

## Adam Smith – Creator of the System of Economic Science

**Jemal Kharitonashvili**

*Faculty of Economics and Business, Ivane Javakhishvili Tbilisi State University, Tbilisi, Georgia*

(Presented by Academy Member Avtandil Silagadze)

Adam Smith (1723-1790) is the founder of economics as a science. It is true that the foundation of economic science was laid already in U. Petty, P. Bouguilberry, F. Kenesa and A. In Turgo's works, who formulated some provisions of a theoretical nature and methodological principles important for economic science, but only A. Smith brought all of these into the whole system, and through his studies, economic thought acquired the character of science. A. Smith's special contribution is that, based on his ideas, a new form was given to economic theory as a subject of science. Many things about economic science, as well as about market economy, are known to us from his works. Smith is legitimately regarded as the father of modern economics thanks to his greatest contribution to its formation. A. Smith proposed the principle of the "invisible hand." The "principle of the invisible hand" is important in Smith's work. According to this principle, the driving force of each person is only personal interests, which, in the final analysis, echoes public interests as well. Some economists considered the "invisible hand" policy as a universal mechanism. According to them, it plays a role similar to the Universal Law of Attraction in society. But the concept of freedom in the economy still failed to play the role of the law of universal attraction in the development of humanity. The principle of the "invisible hand" is somewhat opposed by the equilibrium of the American economist-mathematician John Nash. Nobel Prize (1994) and Abel (2014) laureate. According to Nash, market entities should build their strategy in such a way that the result is acceptable to everyone. Such an approach is not only an expression of humanism, the increase in jobs and, accordingly, incomes expands the market and will promote the sale of goods produced by expelling the "invisible hand" (private interests). The latter is a prerequisite for avoiding the crisis, which will be followed by overcoming poverty, reducing crime and increasing the level of civility. © 2023 Bull. Georg. Natl. Acad. Sci.

system, value, "invisible hand", absolute advantage

What is the relevance of A. Smith's ideas? This question is difficult to answer because his thoughts can be understood very broadly today. The reasoning strategy established by A. Smith has not yet been studied. It is these ideas that matter today.

A. Smith was an economist of the pre-Industrial Revolution, the manufacturing period. During that period, new problems of economic thought emerged and it became necessary to revise the previous regulations. The merchants were replaced by the industrial capitalist, whose economic platform

needed justification. Therefore, before formulating his economic theory, it was necessary to free the ground from previous views.

In the light of the industrial revolution, the mercantilist doctrine looked very helpless, its prescriptions and protectionism became a limiting factor for economic initiative. According to K. Marx, "the classicists, such as Adam Smith and David Ricardo are representatives of the bourgeoisie who fought against the remnants of feudal society. They tried to facilitate the establishment of such new economic relations, the development of which would open a wide path for the development of productive forces and give a new impetus to the development of industry and commerce [1].

The bourgeoisie sought the source of wealth in industrial production. Foreign trade was reduced to the service role for industry. Therefore, A. Smith considered mercantilism to be a medieval nonsense. He argued that wealth is not money, but what can be bought with money.

But it must still be said that mercantilism can be considered a necessary stage, because it was motivated to earn money, which was necessary for the establishment of capitalist manufactures.

A. Smith also exposed insubstantiality of physiocracy only regarding the fertility of agriculture and the infertility of industry. A. Smith managed to significantly overcome the sectoral approach to the analysis of economic processes. A. Smith's economic views are based on the idea that the wealth of society is created by human labor spent in the production process.

According to A. Smith, the growth of wealth depends on the productivity of labor, the main factor of which is the division of labor. According to A. Smith, the wealth and reproduction of people depends on the development of the division of labor. According to him, the division of labor is nothing but a form of expression of human tendency to exchange. In the division of labor, he sees the exchange of labor for labor.

