

NEOCLASSICAL ECONOMICS

Economics “The study of how societies use scarce resources to produce valuable commodities and distribute them among different people.” (Paul Samuelson *Economics*)

Economy (1530) from *oikonomos*, *oikonomia* (Greek *Οικονομικών* = *oikos*, house + *nemein*, to allot, manage; Latin *oeconomia*) = household manager/steward; household management

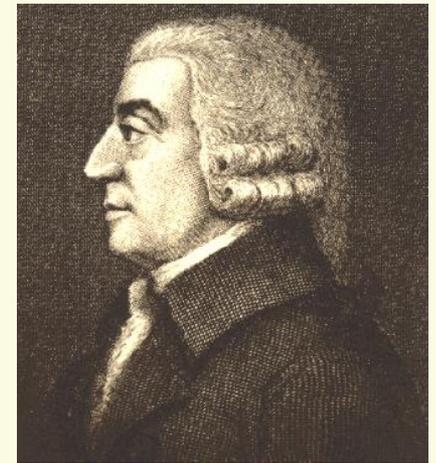
Economic Sociology “The application of the frames of reference, variables, and explanatory models of sociology to that complex of activities concerned with the production, distribution, exchange, and consumption of scarce goods and services.” (Smelser & Swedberg 1994:3)

“Economics is all about how people make choices; sociology is all about how they don’t have any choices to make.”

(Duesenberry, James. 1960. “Comment on Gary S. Becker’s ‘An Economic Analysis of Fertility’.” Pp. 231-234 in *Demographic and Economic Change in Developed Countries*. Princeton, NJ: Princeton University Press.

Marginal Analysis

Classical economics – created by Adam Smith (*The Wealth of Nations*, 1776), David Ricardo, John Stuart Mills – stressed the benefits of free trade, market tendency to equilibrium, and a labor theory of value. Prices objectively reflect the amount of labor required to produce goods. This assumption is the basis of Marx's theory of capitalist exploitation of workers.



A. Smith

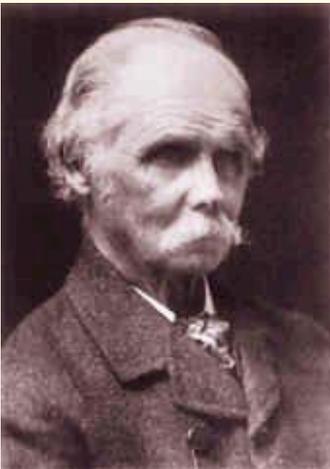
Marginal utility theory dominated **neoclassical economics** after 1870. **Marginal utility**_{df} = added subjective satisfaction or benefit that a consumer derives from an additional unit of commodity or service. Utility is inverse to consumption: the price a consumer is willing to pay for additional purchases diminishes due to satiation.

EX How much are you willing to pay for your first laptop? How much for a second; third; hundredth?

Individuals Maximize Utility

Neoclassical economists assume **methodological individualism**: all economic phenomena can be explained by aggregating over individuals' behaviors. They de-emphasize institutions – rules & regulations that predate and condition an individual's actions.

Consumers and producers are rational actors who seek to **maximize subjective expected utility** across a set of goods and services, making choices within a budget constraint: e.g., what *Ns* of bananas & mangoes for \$XX will maximize your SEU?



A. Marshall

Alfred Marshall (1890) analyzed commodity prices and production quantities as the intersection between supply and demand curves:

- ▶ **Consumer utility maximization** explains shifts in the supply & demand curves for consumer goods.
- ▶ **Producer profit maximization** explains the origin of firms' demand curves for factors of production, and underlies neoclassical economics' theory of the firm.

Factors of Production



Land



Labor



Capital

Technological constraints

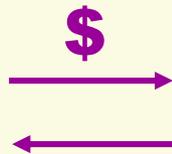


Firm production function



Budgetary constraints

Business Buyers



Goods & services for sale in the market



Consumer Buyers

Firms Maximize Profits

The core neoclassical assumption: Firm goal \equiv profit maximization

Profit maximization is the process by which a firm determines the price and output levels that will return its largest profit.



