Tenets of neoclassical economy

[Economics](#)

The objective of thisacademicessay is to discuss the main tenets of neoclassical economic liberalism, explain whether less developed countries should entirely depend on developed countries not and give the reasons. According to Schumpeter (1954), the classical school of economics was developed in the 1750 and lasted as the mainstream of economic thought until the late 1800.

Adam Smith's Wealth of Nation book published in 1776 can be used as the formal beginning of classical economics but it actually evolved over a period of time and was influenced by Mercantilist doctrines, Physiocracy, the enlightenment, classical liberalism and the early stages of the industrial revolution. Adam Smith is recognized as the originator of classical economic. John Stuart Mill a British philosopher 1806-1873 is often regarded as the synthesizer of the school.

While Adam Smith would be regarded as the originator and leader of the school, David Ricardo 1772-1823 should be credited with establishing the form and methods of school. Neoclassical economic liberalism is based on principles of namely free competition, a self-regulating market economy, and low or no taxes on income and property, while sharing with other forms of liberalism " a belief in progress, the essential goodness of the human race, and the autonomy of the individual and standing for the protection of political and civil liberties.

Liberalism has long history rooted in the theories of liberal political thought. It focuses mainly on the individuals rights. It attaches a lot of value to personal freedom be it political or economical. It strives to limit the state's influence in the economic and social life of society. Liberal theorists believe that economic life should not be interfered by constitutional and legal rights to run all the national or public services. Economic life should be let flourish on its own without interference by the state.

Therefore, the cornerstone or the most important thought of liberalism are free trade and free competition (Schumpeter 1954). Neo-classicists see the market for organising economic activities and individuals and companies are rewarded for their efficiency. The market is seen to be at the centre for economic growth and not the state. In other words, Neoclassical seek to understand economic development in terms of the market behaviour of individual actors and therefore can be described as essentially individualistic (Downs 1957).

Economics is asciencethat studies human behaviour as a relationship between ends and scarce means that have alternatives uses. Neoclassical economics pursues this study by means of supply and demand models that determine prices based on the subjective preference for determining prices in order to escape from the so called objective value theory of classical economics, according to which the value of goods could be established by reference to some basic commodity or the labour input required to produce a good.

Neo-classicists hoped that by throwing away objective values, economics could be placed on a more scientific basis as an essentially descriptive and predictive theory of human behaviour (Thirlwall, 2006). Neoclassical economics can be understood in terms of both its subject matter and its method. The subject matter of economics deals with variables such as incomes and prices, and aggregates like gross national product, employment levels and inflation rate.

The methods offer a way to think about large number interactions within markets, although in principle the range of social institutions can be extended to include politics. The characteristic feature or main tenets of the neoclassical method are instrumental rationality, methodological individualism, economic self interest, equilibrium analysis and the use of mathematical techniques (Riker, 1982). With instrumental rationality entails that agents are supposed rational in a broad sense that their behaviour can explained in term of their preferences.

Preferences are assumed to be determined by the individuals' desires and beliefs and well ordered with regard to outcomes. For many purposes, preferences can remain specified only up to certain abstract structural features, such as consistency, completeness and complexity. The latter requirement forms the basis of relative price analytics focused on behavioural effects of changes in the relative prices of different objects of value. More specifically, rational individuals are assumed to respond to any increase in the price of a good by consuming less of it.

This simple relative price proposition turns to be surprisingly powerful in predicting behaviour in economic setting and includes specifically the basis of institutional analysis: Institutions yield different social outcomes because they alter the incentives that agents face (Buchanan, 1975). In principle, individuals' preference could have any content whatsoever: agents could be benevolent or could be driven by group interests or a desire to comply with group norms. But in practice , there is a strong tendency to ascribe predominantly self interested motives o individuals and to rely more on institutional mechanism that bend interests to the service of duty than on individuals inherent sense of dutifulness. Accordingly, the first question economists are likely to ask of institutions is what economic incentives they give rise to. Equally, when individuals agents interact, neo-classicists generally assumes that each agent maximizes his or her own well being, considered apart from the well being of the other agents with whom he or she interacts.

According to Downs (1957) in the resultant interplay among rival interests, neoclassical economists tend to conceptualize stable social outcomes as form of “ equilibria,” in which the strength of the various contenders are in balance. Furthermore, analysis proceed by examining changes in external circumstances that would alter the strength of different forces and thereby induce all to change their behaviour in particular directions.

The external circumstances in question include policy change by government and changes in broader institutional arrangements though there is an issue as to how far government action should be regarded as external to the social system. Buchanan (1975) argues that the distinct feature of the neoclassical approach to economics can be usefully illustrated with reference to classical economics, in particular to Adams Smith’s metaphor of the invisible hand.

Smith’s metaphor express the idea that, under certain conditions, the behaviour of agents who act in their own interests can also ultimately promote the public interest. Smith claimed specifically that the freely operating market under the system of natural liberty would constitute such an invisible hand process. Although agents are assumed to be neither particularly benevolent nor cooperate by nature, the exchange processes that the free market were seen to mobilize vast benefits from large scale human cooperation that are individually not attainable.

