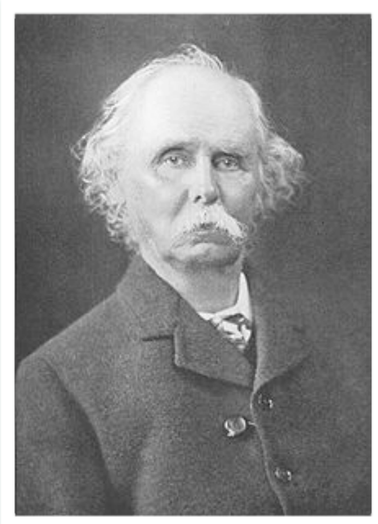
NEOCLASSICAL ECONOMICS

Neoclassical economics refers to a general approach in economics focusing on the determination of prices, outputs, and income distributions in markets through supply and demand. These are mediated through a hypothesized maximization of income-constrained utility by individuals and of cost-constrained profits of firms employing available information and factors of production.
Neoclassical economics, as its name implies, developed from the classical economics dominant in the eighteenth and nineteenth centuries. Its beginning can be traced to the Marginal revolution of the 1860s, which brought the concept of utility as the key factor in determining value in contrast to the classical view that the costs involved in production were value's determinant. Separating from the Austrian school of economics, the neoclassical approach became increasingly mathematical, focusing on perfect competition and equilibrium.

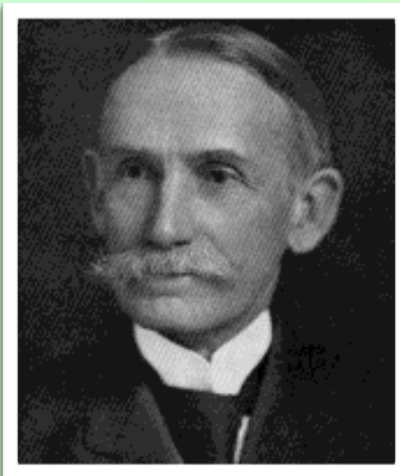
Key theorists

Carl Menger (1840-1921), *an Austrian economist stated the basic principle of marginal utility in Grundsätze der Volkswirtschaftslehre. Consumers act rationally by seeking to maximize satisfaction of all their preferences. People allocate their spending so that the last unit of a commodity bought creates no more than a last unit bought of something else.*

Leon Walras (1834-1910) - *Elements of Pure Economics (1874): small changes in people's preferences, for instance shifting from beef to mushrooms, would lead to a mushroom price rise, and beef price fall. This stimulates producers to shift production, increasing mushrooming investment, which would increase market supply leading to a new lower mushroom price and a new price equilibrium between the products.*



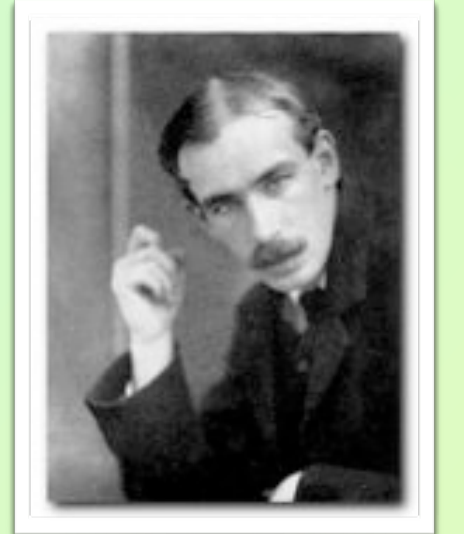
Alfred Marshall (1842-1924) - *the first Professor of Economics at the University of Cambridge and his work -Principles of Economics (1890), coincided with the transition of the subject from "political economy" to his favored term, "economics." Coming after the marginal revolution, Marshall concentrated on reconciling the classical labor theory of value, which had concentrated on the supply side of the market, with the new marginalist theory that concentrated on the consumer demand side. Marshall's graphical representation is the famous supply and demand graph, the "Marshallian cross." He insisted it is the intersection of both supply and demand that produce an equilibrium of price in a competitive market. Over the long run, argued Marshall, the costs of production and the price of goods and services tend towards the lowest point consistent with continued production.*



