



ADAM SMITH

(5 June 1723 – 17 July 1790)

Adam Smith was a Scottish moral philosopher and a pioneer of political economy. Smith is best known for two classic works: *The Theory of Moral Sentiments* (1759), and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). The latter, usually abbreviated as *The Wealth of Nations*, is considered the first modern work of economics. Smith is cited as the "father of modern economics" and is still among the most influential thinkers in the field of economics today. His contributions are as follows:

'Invisible Hand' or Individual Self Interest

! Very Popular Question!

In economics, the *invisible hand of the market* is a metaphor to describe the self-regulating behaviour of the marketplace. Individuals can make profit, and maximize it without the need for government intervention. It has come to capture his important claim that individuals' efforts to maximize their own gains in a free market may benefit society. Smith assumed that individuals try to maximize their own goods (and become wealthier), and by doing so, through trade and entrepreneurship, society as a whole is better off. This supported his belief in a free enterprise system as the best form of economic systems i.e. a laissez-faire system.

Labour Theory of Value

The labour theory of value suggests that goods which take the same amount of time to produce should cost the same. Opponents of the labour theory of value imply that it is not labour that determines the price of a good or service; it is simply supply and demand for a given good or service that determines its price. According to the theory, if the cost of purchasing something is greater than the amount that the purchaser values the time it would take to produce the good, then he will make it himself rather than buy it.

Canons of Taxation

! Very Popular Question!

1. Economy – the cost of assessing and collecting a tax should be less than the amount being collected.
2. Equity – a tax system should take into account a person's ability to pay.
3. Certainty – The amount of tax payable should be certain (e.g) tax bands
4. Convenience – Tax should be taken at a convenient time and manner for the taxpayer.

Division and Specialisation of Labour

Growth, according to Smith, is rooted in the increasing division of labour. This idea relates primarily to the specialization of the labour force, essentially the breaking down of large jobs into many tiny components. Under this regime each worker becomes an expert in one isolated area of production, thus increasing his efficiency. The fact that labourers do not have to switch tasks during the day further saves time and money

Perfect Competition

Perfect competition is the underlying assumption of Adam's Smith's treatise on capitalism. The view that free markets (with freedom for new producers to enter the market) are well suited to the allocation of labour and resources, because it ensures that people will adjust their behaviour to produce what is most in demand and least supplied. In other words, market price is determined by demand and supply.

Free Trade

Smith advocated international free trade unhindered by the imposition of tariffs so that markets could operate efficiently and allow the gains from free trade to spread between nations. This theory evolved from his specialisation of labour theory as those countries that specialise in one industry, should trade for their other needs.

EXAM QUESTIONS ON SMITH

2013 SQ.7

Outline four contributions of Adam Smith to economic thought. (17 marks)

(a) The pursuit of self-interest

This best benefits the individual and hence best benefits society.

(b) The Division of Labour

Increased productivity and increased country's wealth.

(c) Labour Theory of Value

The value of a product was equal to the amount of labour that went into producing the product.

(d) State protection of property rights

Encourages the accumulation of personal wealth.

(e) 'Invisible hand of competition'

Allows a self-regulating market to operate thus ensuring economic progress is achieved.

(f) Perfect Competition

Free entry into markets; profits sufficient to reward entrepreneurs; inefficiency penalised and price based on the cost of production. Monopolies would not persist.

(g) Laissez-faire / Limited government intervention

Except for defence/justice.

(h) Canons of Taxation

To fund the state's defence/justice systems taxation was necessary and he developed the four principles of a fair tax system: equity, economy, certainty and convenience.

(i) Paradox of Value

He distinguished between 'value in use' and 'value in exchange'. Some items had an immense utility (i.e. air, water) but are not exchanged, while others (i.e. diamonds) possessed little utility but could command a great value in exchange.

(j) Advocated Free Trade

He advocated international free trade unhindered by the imposition of tariffs so that markets could operate effectively and allow the gains from trade to be spread between nations.

