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# Relevance of Adam Smith in the contemporary economy

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## ABSTRACT

***In 1776, Adam Smith, highly regarded as the Father of Economics, presented a notable art in the form of the 'Wealth of Nations'. The book comprehended the economic structure in the society. The purpose of the paper is to examine the four major theories put forward by him and accordingly determine its significance in today's world with the occurrence of various events in the economy. The source of data used was secondary data, thereby accessing various research papers, understanding and relating the news reports of many events. Descriptive and diagnostic method of analysis has been used. The paper shows contradicting views with respect to the theories presented by Adam Smith. Based on the study, the researcher would like to conclude that no relevance was found in the application of the mentioned theories with the current scenario. However, these can always be looked up to.***

***Keywords—*** *Adam Smith, government intervention, red herring, the invisible hand, Keynes, 2008 crisis, subsidies.*

## 1. INTRODUCTION

Adam Smith's wealth of nation is recognized as an economic marvel which reshaped the economy (Naz, 2014) and changed the views of several economists such as the Founding fathers of USA, James Maddison and Thomas Anderson and helped them restructure and establish the former policies of the country (Fleischacker, Oct., 2002). The modern-day capitalism and free trade, that the world functions on, was proposed by Adam Smith. He anticipated a free market economy and which would benefit the individuals and the country as a whole with little or no amount of government intervention. (Naz, 2014)

In this Paper the researcher will broadly address the four major theories of Adam Smith which proved to be a highly debated topic throughout the decades. As mentions earlier, the government intervention formed a major part as Adam Smith wished for a free economy with no regulations and the individuals to look after their own expenditures. Which later derived into a country is a capitalist economy with a free market even in cases of goods and services. Since the services sector was not developed at the time of industrial revolution, Adam Smith had little faith in the service industry. On the contrary, as the industrial sector developed, He also believed that the bounties for the red herring fisheries should not be given as the fisherman were only interested in the bounty and not the actual work. The free economy also stated that there was a presence of an invisible hand which helped the market forces to stabilize itself, this caused another major topic for an argument. (Smith, 1776)

The researcher, with various real-life examples, comparisons of views, Statistical analysis (graphs) has inferred on the postulated theories and its relevance to the present world.

## 2. LITERATURE REVIEW

Adam Smith portrayed a bigger picture, a broader one and only sometimes a narrow. M.P. Paganelli asked why one should read a book that was so outdated as the theories may not even be relevant today. (Paganelli, 2017)

Adam Smith was against the authorities and the government watching the finances of private people and restraining their expense. He believed that they should look after their own, and not of their citizens. He viewed a policymaker who tried to intervene in the economy with skepticism. He supposed that authority who guide people attract unrequired attention, assume authority and fancy themselves (Smith, 1776). Skousen, M in his paper wrote that Adam Smith supported a limited role for government. The government, by restraining itself from regulating the economy, stay away from the ideal path. This decides how much the government is following his ideals. (Skouzen, 2001) . Adam Smith, however. Approved of government-operated enterprises, in the case of the postal service. Yet, Adam Smith's theory was criticized stating that the supporters of Government intervention argue that the monopoly was rampant in capitalism and its elimination could take efforts. Oppositions argued that free market restricts monopoly, but government supports it and is made possible only through government's power. (Hetzel, 1894)

Adam Smith penned that the wages of labor encouraged the industry and people to work. Security, which the laws in Great Britain have given to every man that he must enjoy his hard-earned money, is alone required to develop a country. (Smith, 1776). Adam

Smith noticed that the governments of many countries of the 18th century were wasteful and inefficient. However, according to him, individuals because of their desire to improve their condition are more likely to be economical and oversee carefully their expenditures. To an extent governmental redistribution of income is universally accepted taxes, welfare etc. The current issue was whether the role of the government in determining the distribution of income should be limited or allowed to continue. (Hetzel, 1894)

The bounty to the white-herring fishery is given for the burden of the ship, Smith fears that people are more interested in the bounty more than that of the fish. Public services are done well when their reward does not come in consequence of it being performed and is balanced with the thoroughness employed in performing them. (Smith, 1776) Contrary to Adam Smith views on Bounties, it was later proved in the 18th century that the subsidy program worked in favor of the British economy and created a profitable industry. (Leazer, 2013) Reiser too agreed that the herring itself made the public subsidies system succeed. The 'Grand Shoal' in earlier decades accumulated along the Scottish shorelines, and catches by containers of all sizes increased dramatically. (Rieser, 2017) Smith had argued that the concord between private goals and larger socially required goals promoted by voluntary collaboration between individuals in the marketplace is affected by monopoly and government subsidies. Hetzel protested saying one form of government planning takes place when the government decides to give subsidies to encourage the investment decisions of private individuals. (Hetzel, 1894) Adam Smith did not think highly of the service sector, he did not believe that the service sector could produce as much output as by a factory or a bakery. (Yueh, 2018)

