that provide the greatest utility to society and therefore the needs of the nation will be provided for automatically. Adam Smith used his famous image of the "invisible hand" to describe this process.¹³

Personal Interest

At this point, some elaboration on Smith's concept of personal interest is essential. Contrary to popular caricature, Adam Smith did not equate personal interest with avarice. His concept of personal interest was complex and his discussion on this subject in TMS does not at first seem consistent with his descriptions of the motives of businessmen in WN. In TMS, Smith downplays the value of material gain, explaining that contentment and virtue were the true routes to happiness. Therefore, private interest had a moral as well as a material component. Smith describes an internal dialectic, which guides the actions of individuals. People do not freely indulge their base urges, they engage in a mental dialogue with an "internal spectator" who supplies moral instinct and shows where true personal interest lies.

When the happiness or misery of others depends in any respect upon our conduct, we dare not, as self-love might suggest to us, prefer the interests of one to that of many. The man within immediately calls to us, that we value ourselves too much and other people too little, and that, by doing so, we render ourselves the proper object of the contempt and indignation of our brethren. Neither is this sentiment confined to men of extraordinary magnanimity and virtue. It is deeply impressed upon every tolerably good soldier, who feels that he would become the scorn of his companions if

he could be supposed capable of shrinking from danger, or of hesitating either to expose or to throw away his life when the good of the service required it.¹⁴

One thesis of WN is that cooperation borne of mutual dependency is what builds lasting wealth, and that the windfall gains of speculative ventures are transitory. Smith deplored the contrivances of "projectors" whose aim was to realize short-term profits through clever or devious financial maneuvers. Trade, market expansion, and the division of labor are impossible without cooperative effort, the protection of property, and respect for the concept of the commercial and social contract. This much is consistent with the motives discussed in TMS, but in WN he further portrays merchants and manufacturers as acting not in a virtuous manner; he sees them seizing every available opportunity to conspire against the public.¹⁵ It seems that Smith's optimistic view of the concept of personal interest in TMS was tempered in WN by his practical observation of the results of mercantilist producer-oriented government policy.

The Role of Management in Adam Smith's Economic Model

Adam Smith placed a new emphasis on the importance of the management function. The mercantilists recognized the benefits of efficient production, but believed that it should be achieved via State direction and that the proceeds should accrue to the government rather than to the consumers. The Physiocrats saw the benefits of production apart from the generation of trade surpluses, but they downplayed the role of industry. Smith perceived the direct connections between trade, industrial production, and wealth. Labor and its effective employment were what drove the process.

If, as Smith suggested, labor is the source of a nation's wealth, then the amount of wealth is dependent on the "skill, dexterity, and judgment"¹⁶ with which it is applied. This meant that nations might better their position through productivity-led growth rather than by territorial aggrandizement and predatory trade practices. As a mechanism for building wealth, wars of colonization and conquest are replaced by peaceful advancement

through improved production processes and increases in the extent of the market. These tasks are the job of the manager, and so improvements in management processes become the engine of economic growth and national wealth. In this way Adam Smith's economic theory led to a concern for the advancement of management techniques.

Adam Smith on Management: Theories of Motivation

Adam Smith made many observations about the management of business and the role of business in society. One area that he concentrated on was worker motivation. Smith recognized that a productive worker must be a stakeholder. If he is not, then he will put forth only the minimum effort required.¹⁷ Denying workers a stake in the outcome of their labor also inhibits the development of technology because the rewards of innovation do not accrue to the potential innovators.¹⁸ The best way to motivate workers, Smith taught, was with the carrot rather than the stick. He believed that well-paid employees were the most productive, saying:

The liberal reward of labor, as it encourages the propagation, so it increases the industry of the common people...Where wages are high, accordingly, we shall always find the workmen more active, diligent, and expeditious, then where they are low...¹⁹

Excellence must be rewarded in order to promote industry and ingenuity. Systems of wage controls serve to drag everyone's performance down to the least common denominator. Smith also observed that wage manipulation in his day was very one-sided, because the employers could collude to drive down wages but labor was prohibited from organizing counter-initiatives.²⁰

Adam Smith on Management: The Factory

As mentioned above, the problem of how best to manage a factory was a prime concern. The entrepreneur-capitalist himself ran the earliest factories. As the facilities grew larger and more complex, additional supervisory manpower was needed. Smith

recognized that "inspection and direction" was a special type of labor and a separate function from ownership.²¹

Smith observed that the greatest increases in productivity came about when capital intensity was increased and production processes were not carried out from beginning to end by a single person or entity operating in isolation, but broken down into specialized sub-tasks. When Smith described the division of labor in the manufacture of pins,²² he constructed his most famous image. Henry Ford's automobile production system was perhaps the ultimate development of what Adam Smith described so graphically in 1776. The division of labor was not only carried out in factories, it was the basis for the operation of the market system as a whole. Each tradesman specializes in some economic function and sells his surplus product and/or service for money; then, he buys his other needs in the market. Smith suggested that trade will increase to the extent of the market. When price just covered the cost of the marginal producer, the extent was determined. The larger the market, the more it enabled specialization, which in turn led to capital investment, mechanization, and further improvements in production processes.

