

# Sample research paper on are smith, leon and keynes contributions relevant in tod...

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## **Is Smith, Leon and Keynes Contributions Relevant in Today's Market Concept?**

### **Abstract**

This study involves studying, investigating, and analyzing various economic theories, how they relate to each other, and their relevance to modern market concept. The contributions of economic thinkers like Adam Smith, Leon Walras, David Ricardo, John Stuart Mill, Thomas Malthus, Jean-Baptiste Say, and John Maynard Keynes played a lot on what we have today. As the world of market and economics continues to be more complex, some of the ideas of these great economists have ceased to be operational. It all started with classical economics. The Era of "The Wealth of Nation" by Adam Smith in 1776 marks the classical economics beginning. It mainly focuses on the division of labor and free market. In 1870, neoclassical economics replaced classical economics. During this era, Leon Walras explained the concept of general equilibrium through utility maximization and the relationship between supply, demand, and commodity prices. All these took a new dimension in 1930s after John Maynard Keynes introduced the concept of government spending. The aim of John Maynard is to show the effects of government expenditure on output and expenditure.

### **Introduction**

Adam Smith, John Maynard Keynes and Leon Walras analyzed market concepts in different ways. Since then, a lot has changed due to the invention of modern ideas of operating modern markets. These economic thinkers must have predicted the future of the market but maybe not exactly

to what we have today. The paper focuses on their different market analyses, and later on discusses how their contributions are relevant in today's business concept.

- Adam Smith

Adam smith has contributed much of what we know today. Even though he died about 223 years ago, his thinking on how market forces work is still a huge impact on the today modern markets. As the father of modern economics, Smith is among the most prestigious thinkers in the economics.

In “ The Wealth of Nations” Smith puts more emphases on the theory of division of labor and specialization. To him, this theory is the main determinant of economy growth. To put this theory in the work, Adam explained his division of labor point using a pin factory. In the absence of specialization, the pin factory would produce only a few pins per day.

However, if the same factory would break down large and complex jobs into many different components, and each person is specialized to their individual components, the number of pins produced per day would be tens of thousands. Every business, whether small or big, no matter its stage of development, can greatly increase its productivity only if it practices the concept of specialization (Tocqueville 460).

Three reasons of division of labor lead to productivity increase. First, when workers do one the same task for long, they become so skilful in their areas of specialization, thus increasing their efficiency (Smith 13). Secondly, when one divides labor according to specialization, less time is required (Smith 13). In the absence of division of labor, it is difficult for one to move from one task to another so quickly. Sometimes, these tasks do not only require

different skills and tools, but are to be carried on in different places. Lastly, specialization facilitates innovation of different machines and new ways of doing different tasks. These innovations contribute to efficiency and time saving. Most products have to pass through different processing stages to attain the required shapes and standards. Each of these different stages requires different machines. A high degree of cooperation is mandatory between all individuals and bodies involved in the whole process (Smith 22). The ability for one to trade their production is what contributes to division of labor. Smith stresses that, what determines the profession of an individual is not natural talents but custom, education and habit. Even in today's society, most people are engaged in the activities that, in one time of their lives, they had to gain some knowledge and experiences. The concept of division of labor would be impossible if people did not engage in trade. In the absence of division of labor, one has to possess many different skills and talents to sustain their lives.

However, the market extent determines division of labor. Through exchange of commodities, one can specialize in their tasks, and at the same time acquire a wide range of commodities and services. Big markets facilitate labor division more than small ones. Since the division of labor increases with productivity, a large market is required for consumption of the increasingly produced commodities. One way of increasing specialization and division of labor is to minimize barriers to exchange. In addition, in rural areas, division of labor must be limited due to lack of big markets required to absorb different commodities produced. This problem has discouraged industrial improvement in these areas.