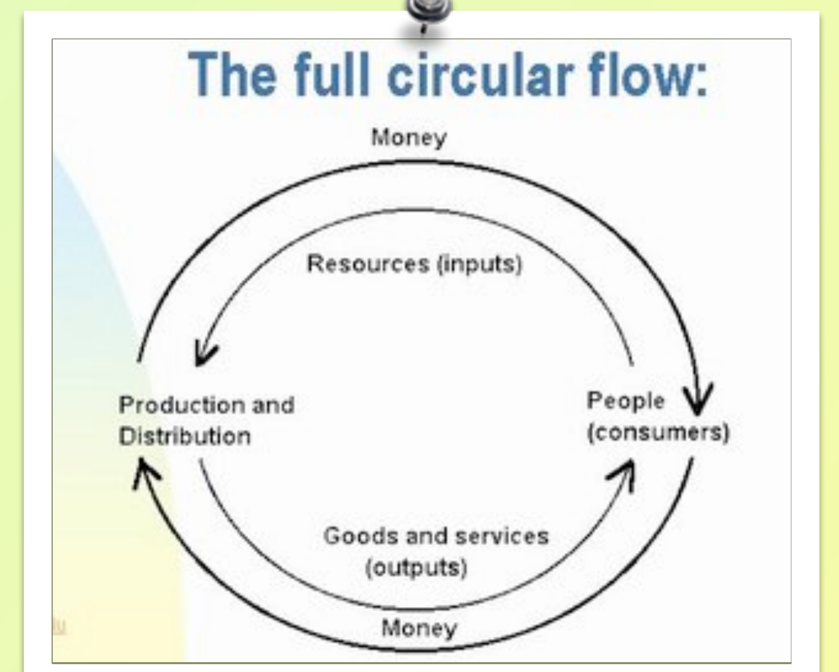
John Bates Clark (1847-1938) *pioneered the marginalist revolution in the United States. Clark sought to discover economic relationships, such as the relationship between distribution of income and production, which he argued would occur naturally in a market based on perfect competition. He believed that his "marginal productivity theory of income distribution" scientifically proved that market systems could generate a just distribution of income.*
He took marginal productivity theory further than others, and applied it to the business firm and the maximization of profits. He also argued that people were motivated not only by self-centered desire, but also considered the interests of society as a whole in their economic decision making. In his Distribution of Wealth, Clark (1899) developed his utility theory, according to which all commodities contain within them "bundles of utilities"—different qualitative degrees of utility. It is this utility that determines the value of a commodity:
If we were here undertaking to present at length the theory of value, we should lay great stress on the fact that value is a social phenomenon. Things sell, indeed, according to their final utilities; but it is their final utilities to society

- *Short-run equilibrium vs long-run equilibrium: in the short-run a company which cannot pay its fixed costs can still operate, providing it can pay the variable costs*
- *In the short-run prices determine wages, rents and profits, in the long run wages, rents and profits determine prices*

- *Academics with mathematical background*
- *Focus on the demand side (the customer)*
- *No more discussions on the theory of value based on human labor*
- *MARGINALISM !!*
- *Founders of modern microeconomics*