A. Smith relates the development of division of labor and exchange of labor to the origin and use of

money. The origin of money A. Smith explained by technical reasons, which is created during the exchange of goods. A. Smith especially singled out the function of a means of circulation. He knew that money is also a measure of value, a means of payment and world money. A. Smith preferred paper money over gold and silver money and considered it expedient to replace gold and silver with paper money.

An important achievement of A. Smith's economic theory is the labor theory of value. In this matter, he continued U. Pete's views. It is to Smith's credit that he determined the value of a commodity by the cost of labor expended on it. He distinguished between the market price and the real price of goods. By the latter he meant value. A. Smith wrote that the word value has two different meanings. Sometimes it represents the utility of an object that comes from owning that object. It also has the ability to exchange for another item. The first one can be called the cost of consumption, the second – the exchange cost.

A. Smith focused on the fact that value is created by the universal public labor spent in the field of material production. This is A. Smith's scientific theory of value. A. Smith pointed out that in the division of labor a person is rich or poor according to the amount of labor he owns or the amount of labor he can buy. Therefore, he argued that the value of each commodity is equal to the amount of labor that it can buy, that is, receive for disposal [2]. By determining the cost of purchased labor A. Smith actually determined the value of a commodity by the ratio of its purchasing power to labor. It's the same as defining the "amount of labor," or rather, wages. In the second variant of this definition, A. Smith defined value by income. According to his definition, replacement value consists only of income: salary, profit and rent ( $v+m$ ). This assertion contradicts the labor theory of value. Instead, it paves the way for a theory of three factors of production (labour, capital and land). This idea was later borrowed and widely used by representatives of the optimistic school (J.B. Say, F. Bastia).

A. Smith defined wage as the price of labor. He considered it a natural remuneration for labor. He did not share the opinion prevalent in the literature of that time that high wages make workers lazy and disincentive to work. A. Smith called for higher wages. He noted that a high salary is an important factor in the growth of labor productivity. The modern American economist, Harvard University professor Gregory Mankiw, is of the same opinion.

A. Smith considered profit to be the portion of income that remains deducted from wages. He pointed out that profit is created by the labor of the worker in all branches of capitalist production wherever labor is expended. Profit is created because the worker works above the norms of working time, more than what is necessary to the creation of the equivalent of his wages. Otherwise, A. Smith understood by profit the balance after deducting rent and interest. In this case, he called profit the income of the functional capitalist. In his understanding, industrial profit is a universal form of surplus value. He considered land rent and the benefits derived by the various classes participating in the appropriation of surplus value to be an offshoot of this.

In A. Smith's theory, surplus value, in whatever form it may be – profit, rent, benefit, is only the result of the labor of the worker. A. Smith rejected the idea that profit is the capitalist's wage for overseeing and managing enterprises. According to him, the amount of profit is determined not by the severity and complexity of the labor involved in supervision and management, but by the amount of capital used in production. A. Smith viewed profit as compensation on the entrepreneur's risk for capital investment.

A. Smith considered capital, on the one hand, as the value that yields a surplus as a result of the exploitation of hired labor, on the other hand, he interpreted capital as a stock of things that are needed for further production, as a stock of means of production. He equated capital with its material carrier, such as the means of production in which labor is accumulated, i.e. means created by previous work. Later, he developed the concepts of

fixed and working capital and extended their operation to all areas of material production.

A. Smith considers the most characteristic feature of capital to be that it brings profit. This is based on the division of capital into basic and working parts. According to A. Smith, "Fixed capital may be used to improve land, to purchase useful machinery and working tools or similar objects which yield income, i.e. profit, without replacing the owner or entering into further circulation. Therefore, such capitals can be called basic capitals". According to A. Smith, fixed capital does not change its owner, remains in his hands and does not participate in circulation. Working capital participates in circulation and provides profit for the owner. "It can be used to grow, recycle or resell products at a profit." The capital thus employed does not yield to its user any income or profit while it remains in his possession or retains its previous form. The products that the merchant has in hand do not give him income or profit until he sells them for money. Money, too, is of less use to him, until he exchanges it again for products.... His capital always departs from him in one form, and it is only by such circulation, that is, by successive exchange by exchange, that capital can give him profit. Therefore, such capitals can be called working capital" [2].

