Famous Economists and their Theories:

Adam Smith and His Invisible Hand of Capitalism

Adam Smith, a Scot and a philosopher who lived from 1723 to 1790, is considered the founder of modern economics. In Smith's time, philosophy was an all-encompassing study of human society in addition to an inquiry into the nature and meaning of existence. Deep examination of the world of business affairs led Smith to the conclusion that collectively the individuals in society, each acting in his or her own self-interest, manage to produce and purchase the goods and services that they as a society require. He called the mechanism by which this self-regulation occurs “the invisible hand,” in his groundbreaking book, *The Wealth of Nations*, published in 1776, the year of America's Declaration of Independence.

While Smith couldn't prove the existence of this “hand” (it was, after all, invisible) he presented many instances of its working in society. Essentially, the butcher, the baker, and the candlestick maker individually go about their business. Each produces the amount of meat, bread, and candlesticks he judges to be correct. Each buys the amount of meat, bread, and candlesticks that his household needs. And all of this happens without their consulting one another or without all the king's men telling them how much to produce. In other words, it's the free market economy in action.

In making this discovery, Smith founded what is known as classical economics. The key doctrine of classical economics is that a *laissez-faire* attitude by government toward the marketplace will allow the “invisible hand” to guide everyone in their economic endeavors, create the greatest good for the greatest number of people, and generate economic growth. *Laissez-faire* is an economic environment in which transactions between private individuals are free from government restrictions; the only government regulations in place exist to protect property rights. Smith also delved into the dynamics of the labor market, wealth accumulation, and productivity growth. His work gave generations of economists plenty to think about and expand upon, and established basic principles that underly Capitalist economic systems today.

Karl Marx: It's Exploitation!

Karl Marx, a German economist and political scientist who lived from 1818 to 1883, looked at capitalism from a more pessimistic and revolutionary viewpoint. Where Adam Smith saw harmony and growth, Marx saw instability, struggle, and decline. Marx believed that once the capitalist (the guy with the money and the organizational skills to build a factory) has set up the means of production, all value is created by the labor involved in producing whatever is being produced. In Marx's view, presented in his 1867 tome *Das Kapital* (*Capital*), a capitalist's profits come from exploiting labor—that is, from underpaying workers for the value that they are actually creating. For this reason, Marx couldn't accept the notion of a profit-oriented organization.

This situation of management exploiting labor underlies the class struggle that Marx saw at the heart of capitalism, and he predicted that the struggle would ultimately destroy capitalism. To Marx, class struggle is not only built into the system—because of the tension between capitalists and workers—but also intensifies over time. The struggle intensifies as businesses eventually become larger and larger, due to the inherent fact that it becomes cheaper for businesses to produce ever larger quantities of the same product. Ultimately, in Marx's view, society moves to a two-class system of a few wealthy capitalists and a mass of underpaid, underprivileged workers. Marx predicted the fall of capitalism and movement of society toward communism, in which “the people” (that is, the workers) own the means of production and thus have no need to exploit labor for profit. Clearly, Marx's thinking had a tremendous impact on many societies, particularly on the USSR (Union of Soviet Socialist Republics) in the twentieth century.

In practice, however, two events have undermined Marx's theories. First, centrally planned economies have proven far less efficient at producing and delivering goods and services—that is, at creating the greatest good for the greatest number of people—than capitalist systems. Second, workers' incomes have actually risen over time, which undercuts the theory that labor is exploited in the name of profit. If workers' incomes are rising, they are clearly sharing in the growth of the economy. In a very real sense, they are sharing in the profits.

While Marx's theories have been discredited, they are fascinating and worth knowing. They even say something about weaknesses in capitalism. For instance, large companies do enjoy certain advantages over small ones and can absorb or undercut them. In addition, income distribution in U.S.-style capitalism, which is a “purer,” less-mixed form of capitalism than that of Europe, can *tend* to create a two-tier class system of “have's” and “have not’s.”

Keynes: The Government Should Help the Economy

John Maynard Keynes, a British economist and financial genius who lived from 1883 to 1946, also examined capitalism and came up with some extremely influential views. They were, however, quite different from those of Karl Marx and, for that matter, Adam Smith. In 1936, he published his *General Theory of Employment*, *Interest*, *and Money*. Keynes' theories mainly involve people's likelihood to spend or to save their additional money as their incomes rise, and the effects of increases in spending on the economy as a whole.

The larger significance of Keynes's work lies in the view he put forth about the role of government in a capitalist economy. Keynes was writing during the Great Depression. It's worth noting at this point that in the United States unemployment reached about 25 percent and millions of people had lost their life savings as well as their jobs. Moreover, there was no clear path out of the depression, which led people to seriously question whether Smith's invisible hand was still guiding things along. Was this worldwide collapse of economic activity the end of capitalism?

Keynes believed that there was only one way out, and that was for the government to start spending in order to put money into private-sector pockets and get demand for goods and services up and running again. As it turns out, President Franklin D. Roosevelt gave this remedy a try when he started a massive public works program to employ a portion of the idle workforce. Keynes' main points were as follows: 1) Interest rates should be reduced as far as possible to encourage private companies to invest more money. 2) A progressive tax system should be used to spread income from the wealthy to the lower paid. 3) The government should actively invest and spend money in the economy in order to stimulate it, should the economy prove unable to maintain full employment. The validity and desirability of Keynes's prescription for a sluggish economy—using government spending to speed the economy up—are still debated today.

Keynesian economics is an approach to economic policy that favors using the government's power to spend, tax, and borrow to keep the economy stable and growing.

There are many influential economists. However, Adam Smith, Karl Marx, and John Maynard Keynes (later Lord Keynes) are widely recognized as the most influential—Smith because he founded and formalized the science of economics, Marx because he challenged capitalism and had such a forceful impact on society and politics, and Keynes because he prompted new practices as well as new theories in the world of economic policy.

Hayek vs. Keynes

The confrontation between John Maynard Keynes and his Austrian born free market adversary and friend, Friedrich August von Hayek, is one of the most famous in the history of economic thought. The debate took place during the Great Depression of the 1930s about the causes and remedies of business cycle downturns in market economies.

Most of Hayek's work in the 1930s and the 1940s focused on the Austrian theory of business cycles. He believed that the price system of a free market was an efficient mechanism to coordinate people's actions, and that markets were a result of spontaneous order that had evolved slowly over a long period of time, as a result of economic exchanges between people. Hayek believed that markets were highly organic, and any interference with the spontaneous order of free markets would distort their efficient operation. On the other hand, Keynes' economic theory was more mechanistic, as economies could be manipulated in a machine-like fashion to behave according to the wishes of economic planners.

It was Keynes' view that when free markets were left to their own devices, this sometimes caused economic slumps, and that decisive government action was needed to pull the economy back to an equilibrium state of full employment, as heresy. In contrast to Keynes, Hayek thought that free markets, driven by people's choices tended to adjust to normalcy if left alone, and if left free from government intervention. Hayek's 1944 book 'The Road to Serfdom' was about the dangers of socialism. This book was written after Hayek moved to Britain where he observed that many British socialists were advocating some of the same policies of government control that had been advocated in Germany in the 1920s right before the Nazi take-over. His basic argument was that government control of people's economic lives was a form of totalitarianism. The book became a best seller in the USA and it established Hayek as a leading classical liberal, or 'libertarian', as he would be called today.

Sources:

The Complete Idiot's Guide to Economics © 2003 by Tom Gorman

http://www.econlib.org/