Smith found both opportunities and problems in what we would now call human resource management in the factory system. The opportunity existed for the line workers, who are the most familiar with the work processes, to make useful improvements to the production system. Smith offers the example of a boy whose job was to operate valves on a steam engine, who found that he could rig a simple device that would do his job automatically.²³ On the other hand, Smith had reservations about the benefits of the division of labor. He explored its dysfunctional implications in a discussion of the dehumanization caused by a life spent in minutely specialized, de-skilled work. A person engaged in factory work "naturally becomes as stupid and ignorant as it is possible for a human creature to become."²⁴ Smith recognized that this was a problem in a free country, which depended on the citizens for good judgment and decision-making,²⁵ but he did not develop a convincing solution. He suggested that

public education be provided to young children before they enter the factories.²⁶ But, if they are destined for a life of stifling monotony, it is possible that any education will only raise their expectations and result in frustration. He identified, but did not resolve, the issue of how to manage workers in monotonous factory jobs. The problem remains.

Adam Smith on Management: The Corporation

Smith deplored the careless oversight and conflicts of interest generated by the practice of governing joint-stock limited-liability companies, i.e. corporations, through boards of directors. He saw that the directors could not be expected to treat the company's money with the same respect that they would if it were their own, and "negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."²⁷ Smith recognized that the ability of corporations to attract capital from investors was their main advantage. Still, he maintained that the abuses and ineffectiveness of their management rendered them uncompetitive against privately held companies unless they held a government monopoly charter or were engaged in specific, routine sorts of businesses. In the 18th century, this category included banking and insurance.²⁸

As Muller points out, Smith's attitude towards the corporation reflects his risk adverse nature and his respect for the virtue of prudence.²⁹ In TMS Smith praises caution, and admires those who are naturally contented with their situation and happy to save up continual small accumulations;³⁰ in WN he criticizes managers who abandon conservative business practices "in consequence of some flattering speculation of extraordinary gain."³¹

Government and Business

Adam Smith was opposed to central direction of the economy, but he recognized certain functions that must be served by government: defense, justice, public works, and

education. Under Smith's theory, the scope and expense of these functions would increase with the development of society. In the pre-industrial world, soldiers may serve in a part-time militia. However, once the factory system is in place workers cannot be spared for military service, and an organized, professional force is needed. In the scheme of societal development, justice becomes necessary once private property is accumulated.

It can be argued that defense and justice serve political functions, therefore do not make good examples of economic roles for government. However, in the provision of public works, an economic public good, Smith found an economic role for government.³² He specified such project as canals, bridges, and roads as suitable means by which government should promote business.³³ Smith also strongly advocated the provision of public education, possibly compulsory, to be paid for by the government and provided especially to poor children. This would serve, as mentioned above, to counter the deadening effects of the children's later life of toil in the factories.

Smith saw that beyond the provision of externalities, the government set the rules that the commercial world followed. Democratic forms were not enough to ensure that government actions produced the best societal outcomes; Smith deplored the fact that the large merchants and manufacturers were able to lobby for the imposition of laws which benefited themselves, whereas the ordinary people are "scattered about in all different parts of the country, without support or protection."³⁴ Smith repeatedly mentions this implicit recognition of the difficulties of arranging for the invisible hand to do its theoretical best. He recognized that private interest was difficult to define, and that society's needs and the wishes of merchants and manufacturers existed in a delicate balance that was not simple to maintain, for the businessmen were

...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.³⁵

Smith was very critical of the practice of the Crown in awarding monopolies to chartered corporations such as the English East India Company. Smith saw that monopoly ruined the market system, and the fact that the government created monopolies was one factor that led him to advocate a minimal economic role for government. Just as Adam Smith was a harsh critic of the 18th century corporations that circumvented the operation of the market by obtaining monopoly power from the State, he would likely to have been equally critical of the powerful oligopolistic combines of the 19th through 21st centuries.

Conclusions and Recommendations

Adam Smith wrote in an elegant and colorful style, and his books are well worth reading for their perspective on the origins of modern management theory. Today's readers will find that some of the issues debated by today's management scholars were apparent to Smith 225 years ago. Smith was the first widely read author to present a complete social analysis which assigned responsibility for creation of national wealth primarily to individual businessmen acting in their own interest. He analyzed the management function, particularly with regard to the employment of capital, organization and motivation of workers, corporate governance, and the proper role of government. Adam Smith wrote that workers must be stakeholders if management is to achieve the greatest possible productivity from them. He quantified the benefits of mechanization but also graphically illustrated the alienation caused by monotonous factory work. He described the divergence of interest that resulted from the separation of management from ownership in large corporations; he recognized that top management would not be motivated to exercise personal economy unless they too are corporate stakeholders. Smith's approach to analyzing the role of government in business affairs was more complex than is commonly thought, and must be considered in the context of the times.

