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William Breit & Roger L. Ransom, The Academic Scribblers, Revsed Edition, New York: College Publishing, 1982.

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2. The Intellectual Gantry of Neoclassical Economic Policy

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The Scope and Method of Neoclassical Economics

Neoclassical theory is distinguished from classical doctrine by significant changes in both scope and method. The shift in scope involved a redefinition of th economic problem; the methodological change was the introduction of marginal analysis.

The classical economists sa the economic problem as being essentially dynamic. The measure of economic welfare to Adam Smith and his followers was the quantity of output. But output was a function of the quantity of labor available and its productivity. The question they presumed to answer was: How can the capital stock be augmented and markets widened so as to increase the productivity of labor, physical output and therefore welfare?

The neoclassical economists, on the other hand, conceived the economic problem as the attempt to get an optimal result by allocating a given quantity of scarce resources among competing uses. Scarcity became the central problem of economics.

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Quote from Philip H. Wicksteed
Comment by BL:

1. Adam Smith was concerned to show the superiority of laisser-faire to mercantilism. His argument that laisser-faire permitted the division of labor, and the division of labor augmented output.
2. The neoclassical analysis supposes that the product in question is infinitely divisible: the more you have of it, the less you desire any increment; and the less you have of it, the more you desire some increment of it. Hence

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"In this fashion, the neoclassicists introduced the role of demand as an important determiant of price."

The Emergence of Economic Man: Consumer Sovereignty

The fact of scarcity creates a necessity for choice and a careful comparison of alternatives. Accordingly, a new view of human nature came into focus in the writings of neoclassical economists. The individual is imagined in a constant process of delicately balancing his marginal expenditures and his marginal utilities.

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Consumer sovereignty supplied one of the cornerstones in supporting the laisser-faire policy of neoclassicism. For granting the maximization of utility as the problem (? the goal) marginal calculations as the tool, and economic man as the actor, the state has little or no role to play. Standards are set by economizing consumers, and scarce resources are allocated so as to maximize welfare.

The specific refinement made in the consumer demand criterion for production is in the concept ofcost. Cost is ultimately determined by consumer calculations. (But) In consider-

everything has its price
a market for
the drugs
sex
abortion
divorce

ing how much of any commodity should be produced, there again the use of margins comes into play. An increase in the consumption of a commodity by a consumer represents an increase in his welfare or benefit. However, it withdraws [illegible] resources from the production of something else. This means a decrease in the benefit (and hence a cost) to the would-be consumers of the alternative commodity. As long as the benefit is greater than the cost, production of the item in question should be expanded; and where the cost is greater, the production should be contracted. The appropriate output is reached, where the additional benefit is precisely equal to the additonal cost, i. e., where marginal benefit equals marginal cost.. At this point, neither an expansion nor contraction of output can increase welfare. But what mechanism guarantees this felicitous result? The answer lies in the neoclassical doctrine of perfect competition.

The Doctrine of Perfect Competition

1. Perfect Knowledge. At a given place and time only one price for a given object, and no scope for higgling.

2. Large Numbers. Both producers and concumers are price takers rather than price makers in all markets.

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3. Homogeneous products. Any product of a kind can be substituted for another of the same kind.

Granted the above mentioned conditons, it should be obvious that the competititive firm can sell any output it desires at the given market price. With even a slight increase in price it would lose all its customers.

The doctrine of perfect competition is the required corollary of the doctrine of comsumer sovereignty.

First, it guarantees that the will of the producer will submit to the will of the consumer.

Second, it assures ideal output, in the sense that marginal benefit is always equated with marginal cost.

For the producer will expand output as long as the price is above marginal cost.

Similarly, if marginal cost exceeds price, the entrepreneur will reduce output.

So the conditions of competition create an equilibrium where marginal costs always equal marginal benefits. In short freedom of choice and competition are the best instruments for promoting the welfare of society.

But was there any guarantee that this solution would imply employment for all the resources in the economy?

Say's and Full Employment Equilibrium

Stated crudely, Say's Law of Markets was the "Supply creates its own demand." Given the insatiability of human wants, the suggestion that inadequate demand could cause unemployment was inconceivable.

For if human needs are insatiable, the money for which men work

p. 12 will be used to satisfy these wants. Supply will always generate sufficient demand to clear the market through through the circular flow of payments from suppliers to consumers or investors. No money would hoarded, and hence all payments returned to the system in the form of the purchases of goods. Saving was possible, however, all money saved was invested since the interest rate would adjust in such a fashion as to induce any idle funds into the market for capital goods. Shifts in demand might create temporary gluts in markets; these, however, would be adjusted through the movements of wages and prices for each market.

pp. 12-14 The substance of the additional argument is from p. 14:

The intersection of the two curves, labor demand and labor supply, gives the uniquely determined point of employment and the average real wage corresponding to the volume of employment. This is a position of full employment since there is neither a surplus nor a shortage of labor. If the real wage were pushed up to $(W/P)_2$, there would be unemployment in the amount AB. But this could only be temporary since the surplus laborers would bargain to push wages down again to $(W/P)_1$ by cutting money wages. Only an absence of perfect competition, or government interference in the form of minimum wage laws, could cause permanent unemployment by not allowing wages to reach the level at which the two curves intersect.

Note that the level of money wages did not determine the price level. Rather it was the price level that determined the level of money wages. Then what deter ined the price level? The answer was provided by the quantity theory of money, which was accepted by practically every neoclassical writer.

Quantity Theory of Money

Though there were a number of variants of the quantity theory of money, all of them centered upon the assertion that there was a rough propo tiona lity between changes in the stock of money and changes in the general level of prices.

Money, real value, what it will buy

, nominal value, the unit of account, the dollar.

Quantity theorists insisted that people maintain some level of real balances, without regard to their nominal holding.

If an increase in the stock of money has increased nominal balances, people may tend to reduce the nominal balances by increased spending. But this merely increases the nominal balances held by others. For the community as a whole to reduce their balances, they must increase their expenditures and, if there is no change in output, the nominal value will drop until it balances the real value.

Inversely, if rising expenditures were met by an increase in output, then people would desire larger holdings in real terms.

In either case, whether a fall in the value of money as prices rise, or a rise in production, the system is returned to equilibrium.

so that prices fall

These relationships betweenmoney, prices, and real income can be expressed through the circu ar flow of payments in the economy.

There are two app roaches: the transactions approach of the American economist, Irving Fisher, and the cash balances approach

of the economists at Cambridge, England.

For Fisher, average price (P) tomes the number of transactions (T) will equal the total amount of money in the economy times the velocity of the money (MV). The drawback here is that the velocity V is known only implicitly from the equation: V=PT/M.

On the real balances approach, M = kPy, where "y" is real income, P is the price level, and "k" is the ratio of money balances to money income, k = M/Py.

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On comparison, the demand for cash balances, M, is the reciprocal of the velocity, V, of Irving Fisher.

Given a flexible price level, any level of real income can be consistent with any nominal supply of money; people must simply adjust their money balances to bring the real balances to the desired level. The determination of output , as we have already seen, was left to the interaction of supply and demand in the factor markets of the economy; the quantity theory of money saw to it that the flows of money payments would automatically let supply create its own demand.