CHAPTER 18

Free-market Economics

The foundations

Why study neoclassical economics?
What were the origins of this influential school of economic thought?
What support does this type of economic theory give to neo-liberalism today?

There is much more to capitalism than markets. There are underlying property
dispatches and class relationships, economic activities by the state, and distinctive ideologies—as emphasised in chapter 6. However, a dominant, if not exclusive, focus on markets is characteristic of orthodox economics. The core of that orthodoxy throughout the last century has been neoclassical theory. Its exponents seldom use the term ‘capitalism’. They implicitly represent the economy as a set of interconnected and self-regulating markets in which buyers and sellers freely interact without the need for substantial government regulation—indeed they work better in the absence of such regulation. This is a body of theory that has been particularly influential in the last couple of decades as a means of reshaping the role of government in the economy. It needs to be understood.

THE MARKET RULES

Why are markets held in such high regard by orthodox economists? The short answer is because they are thought to permit mutually advantageous exchanges and ensure the efficient allocation of economic resources. Markets allow consumers to ‘shop around’ for what suits them best, at a price they can afford. Producers seek to satisfy those consumer demands—producers whose goods are not favoured by consumers will go out of business. There is no coercion and no intervention by third parties to disrupt or impede the transactions between self-interested buyers and sellers. From this perspective, in the words of one textbook author, ‘markets are the most effective as well as the most democratic mode of economic organisation that has yet been developed’. 1

Underlying this faith in markets are two related assumptions: the desirability of private property and the undesirability of a substantial role for the state in economic affairs. These are the hallmarks of free-market ideology, most clearly expressed in neoclassical theory. Private property is favoured because it is the basis of the individual interests and incentives that drive a market economy. Collectively owned and managed property is held to be less conducive to the development of markets as the principal means of allocating economic resources. Similarly, a substantial role for the
state in the economy is held to constitute an unwarranted ‘intervention’ likely to ‘distort’ patterns of resource allocation. The institutions of the state cannot know what serves individuals’ interests as well as the individuals do themselves. Because the collective well-being of society is no more than the sum of individual well-beings, it is best to leave the individuals to organise their own transactions in the economic market place.

A variation on this theme emphasises the dynamic character of the market as its principal virtue. According to this view, markets encourage innovation and risk-taking, while penalising failure. A world of ‘rugged individualism’ provides the necessary incentives for economic progress; thus, the strength of the market economy is not that it necessarily produces an efficient allocation of resources at any time, but that it is conducive to change and growth. This view of the market is significantly different from the view of the market as an ‘equilibrium mechanism. It derives from the Austrian school of economic thought, most notably the work of Frederik von Hayek (1899–1992), one of the most controversial winners of the Nobel Prize in Economic Sciences. However, it shares with neoclassical theory a strong belief in the market economy as the best of all possible worlds.

These pro-market economic theories have significant echoes of ‘social Darwinism’ emphasising the ‘struggle for existence’ and ‘survival of the fittest’ in producing a healthy society. Modern economists generally eschew any explicit connection with these principles, which were popular a century ago and were most clearly expounded by Herbert Spencer (1820–1903). The implicit connection is still there, though. Because markets reward enterprise and weed out inefficiency, orthodox economists continue to hold them in high regard. By emphasising those features, neoclassical theory links up with general social beliefs—what Daniel Fusfeld calls ‘the folklore of individualism’. It links up with ‘New Right’ beliefs favouring ‘free enterprise’ and ‘freedom of choice’ and opposing ‘politically motivated interventions’ in economic affairs. As such, neoclassical economics is an intriguing blend of technical analysis and ideology.

THE ORIGINS OF NEOCLASSICAL ECONOMICS

Neoclassical theory originated in the 1870s, when scholars, working independently in different countries, laid the foundations for a new paradigm of economic analysis. The most prominent among them were the English economist William Stanley Jevons (1835–82), the Austrian economist Carl Menger (1840–1921), and the Swiss economist Leon Walras (1834–1910). Earlier in the century, David Ricardo had steered economic analysis towards more abstract reasoning, paving the way for the theoretical model-building of orthodox economics. The neoclassical economists took this model-building further, narrowing the broad-ranging concerns of classical political economy to a formal analysis of individual economic behaviours and the functioning of markets.