In Adam Smith "invisible hand" principles of the free market, the quantities of the commodities available in the market and their demand regulate their prices (Smith 56). In addition, for demand and supply forces to control the prices of different commodities, government intervention should be discouraged. People should be free to trade on what interests them. Smith's market analysis is never complete without mentioning his views on the source of commodity value. The source of a commodity is never derived from its price but from the amount of labor required to purchase it. For example, the price of diamond metal is much higher than that of water. In theory, we expect water to cost more than the diamond since it sustains life. Diamond is not a necessity for life. Since the amount of labor required to bring diamond in the market is higher than that of water, the price of the diamond must be higher. The prices of different commodities may fluctuate due to varied reasons, but the amount of labor needed to purchase a particular commodity remains the same.

- Leon Walras

Leon Walras marks the era of neoclassical economics. Other economic thinkers in this era were William Stanley Jevons, Bates Clark, and Carl Menger. In his "Element of Pure Economics" Leon Walras attempts to explain the use of neoclassical economics theory in the economy. In his general equilibrium theory, Leon uses a series of simultaneous equations to show how to come up with equilibrium prices and amounts of commodities. Even though he was unable to prove this in the real life, he at least took the first major steps.

General equilibrium theory seeks to show the behavior that exists between

prices, demand, and supply, through interactions of different markets in the whole economy. It seeks to explain how different prices of different commodities in the economy relate to the amounts of goods and services supplied and demanded. Leon simulates an artificial market in which prices were set and people in the market would decide on how much of the commodity they were willing to supply or to demand at that price. If the supply exceeded demand, the average prices of commodities would be lowered up to equilibrium (mark 262). In his General economic theory, Leon claims that, all the time, people are aiming to move from their present level of satisfaction to a more satisfying level (Beinhocker 30).

Realizing it was impossible to integrate non-competitive elements into his approach (Walras 256), and perceiving that competition was omnipresent in any business activity, Walras based his argument on free competitive markets. He assumed that natural resources, the number of workers, technology and preferences were constant. To explain his approach, Walras formulated four theories: capital formation and credit, money and circulation, production, and exchange theory. Before formulating these theories, he had to study the free competitive market structure. He had to identify the players in this market, their economic activities, their aims and objectives, and the goods and services they traded. In addition, he would study the relationship between supply and demand, and the rules of this market. He also was to study how the market would adjust itself during periods of disequilibrium (Walras 84).

#### - The Theory of Production

In this model, Leon's main aim was to determine the productive services

equilibrium prices. To formulate this theory, he was to first identify the market of productive services, where he assumed that the amount of available resources together with their services were constant. In this model, entrepreneurs were the ones who demanded productive resources. The main aim of these entrepreneurs was to maximize utility through maximizing their profits. The next step was to find the technical coefficient of production through combining productive services with resources. The coefficient determined the amount of inputs required to produce one unit of output. With given productive services prices and a fixed coefficient, the final output would vary but the average costs required to produce the output remained constant. The workers, the natural resource owners such as proprietors, and the capital goods owners such as capitalists supplied the productive services (Walras 214). Walras argues that entrepreneurs' roles determined the success of this market since they were able to determine the profitability of differently produced commodities. The entrepreneurs would also buy unfinished goods, productive services and raw materials, and later sell finished goods to consumers (Walras 426).

#### - The Theory of Exchange

Walras formulated this theory to determine the equilibrium amounts of different commodities and their equilibrium prices. This model never used money, but instead, it involved an exchange between commodities. Brokers, wholesalers, retailers, entrepreneurs, traders and agents were the participants. The theory states that demand and supply relate to each other reciprocally (Walras 96). In his theory of references, Walras points out that the main aim of traders is to maximize their utility, and that utility is

independent. He also points out that the marginal utility decreases with the quantity of a particular commodity consumed. In 1872, with the help of Antoine Paul Piccard, he developed a utility maximization model, which explained the relationship between market behavior and utility (Jaffe 309).

