Adam Smith: managerial insights from the father of economics

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Abstract

Purpose – The paper aims to apply the ideas found in the paper of Adam Smith, the pre-eminent eighteenth century economist, to the field of management.

Design/methodology/approach – The paper provides a brief biography of Smith, summarizes his main contributions, and then applies them to contemporary management practices.

Findings – Adam Smith was the first person to identify specialization and the division of labor as the main drivers of productivity. He also conceptualized the "invisible hand principle" which explains how, under the proper set of incentives, self-interested individuals are directed to pursue activities that benefit the whole of society. Both ideas are of utmost importance in the field of management. Specifically, successful managers are those who are able to create good "rules of the game" which align the incentives of labor with the goals of the firm.

Practical implications – Smith's contributions provide a foundation for the division of labor and demonstrate the importance of establishing the right "institutions" within a firm.

Originality/value – The paper arrives at practical implications for managers from the paper of an eighteenth century economist.

Keywords Economic theory, Management theory, Division of labour, Economic history

Paper type Viewpoint

1. Introduction

Adam Smith's importance to the economics discipline is unquestionable. Indeed, he is commonly known as the "father of economics". His most influential paper, "An Inquiry into the Nature and Causes of the Wealth of Nations" (1776) remains the quintessential text in economic science even some 200 years after its publication. While at its core Smith's paper focused on answering the question "Why are some nations rich and others poor?" his ideas and conclusions have a broad applicability, and are especially relevant to contemporary management. Specifically, Adam Smith was the first to realize that specialization and the division of labor were the primary source of productivity, and he was the first to conceptualize the "invisible hand principle" demonstrating the tendency for self-interested individuals to be guided towards undertaking activities valued by the whole of society in a free market system governed by the rule of law and market prices.

Adam Smith was a pre-eminent contributor to the Scottish Enlightenment of the eighteenth century. Born in 1723 in Kirkcaldy, Fife, Scotland, Smith attended the University of Glasgow on scholarship at the age of 14 and later studied at Balliol College at Oxford. Smith would return to University of Glasgow as a professor of logic in 1751, and eventually became the chair of moral philosophy in 1752. His other famous paper, *Theory of Moral Sentiments*, was published in 1759. In 1764, Smith left university education to tutor the Duke of Buccleuch. He later retired back to Kirkcaldy,

Journal of Management History
Vol. 16 No. 4, 2010
pp. 504-508

1751-1348
DOI 10.1108/17511341011073979

where he completed paper on *Wealth of Nations*. Smith never married, and died in Edinburgh in 1790 (Henderson, 2007).

While Adam Smith is credited as the first modern economist, his formal education and teaching experiences were rooted in philosophy. Indeed, "economics" did not exist in Smith's time. Naturally, then, the relevance of his paper extends well beyond the contemporary discipline of economics. For managers in particular, Smith's "invisible hand" and its implications as well as his ideas concerning the division of labor and specialization are of utmost importance.

2. The invisible hand

Without question, the most widely cited idea found in Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* is the notion of the "invisible hand." Smith's invisible hand explains how a decentralized capitalist system, which lacks any central planner, can still manage to thrive and produce goods and services valued by consumers. The key insight at work in Smith's theory is that a free market aligns the incentives of a self-interested individual with the objectives of society. Specifically, anyone who earns money from his or her labor can do so only by offering a good or service valued by someone else. To the extent the individual wishes to earn the highest possible wage, therefore increasing his or her standard of living, he or she will be motivated to pursue that activity most highly valued by those around him. It is the pursuit of these highly valued activities which create the most wealth for society. An oft-quoted passage in *Wealth of Nations* reads:

> It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest [. . .] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention (Smith [1776] 1994, I.15, IV.485).

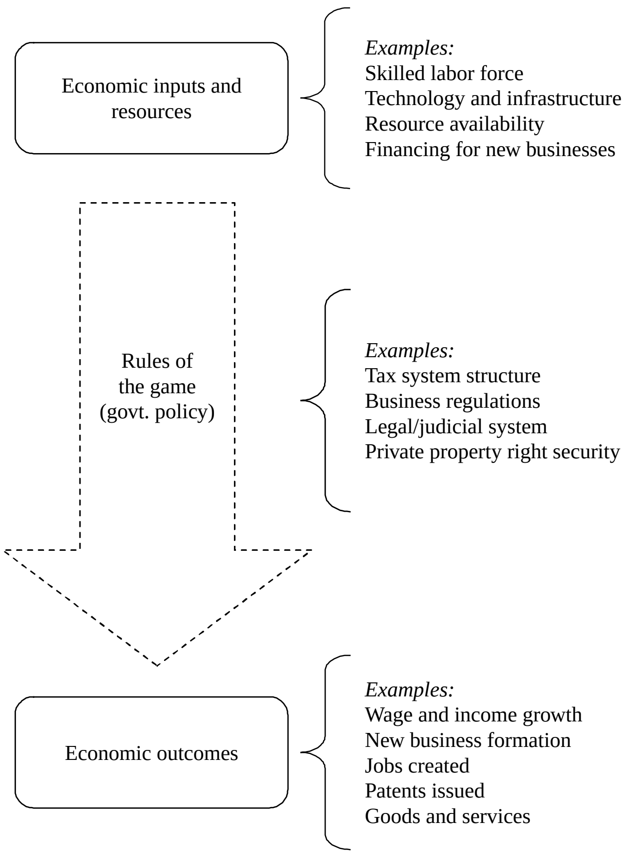
An example will help to clarify this point[1]. Suppose the price of maple lumber increases because of higher consumer demand for maple furniture. This single price change will change the incentives faced by decision makers throughout the economy, likely resulting in changes in which properties are harvested, the percent of maple sent to sawmills versus other uses, the incentive of non-furniture makers to substitute away from maple, etc. The "signals" sent by these market prices are what enable self-interested workers and businesses to identify changes in which goods and services create the most income for them, and simultaneously the most value for society. Price signals not only tell us when new opportunities are arising; they also help us to find out when what we are doing is no longer as highly valued, or when the resources we are using have found an alternative use in which they create even more value.