Marginal analysis reveals that profit maximization requires reducing total cost relative to total revenue:

Revenue = Price of product X Quantity sold

Cost = Price of inputs X Quantity used

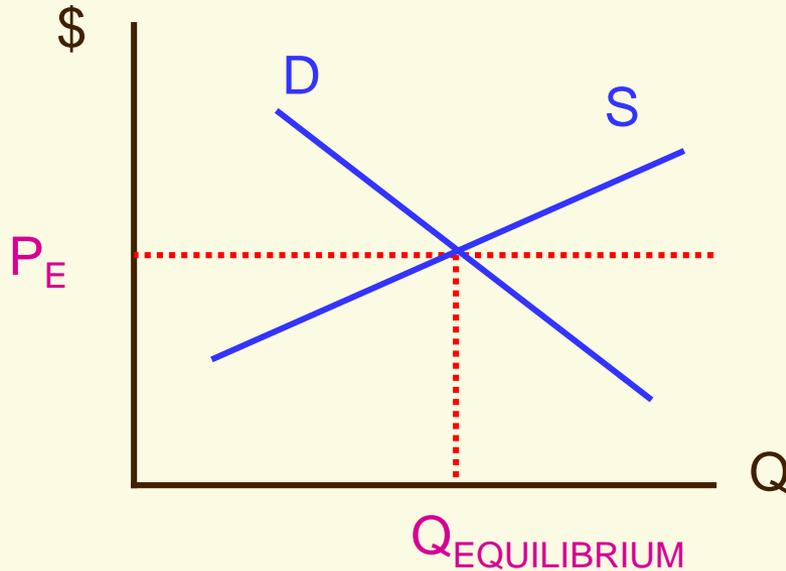
Profit = Revenue – Cost

To maximize its profit in a **perfectly competitive market** (where all firms are price-takers, not price-makers), a firm should produce output until its marginal cost of producing the last unit exactly equals the **equilibrium price** in the market, at which every firm sells all the units they produce. General equilibria are the aggregate solutions to individual maximization problems.

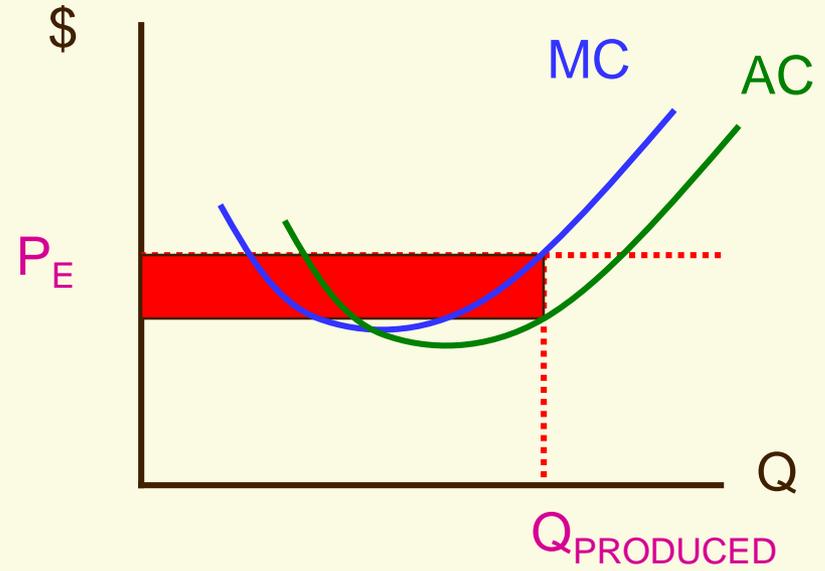
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Finding the Maximum Profit

The Market



The Firm



Market price for a good & the quantity produced by all firms is determined at equilibrium by the intersection between:

- (a) downward sloping consumer demand curve D;
- and (b) upward sloping producer supply curve S.

Firm produces the product until its marginal cost of producing the last unit equals the market price. Its profit is the difference between:

- (a) total revenue ($= Q \times P$) minus
- (b) total cost ($= Q \times \text{Average Cost}$)

Market Transactions

Economics claims that the market, through its pricing mechanism, is the most **efficient** means to coordinate all buy-sell transactions.

