



## Case study: Economic thinkers

### Introduction

This case study has been written by teachers for teachers to support the delivery of a new topic within the specification. It provides ideas and suggestions for teaching approaches and is not intended to provide exhaustive coverage of this topic. It is not intended to be prescriptive or indicative of content and questions in the specification and assessments. The specification must be referred to as the authoritative source of information.

This case study focuses on economic thinkers. It provides research ideas and practice questions for students for use within class or as homework activities.



## Economic thinkers

### Adam Smith, Friedrich Hayek and Karl Marx

This resource sheet is designed to support the AS and A level Economics A specification Topic 1.1.6: Free market economies, mixed economy and command economy:

- a) The distinction between free market, mixed and command economies: reference to Adam Smith, Friedrich Hayek and Karl Marx.

### Karl Marx (1818–1883)

Karl Marx was an extremely influential thinker whose ideas ignited the movement by a third of the world's countries towards communism in the 20th century.

Marx provided a criticism of **capitalism**. Capitalism is a system where the small minority – the 'bourgeoisie' (the owners of capital such as machines and factories) – are the ruling class, and the masses – the 'proletariat' (the labourers) – provide the labour to produce goods and services. Marx essentially believed that economic systems progress through different stages – capitalism is just one stage in this development process and, due to its weaknesses and flaws, will eventually self-destruct, leading to the final stage of communism.

Marx believed that capitalists (the owners of capital), whose objective is to make a profit, must end up exploiting workers to achieve this objective. This means that workers will earn wages lower than their true value. Capitalists will also have an incentive to replace labour with machines, creating both more monotonous jobs as well as unemployment. The combined effect will be to create an exploited and alienated workforce, leading to social unrest.

He also believed that competition would cause many firms to go bust, leading to a few firms holding monopoly power which would allow them to further exploit both workers and consumers. This would also lead to owners of the bust firms joining the ever-increasing proletariat majority, causing social tensions to further increase.

The capitalist economic system is also weak, Marx said, since it is an unplanned system which causes one crisis after another. This impacts most negatively on the proletariat.

Marx believed that revolution among the proletariat was inevitable. Revolution would enable workers to seize the capital (so that ownership would be among the majority). Economic planning would direct economic activity. As the economic system moves towards communism, there would be abolition of private property replaced by common ownership of resources. However, although Marx wrote a lot criticising capitalism, he wrote relatively little on how communism would work.

Marxism has had a resurgence lately. Many global problems, such as the Global Financial Crisis and growing inequalities observed in many economies, may have their root cause in the free market system.



## Research ideas

1. Watch the video clip *The World According to Marx* from the BBC *Two Masters of Money* series, by Stephanie Flanders ([www.bbc.co.uk/programmes/p00z0yb2](http://www.bbc.co.uk/programmes/p00z0yb2)). It is approximately four minutes long. Stephanie explains why capitalism, according to Marx, is inherently unstable and will lead to crisis after crisis. Watch the video and write a summary of the key points.
2. The end of the 20th century saw the general collapse of communism. Identify the reasons why communism in practice had major weaknesses as an economic system. (A variety of textbooks will be useful resources, as well as articles such as 'Marx's theory on labour still has capital' from The Telegraph dated 6 September 2009 by Edmund Conway.)



## Adam Smith (1723–1790)

Adam Smith is viewed to be the founder of **classical economics** and was a key advocate of the market economy. *The Wealth of Nations*, which Smith wrote in 1776, remains a classic book in economics. His key conclusion is that, by pursuing their own self-interest, individuals would be led 'as by an invisible hand', with resources allocated in such a way that is in the best interests of society.

He was writing at a time when most firms were owned and run by single individual capitalists who had an active, hands-on approach to running their businesses. Like today, most capitalists ran their businesses with the self-interested aim of maximising profit. Consumers also had their own self-interest at heart when making decisions about what to buy.