When discussing fruitful and fruitless work, A. Smith argued that labor is productive in every branch of production where it is exchanged for capital, thereby creating profit. Labor that does not exchange for capital, does not create a material product and does not increase the value of commodities is fruitless. Unproductive labor is directly exchanged for income. According to A. Smith, the smaller the number of productive workers in a society, the faster its wealth can increase.

The idea of economic liberalism occupies an important place in the doctrine of A. Smith. A. Smith almost completely rejected the intervention of the state in economic activity and considered economic freedom as the basis of economic policy. He demanded freedom of competition, competitive struggle.

A. Smith assigned the state only those functions (defense of the country, issuing banknotes, etc.) that would play a positive role in ensuring free competition and economic freedom. He attributed the role of the “night watchman” to the state.

Georgian thinker Ilia Chavchavadze shared Smith's idea of economic liberalism [3].

At the end of 19th century, the idea of economic liberalism was transformed and a neoclassical theory was formed (A. Marshall) [4].

In the middle of the 20th century (1948) neoliberalism was formed on the basis of the new historical school and traditional liberalism. This trend is connected with traditional liberalism by the idea of individual freedom [5].

The “principle of the invisible hand” is important in Smith's work. It must be said that the metaphor “invisible hand” is not made by Smith. It is still mentioned in Homer's “Iliad” (from BC to the VIII century). With Horace (65 BC to AD) we find “the invisible hand of the breaker.” From A. Smith's works, the metaphor “invisible hand” appears for the first time in “History of Astronomy” (1751-58) (published 1895). A. Smith cites the “invisible hand” of Jupiter. Roman citizens worshiped Jupiter as a deity. They recognized an “invisible hand” that guided and maintained order in the world, balancing private and public interests.

In Smith's work “The Theory of Moral Sentiments” (1759) we meet the “invisible hand” for the second time. In “The Wealth of Nations” the term “invisible hand” is found only once, in the fourth chapter. In Malthus, D. Ricardo, J. S. Milli, K. Marx's writings, there is not even a reference to the “invisible hand”. Not even in 1876, when the 100th anniversary of “Khal Khta's wealth” was celebrated, was the “invisible hand” mentioned.

The phrase “invisible hand” has become a popular metaphor since the second half of the 20th century. Modern economists attribute the greatest role to the “invisible hand” theory. American economist, Nobel Prize laureate in economics Kenneth Arrow believes that the metaphor of the “invisible hand”

has “really made the smallest intellectual contribution to economic thought” (Arou). According to American economist James Tobin, it is “one of the greatest and most influential ideas in history”.

According to this principle, each person is motivated only by personal interests, which, in the final analysis, also refers to public interests. In his book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Smith described the harmony between private and public interests. A. Smith noted: “Each individual tries to employ his capital in such a way that brings maximum profit. Ordinarily, he does not intend to affect the public interest, nor does he know how much he affects them. The individual strives only for his own safety and benefit; he is guided by an “invisible hand” to ultimately influence what he did not intend. By protecting his own interests, he (individual) often greatly contributes to the prosperity of society, than if he consciously tried to do so”.

The action of the “invisible hand” looks like this: “We get our bread not by the mercy of the baker (Khabazi), but by his selfish interests”. The basis of human cooperation is that everyone considers their actions in accordance with their own interests. Smith argued that “there is no other motivation for economic exploitation in the market, except for self-interest” [6,7].

A. Smith also introduced the concept of “economic man” (*homo economicus*). A. Smith characterizes the “economic man” as a complete egoist who strives for personal enrichment: “He will more easily achieve his goals if he appeals to their (his neighbor's) selfishness and can make them do for him what he asks of them out of self-interest. Give me what I want and you will get what you want. This is the essence of every kind of calling. We do not expect our dinner from the benevolence of the butcher, the brewer or the baker, but from their protection of their own interests. We appeal not to their humanity, but to their selfishness, and we never tell them of our need, but of their usefulness”.