Menger and Jevons simultaneously developed the basic principles of marginal analysis, still the essence of the neoclassical method today. Marginalism emphasises small adjustments, such as the adjustments a consumer might make in deciding which combinations of commodities might yield the greatest satisfaction. A little
more of this and a little less of that’, or ‘a little more of that and a little less of this’ — this incrementalism in individual choices is presented as the essence of economic decision-making. A rational consumer, one may surmise, will shift his or her spending between commodities until the utility, or satisfaction, given by each is equalised ‘at the margin’.

Jevons also posited that the utility gained from consuming extra units of each commodity would diminish as more of it were consumed. This is the basic principle of diminishing marginal utility. The more you have of something, it is inferred, the less extra satisfaction results from having a little more of it. So, commodities that are abundant in supply generally command lower prices; consumers, experiencing diminishing marginal utility, are reluctant to pay much for additional units. Scarce commodities, on the other hand, are expensive, not necessarily because of the amount of labour that has gone into their production, but because they yield higher utility at the margin. Hence, diamonds are more highly priced than water — notwithstanding the fact that the latter is of greater importance to life. Marginal utility is decisive.

Walras developed a view of the economy as a whole that showed how consumers’ decisions interlock with producers’ decisions. Changes in consumers’ purchasing patterns, it was argued, would change the prices of the goods and thereby change the amount of each that would be supplied in the market. Thus a web of intricate relationships would ensure the pattern of production would continuously adjust to the pattern of demand. Walras represented this interdependence in a mathematical model of the equilibrium conditions for an economy with numerous producers and consumers. It forms the basis of what is known as general equilibrium theory.5

These contributions constituted powerful theoretical innovations. Classical explanations of value, emphasising the role of labour, were refuted. Utility replaced labour values. As Menger put it, ‘the value of goods arises from their relationship to our needs, and is not inherent in the goods themselves. With changes in this relationship, value arises and disappears’.6 Concern with analysing the total economic surplus is jettisoned, along with the labour theory of value. Only individuals have surpluses, and these are of a psychological kind, such as when the utility derived from a commodity is over and above what the consumer had to pay for the commodity. The social perspective changes accordingly. The previous political economic concerns about classes, their competing interests, and the conditions for social progress — characteristic of both Marx’s and the classical political economists’ analyses — have no place in these new theories. Instead, the spotlight shifts to the behaviour of individuals and competitive markets, and to how consumers’ demand influences prices and the allocation of resources.

A synthesis of these ideas, and further extensions and practical applications, was provided by Alfred Marshall (1842–1924). His Principles of Economics, first published in 1890, was the standard economics textbook in the first few decades of the twentieth century. Even today, it is possible to come across economists who claim that pretty much all worthwhile economic reasoning can be found in Marshall’s text. It was certainly a significant achievement — blending the central concepts of marginal analysis with enduring ideas from classical political economy, adding some more
practical concerns about industry and trade, and introducing (mainly in footnotes) a distinctive form of diagrammatic representation that has been widely used in orthodox economic analysis ever since. Marshall was not blind to the social problems that accompanied capitalist economic development in his time; however, his economic theory was, in essence, a sophisticated exposition of the self-adjusting mechanism operating in a competitive market economy.

**Box 18.1**

**Alfred Marshall (1842–1924)**

Alfred Marshall was Professor of Economics at the University of Cambridge in England during a period when that university was renowned as a citadel of Victorian piety and temperance. In his inaugural lecture in 1885, Marshall set himself three tasks: to strengthen the scientific authority of economics, to align it with the Victorian moral and political mood, and to draw the best Cambridge men to the subject. During the twenty-three years he occupied the chair he energetically pursued these goals, and did so with considerable success.

As a mathematician, Marshall thought that economics would have greater potential for scientific development if it were detached from moral philosophy. He believed that mathematics should only be an adjunct to economic reasoning, however—used as a means of expressing economic ideas in clear writing. Subsequent neoclassical theorists have tended to invert these priorities, defining the concerns of the subject in terms of analytical technique; in Marshall's work the mathematics and diagrams are usually in the footnotes, not in the body of the text.