The neoclassical version of the claim is embodied in the so called fundamental theorems of welfare economics, which asserts that all perfectly competitive equilibria are Pareto optimal, and all Pareto-optimal points are equilibria of a perfectly competitive market under some initial distinction of goods. Pareto optimally is defined as the situation in which all possible mutually beneficial moves have been made. Interestingly, the neoclassical version of this result follows David Ricardo’s formulation in which gains from exchange arise from exploiting natural differences among agents according to principle of ompetitive advantage. In Adam Smith’s version by contrast, the gains from exchange arise not merely from natural difference but from gains from specialisation (Buchanan 1975). There is however, a more significant limitation to fundamental theorem of welfare economics. The theorems are restricted in their scope to private goods that are excludable. Markets cannot guarantee the optimal provision of public goods and collective consumption goods. Under plausible conditions, non excludable goods such as defence or law and order and non patentable discoveries may not be provided at all.

Even accepting the limited normative reach of paretian concepts, therefore, markets cannot reliably deliver much that is required for their successful operation, such as a secure system of property rights and many goods that are important for human flourishing, such as publichealthmeasures or plausible theories about the working of the economy (Thirlwall, 2006).

Furthermore, Pareto–optimal outcomes are not necessarily just. Pareto-optimality is consistent with slavery if slaves cannot purchase their own freedom.

It is also consistent with very large disparities in income levels. Although the fundamental theorem of welfare economics state that any Pareto-optimal outcome can be realized by a suitable initial redistribution of goods, perfectly competitive markets remain themselves neutral with regard to distributive issues. In other words, the neoclassical defence of perfectly competitive markets can offer only a partial foundation for a comprehensive theory of cooperation, because the normative basis of evaluation that the neoclassical approach offers is too thin.

Political philosophers such as Robert Nozick (1974) and David Gauthier (1986), for example, have taken this lack of normative justification as a starting point to embed markets into broader theories of social and economic cooperation that balance efficiency considerations with concerns for justice. Nevertheless, the neoclassical analysis of markets carries important normative implications. First, the analysis demonstrates that the benefits available from human cooperation are considerable.

Neoclassical economics depicts social interaction as potentially " positive sum. " Beyond enjoyed by some individuals need not imply a loss to other and can lead to additional gains. Second, in mobilizing the mutual benefits available, there is a significant task of coordination among individual participation, a task that markets perform well for private excludable goods. Third, in part, markets work well in this coordination role, because they induce predominantly self-interested persons to serve others' interests.

It might be said that markets economize on benevolence, which tends to be a scarce good for many human interactions. Finally, the neoclassical account help to identify cases of marketfailurecases in which markets cannot guarantee optimal outcome (Emrah, 2008). Less developed countries cannot depend entirely on the notion of neoclassical economic liberalism or markets mechanism to the extent developed countries. This is because most markets in developing countries are characterised with widespread imperfection.

One example is lack of information and existence of uncertainty that most individual producers face. Most producers in developing countries are generally unsure about the size of local markets, the existence of other producers and the availability of inputs both domestic and imported. Therefore in such a situation profit-utility maximising may be based on incorrect information and in the end lead to inefficient allocation of resources. (Todaro and Smith, 2009) Under such circumstance, the government may perhaps intervene to provide information by guiding producers and consumers.

Therefore it can be analysed that, although free market economies have been successful in developed economies, it cannot be so in developing countries and the only recourse is the model of the mixed economy or social market economy. According to Thirlwall (1989), the true benefits of free market outputs may not be reflected in the prices because of the presence of substantial externalities. A number of goods may have high social value that is not reflected in their market prices.

Because of market distortion or imperfections, the prices may not reflect marginal cost and many social goods and services such as health andeducationmay not be produced at all or offered at a low price even free because markets are incomplete and private sectors have no incentives to produce them. In addition there is no guarantee that market mechanism will distribute resources equitably. Therefore, the government usually has theresponsibilityto provide them. Todaro and Smith (2009) further argue that although markets may ensure efficient allocation of resources, it can also lead to high levels of income inequalities.

Over dependence on market may not improve the distribution of income but it worsen it. Due to these kinds of market failures, different developmental experts and economist have argued in the past that there must be government intervention in the development process and adopt various forms of planning models to allocate resources. In some countries resource allocation or planning is managed by bureaucrats and not by consumers. The government plan how resources are allocated across different sectors of the economy (Thirlwall, 1989). In conclusion, the welfare role of the state is retained in a social market economy which cares for the poor.

In cases where the poor countries are striving towards a free market economy, there should be certain segments controlled by the state but with prevalence of free enterprise such that efficiency is restored and the country moves towards economic prosperity. Free market economy under centralized political control is the most effective way for distributing resources. BIBLIOGRAPHY Aydinonat, N. Emrah. (2008) The Invisible Hand in Economics: How Economists Explain Unintended Social Consequences: Routledge, New York. Buchanan, J. M. (1975). TheLlimits Of Liberty : University of Chicago Press, Chicago: Downs, A. 1957). An Economic Theory of Democracy. Harper, New York: Gauthier, D. P. (1986), Morals by Agreement: Clarendon Press, Oxford, UK. Nozick, R. (1974), Anarchy, State, And Utopia: Blackwell, Oxford, UK. Riker, W. H. (1982), Liberalism against populism: A confrontation between the theory of democracy and the theory of social choice: Freeman, San Francisco. Schumpeter, Joseph A. (1954), History of Economic Analysis: Oxford University Press, New York. Thirlwall, P. A (2006), 8th ed Growth And Development; Macmillan, London. Todaro, M and S. Smith (2009) Economic Development : Dorling, New Delhi.