A. Smith made a scheme of operation of the new economic system, in which Western European countries were established at that time. In his opinion, two conditions are necessary for the smooth operation of this system. Freedom from state interference in the economy and freedom of competition.

Human cooperation is based on the fact that all of them act in accordance with their own interests [8]. Smith claimed that there is no other motivation for economic exchange in the market, except for personal interest [5].

Some economists considered the “invisible hand” policy as a universal mechanism. According to them, it plays a role similar to the Universal Law of Attraction in society. But the concept of freedom in the economy still failed to play the role of the law of universal attraction in the development of humanity [2].

The doctrine of the “invisible hand” belongs to an economy in which all markets are characterized by perfect competition. This is a situation in which all goods and services have their own price and are sold in the market. However, no single firm and no single consumer can be too important to influence market prices.

A. Smith discovered an excellent feature of the competitive market economy. Under conditions of perfect competition, the market produces the maximum possible amount of useful goods and services under the available resources. However, where monopolies, environmental pollution or other weaknesses prevail, the invisible hand's excellent effective means may even disappear [6].

Imperfect competition occurs when buyers or sellers can influence prices. In the presence of imperfect competition, markets cannot efficiently develop resources. At this stage, the state can act and start regulating. “It is impossible to overcome the negative consequences of market assets without some regulation on the part of the state” [2].

Since the time of Adam Smith, the market economy has undergone significant evolution. As P. Samuelson and U. Nordhaus notes, “Smith's

assumption about the functioning of the market mechanism will challenge modern economists, both supporters and critics of capitalism. Nevertheless, two more centuries would pass, and after the accumulation of experience and reflection, the framework and practical limitations of this doctrine were revealed. It is known that there is “market weakness” and it does not always give the best results. One of the weaknesses of the market is related to monopolies and other forms of imperfect competition. Another fallacy of the “invisible hand” arises from the presence of externalities around the market, such as positive externalities – scientific discoveries and negative externalities – such as environmental pollution. Without a market, an economic disadvantage is a distribution of income that is politically or logically unfavorable. If there is even one element, Adam Smith's doctrine of the invisible hand no longer works, and the government can intervene to 'cure' the diseased invisible hand” [6].

At the end of the 19th century, the growing development of capitalism led the USA and the industrialized countries of Western Europe to reject the principle of state non-interference. Governments began to play an ever-increasing economic role. By regulating monopolies, collecting taxes, providing assistance to the elderly, etc.

In the 20s-30s of the 20th century, the English economist J. M. Keynes restored the “visible hand” doctrine. In the paleo liberal doctrine the role of the “night watchman” was assigned to the state, in the Keynesian model the state has the role of “conductor”. However, a part of economists does not agree with this and remains in the position of liberalism. After World War II, the neoliberal doctrine of the “invisible hand” was recognized as state doctrine in West Germany. In the 80s and 90s of the 20th century, neoliberalism prevailed not only in Germany, but also in England, the USA, and the countries of the post-socialist space. But, in 2008 the global financial crisis that started turned the situation upside down again. As a modern

Polish professor G. Kolodko notes that neoliberalism also suffered a collapse in the background of this crisis. "It can definitely be said that we are dealing with the collapse of the neoliberal model" [8]. Today, the world's leading states are forced to intervene in the economy and even implement unpopular protectionism. Although some European countries refrained from state intervention in the economy, they still had to take a forced step [2]. John Miklzueth notes that in the conditions of the crisis, there will be protectionist demands from the Congress in the US as well [9]. Robin Bew points out that "increasing unemployment motivates governments to resort to populist protectionism in order to keep their seats [10].