The invisible hand theory – the market forces eventually set its prices of the products in accordance with the demand and supply. And no other external force is needed in order to correct it in case it goes wrong (Smith, 1776) The Wealth of Nations discusses issues that arise out of the irregularities of the national economic planning in which the government instead of the marketplace determines the distribution of income. (Hetzel, 1894) Johnathan Schlefer had lived in Mexico around the 1994 crisis and studied its politics, He saw the absence of an invisible hand as a practical element. (Schlefer, 2012). On the other hand, (Arrow & Debreu, 1954) developed the canonical "general-equilibrium" model. Making assumptions to characterize competitive markets, they proved that there exists some set of prices that would balance supply and demand for all goods. However, no one ever showed that some invisible hand would actually move markets toward that level. It is just a situation that might balance supply and demand if by chance it occurred. (Schlefer, 2012) In Keynes's analysis, to prevent depressions it had to be necessary to prevent speculative bubbles. To do it, it would be necessary to avert too much money from accruing in the hands of too few people. To have that, marginal tax rates would have to be increased. The government would then collect taxes and return that money to the private sector through expenditures. (Yearwood, 2013)

## 3. FINDINGS

Adam Smith postulated his economic theories in Britain during the 1870's. Here we will try to examine whether and to what extent the theories are relevant in today's date.

### 3.1 On government intervention:

The government intervention deals with the actions that are taken by the government to regulate and interfere in the economic, social and financial matters of the individuals, groups, and the society.

The question that arises here is whether the government should intervene in the above matters?

Adam Smith did not fancy the idea of government intervention. He felt that 'the authorities and Government watch the finances of private people and restrain their expense. They should instead look after their own, and not that of their citizens. He viewed a policymaker who tried to intervene in the economy with skepticism. The authority who guide people will get unrequired attention and assume authority and will fancy himself. (Smith, 1776)'

To an extent, an authority is it the government or a body that controls the economy is always needed to ensure the financial security and safety of the fellow residents. For example: Had the US government been more stringent and taken part in the decision making of the federal reserve system, made its policies and rates a little higher. The reserve bank of India cautiously had predicted it and had advised the banks to go slow on the sectors such as real estate and capital markets, is the most sensitive and pricey. The authorities had been aware of the situation in the USA and wanted and tried hard to save the country from it. (Reddy, 2009) It had also asked its foreign banking counterparts to cut down on the transactions with the USA. Banks stopped selling derivatives to help corporate clients to get over difficult situations in currency fluctuations and closely monitored their unhedged foreign currency exposures.

The banks were not regulated and the bill of regulating derivatives which created the whole economic chaos was also rejected. This had an impact on not only the country's citizen's savings and investments but also on the entire world. The International Monetary fund warned the USA government and its federal reserve about the upcoming crisis, every other country saw it coming, but the major banks in the country had influenced the Federal Reserve and the government so much that nothing changed their mind. In September 2008, banks credit-deposit ratio was 73.10%. Since the banks need to keep 4% of deposits with RBI and buy government bonds with 23% of deposits, they needed to garner more deposits to be able to give loans. (Bandyopadhyay, 2013). While on the other hand, the US had its credit-deposit ratio of 100% due to which it had no money left for its contingencies. (Trefis Team; Great Speculations, 2015)

Similarly, had the Iceland government not privatized and de-regularized the banks in 2000, 3 of its major banks named Islandsbanki (Bank of Iceland), Kaupthing Bank and Glitnir Bank, there wouldn't have been terrible consequences to the country. These 3 banks in a matter of 5 years ended up taking loans of $120 billion, 10 times that of Iceland's economy. All this money was used for self-consumption by the bankers and no government body regulated them. After the crisis of 2008, the unemployment rate of Iceland was 3 times bigger than the general rate. Also, almost 1/3rd of Iceland's population worked in the banking sector. After the big three collapsed, the government did not do much to prevent it, no bailouts were offered. The foreign creditors and the investors lost all their money. The 3 banks were then controlled and loaned by the government because they controlled the entire economy of Iceland. (Nguyen, 2017)

Hence, the researcher would like to conclude that the idea of private individuals handling finances was not a very or rather a private firm handling other's finances, because most of the times they were driven by a major motive, greed and do not necessarily protect the interest of the customers. In the situations explained above even the credit rating agencies, on which the people relied upon for the advice on the investments, were merely sharing their opinions and they shouldn't have had completely relied upon it, as it was alleged by various credit rating groups. (Fox, 2011) This may not have had happened if the government too regulated the banks, monitored it, and had overseen the implications of it or had at least taken the suggestions of the world body for financial stability i.e. the International Monetary fund.