#### - Capital Formation and Credit Theory

Walras formulated this theory to examine what determines prices of land. The ratio between the rate of net income and the gross income determined the price of land (Walras 309). In addition, the research shows that the land aggregate supply is perfectly inelastic (Walras 309). The model calculates the price of a worker by subtracting the cost of replacing him from his gross income, and then dividing the result with the net income rate.

In capital goods production, entrepreneurs would acquire more of those capital goods whose returns are relatively higher as compared to those capital goods that have lower returns. The model states that all capital goods net rates tend towards equality (Walras 273). The increase in profit from production of capital goods does not only motivate entrepreneurs to enter into the industry but also facilitates those already in it to increase their production. The result is an increase in production services prices, which then makes the cost shift toward equality. During losses, entrepreneurs lower production. The result is a decrease in production services prices, which then lowers costs towards equality (Walras 272).

#### - John Maynard Keynes.

In his book "The General Theory of Employment, Interest and Money" Maynard formulates the Keynesian Economic theory. He strongly disagrees with some of the neoclassical and classical economics theories. His work



coincided with the Great Depression, which occurred in 1930s during the World War II. He based his argument on the effects total spending has on inflation and output. Unlike classical economics that focused on aggregate supply, Keynes put his focus on aggregate demand. In addition, he did not put his focus on flexible prices, but instead he focused on potential rigidities in price. In the labor market, Keynes argues that since machinery lay idle due to lack of customers, workers remain unemployed. In the output market, Keynes focuses on consumption spending. To him, the primary households' spending determinant is income, but not interest rates as pointed out by classical view. He introduces Marginal Propensity to Consume (MPC) concept that explains the relationship between income and consumption. MPC is the change in consumption due to a unit change in income (Haavelmo 107).

If the investment is lower than saving, recession occurs. If the investment is higher than saving, the economy experiences inflation. During the economic depression, government should discourage savings but encourage spending. To facilitate spending, the government should borrow money and push it into the economy. In addition, when some people spend and others earn, they create a cycle that improves the economy. During World War II, when the great depression hit Europe, people made a huge mistake of holding money. By doing so, they stopped the circulation of money, which put their economy at a standstill.

During periods of depression, the government should also stimulate the economy through lowering interest rates. When the government reduces interest rates that the central bank lends funds to local banks, it expects the local banks to do the same to their customers. In classical economics, supply

of funds determines the amount of investment for fixed business. Since people keep their savings in banks for investors to borrow, the amount saved in banks determines the amount available for investment. However, in Keynesian Economics, both long-term profit expectations and interest rates determine the amount of investment.

Keynesian economic theory also goes contrary with earlier economists, who claimed that to restore full employment; employers should cut on their employees' wages. The saved money would be used to employ more employees, which would increase the amount of goods produced. The action would only make the matter worse, since an increase in production would make the supply increase.

Unlike Adam's theory, in Keynesian model, for effective economy management, active government policy is required. Market forces alone are unable to determine prices of different commodities, leave alone the amount of commodities supplied and demanded. The government should solve these problems in the short run, instead of waiting for market forces to try to solve them in the long run. In Keynes' view, even on government intervention, demand and supply would equalize, but would be hard to deliver full employment since economy is subject to instabilities and fluctuations.

Keynes did not leave behind the multiplier concept. He based his argument on fiscal multipliers where he examined the extent at which national income would change due to an increase in government spending. Proposed for the first time in 1930 by Richard Kahn (Snowdon 61), Keynes pointed out that, exogenous spending multiplier resulted from a change in autonomous spending such as government spending, private investment spending, and

consumer spending. The aim was to realize a multiplier effect ratio, which exceeds one. Multiplier effect results from an increase in aggregate output, which results from the initial increase in aggregate demand. Sometimes, the economy may experience a multiplier effect measure less than one. Keynes argues that, during these times, due to market instabilities and fluctuations, an effort to increase spending may lead to an increase in the general price level.

