

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. Deep examination of the world of business affairs led Smith to the conclusion that collectively the individuals in society, each one 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 occur “the invisible hand,” in his groundbreaking book, *The Wealth of Nations*, published in 1776.

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.

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. Smith also delved into the dynamics of the labor market, wealth accumulation, and productivity growth.

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 abide 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 that struggle would ultimately destroy capitalism. To Marx, class struggle is not only inherent in 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 efficiency of large outfits and their ability to withstand the cyclical crises that plague the system. 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, in socialist, 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, as we will see in *Wealth and Poverty*, 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 Out 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*. They mainly involve people's propensity 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. 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. A Keynesian is an economist or other believer in Keynesian economics.

The validity and desirability of Keynes's prescription for a sluggish economy—using government spending to prime the pump—are still debated today.

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. Keynes also played a key role in the founding of the International Monetary Fund and in other political economic measures taken at the end of World War II.