As a modern American scientist A. Sen notes that he did not think A. Smith's pure market mechanism was absolutely ideal. He also spoke about the fact that a person is governed not only by personal gain, but also by common sense. "Kindness" is the virtue that brings the most benefit to a person. Philanthropy, justice, generosity, the desire to create a public state that is very useful for other people. The last economic crisis has made it clear that a normal social order must give up irregular and boundless greed.

In his behavior, a person, first of all, proceeds from the position of optimizing the achievement of the goals in front of him. Such goals are the maximization of utility for households and profit maximization for firms. But according to the modern understanding of homo economicus, it carries much more complex goals, because, in addition to purely economic aspirations, it also has to take into account social goals, which expands the degree of rationality. The answer to the question of how rational human behavior is depends to a significant extent on the rationality of the social system. The free market is only a theoretical construct, which is used to study the general regularities of the market. In reality, deviations from these regularities occur very often in the market, therefore, the free market, as an ideal market model, should be the

standard to which the state regulation of the market should strive. A large group of economists transfer the function of correcting the shortcomings of the free market to the state and believe that the state should intervene and do what the market cannot do on the one hand, and on the other hand, prevent the restriction of elements of freedom in the market by private entities operating there. Because the fiasco of government intervention in the market is either completely ignored or considered a secondary problem, therefore, various theoretical constructions of government intervention in the economy have many supporters among economists [11].

The principle of the "invisible hand" is somewhat opposed by the equilibrium of the American economist-mathematician John Nash, Nobel Prize laureate (1994) and Abel (2014). According to Nash, market entities should build their strategy in such a way that the result is acceptable to everyone. Such an approach is not only an expression of humanism, the increase in jobs and, accordingly, incomes expands the market and will promote the sale of goods produced by expelling the "invisible hand" (private interests). The latter is a prerequisite for avoiding the crisis, which will be followed by overcoming poverty, reducing crime and increasing the level of civility.

A. Smith's great merit is the establishment of the principle of absolute superiority, according to which this or that country or person has an absolute advantage over others in a certain activity, therefore, it is preferable for him to do this work and as a result of it to come out in the public or international division of labor [12].

The principle of absolute advantage formulated by A. Smith is still used today in the international division of labor. In this regard, the Heckscher-Ohlin theory is worth noting, according to which countries should take advantage of the production factor. Developed countries come out with the capital factor. Developing countries with the labor factor, some countries with the resource factor [13].

## Conclusion

As we can see, it is wide. Smith's range of views, which have not lost their importance even today [14]. A. Smith's ideas are very important to explain the current world global financial crisis and to find

a way not only to escape from it, but to build an acceptable, orderly society. Fundamental concepts such as justice and impartiality are covered in his works.

## ეკონომიკა

# ადამ სმითი – ეკონომიკური მეცნიერების სისტემის შემქმნელი

## ჯ. ხარიტონაშვილი

*ივანე ჯავახიშვილის სახ. თბილისის სახელმწიფო უნივერსიტეტი, ეკონომიკისა და ბიზნესის ფაკულტეტი, თბილისი, საქართველო*

(წარმოდგენილია აკადემიის წევრის ა. სილაგაძის მიერ)

