Adam smiths contributions to economic theory economics essay

Adam Smith's chief contribution was to build a coherent and logical theory of how the economy works. The elements of Smith's theory were mostly already available in the writings of earlier writers. However, in these writings good ideas coexisted alongside numerous other useless theories. Somebody had to figure out which theories were useful and which were useless and combine the useful theories into a consistent and persuasive overall theory that we can reliably use to think about society. This is what Smith did. For this he is called the father of economics.

His two main works are: The Theory of Moral Sentiments and An Inquiry Into the Nature and Causes of the Wealth of Nations.

Theory of Moral Sentiments. This work was an argument against the views of writers such as Hobbes and Rousseau who argued that the pursuit of self-interest, an important human instinct, inevitably leads to a cruel and nightmarish society. Smith argued that as people are able to imagine what others are going through, they are able to empathize with the sufferings of others. When the experiences of others are felt as our own experience, our instinctive pursuit of self-interest can lead us to pursue the interests of those others. So, it is perfectly consistent to believe that human beings pursue self-interest and are generous towards others.

Sometimes our passions cause us to do bad things. And our instinctive tendency to defend ourselves even when we do bad things leads to a bias that prevents us from seeing that we did something wrong. This problem is partially corrected by the wide acceptance of moral rules in a society. When the moral rules are clear cut, a misdeed may so clearly violate a moral rule that it might be impossible even for the perpetrator to deny the misdeed.

Of course, even moral rules may not be enough, in which case laws and the enforcement of those laws would be necessary to keep society together. However, unlike Hobbes and Rousseau, Smith did not believe that without a structure of laws society would inevitable descend to chaos.

Moreover, apart from the human ability to empathize with the sorrows of others, the sheer practicality of peace-the fact that we realize that it is necessary for prosperity-may be enough to encourage good behavior.

Wealth of Nations. The wealth of nations derives from the level of the technology in use. The level of technology and its rate of improvement depend on the division of labor. Smith discusses three reasons why a greater division of labor may increase productivity. (Smith was unaware, however, that the increasing returns that is associated with the productivity gains from division of labor that are internal to each firm are inconsistent with perfect competition.)

The division of labor is determined by the extent of the market. This creates the possibility of an ever expanding economy. For example, if the extent of the market increases-perhaps because of an expansion of trade within the country or with another country-there will be greater division of labor, which will lead to improvements in the level of technology, which will lead to greater national income, which will lead to another increase in the extent of the market, which will lead to another increase in the division of labor, which will lead to another increase in the level of technology, and so on and on.

However, Adam Smith felt that a scenario in which this growth gradually peters out (with each round of increases being smaller than those of the preceding round) was more likely. Earlier writers had argued that the growth of an economy depended heavily on the luxury spending by the rich; the poor consumed just the bare necessities and, therefore, more would not be produced unless the rich would buy the extra output. Smith argued that this idea was false. If the rich saved any money they would lend it to businessmen (to earn interest). The businessmen would borrow the money and spend it on capital equipment. Therefore, all income would be spent and all production would be purchased. There was no need to encourage luxury spending. In fact, the more the rich saved the greater would be the level of investment by businesses and the faster would be the rate of growth.

Smith was in favor of free trade. He derived his support for free trade among nations by basing it on the obvious desirability of trade among individuals: " It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy". Though Smith is usually thought to have relied on the Theory of Absolute Advantage to derive his support for free trade, this quote shows that Smith's argument in favor of free trade actually relied on the Theory of Comparative Advantage. (It was David Ricardo, however, who later worked out the details of that theory.) According to Smith, free trade not only expanded the extent of the market and, thereby, allowed greater division of labor; free trade also increased productivity by allowing countries to specialize in what they do well. Here he used the Law of Absolute Advantage.

For primitive economies sustained by hunting and fishing, Smith's theory of value was a form of the Labor Theory of Value, which was adopted by all Classical economists such as Smith, Malthus and Ricardo. But when analyzing the industrialized economy of contemporary Great Britain, Smith thought of the ' natural price' (or, long run price) of a product as the cost of all resources used in production and did not seek to reduce the different resources into one resource the way Cantillon had done. (Cantillon's Land Theory of Value had lost favor by then. Ricardo realized, however, that neither labor nor anything else could provide an invariant measure of value.) From today's point of view this theory, which denies the influence of demand and identifies production cost as the only influence on prices, has some validity in the long run but is not useful for short run analysis.

In Smith's view of the workings of the market system, any short-run deviation of the market price from the long-run price would trigger the forces of competition-by which Smith meant profit-seeking entry and loss-avoiding exit-which would eventually take the market price to its long-run level.

Smith's theory of wages was a form of the Iron Law of Wages which held that wages are by and large equal to the subsistence level of wages. (If wages exceed the level that is just enough to keep the worker and his dependents alive, there will be an increase in population that will drive wages down to the subsistence level. If wages fall below what the workers need to stay alive, population will fall and wages will rise to the subsistence level.) This meant that any increase in total output went not to the workers but to capitalists who would save and invest in machinery that would make possible further division of labor and technological progress.

Smith thought of rent as a residual that is leftover after wages and profits had been paid out of total output. Wages would be reduced to the subsistence level, as I said before. Competition will gradually reduce the rate of profit to a low level that would also be uniform across all industries. Therefore, only those who earn rent income would benefit from progress.

Smith’s argument that the pursuit of self-interest can lead to a socially efficient outcome is the crowning glory of the Wealth of Nations. (Even though Cantillon had set out these ideas before Smith, a lot of the credit has traditionally been-and continues to be-given to Smith.)

What economists call the First Welfare Theorem, which emphasizes the role of prices in bringing about an efficient allocation of resources in a free-market economy, is only a part of Smith’s more nuanced view. Referring to a contrast drawn by Smith between the institutional features of the Universities of Oxford and Glasgow and the incentives faced by professors at those two institutions to be good teachers, Smith had emphasized that the consequences of the pursuit of self-interest for social efficiency would depend on the characteristics of various institutions in cases in which the price mechanism is not operative. In this sense, Smith may be considered a forerunner of modern theorists who study the economics of incentives.

Smith was suspicious of businessmen and believed that, given the chance, they would do anything reduce competition among themselves and then form a group to gang up on consumers and charge them more than the competitive price. In this sense, Smith may be considered a pioneer of the modern economic approach to politics.

As one might expect from Smith's conviction that markets were extremely efficient, he was in favor of a government that did not hamper the working of the market. However, Smith emphasized the fact that the government should maintain law and order, ensure the defense of the nation from foreign enemies, erect and maintain public works that private citizens will not build, and subsidize the education of those who could not afford it.