

The neoclassical school of thought and its rivals

Core neoclassical characteristics

One reason why neoclassical economics will seem to have something to say about everything is that it is in many ways more a methodological programme than a single theory that can be put to empirical test. We can pick out four core features of neoclassical methodology: methodological individualism, rationality, equilibrium and the importance of the price mechanism.

Methodological individualism

This is the methodological position that aims to explain all economic phenomena in terms of the characteristics and the behaviour of individuals. Because everything ultimately reduces to what individuals do, methodological individualism states that any theory of how the economy runs should be built up from an understanding of how the individuals within it behave.

Its commitment to methodological individualism means that neoclassical economics puts clear boundaries around what it is attempting to explain (since theories cannot explain everything). It does not want to look at the influence of the economy on the characteristics of individuals, on their tastes for example. Rather, it is concerned with the influence of individuals on the economy. So neoclassical economists start their analysis by taking the fundamental characteristics of individual economic agents, such as their tastes, as given. This means that such characteristics are taken either to be fixed and unchanging or, if they do change, this is due to factors that lie outside the economic field of enquiry. In the terms of economic theory, these characteristics are said to be *exogenous*.

Margaret Thatcher's famous claim that there is no such thing as society, just individuals and families, can be seen as a classic statement of the politics which is often seen to lie behind an approach based on methodological individualism. And just as she recognized families as well as individual people, neoclassical individualism embraces other individual units, specifically firms and households. Strictly, a methodological individualist would want to explain how households and firms behave by analysing the behaviour of the individual people who make up the household or firm. Institutionalists reject methodological individualism arguing that human behaviour, including economic behaviour, is fundamentally shaped by its environment, in particular the social and economic institutions of society, including social norms. Therefore, it does not make sense to talk of a pre-social individual and to see society as an aggregate of the behaviour of individual agents.

Rationality

Neoclassical theory assumes that all individual behaviour is 'rational' according to a very specific definition of this term. Individuals are assumed to be self-interested and to have well-identified goals that they pursue in the most efficient way possible. To do this, they maximize something; usually consumers are assumed to maximize pleasure (utility) subject to what they can afford, and firms are assumed to maximize profits subject to what it is technically possible for them to achieve. Institutional theories criticize the assumption of rationality from different angles. Evolutionary economists, for example, reject the notion that agents can maximize their goals, and see behaviour as aimed at the achievement of a satisfactory outcome through adaptation in response to previous experience rather than a conscious effort to maximize.

Other institutionalist theories question whether we can see the goals of individuals as given, rather than being produced by the economy, while more interdisciplinary

approaches suggest that values beyond pleasure and profit inform human behaviour; in particular, that people may also act out of habit, a desire for status, a sense of obligation or concern for others.

Equilibrium

In order to build models which reduce the complexity of the real world economy and are therefore manageable and easy to understand, neoclassical economics concentrates on the analysis of equilibrium. These are situations where whatever aspect of the economy is being modelled is at rest because no individual has any incentive to change what they are doing (unless external factors change). A single market, for example, is in equilibrium when the market price is such that all buyers can buy as much as they want and all sellers can sell as much as they want at that price. This price is then the equilibrium price. In such a situation, no buyer or seller has any incentive to change what they are doing and the *status quo* persists, unless external forces alter anything.

Much of neoclassical theory is concerned with understanding the conditions under which an equilibrium exists and whether those equilibria are unique and/or stable. A frequent next step is the method of comparative statics, which compares the equilibrium that results in two different situations, to see the effect of changing external conditions, say the cost of raw materials, on output and price within a particular market.

Two main criticisms are made in this course of the neoclassical emphasis on equilibrium. First, proponents of both evolutionary economics and the school known as Austrian economics consider the equilibrium state in which nothing changes to be of little practical or theoretical interest. Instead, they focus on the dynamic process of disequilibrium. Second, the method of comparative statics seems to imply that with an appropriate change in external conditions any equilibrium is achievable. In contrast with this approach, other economic theories see economic processes as path dependent so that past conditions have a lasting and cumulative effect on what happens. Path dependence is necessary if we are to explain why economies differ, both in how they work as a whole and in having different ways of organizing particular aspects of the economy. We need a notion of path dependence both to explain how those different characteristics of economies arose and to investigate different possible future paths.

The importance of the price mechanism

The fourth main characteristic of the neoclassical school of thought is the central role it gives to the price mechanism in connecting economic agents. In neoclassical models the main, frequently the only, interaction between economic agents takes place through the price system. Decisions are based on prices alone: individuals do not have any other information in order to help them decide what to buy and sell. This means that neoclassical models assume that prices contain all the information needed by buyers and sellers, and that they provide agents with the necessary incentives to act (buy, sell, produce). In other words, the only information an individual has about the outside world is obtained through the market and the prices encountered there.