ადამ სმითს საპატიო ადგილი უკავია ეკონომიკური მოძღვრების ისტორიაში. იგი იყო ეკონომიკური მეცნიერების ფუძემდებელი. მის მოძღვრებაში მნიშვნელოვანია „უხილავი ხელის პრინციპი“. ამ პრინციპის მიხედვით, თითოეული ადამიანის მამოძრავებელი მხოლოდ პირადი ინტერესებია, რაც, საბოლოო ანგარიშით, საზოგადოებრივ ინტერესებსაც ეხმარება. ზოგიერთი ეკონომისტი, „უხილავი ხელის“ პოლიტიკას უნივერსალურ მექანიზმად მიიჩნევდა. მათი აზრით, იგი მსოფლიო მიზიდულობის კანონის მსგავს როლს ასრულებს საზოგადოებაში, მაგრამ ეკონომიკაში თავისუფლების კონცეფციამ კაცობრიობის განვითარებაში მსოფლიო მიზიდულობის კანონის როლი მაინც ვერ შეასრულა. კვლევაზე დაყრდნობით უნდა აღვნიშნო, რომ: ადამ სმითის დროიდან მოყოლებული, საბაზრო ეკონომიკამ მნიშვნელოვანი ევოლუცია განიცადა. ადამიანს მართავს არა მარტო პირადი სარგებელი, არამედ კეთილგონიერებაც. 2008 წელს დაწყებულმა გლობალურმა კრიზისმა, კვლავ თავდაყირა დააყენა სიტუაცია. „უხილავი ხელის“ პრინციპს გარკვეულად შეიძლება დავუპირისპიროთ ამერიკელი ეკონომისტ-მათემატიკოსის ჯონ ნეშის წონასწორობა. ნობელის (1994 წ.) და აბელის (2014 წ.) პრემიების ლაურეატის ჯ. ნეშის მიხედვით, საბაზრო სუბიექტებმა ისე უნდა ააგონ თავიანთი სტრატეგია, რომ შედეგი ყველასთვის მისაღები იყოს. ასეთი მიდგომა არა მარტო ჰუმანიზმის გამოხატულება, არამედ დასაქმებით და, შესაბამისად, შემოსავლების ზრდით, ბაზარს აფართოებს და „უხილავი ხელის“ (კერძო ინტერესები) გამოდევნებით წარმოებული საქონლების რეალიზაციასაც უწყობს ხელს. ეს უკანასკნელი კი კრიზისის აცილების საწინდარია, რომელსაც მოჰყვება სიღარიბის დაძლევა, კრიმინალის შემცირება და ცივილიზებულიობის ხარისხის ამაღლება.

**REFERENCES**

1. Samuelson P., Nordhaus W. (1992) Economics, Tbilisi (in Georgian).
2. McConnell K.R., Brew S.L. (1993) Economics, part I, translation (in Georgian).
3. Heilbroner R., Turow L. (1991) Ekonomika dliia vsekh. London, translation (in Russian).
4. Silagadze A. (2010) Economic Doctrines, Tbilisi (in Georgian).
5. Silagadze A. (2022) Contemporary global economic trends: transitional economies during Covid-depression. *Bull. Georg. Natl. Acad. Sci.*, **16**(3):130-135. <http://science.org.ge/bnas/vol-16-3.html>
6. Silagadze A., Atanelishvili T., Silagadze N. (2022) Covid depression and search for a new paradigm. *Bull. Georg. Natl. Acad. Sci.*, **16**(1):121-126. <http://science.org.ge/bnas/vol-16-1.html>
7. Silagadze A., Atanelishvili T., Silagadze N. (2020) Some economic problems of the post-soviet states after the global financial crisis. *Bull. Georg. Natl. Acad. Sci.*, **14**(3):149-154, <http://science.org.ge/bnas/vol-14-3.html>
8. Sen A. (2011) Adam Smit i sovremennost', "Voprosy Ekonomiki", **11** (in Russian).
9. Kharitonashvili J. (2019) History of economic thought. 305 p. Tbilisi (in Georgian).
10. Marks k. (1995) Nishcheta filosofii, K. Marks and F. Engels, soch., vol. 4, M. (in Russian).
11. Smith A. (1938) An Inquiry into the nature and causes of the wealth of nations, vol. I (in Georgian).
12. Todua G. (2000) Adam Smith and current issues of modern economy (in Georgian).
13. Kolodko G. (2011) Neoliberalizm I global'nyi ekonomicheskii krizis, *Voprosy Ekonomiki*, no. 3, M. (in Russian).
14. Papava V. (2011) Unconventional economics, Tbilisi (in Georgian).

*Received February, 2023*