- Producers and consumers are rational actors, assumed to have **perfect information** about market prices at the time of exchange.
- Actors' abilities to calculate their utility and profit maxima are equal (**no information asymmetries**). Participation in market transactions doesn't run a risk of opportunistic behavior ("self-seeking with guile").

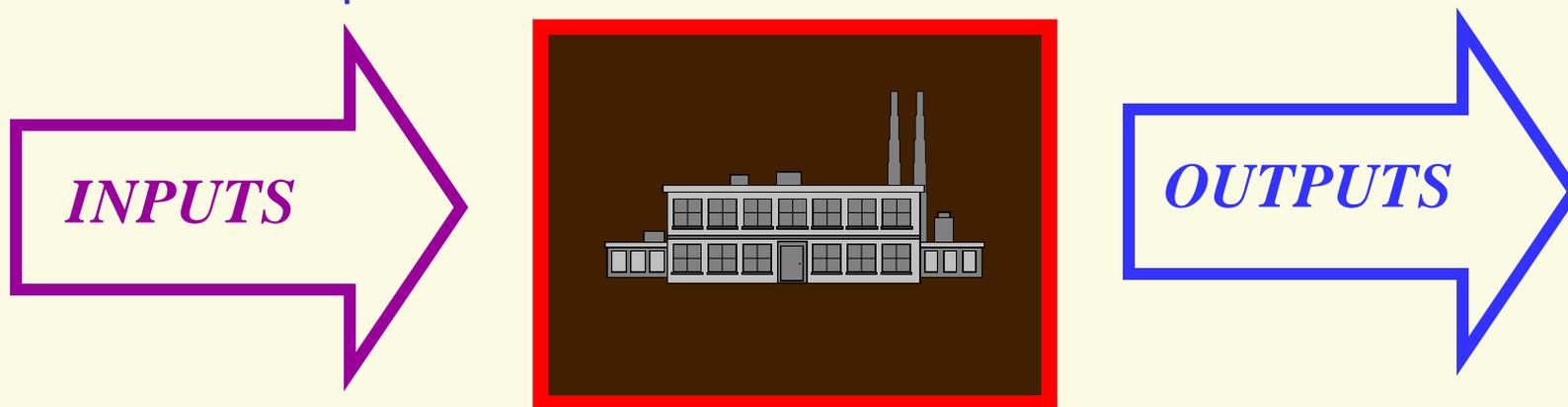
Therefore, no transaction costs need occur:

- Search costs
- Negotiation costs
- Organizational costs
- Monitoring costs
- Opportunity costs



The Firm as Black Box

Neoclassical economists did not theorize about what goes on inside firms. Organizationally, the “production function” is an undifferentiated black box that mysteriously transforms factors of production into products & services for sale on the market.

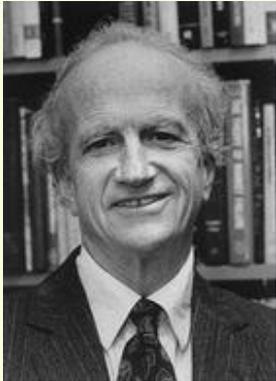


Using the firm’s production function, a single owner/manager decides what & how much will be produced, subject to its budget constraint.

Neoclassical theory of the firm ignores the differing interests, resources, and actions of entrepreneurial owners, boards of directors, shareholders, managers, employees, communities, governments, and numerous other firm stakeholders.

Criticisms of Neoclassical Economics

Neoclassical economics is often criticized for not explaining actual economies, instead describing a normative “Pareto-optimal Utopia”



Over-Reaching Claims (a.k.a. economic imperialism): “The economic approach is a comprehensive one that is applicable to all human behavior – all human behavior can be viewed as involving participants who maximize their utility from a stable set of preferences and accumulate an optimal amount of information.”

(Gary S. Becker 1976 *The Economic Approach to Human Behavior*).

Unrealistic Assumptions -- Do these principles reflect a real world?

- People & orgs are rational, risk-neutral, self-interested utility maximizers
- Humans possess perfect information (certainty) about prices & qualities
- Production, profit, efficiency, ... are the only important economic values
- Markets are perfectly competitive (participants are price-takers, not -makers)
- Economies can use unlimited planetary resources, no externalities (pollution)
- Simplification to obtain (mathematical) rigor is analytically worthwhile