## **Discussion**

Since the days of Adam Smith (1723-1790), John Maynard Keynes (1883-1946), and Leon Walras (1834-1910), a lot has changed in the world of economics. Some of their economic theories are still functional even to today. Theories are becoming more complex each day. Different ways of doing business are evolving. This complexity makes some of these theories not relevant today. For example, Adam Smith advocates a free market with no government intervention. In today's market, we know this is impossible. The Government plays vital roles not only in running of any modern market, but also in facilitating market competition and achievement of national policy objectives. Market infrastructure improvements such as roads and market facilities would be impossible if there were no government intervention. The government is also required to facilitate effective marketing through market information improvement. In addition, any modern market needs the government to provide market security, through protecting contracts and property rights. All these go contrary to the traditional Adam Smith free government intervention approach.

Smith's division of labor concept is still applicable even today. Due to innovation of different complex devices each day, it may be hard for one to be skilled in all areas of the device configuration. With the division of labor, each person requires only to be skilled on a particular part of the whole. A good example is building a vehicle. In most cases, different parts of the vehicle have to be imported from different places. This practice is more efficient, cheaper, and faster than assembling the whole task to one person. Some of Leon's analyses are impossible in today's life. In the world of economics, money circulation determines the future and success of any business. In most of the Leon models, he assumes that money played an insignificant role throughout the general equilibrium analysis. He argues that, during disequilibrium, and particularly during the process of attaining equilibrium, all entrepreneurial activities such as selling, buying, and firms' expansion do not involve any spending. In today's world, it is impractical to assume that processes such as information acquisition, business transactions, controlling demand and supply, and many more can run without spending (Walras 319). In addition, every activity in today's market is subjected to risks and uncertainties. Walras ignored this fact.

Walras claims that, through his approach, he was able to prove that equilibrium existed. In today's world, apart from commodity price, other factors may affect supply and demand of a commodity. These factors include tastes and references, prices of related goods, income, and consumer expectations. Walras assumes that all these factors are constant, and put his argument only on the price of the commodity. For example, an increase in people's income may result to an increase in demand over supply, since they

can know afford more. Walras ignores this fact. Under what circumstances can demand and supply be equal in goods whose prices are zero? Walras was not able to give a definite answer to this question. With all this, it becomes impossible to employ his approaches in real life.

On the other hand, Keynesianism points out that increase in total spending in the economy not only stimulate demand, but also fights inflation and unemployment. Many countries in the world have applied the Keynesian policy to fight the recession. As many have experienced, Keynesian fiscal policy works well in theory than in practice. Since John Keynes times, economies of different countries have increasingly become more and more complex for Keynesianism. For many years, policy makers and economic thinkers have tried Keynesian theory with no success. After the 2003 study of the 91 countries that practiced Keynesian policy, researchers found that these countries experienced macroeconomic instability (Fatas & Mihov 1431).

The main problem facing different countries today is high rates of unemployment. For example, in applying Keynesian Economics, the Obama administration aimed at lowering the unemployment rate to 6% by the end of year 2011. Even after applying this policy, the rate of unemployment is currently at 9%. Do Keynesian policies work? Many have asked this question. However, in my opinion, I think these policies have worked since without them, the rate of unemployment in America would be around 15%. For the state to attain the unemployment rate of 6%, I think it needs to further increase on its spending.

The main reason that makes Keynesianism fail in practice is fear and

expectations among people. When government increases in its spending, people become worried about the future, which makes them hold savings more. The result is signs of recession. Researchers argue that, Keynesian approach can be very difficult in countries with high debt to GDP ratios (Reinhart & Rogoff 576)

## **CONCLUSION**

Each day economic concepts are increasingly becoming complex. Today's economics analysts have tried and proved that some earlier proposed economic theories cannot work in today's market. Even though we cannot ignore the work of earlier economic thinkers, according to how the world is changing, the remaining functional theories might cease to be operational in the near future.

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