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Neoclassical Thought

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NEOCLASSICAL economics is the body of thought that developed in the latter half of the 19th century and continued on through the 20th century and beyond. The term is used to demarcate a methodological break with the previous body of thought known as classical economics. The expression *neoclassical economics* goes back to Thorstein Veblen and was originally attributed to the Marshallian School.

The beginning of neoclassical economics can be placed around 1870, when the so-called marginal utility revolution began. This revolution in economics is usually associated with three or four contributors, although there are a number of important precursors. William Stanley Jevons, Karl Menger, and Leon Walras were in the forefront, while Alfred Marshall, who wrote around the same time but published later, was the fourth creator of the new approach to economics. What characterized the new approach was the self-declared use of mathematics and marginalism. It was more scientific in its approach in many ways. Economics became the science of scarcity—thus of measures—and it is no long shot to describe neoclassical economics as the quantitative method in contrast to classical economics.

Classical economists focused on development and growth, the distributive shares of income among capitalists, landowners and laborers, international trade, money, and population. The focus in their economics was the national economy. With neoclassical economics, this prominence gave way to the individual in economics, that is, to the microeconomics of the household, firm, and industry.

The three writers most responsible for launching neoclassical economics, Menger, Walras, and Jevons, all independently discovered the neoclassical paradigm. No longer would the science be called political economy but economics. Although the three writers emphasized marginalism and utility in their economics, they each had a different tack. Of the three, two—Menger and Walras—established genuine schools with followers to elaborate and extend their economics.

Menger founded the Austrian School of economics with his *Principles of Economics* in 1871. The school would be famous for its subjectivism and methodological individualism. The school stressed the importance of theory as well as empiricism, as

opposed to undirected empirical analysis. Austrians opposed the historicism of the German School.

Walras is the founder of the general equilibrium approach. Economic systems—with firms and consumers giving way to supply and demand in various markets—have a great degree of interdependence. Markets must determine many prices and quantities simultaneously, and when any one market is not at equilibrium, a situation where there is excess demand or supply means that some other market will also be in disequilibrium. Walras constructed a mathematical model whereby he showed a general equilibrium occurring with consumers maximizing utility and firms maximizing profits.

Although Jevons failed to inaugurate a sizable following, he did manage to pave the way for the Cambridge School, founded by Alfred Marshall. Jevons's focus was on a theory of exchange based on utility-maximizing individuals. He did not formulate a theory of the firm. Jevons also made original contributions in the problem of index numbers and in capital theory.

The final major contributor to this revolution, although he had a later publishing record, was Marshall, founder of the Cambridge School. Marshall's *Principles of Economics*, whose first edition appeared in 1890, sold remarkably well and became the standard text among English-speaking nations for many years.

Marshall's approach to markets was to study them in partial equilibrium, where the *ceteris paribus* assumption is all necessary. Marshall also divided time into components according to the fixity of certain market elements. Marshall brought to the forefront a theory of the firm. He also worked out the idea of consumer surplus and in a spark of high originality, developed the concept of elasticity. Marshall would build a reputation upon which a considerable number of followers would disseminate his ideas throughout the world.

By the early 20th century, the central features of neoclassical thought were determined: a theory of the firm, the consumer, the industry and market structure, general and partial equilibrium analysis, welfare economics, capital and interest, and money was in place. All rested on the neoclassical paradigm, that is, an analytical scheme that placed

rationality and the maximizing efforts of firms and consumers as central in determining equilibrium.

Neoclassical economics fashioned itself as the science of scarcity, whereby opportunity cost becomes the overriding factor in determining individualistic behavior. And it is the individual who reigns supreme in neoclassical thought. The neoclassical school placed much of its effort on microeconomics.

The consumer is assumed to be rational and maximizes utility with a budget constraint. Value is demand-driven in many neoclassical formulations, with the [p. 762 ↓] consumer taking prices as given. The concept of marginal utility—the idea the whole revolution giving rise to neoclassical economics rested upon—plays a crucial role in determining the equilibrium of the consumer. Maximizing utility, along with the law of diminishing marginal utility, means that with given prices and income, the consumer will allocate his budget so that the last dollar spent will yield a similar final marginal utility. This is the famous equimarginal principle. At first economists assumed that utility can be measured in some sense—at least this was necessary to their analytical apparatus.