Several Economists had shared their theories on Government interventions, below is the table indicating the contrasting views between Adam Smith, Father of economics; John Maynard Keynes, Father of Modern Macroeconomics and The Neo-Classical View which was greatly influenced by the classical Theory.

**Table 1: Comparison of views by Adam Smith, Neo-Classical economists, and John Maynard Keynes**

| Adam Smith's View | Neo-classical View | John Maynard Keynes's View |
|---|---|---|
| Adam Smith did not fancy the idea of government intervention. He felt, 'the authorities and Government watch the finances of private people and restrain their expense. They should instead look after their own, and not that of their citizens. He viewed a policymaker who tried to intervene in the economy with skepticism. The authority who guide people will get unrequired attention and assume authority and will fancy himself'. (Smith, 1776) | The Neoclassical Economists were greatly influenced by the classical economists. They had a significant amount of faith in the market, that it was capable in terms of utilizing and allocating the resources and would produce an efficient outcome. However, unlike the classical economists, the neoclassical economist did not rule out the possibility of oversupply, unemployment, and fluctuations in the economy which caused instability. In such cases, the economy would adjust itself with the help of government intervention in providing sources of instability. (Khan & Aziz, 2011) | The economy may fail to achieve the full employment level due to market fluctuations caused by price rigidity and liquidity trap. Keynes then concluded that state intervention was needed to restore the full employment level which would offset imbalances between the savings and investments. The reasons for state interventions are a) limited knowledge possessed by individuals and b) The rules of aggregate behavior, which can be understood by the state. (Wolff & Resnick, 2012) |

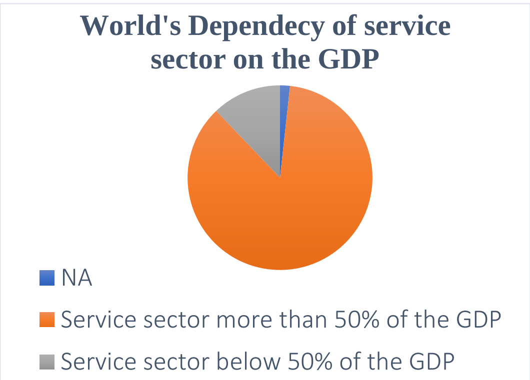
**3.2 Services sector**

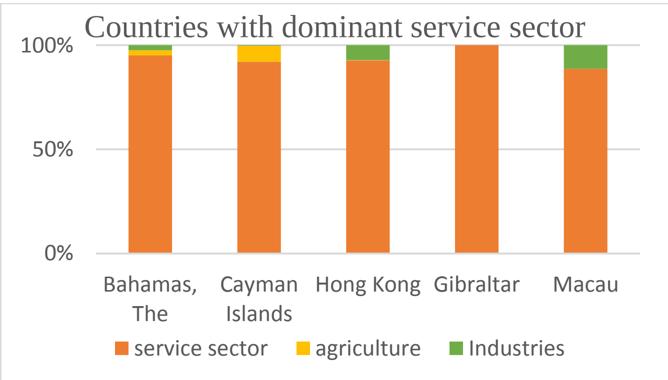
Adam Smith did not think highly of the service sector, he did not believe that the service sector could produce as much output as by a factory or a bakery. (Yueh, 2018)

Adam Smith did not believe that service sector could reap as much as the manufacturing sector and that happened to be the reason for the economic crisis such as The Global recession, Dotcom bubble in 2003, the Asian crisis in 1997 and several financial recessions. What is baffling here is since the 1660s there have been instances of recessions, the Tulip Mania, Dutch financial bubble, which had been the reason behind the first ever financial fallout.