The invisible hand succeeds at aligning individual incentives with societal prosperity. An important consideration in determining whether incentives will be aligned, then, is the extent to which the "hand" is able to freely operate. Smith noted this, again in reference to the differences in countries' successes, "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things" (Stewart, 1793)[2]. To invoke modern terminology, Smith was referring to the role of institutions in determining economic outcomes. In this context, institutions are the "rules of the game" under which individuals operate

(North, 1990, 1991). When the institutions allow the invisible hand to align interests, wealth is created; when the rules of the game get in the way, however, less desirable outcomes are created.

Figure 1 shows a simple diagram of the relationship between inputs, institutions, and outcomes. Here, inputs such as raw materials and labor are used to produce tangible goods and services. When the "right" institutions (including the protection of private property, reasonable taxes, etc.) are in place, we can achieve the maximum possible output from a given set of inputs. When the institutions are not good, the same amount of inputs results in less output.

In the context of management, the invisible hand principle has clear implications. It is a plea for decentralization rather than command and control (i.e. "central planning") by firm managers. Decentralized decision making can and will result in the best outcomes, as long as the proper "rules of the game" are in place. In particular, all that is required is that an incentive structure exists to align the individual self-interest of workers with the outcomes desired by the firm. For example, incentives such as stock options or profit-sharing can help to create this alignment of individual



Source: Hall and Sobel (2006)

Figure 1.
Inputs, institutions, and outcomes

incentives with firm objectives. Note, however, that while it is important that workers face benefits that relate to the revenue of the firm, it is equally important that they understand (and bear some of) the costs their decisions have on the firm. A department within a firm would have, for example, little incentive to conserve on the physical space it uses unless, like the firm as a whole, it bears a cost for the space it utilizes. In the presence of the right incentive structure, Smith's invisible hand will do the rest.

3. Specialization and the division of labor

In answering the main question of Wealth of Nations, "Why are some nations rich and others poor?" Smith identified specialization and the division of labor as the main driver of productivity and economic progress. By observing the workings of a French pin factory, Smith noted that each individual worker, if working alone and responsible for making the entire pin, could not make more than 20 pins per day. But when the process was divided up so that, for example, one worker draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head, and a sixth puts the head on the pin, that the average output per worker jumps to 4,800 pins per worker per day.

The division of labor allows individual workers to specialize in specific phases of the production process and collectively produce more than if each were to produce individually. Likewise, when individuals specialize across different industries similar gains are realized. This increase in labor productivity not only yields higher output, but also leads to increases in wage rates.

Smith, however, also presents an often overlooked caveat to this argument. A group's ability to specialize (and thus increase productivity, output, and wages) is limited by the "extent" (or size) of the market to which it sells. Specifically, in large markets more specialization is possible. In large consumer markets, for example, small specialty stores are able to succeed. These same specialty stores would likely not be able to survive in a small town.

The implications for managers of Smith's observation concerning the benefits of a division of labor and specialization are clear. Workers are more productive when the steps involved in production are divided and workers are allowed to specialize in specific tasks. Smith's caveat concerning the extent of the market is important, however. A firm producing and selling ten units of output per day will not be able to specialize as finely as one selling 10,000 units. When firms can find ways to reach out to larger marketplaces, they will be more productive. For example, a specialty store might survive in a small town if it can sell its products on the internet, reaching out to a larger market. When firms can penetrate the markets of other states or nations, and sell to a global marketplace, they can specialize more finely.

4. Conclusion

The paper of Adam Smith, the father of modern economics, has far-reaching implications that stretch beyond any one discipline. Of particular relevance to managers, Smith was the first to conceptualize the invisible hand and identify the benefits of specialization and a division of labor. The invisible hand describes the link between individual self-interest and the well-being of the group. The division of labor, which Smith identified as the main driver of economic progress, describes how decentralization and specialization leads to increases in output and wages. While the virtues of these concepts are widely accepted, the factors which limit them are often overlooked. The invisible hand can be stifled by poor institutions or "rules of the game" which do not align worker interests with those of the firm. Similarly, the gains from specialization and a division of labor are limited by the extent of the market.

The role of a manager wishing to gain from Smith's insight is then to minimize these limiting factors. A successful manager will not attempt to "top-down" plan but will instead establish an appropriate incentive structure which aligns worker and firm interests. From there, the invisible hand will guide self-interested labor towards achieving goals which benefit the whole firm. Further, a manager must be ever mindful of the extent of the market in which he or she operates as well as the size of the firm itself. Gains from specialization are best realized in an expanded market.

These insights, which Adam Smith originally used to explain *The Wealth of Nations*, have obvious and broad implications. A manager who is able to integrate the teachings of the great eighteenth century economist will be far more effective than one who considers them outside the realm of contemporary management.

Notes

1. This example is originally found in Sobel (2007).
2. This quote is originally attributed to Smith in 1755 by Stewart (1793).

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