Smith argued that these self-interest objectives, via the operation of the price mechanism, leads to the optimum resource allocation and therefore the best outcome for society. The 'invisible hand' enables consumers and producers to interact in the market so that both can achieve their objectives.

For example, if consumers suddenly want more robot vacuum cleaners, then this will push up the price in the market: consumers are competing with each other for the existing number of robot vacuum cleaners. Firms currently in the market will react by wanting to supply more of the product since there is greater scope to make higher profits, while new suppliers will be enticed into the market to take advantage of the profit opportunity. (Smith said low barriers to entry were essential to make this happen.) More resources are then being allocated to the production of robot vacuum cleaners, which is precisely what consumers wanted. Therefore everyone is happy.

Smith believed that competition in markets ensures that firms, whose main objective is to maximise profits, produce their goods at the lowest possible cost. This benefits society and ensures markets will use resources efficiently.

Smith recognised the dangers of monopoly power but at the time of his writing this was not viewed as being too significant. He also believed prices would end up being 'fair' but that competition was essential in achieving this (low barriers to entry are necessary to prevent firms from gaining monopoly power).

Smith also wrote about the process of specialisation and the division of labour, and how this production method could increase production and create wealth. By breaking down the production process into smaller, specialised parts, productivity rises. This is because this process helps incorporate some automation into the production process, which speeds up production. Workers also spend less time switching between tasks and the repetition of tasks makes their efficiency increase.

## Research ideas

Explain how a fall in demand for CD music systems would lead to fewer resources being allocated to the production of this good in a market economy.



## Friedrich Hayek (1899–1992)

Friedrich Hayek was a key supporter of the **free market** and deeply critical of **socialism** (state planning). He believed that the resource allocation brought about by individuals, spontaneously, by the operation of market forces, would be far superior to any state planning system. He believed that governments should not intervene in resource allocation decisions, except in the provision or protection of public goods. While Hayek did not think that individuals make decisions about what to demand or supply based on perfect information, he did believe that they have the best knowledge of their own situation. For example, a consumer will have the most accurate knowledge of his/her particular tastes, and a manager will know what raw materials he needs to make his product.

Price movements will occur as individuals and firms participate in the market. These price movements will be observed, and individuals and firms can choose how they wish to act in terms of their demand or supply decisions, with the information they each have. The price mechanism acts as a communication network.

The market will aggregate all these individual decisions, so ultimately the market will reflect all the information available to society as a whole. This means the outcome in terms of resource allocation will be the best that it can be. If government officials made decisions on how resources should be allocated, this would not be successful since these officials lack sufficient information about markets to be able to make informed decisions.

With the real-world failings of communism and the questioning of the effectiveness of Keynesian demand-side management, free market advocates such as Hayek have had more prominence again since the late 20th century.

## Research ideas

1. Read more about the reasons why Hayek thought socialist planning could not work. The website <http://econlib.org> has a helpful summary. The Learn Liberty website ([www.learnliberty.org](http://www.learnliberty.org)) has a useful video clip called 'What do prices "know" that you don't?'
2. Read the article 'Masters of Money: Friedrich Hayek' on the BBC News Business website dated 24 September 2012 ([www.bbc.co.uk/news/business-19706272](http://www.bbc.co.uk/news/business-19706272)) which explores the theme that the Global Financial Crisis might have been caused by too much government intervention – a Hayek interpretation. Also listen to 'Analysis: Radical Economics: Yo Hayek!' ([www.bbc.co.uk/programmes/b00y2bwz](http://www.bbc.co.uk/programmes/b00y2bwz)), a BBC Radio 4 podcast which explores the same theme. (This podcast integrates many macroeconomic themes and also discusses Keynes' view and the Great Depression, so could be used to help with Theme 2, too.) Afterwards, create a wordle summary of the main points or create a poster highlighting them.
3. Produce a poster on the three key thinkers covered in this handout, summarising their views.



