Neoclassical Political Economics
• **Neoclassical economics** refers to a general approach (a ‘metatheory’) to economics based on supply and demand which depends on individuals (or any economic agent) operating *rationally*, each seeking to maximise their individual *utility* or *profit* by *making choices* based on *available information*. Mainstream economics is largely neoclassical in its assumptions.
• Neoclassical economics is the grouping of a number of schools of thought in economics. There is not complete agreement on what is meant by neoclassical economics, and the result is a wide range of neoclassical approaches to various problem areas and domains—ranging from neoclassical theories of labour to neoclassical theories of demographic changes.
Neoclassical economics rests on three assumptions, although certain branches of neoclassical theory may have different approaches:

1. People have *rational* preferences among outcomes that can be identified and associated with a *value*.
2. Individuals maximise *utility* and firms maximise *profits*.
3. People act independently on the basis of full and relevant information.
From these three assumptions, neoclassical economists have built a structure to understand the *allocation of scarce resources* among alternative ends— in fact understanding such allocation is often considered the definition of economics to neoclassical theorists.
Origins of Neoclassical economics

• Classical economics, developed in the middle of the 19th century, focused on value theory and distribution theory. The value of a product was thought to depend on the costs involved in producing that product. Goods were distributed in an economy, it was assumed, in the same way that costs were distributed — thus, a landlord would receive more goods than a tenant farmer because the landlord bore most of the cost. This classic approach included the work of Adam Smith, David Ricardo, Karl Marx.
• The problem with this approach was the prices for a product did not always reflect the expected value as indicated by the costs of a product. Clearly, something was wrong with the perspective that the price of a product was inherent in its manufacture. Economists began to explore the way that elements such as supply and demand effected price, and neo-classical economics gradually came into being.
The Nature of Neo-classical Theory

• The choosing agent:
  – Decides amongst the alternative actions to seek the highest level of satisfaction, utility, happiness
  – Ranks the options according to their satisfaction—‘preference ordering’
  – Using rational choice, follows preferences that yields a maximum welfare
  – Scarcity (i.e., limited resources) requires choice amongst competing ends
  – The idea of ‘constrained choice’ can be applied to all areas of life; there is no distinction between the economy and other spheres
• **The group welfare:**
  
  – We cannot add up individual welfares to derive the group welfare
  
  • An individual’s consumption can affect positively or negatively others’ satisfaction and utility; i.e., ‘externalities’
  
  • There are opportunities for mutual welfare benefit through trading and exchange
    
    – Voluntary transactions between members to enhance their own well-being
    
    – The desire of individuals to maximise satisfaction will drive them to exchange their resources
• ‘perfect market’:
  – Large number of participants, buyers and sellers
  – A unique (equilibrium) price that maximises group welfare
  – A process of substitution of goods yields a maximum happiness for consumers (who choose the best group of products) and producers (who choose the best combination of land, labour and capital)
  – A ‘free’ market leads to a social welfare optimality—‘Pareto optimality’
  – Against government intervention
• **Property rights**
  – They are rights of ownership, use, sale and access to wealth:
    • Rights are historical, political and dynamic
  – Property includes physical and intangible property
  – A system of property rights defines the permissible uses of property:
    • Violations of rights recognised as criminal
  – Problems arise when property rights are not properly defined; i.e., the pre-conditions for market operations are not in place
  – Government intervention to better define and enforce property rights
Market Failures

- **Externalities** (spill-over effects)
  - They refer to effects on third parties that are no transmitted through the price system, and that arise as an incidental by-product of another person; e.g., pollution from cars.
  - They are defined as **third party** (or spill-over) **effects** arising from the **production** and/or **consumption** of goods and services for which no appropriate compensation is paid.
  - Externalities can cause **market failure** if the **price mechanism** does not take into account the full **social costs** and **social benefits** of production and consumption.
  - The study of externalities by economists has become extensive in recent years - not least because of concerns about the link between the economy and the environment.
  - **SOCIAL COST = PRIVATE COST + EXTERNALITY**
– E.g., a chemical factory emits wastage as a by-product into nearby rivers and into the atmosphere. This creates negative externalities which impose higher **social costs** on other firms and consumers. e.g. clean up costs and health costs.