In the theory of the firm, the marginal principle was also applied. Starting with the notion of a profit-maximizing firm, the firm would hire resources up to the point where their additional values added would be equal to their costs. Thus neoclassical economists were able to construct a theory of value and distribution displacing the old Ricardian framework. No longer would there be a residual landowning class receiving rent as a residual.

This language of mathematics would become the tool for later economists.

In industrial structure the early writers assumed that markets operated at bipolar ends of the spectrum; it was either perfect competition or monopoly. Monopoly was assumed to be the exception so that most production was assumed to take place under competitive conditions. By the 1920s and 1930s the concept of perfect competition was called into question. Joan Robinson and E.H. Chamberlin, each working independently, introduced in 1933, into economic theory, imperfect or monopolistic competition. This form of market structure or industrial organization sought a more realistic picture or

framework. It combined elements of monopoly and perfect competition. At first thought to be revolutionary, it was later to be found lacking; however, it made economists aware of the variety of market structures that actually exist and paved the way for the study of oligopolies.

One of the lasting innovations of the neoclassical school was its unabashed adoption of the mathematical approach. Since economics is concerned with quantities, one is naturally inclined to use mathematics as the language of expression. The early writers were sometimes hesitant to put mathematics in the forefront—Marshall was reluctant to put mathematics in the main text for fear of diminishing general readership. Nonetheless, neoclassical economist relied on mathematics to communicate their most important ideas. There were few exceptions. This language of mathematics would become the tool for later economists working after the era of neoclassical economics, roughly speaking, 1871–1930.

Economists, armed with the toolbox created by the neoclassical writers, began to venture into other areas, such as game theory and the economics of information and knowledge. And though once the mainstream focused on value, production, and distribution within the neoclassical paradigm, a more heterodox approach began to emerge. The American institutionalists, led by Veblen, began to challenge, question, and offer new approaches to the neoclassical paradigm.

In the realm of macroeconomics, the early neoclassical school subscribed to a quantity theory of money with a reliance on the self-correcting mechanisms built therein. The quantity theory of money appeared in various forms, including the transaction cost approach, the cash-balance approach, and the income approach. In its simplest form, the quantity theory of money asserts that the general price level is directly related to the quantity of money. Any immediate doubling of the quantity of money will cause the price level to also double. How this doubling takes place is critical to understanding the dynamics of the quantity theory of money.

Neoclassical economic theory treats poverty rather narrowly. At the microlevel poverty is perceived as “voluntary.” In the context of growth theory, where the focus is why poor nations are poor, the emphasis is on the low levels of savings, capital accumulation, and technical progress in low-income countries. As a result, the income gap between

the poor and rich nations rises. The policy implication for these theoretical findings for poor countries is to open their economies to free trade and foreign investment to stimulate growth and to enjoy the resulting externalities and economies of scale.

Banking System

Now, as mentioned, the process whereby an injection of money into the system is to cause prices to increase is vital. This may mean stimulation to the economy creating very real effects. In the version of the quantity theory, this happens in the loanable funds market through the interest rate. The banking system comes to play a crucial role in the process of driving prices upward in a monetary expansion. Since the loanable funds market is directly involved, the roles of saving and investment become **[p. 763 ↓]** critical variables in determining national income and equilibrium.

One may almost say that in the realm of macroeconomics, the neoclassical approach is very classical in that it accepted a quantity theory of money along with a self-adjusting mechanism to bring about full employment. John Maynard Keynes, in his *General Theory* would change the face of macroeconomics. Keynes's theory emphasized the role of quantity adjustments as opposed to price adjustments and that the economy may operate below full employment for extended periods of time. The Keynesian revolution swept macroeconomics and created new analytical frameworks for analyzing the economy; for instance, the Hicks IS-Lm framework became a standard tool. Economists have sought to reconcile the Keynesian School with neoclassical thought by constructing the neoclassical synthesis.

Since the 1960s there has been a revival of the classical approach. The rational expectations method has brought the discipline almost full-circle. Tensions, of course, remain. But where the "new classical" economists once debated heatedly with the Keynesians, they now have the more conventional approach.

To assess the contribution of the neoclassical contributions to the literature is almost to evaluate the entire science of economics. One cannot separate neoclassical economics from the writings or approaches of the mainstream economists of this day.

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