In the days of Adam Smith, the 16$^{th}$ century, the service sector had not flourished much, however, there was one institution which played an important role in the economy, in fact, it controlled the economy. This was the banking sector. It controlled the money flow in the economy. Influenced by Adam Smith's 'Invisible Hand' theory, people started taking control of the banking department and restricted the involvement of the states. The lack of government control and a limited amount of gold reserves caused the banks to wind up.[6] The circulation of the currency, purchasing power of it, and lending to people so they could utilize it, all this money then goes to the industries in exchange for the purchase. The stock market which came into existence in 1792, had a major role to play in the economy. Hence, overlooking the produce of the stock market may not have been the wisest decision. One part of the argument may be verified as said by Linda Yueh that, had there been more manufacturing sectors in the USA, which only comprises on 20%, such a recession could have been avoided as the GDP would not have been dependent on the financial sector alone. However, just like the USA, India too is majorly dependent on the service sector, and yet it was not as affected as compared to the USA. The reason could've been the government's intervention in the financial banking, and every such domain where finance was concerned, apart from the 8% fall in the stock market in a single day.

Below are the Graphs representing the dependency of the services sector on the world's GDP.




*Source: Central Intelligence Agency – The world factbook (CIA, 2017)*

**3.3 Red herring**

The bounty to the white-herring fishery is given for the burden of the ship, Smith fears that people are more interested in the bounty more than in the fish. (Smith, 1776)

Adam Smith argued that the fishermen of the redfish herring are more interested in the bounty than in actual fishing. By the statement what he meant was; Incentives, bounties, bonuses are given to a producer/employee may prove to be ineffective as they may be more interested in the incentives and may not be as productive as expected.

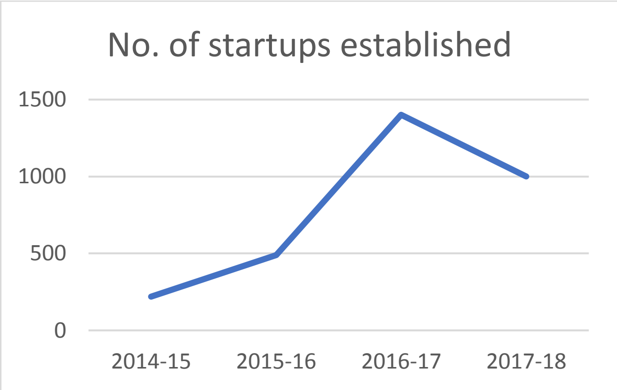
Due to uncertainties, it may happen that that bounty could be the reason for the sustenance of those fishermen, or any other worker or an employee for that matter. For instance, the researcher would like to take the case of farmer's plight in Maharashtra and many more states in India. They faced huge problems which resulted in thousands of farmers taking their lives due to the burden of high debt which was a result of their crops being destroyed on a large scale due to unpredictable weather and poor rainfall. Droughts, inadequate pricing policies, and poor water management have affected agriculture in the state (online, 2018). This compelled a lot of farmers to borrow money from either banks or money lenders, who exploited them. This was the major reason why a lot of farmers were bankrupt. The only incentive they had was either subsidies or if the government waived off the loans. Now in this situation asking for a bounty is like asking for one's life. It would have been fair if the farmers had gone for the bounty other than farming as survival is more important than production in such cases.

Another example that the researcher would like to present is that of the Sweden fisheries case and the British fisheries industries, as researched by (Rieser, 2017) and (Leazer, 2013) respectively. There has been a significant improvement in the productivity of their fisherman, they performed even better than those who weren't given any incentive.

Another research conducted was how the group incentives to the teachers influenced students' achievements. This empirical study was published between 1990 and 2011. According to the study, the group incentives had a higher magnitude of positive effect in the developing countries compared to that of a developing on. Moreover, the individual incentives given to the teachers had more effect compared to group incentives. However, there is insufficient research on the differences that arose between the group incentives and Individual Incentives, but in both the cases, it is expected to show a positive result. (Tirivayi, Brink, & Groot, 2014)

Another case the researcher would like to present is that of the Start-Up ecosystem scheme which was launched by the Indian Government on 16th January 2016 with the aim of making India a country of job creators and not of job seekers. (Start Up India - Best Practices). However, the government started funding for equity to encourage new startups formed by the skilled youth in 2014, it provided Rs. 10,000 crores. It allotted 1804 crores for the year 2017-18. (Union budget, 2014; 2017) By 2017. With more than 5000 as its startup base, India had proved to be the world's third largest. (NASSCOM) And is also the world's 3rd tech innovation leader. (Mostowyk, 2018)

Below is the data of a number of start-ups launched in India after the required funding and encouraging the skilled youth to take part in it.