## Short-answer questions

1. Czechoslovakia (today known as the Czech Republic) became a communist country in 1948 and central planning was introduced as a means of allocating scarce resources. Since 1993, the Czech Republic has made the transition towards a market economy, experiencing high economic growth rates compared to when it was a command economy.
  - a) With reference to the statement above, explain how scarce resources are allocated in a command economy.
  - b) Which of the following statements best describes the changes to the economic system in the Czech Republic?
    - A Demand and supply decisions in the Czech Republic are now largely directed by government officials.
    - B Resource allocation in many markets is now allowed to be determined by individual consumers and producers, acting in their own self-interest and co-ordinated via the 'invisible hand'.
    - C Marx predicted economic systems would switch from command economies to market economies as a progression over time.
    - D The public sector must now be bigger in the Czech Republic compared with when it was a communist country.
2. Both Hayek and Smith were strong advocates of letting markets determine resource allocation.
  - a) Explain the sequence of events, in terms of price movements and supply, which will result if consumers suddenly increase their demand for a certain type of product in a market economy.
  - b) Which of the following statements would be true for a pure free market economy?
    - A The government decides what should be produced.
    - B Central planners decide how much of a good should be produced, who should receive them and how they should be made.
    - C Prices will be determined by market forces.
    - D The government provides public goods.
3. Explain why productive efficiency is likely to be higher in economies where systems allow entrepreneurs to pursue the profit motive.
4. Only in a pure command economy does production:
  - A respond to changes in prices
  - B change in response to the profit motive
  - C reflect the preferences of consumers
  - D respond to state directives.



5. Which statement is true?

- A Hayek was a key advocate of command economies as a way of allocating resources.
- B Karl Marx was a free market economist.
- C Hayek was critical of central planning as a way of allocating resources since the government would have insufficient information to do this effectively.
- D Adam Smith believed the market mechanism could not reflect the preferences of consumers.

### Essay questions

1. 'Command economies will always be inferior to free market economies as economic systems'. To what extent do you agree with this statement?
2. Evaluate the likely economic effects for countries, such as Poland and Russia, that have transformed their economies away from the command economy system towards a market economy.



## Marking guidance

### Essay questions

Aim to get students making *some* reference to these thinkers in their responses.

1. References might be made to:

- Marx's view that free markets are unstable and have such significant weaknesses and flaws that revolution inevitably results. Discussion on growing inequalities which arise in a free market economy and monopoly power. Hence an argument against the statement.
- Complexity or impossibility of informed state planning as a means of allocating resources – Hayek's view. Hence an argument in favour of the statement
- Advantages of the free market system as a means of allocating scarce resources – Adam Smith's invisible hand, Hayek's view that the price mechanism acts as a communication network and that it is impossible for governments to effectively process all the information which individuals have. Hence an argument in favour of the statement.

The conclusion overall may highlight that both systems are likely to have significant flaws, although in practice the fall of communism might suggest that, in general, command economies have been inferior.

Students might also comment that a normative judgement is being made by agreeing or disagreeing. It depends what weight is placed on the relative advantages and disadvantages of each of the systems.

2. References might be made to:

- Allocative efficiency – Adam Smith's invisible hand, Hayek's view on information and how markets process information (that this will be done the most effectively in a market economy). The view that consumers can strongly influence what is produced in a market economy. However, monopoly power might start to dominate in some markets (Adam Smith did recognise this), therefore needs some government regulation to ensure competition.
- Productive efficiency should increase – profit incentive with competition provides the drive to reduce costs so the maximum can be produced with a given set of resources. (links with Adam Smith). Therefore, growth rates likely to be higher.
- Efficiency should start to rise when the inefficiencies of state planning are removed (Hayek).
- Income distribution is likely to widen (reference to Karl Marx – capitalists versus the proletariat).

Students are likely to focus on the general arguments for and against free markets. Evaluation comments might include how the government can effectively minimise the disadvantages, since a market-orientated economy will still have a role for some government intervention, ie a mixed economy.