All economists would agree that the price mechanism is a very powerful institution that has a central role in markets. The neoclassical approach is distinguished by its almost exclusive focus on prices in the analysis of markets. This applies to all kind of markets, irrespective of the goods and services traded and the type of exchange between buyers and sellers. Institutional economists, by contrast, believe that other social relationships and the characteristics of the good or service exchanged in a

market affect how market processes work and the extent to which the price mechanism alone can co-ordinate a market. In some markets, prices cannot carry all the information that agents would wish to have: for example, employers often do not know how productive employees they intend to hire will be. In these circumstances, there will be other non-market signals about other people's behaviour that agents take into account in deciding what to do. The institutional approach, therefore, has theories about these and other circumstances in which habits, trust, values and cultural norms inform and influence economic behaviour.

Another distinguishing feature of the neoclassical focus on the price mechanism is the attitude it takes to 'transaction costs', the costs that are associated with market transactions. There are a number of 'costs' that buyers and sellers incur in order to carry out a market transaction. Some of these, such as search and monitoring costs, are a direct consequence of the fact that agents do not have all the necessary information to carry out a transaction effectively. Other transaction costs include the costs of bargaining and arranging contracts and then enforcing them. Although many neoclassical economists would recognize that such costs exist in the real world, in order to make their models simple and usable they treat market transaction as costless. Many institutionalist economists feel that this simplification is too unrealistic and so build theories that are based on the existence of transaction costs.

There are some economists who have no quarrel with the other characteristics of neoclassical economics outlined above, but recognize that transactions are not costless and that the information transmitted by prices may be incomplete. These 'new institutionalists' have put forward theories to explain how institutions developed in market economies cope with the lack of full information and transactions costs. These economists are referred to as 'new institutionalists', because they focus on institutions beyond the price mechanism, but unlike 'old institutionalists', they are similar to neoclassical economists in that they are methodologically individualist, assume rationality and focus on equilibrium, and they do not consider wider societal factors such as social values and norms.

Traditional neoclassical characteristics which are not core

In addition to the core features of the neoclassical approach, which have provided the main areas of contention between neoclassical theorists and their critics, there are also a number of additional non-core features that are often, but not always, present in neoclassical theories. Three of these non-core characteristics concern: the extent of competition, the degree of knowledge economic actors can be assumed to have, and the use of formal modelling. The final one is the way that the different parts of neoclassical economics can be amalgamated in one overarching theory, known as competitive general equilibrium theory.

Competition

A strong assumption of much neoclassical economics is that the power of individual economic actors is sufficiently small that they can take their environment as given, without thinking about the effects of their own actions on it. Specifically, given the neoclassical focus on the price mechanism, this assumption means that all agents are assumed to be price takers, reacting to prices which the agents do not believe that they themselves can influence. In real world markets, many agents have much more power than this and can have significant effects on prices in the markets in which they buy and sell.

Agents' knowledge

Traditionally, in neoclassical theory the unrealistic assumption is made that all economic agents have perfect knowledge of anything in the past, present or future

that might influence their decisions; in particular, that they know all future prices. There are now modified versions of neoclassical theory that allow for agents being uncertain about the future.

If the uncertainty about the future is about the decisions that other agents will take in the future, and choices and outcomes are interdependent, then agents have to act strategically in order to make the most of the situation. This happens, for example, in the case of asymmetric information, that is, when some agents know things that are not known to others. Situations where strategic behaviour is likely to occur are analysed using game theory.

The use of formal modelling

One of the characteristics of economics as compared with other social sciences is its systematic use of formal models, models that abstract from the complexities of the real world to concentrate on a few variables at a time, and then investigate very thoroughly the relationships between these variables, sometimes using mathematical techniques to do so. Neoclassical economics, in particular, uses a highly developed set of formal models. In developing such formal models, certain abstractions have to be made and theories often differ in what they see as the significant aspects of an economic problem. Because neoclassical theory uses mathematical modelling a great deal, some of its abstractions are designed to make the mathematics tractable.

Building up to competitive general equilibrium theory

As mentioned earlier, neoclassical economics should be seen more as a methodological programme of how to do economics than a collection of particular theories. The theory of competitive general equilibrium can be seen as the culmination of this neoclassical programme, building on all its features (both core and non-core). Many economists would agree that it is the greatest achievement of the neoclassical approach.

In brief, competitive general equilibrium theory examines the conditions under which a decentralized market economy, in which economic agents follow their own interests, will reach an orderly outcome that is economically efficient. What is meant by 'orderly' is that all markets are in equilibrium and by 'efficient' is that nobody's welfare can be improved without making things worse for someone else.

Competitive general equilibrium theory represents the neoclassical school of thought in its purest form. Its requirements go beyond the four core characteristics of the neoclassical approach as it also needs the non-core assumptions of perfect competition and perfect knowledge, and it is usually presented using formal mathematical models.

Competitive general equilibrium theory has not only had a great impact on economic theory, but it also has strong policy implications. The result that, under some (admittedly restrictive) conditions, a decentralized market economy can be coordinated through the price system alone and achieve an outcome that is economically efficient is a very powerful statement in favour of market economies and leaving economic policy to 'the market'.