5+4+4+4

2007 Q.4 (C)

In the case of any TWO of the following economists, outline TWO contributions which each one has made to the development of economic ideas: Adam Smith, Alfred Marshall, Keynes, Milton Friedman (20 marks)

Adam Smith

(a) The pursuit of self interest

This best benefited the individual and hence best benefited society.

(b) Division of Labour

Increased productivity and a country's wealth. His example - the manufacture of pins illustrated the benefits of the division of labour.

(c) Labour Theory of Value

The value of an item was equal to the amount of labour that went into producing the product.

(d) State protection of property rights

Encourages the accumulation of personal wealth.

(e) 'Invisible hand of competition'

Allows a self-regulating market to operate thus ensuring economic progress is achieved.

(f) Perfect Competition

Free entry into markets; profits sufficient to reward entrepreneurs; inefficiency penalised and price would be based on the cost of production. Monopolies would not persist.

(g) Laissez-faire

No justification for government intervention in the economy except for defence/justice.

(h) Canons of Taxation

To fund the state's defence/justice systems taxation was necessary and he devised the four principles of a fair tax system: equity, economy, certainty and convenience.

(i) Paradox of Value

He distinguished between 'value in use' and 'value in exchange'. Some items had a vast utility (air, water) but are not exchanged, while others (diamonds) possessed little utility but could command a great value in exchange.

(j) Free Trade

He advocated international free trade unhindered by the imposition of tariffs so that markets could operate effectively and allow the gains from trade to be spread between nations.

10 Marks

2006 Q.5 (A)

Among Adam Smith's contributions to economic thought, were his Canons of Taxation.

(i) State and explain Adam Smith's FOUR Canons of Taxation.

Equity - Takes a higher proportion of income in tax as income rises **Or** The ability of each person to pay the tax must be taken into account.

Economy - The revenue collected should exceed the costs of collection. The costs of tax collection should be small relative to the yield.

Certainty - The amount paid should be certain and clear/not arbitrary.

Convenience - The tax should be collected in a way and at a time which suits the taxpayer / the method and timing of the tax should suit the taxpayer.

16 marks: 4 canons at 4 marks each graded.

(ii) Do you consider that these Canons are useful for analysing the taxation system in Ireland?

YES = 1 mark

Use the Canons to illustrate your answer

Equity

With PAYE, people on higher incomes pay a greater proportion in tax. One of the accepted functions of taxation is the redistribution of wealth, which is an argument for equity. Highlights that indirect taxes are regressive as a taxpayers' ability to pay is not taken into account.

Economy

If a tax does not collect more than the cost of administering the tax it should not be introduced. This is one of the advantages of direct taxes. One of the arguments against indirect taxation is the complexity of the collection system.

Certainty

The main advantage of direct taxes is that the amount to be collected is clear to the state, thereby helping financial planning. A difficulty of administering indirect taxes is that the amount to be collected is unclear and makes planning by the state difficult.

Convenience

This is one of the justifications for the PAYE system of income tax, where the tax is deducted at source from income. VAT is paid at the time of purchase. If the method of paying and the timing of the tax does not suit the taxpayer it can lead to evasion.

2 reasons at 4 marks each graded.

Candidates must analyse the Irish Taxation system with reference to the Canons.

Or

The candidates could argue: NO – 1 mark and argue as follows:

Besides these canons there are other key principles which could be considered for analysing the taxation system.

Is it possible to evade the tax?

None of the canons help us measure the level of tax evasion, which in Ireland has been a problem.

Does the tax cause a disincentive to work / save or invest?: Should the taxation system cause any of the above then this is a serious difficulty for promoting economic growth.

2 reasons at 4 marks each graded.

2003 Q.8 (C)

Adam Smith, author of 'The Wealth of Nations' (1776) explained the reasons for and benefits of free trade. Outline FOUR other areas in which he made contributions to economic thought.

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(b) The Division of Labour

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(c) Labour Theory of Value

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20 marks: 4 x 5 marks each graded