*Source: Nasscom startup report (NASSCOM, 2015; 2016; 2017)*

Hence, the researcher would like to conclude by saying that a little bit of help in the form of incentives or subsidies goes a long way. It can lead an entire generation to touch the heights of success and prosperity.

**3.4 The invisible hand**

The invisible hand theory – the market forces will eventually set prices of their products in accordance to the demand and supply. And no other external force is needed to correct it in case it goes wrong. (Smith, 1776)

Invisible hand states that in everything, the prices are set on their own. This may not be true because, during the times of excess demand and excess supply, the government sets the floor price and the maximum and minimum retail price as to safeguard the buyers. This is needed to protect both the consumers and the manufacturers. A lot of economists don't really believe in this theory and deduced it of being a mere coincidence like in Mexico where there was no proof of the presence of an invisible hand.

In cases such as the great depression, the dot-com bubble, the 2008 crisis and all the financial crisis that took place, in none of the situations where the prices products, in this case, stocks were adjusted in accordance with the general equilibrium.

Another example that the researcher would like to give is that of Venezuela's recession that has been going on since 2014, and the Inflation is expected to increase to 1 million percent according to the IMF. In such a situation only, external factors such as lack of government policies and oil production crisis caused the economy to go in splits, it's been 4 years and there has been no sign of invisible working to its place in order to balance out the economy.

Below is the comparative study of various economists who have either praised the theory of Invisible hand or have heavily criticized it. This was presented in the book 'The Big Three Economists' by Mark Skousen (Skousen, 2007)

| Praises | Criticisms |
|---|---|
| 1) It improves the lives of the citizens. (Bush, 2002) | 1) It is an invisible foot that crushes people's hopes and their dreams. (Shleifer & Vinshny, 1998) |
| 2) The Individual hand works in harmony, it is a major intellectual achievement. This leads to growth in the output of goods. (Hahn, Reflections on the Invisible Hand, 1982) | 2) Frank Hahn declared that there is a lively sense of original sin that is inherent in a society made up of self-seeking and greedy people. (Hahn, 1982) |
| 3) Milton Friedman found Adam Smith's vision to be highly sophisticated and a subtle sight, for the ways voluntary actions of the individuals could be coordinated through price system and without a central direction (Friedman, 1978; 1981) | 3) According to Keynes, individuals by themselves or as a social unit did not possess the natural liberty to optimize the economic activities. (Keynes, 1951 [1931]) |
| 4) William Baumol and Alan Blinder felt that the invisible hand had an astonishing power to handle a coordination problem of massive proportions. (Baumol & Blinder, 2001) | 4) Paul Samuelson could understand the theories by Keynes, he said: Keynes denied the presence of an invisible hand which channeled the self-centered actions of each person to an optimal level, this was said with respect to the level of total purchasing power and employment. (Samuelson, 1947) |

## 4. CONCLUSION

The researcher would like to conclude that in the theories stated above, Government intervention, Services sector, Red herring Fisheries and the invisible hand do not hold any relevance in today's world. These theories were written at the time of Industrial Revolution and have proven to be outdated.

Government interventions and regulations have become a necessity in order to safeguard the finances and interest of the citizens and that of the economy too. As Keynes stated that the government intervention is needed to balance the market fluctuations that arise due to the disproportionate nature of demand and supply of the goods, services and the monetary aspect.

The service sector has become the source that contains the major part of the country's GDP and people's source of income. The advent of the internet and the information technology has completely overtaken the economy in the services form. Although back in the days this was not present, and goods were majorly traded. However, over the time, the service sector has shown a great significance in the economy. The economy is basically running on it, though not technically. A country such as Gibraltar runs 100% on the services sector. Hence, it should not be underestimated.

Subsidies form a larger part of motivation among people to work effectively, not only are they satisfied but also their behavior towards other and their work productivity is improved.

The invisible hand has shown no significance in the economy. After the various crisis, recessions and economic turmoil such as the great depression, 2008 crisis, the Asian crisis, and present-day Venezuela economic breakdown, nowhere can the presence of the invisible be seen.

Hence, I would like to conclude by writing that the above theories are no more relevant, and we must rely on, study and look up to the neoclassical theories. But at the same time refer to the theories of Adam Smith as they make up the base for all the theories that were theorized after the classical period and especially now at the neo-classicalism, where the demand-supply equilibrium forms a major base.

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