– ‘too much’ or ‘too little’ is produced as society’s costs do not equal society’s benefits.

– Intervention to correct the market failure by equating social benefits with social costs:
  
  • Fines (e.g., polluters pay for their effects) and subsidies (e.g., polluters given payment to stop their effects)
  • Government regulation (e.g., output restrictions, safety and quality standards, and licenses)
• Public goods
  - As with externalities, neoclassical theorists treat public goods as examples of market failure. With an externality, an activity has a consequence that confers a (non-priced) cost or benefit on a non-participant. Where public goods are concerned, the problem is that these goods often will not be produced by the market. The reason for this underproduction of public goods is that the market will produce only those goods for which the producers who bear the costs can also capture the benefits. Such goods are in some sense ‘ownable’, fungible, and transferable.
- Many goods do not fit these criteria. These goods, by virtue of their indivisibility and diffuseness, are difficult to own. Once produced, they enter the public realm. Indeed, one definition of a public good is a good that, once produced for any member of a group, automatically is available for any other member of that group. This definition highlights the importance of non-excludability for public goods.
The general properties of public goods are their non-excludability and non-rivalness. Goods exhibit non-excludability when there is no practical way to channel their benefits exclusively to those who have paid for them— or, to put it the other way, those who have not purchased the good cannot be excluded from consuming it. They become ‘free riders’, enjoying all the benefits without any of the costs. The property of non-rivalness means that as one person consumes the good, no less will be available to someone else. These two properties are practical categories rather than logical absolutes. They depend on the goods in question or, more importantly, on the specification of property rights.
– At a macroeconomic level the difficulty is that private costs and benefits cannot be linked to social costs and benefits. As with externalities, this distorts resource allocation and leads to an undersupply of public goods.

– The often cited case of the lighthouse illustrates the basic principle well.

– It follows that even where total benefits exceed total costs, lighthouses may not be built. This underproduction of public goods involves an inefficiency and provides a rationale for government intervention.
• **Monopoly and Oligopoly**
  
  – In a perfectly competitive market, there are a large number of buyers and sellers. Each producer and consumer is so small in relation to the rest of the market that he or she cannot affect aggregate market properties, especially prices.
  
  – In fact, under perfectly competitive conditions, individual firms have very little power at all. Their choices are limited to which products to produce and how much. For firms to be restricted in this fashion is simply to say that markets are functioning as they should.
Oligopolies occur when several firms control a large share of the market (or assets) in a particular sector. In these circumstances, firms may affect key market parameters such as prices. Indeed, firms might set prices well above the level allowed in a perfectly competitive market.

- Prices reflect market power
- Too little is produced at too high a price
- The state breaks up monopoly power and cartels, and prevents restrictive practices
Neoclassical economics is a theory of voluntary exchange and efficient allocation of resources. Its analytical starting point is the self-interested individual, operating in an environment where many potential objects of satisfaction are in commodity form, and where, the aim of action is ‘the competitive maximisation of utilities’. In this kind of world, individuals will freely contract to do the best they can, subject to endowments, technology, and existing rules.
• The neoclassical idea of political economy is subsidiary to the central focus of efficient exchange within markets. Once individual welfare is at the centre, and this welfare is equated with fulfilment of preferences, politics becomes an alternative instrument to achieve what cannot be efficiently achieved by the market. This makes market failure the master idea of neoclassical political economy. Markets may fail in the ways we have discussed. They do not define and institute property rights; they cannot put into place their own preconditions. They may involve significant externalities, problems of public good production and loss of competition through industrial concentration.
We have explored the idea of linking political economy to market failure. When we focus on market failure, we leave out of account one important feature of neoclassical thinking. The welfare improvement stemming from voluntary contracts (in the absence of public goods and externalities) is relative to the initial distribution of endowments. It is the best we can do accepting who owns what at the outset.
‘Voluntary’, in this context, means absence of coercion by another person. It does not require that any specific set of options actually be available to the individual. The less wealth we own at the outset, the fewer the options the market affords, the less well off we are likely to be as the result of exchange. The market does not redistribute property in the interests of equality of life chances or of removing goods from those that have a surfeit and giving them to those having little.