**Adam Smith’s “Free Market Mechanism”**

*The following is a simplified version of the economic system Adam Smith believed would*

*emerge once governments ended their oppressive mercantilist policies.*

1. A man builds a cloth-making factory, hires workers, and divides their labor into

many specialized operations. The factory owner is motivated by self-interest,

profit, maybe even greed.

2. Others, however, are also building factories to make and sell cloth. They all have

to compete for the money of the buyers whose self- interest is to buy cloth at the

best price.

3. Buyers bid up the price of the cloth when the supply of cloth is low and their

demand for it is high. But when there is an oversupply, the buyers can pick and

choose and refuse to purchase high-priced cloth. The factory owners then have to

reduce their prices to attract more buyers. Economists call this the “law of supply

and demand.”

4. Additional innovative divisions of labor, maybe brought on by new machinery,

motivate others to invest in more factories. But they must compete to hire more

workers. The “law of supply and demand” applies here, too, and wages go up.

5. Higher wages lengthen the lives of workers and their children. The population

grows, which increases the supply of workers. Wages then stop rising. But, soon

another division of labor wave occurs, producing more economic growth and the

need for even more workers. Wages go up again. The cycle repeats itself.

6. Families now can afford to buy (demand) more cloth and lots of other products.

The factory owners make more profits. Everybody wins and society as a whole

improves.

7. The cloth factory owner never intended to improve society; he just wanted to

make money for himself. But his self-interest, as if “led by an invisible hand,”

resulted in the betterment of all. As Adam Smith himself put it, “By pursuing his

own interest he frequently promotes that of the society more effectively than

when he really intends to promote it.”

Questions:

1. According to Adam Smith, what are the advantages of capitalism over communism to the citizens of the country?

2. Briefly describe how supply and demand affect prices. Is this the same for capitalism and communism?

3. Which of our philosophers (Locke, Rousseau, Hobbes, Montesquieu) would agree with many of the ideas of Adam Smith? Why?