John Maynard Keynes, (1883-1946)
a student of Marshall, wrote his most seminal work during a period in which the Great Depression was challenging neoclassical assumptions about the lawful mechanisms of market systems. What was most radical about the book that Keynes felt would occasion this revolution, The General Theory of Employment, Interest and Money, is that it grounds economic processes in historical time, or in a more experiential sense of time where the future cannot be known and the past cannot be changed. The mathematical formalism borrowed from the equations of the mid-19th's century theory in physics obliged Walras to view economic actors as imbued with prodigious knowledge of economic variables and existing in a wholly abstract realm where time in all of its real or actual dimensions does not exist. Keynes' more recognizably human economic actor is quite different. He or she is motivated in part by "animal spirits" and irrational desires and inhabits an economic reality in which knowledge is always proximate and future outcomes are essentially indeterminate.
In The General Theory, Keynes first makes the case that there is nothing inherent in the mechanisms of a free market system to prevent a situation in which surplus savings does not result in lower interest rates and investment spending plummets due to expectations of future low sales. In the absence of borrowing and investment spending, there is, he concluded, no economic impetus to expand or grow the economy. As the world-wide depression in the 1930s had shown, these conditions could lead to some very unfortunate results—massive unemployment, a spiral of contraction due to lack of spending on capital equipment, and a climate of uncertainty in which private investment was not sufficient to reverse the economic decline. Keynes' well-known solution to this problem is that government should take up the slack by funding projects that employ the unemployed. The monies earned by these individuals would, said Keynes, increase the buying power that fuels consumption and lead to resumption of private investment and business expansion.
There was much that was troubling, then and now, about The General Theory from the perspective of neoclassical economists. Keynes' claim that the unimpeded operations of the natural laws of economics can result in a situation in which an economy not only fails to grow but even contracts suggested that the laws of economics were fallible. Because the prescribed remedy for this situation was large-scale intervention by government, or by an agency "outside" the closed market system, this not only suggested that the system cannot under all conditions be viewed as closed. It also indicated that there were situations where the natural laws of economics, if left alone, could not sustain the economic well-being of even the majority of economic actors.
Keynes' suggestion that the behavior of economic actors and firms cannot under certain conditions prevent the market system from moving toward a state of general equilibrium resulted in the development of macroeconomics. Based largely on the broadly homogenous categories of economic activity developed by Keynes, macroeconomists attempt to study the whole of the economy by representing the economic behavior of economic actors and firms within these categories as lawfully determined based on deductions from general equilibrium theory. The resulting mathematical models are used to assess macroeconomic issues, such as the effects of government policies on inflation and unemployment, the impacts of changes in the overnight interest rates by the central bank on stock markets, and the overall costs associated with increases in the minimum wage. Virtually all of the macroeconomic models are extensions of the means and methods of the microeconomic models in general equilibrium theory and predicated on the same assumptions about the allegedly lawful dynamics of market systems.



Framework of neoclassical economics:

Individuals make choices at the margin, where the marginal utility of a good or of a service is the utility of the specific use to which an agent would put a given increase in that good or service, or of the specific use that would be abandoned in response to a given decrease. This results in a theory of demand for goods, and supply of productive factors.
Buyers attempt to maximize their gains from purchasing goods, and they do this by increasing their purchases of a good until what they gain from an extra unit is just balanced by what they have to give up to obtain it. In this way they maximize "utility"—the satisfaction associated with the consumption of goods and services.
Individuals provide labor to firms that wish to employ them, by balancing the gains from offering the marginal unit of their services (the wage they would receive) with the disutility of labor itself—the loss of leisure.
Similarly, producers attempt to produce units of a good so that the cost of producing the incremental or marginal unit is just balanced by the revenue it generates. In this way they maximize profits. Firms also hire employees up to the point that the cost of the additional hire is just balanced by the value of output that the additional employee would produce.
Neoclassical economics is what is called a "metatheory." That is, it is a set of implicit rules or understandings for constructing satisfactory economic theories. It is a scientific research program that generates economic theories. Its fundamental assumptions include the following:
- *People have rational preferences among outcomes that can be identified and associated with a value.*
- *Individuals maximize utility and firms maximize profits.*
- *People act independently on the basis of full and relevant information.*

Critiques of this approach involve its separation from the real world, both in terms of the time-frame for an economy to return to equilibrium through market forces, and in the "rational" behavior of the people and organizations that is assumed. Indeed, neoclassical economics has not been entirely successful in predicting the actual behavior of people, markets, and economies in the world so far, nor does it offer a view of a society that resonates with the ideals of a world in which people are able to express their uniquenesses as part of a society of peace, harmony, and prosperity. Despite much criticism, however, mainstream economics remains largely neoclassical in its assumptions, at least at the microeconomic level.