He lived in a society burdened with excessive economic regulation, and he sought to reduce the government's role in order to allow the market mechanism to function.

Adam Smith was an influential thinker in his own day and has been a constant focus of critical and scholarly attention ever since; there is a huge literature that covers his thought and impact. Smith's writings were complex and multi-faceted, and a reading of his works from a management perspective can provide a useful historical background for today's debates on worker motivation, corporate governance, and other issues. This paper has focused mainly on *The Wealth of Nations* and *The Theory of Moral Sentiments*; further reading might profitably focus on the origins of Smith's thought on business, management, and society as manifested in his two other major works, *Lectures on Jurisprudence* and *Lectures on Rhetoric and Belles Lettres*.

Notes

References to the works of Adam Smith are indicated by the abbreviations WN (*The Wealth of Nations*) and TMS (*The Theory of Moral Sentiments*). Following the abbreviation are the divisions, paragraph numbers, and page numbers from the standard Glasgow Edition (Oxford University Press, 1976).

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- ¹ Thomas Mun, "England's Treasure by Foreign Trade" (London, 1664), in Ingrid Hahn Rima, *Development of Economic Analysis* (Homewood, Ill.: Richard D. Irwin, 1991), pp. 34-36.
 - ² John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (San Diego: Harcourt Brace Jovanovich, 1953, originally published 1935), pp. 346-347.
 - ³ WN IV.ii.38 (p. 467) and Rondo Cameron, *A Concise Economic History of the World*, 2nd. ed. (Oxford University Press, 1993), p. 152.
 - ⁴ Paul Langford, *A Polite and Commercial People: England, 1727-1783* (Oxford University Press, 1992), p. 174. Also, on p. 3, Langford observes that for England during the 18th century, "Every war during this period was in essence a commercial war...Every peace was the continuation of war by economic means."
 - ⁵ David Hume, "Of the Jealousy of Trade" (1758) in *David Hume: Political Essays* (Cambridge University Press, 1994), pp. 150-153.

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- ⁶ David Hume, "Of the Balance of Trade" (1752) in *David Hume: Political Essays* (Cambridge University Press, 1994), pp. 136-149.
- ⁷ Douglas C. North, *Structure and Change in Economic History* (New York: Norton, 1981), pp. 166-170.
- ⁸ Daniel Wren, *The Evolution of Management Thought*, 3rd ed. (New York: Wiley, 1987), pp. 38-48.
- ⁹ WN IV.viii.49 (p. 660).
- ¹⁰ WN Intro.1-4 (p. 10).
- ¹¹ WN I.viii.24-25 (pp. 89-90), WN I.xi.e.34-35 (pp. 208-209).
- ¹² WN I.viii.36 (p. 96).
- ¹³ TMS IV.i.9 (pp. 183-185), and WN IV.ii.9 (pp. 455-456).
- ¹⁴ TMS III.3.5 (pp. 137-138).
- ¹⁵ WN I.x.c.27 (p. 145).
- ¹⁶ WN Intro.3 (p. 10).
- ¹⁷ WN III.ii.8-12 (pp. 386-390).
- ¹⁸ WN IV.ix.47 (pp. 683-684).
- ¹⁹ WN I.viii.44 (p. 99).
- ²⁰ WN I.x.c. 60-63 (pp. 157-159).
- ²¹ WN I.vi.6 (pp. 66-67).
- ²² WN I.i.3 (pp. 14-15).
- ²³ WN I.i.8 (p. 20).
- ²⁴ WN V.i.f.50 (p. 782).
- ²⁵ WN V.i.f.61 (p. 788).
- ²⁶ WN V.i.f.54 (p. 785).
- ²⁷ WN V.i.e.18 (p. 741).
- ²⁸ WN V.i.e.15-40 (pp. 740-758).
- ²⁹ Jerry Z.Muller, *Adam Smith in His Time and Ours: Designing the Decent Society*. (New York: Free Press, 1992), p. 178.
- ³⁰ TMS VI.i (pp. 212-217).
- ³¹ WN V.i.e.33 (p. 756).
- ³² D. D. Raphael, *Adam Smith* (Oxford University Press, 1985), pp. 77-80.
- ³³ WN V.I.d (pp. 724-731).
- ³⁴ WN IV.viii.4 (p. 644).
- ³⁵ WN I.xi.p.10 (p. 267).