Marshall's alignment with Victorian sentiments was evident in the way he sought to reconstruct economics to mirror the ethical aspirations of the enlightened middle class of his time. His political inclination was to favour incrementally raising the living standards of ordinary people, but only as part of a process of raising the moral tone of society, 'as capitalists and workers learnt to behave more honourably towards each other'. He had some interest in socialism, but came to strongly oppose it. He was cautious about trade unionism and evidently feared the exercise of union power. Of the engineers' strike of 1887, he said, 'I want these people beaten at all costs: the complete destruction of Unionism would be ... not too high a price'.

His lectures did indeed attract able students. Marshall initially supported women's rights to study at the university—a contentious issue in the late nineteenth century—but later opposed the granting of degrees to women.

One of Marshall's biographers describes him as 'the Soaring Eagle', but others regard him as a rather pedestrian figure. He exemplified the Victorian occupation to blend practical concerns with a more 'scientific' method of analysis. His synthesis of economic analysis in the *Principles of Economics* had original elements; however, in trying to make economics more rigorous in its methods, he imposed a *particular* analytical orientation that excluded radical and challenging lines of enquiry. The price of respectability was, and is, a narrowing of vision.
WHY NEOCLASSICAL THEORY?

It is interesting to reflect on why neoclassical theory, pioneered by Menger, Jevons, and Walras and synthesised by Marshall, developed at this particular time and came to be readily accepted as orthodox. At first sight it seems incongruous. Capitalism in the real world was experiencing turbulent times, contrasting vividly with the picture painted by equilibrium theory: a deep, prolonged economic depression had occurred in the 1880s; imperialist adventures were proceeding apace in the late nineteenth and early twentieth centuries; and corporate capitalism was on the rise. As another economist describes the situation:

Just as competitive capitalism seemed to be achieving its greatest successes, the forces that Marx had predicted would lead to the concentration of capital began to show themselves. Improvements in technology were such that larger-sized plants were necessary to take advantage of the more efficient methods of production. Competition became so aggressive and destructive that small competitors were eliminated. Large competitors, facing mutual destruction, often combined in cartels, trusts, or mergers in order to assure their mutual survival.\textsuperscript{11}

For neoclassical economists to be theorising at such a time about free markets, consumer choice, and the stability of equilibrium seems to indicate an enormous gulf between economic theory and actual economic conditions.

How can this be explained? A number of possibilities may be considered. One view emphasises the extension of markets. By the end of the nineteenth century, the spread of market relationships was much in evidence. The proponents of this process needed it to be seen as legitimate and advantageous, particularly because of its links in practice with imperialism. Theoretical developments focusing on the pervasive and generally beneficial character of market relationships fitted well with these developments and attitudes.

Second, an antidote was needed to the ‘dangerous doctrines’ of Karl Marx.\textsuperscript{12} It is not that the leading neoclassical scholars of the time had read Marx, or were consciously attempting refutations—usually that was not the case. But the economic and social elite of the time, fearing the possibility of popular uprisings that might threaten the existing political economic order, were naturally attracted to a body of theorising that showed capitalism in its most favourable light as a market economy in which freedom of exchange would ensure socially beneficial outcomes.

The theorists themselves were more concerned with the extension of ideas and the solution of theoretical puzzles carried over from classical political economy. Therein lies a third explanation, of a purely intellectual character, for the ascendancy of neoclassical economics: the neoclassicals were dissatisfied with the existing theory of value because it seemed to pay insufficient attention to demand-side considerations. Shifting the focus from how labour creates value to how consumers shape the demand for products seemed to address a lacuna in the prevailing economic theory. In other words, the rise of neoclassicism was partly the consequence of novel solutions to some unresolved conceptual problems in classical political economy.

Last, it is pertinent to note that these posited solutions reflected the state of thinking in other disciplines. The growing influence of utilitarian philosophy, associated
with the ideas of Jeremy Bentham (1748–1832), is particularly noteworthy. The neoclassical economic terminology shows some obvious links with utilitarianism—consumers’ utility and disutility, for example. Here are particular economic instances of the pleasures and pains that shape all human conduct, according to utilitarian philosophy. From this perspective, neoclassical theory can be regarded as the application to economics of a prevailing intellectual fashion of the nineteenth century.

All this took place in the context of a general reverence for ‘science’ in social enquiry. No doubt the pioneering neoclassical economists thought they were applying unprecedented scientific rigour to the study of economic phenomena. The delineation of economics as something separate from other social studies certainly reflected this. The label ‘political economy’ was beginning to be regarded as value-laden; ‘economics’ was preferred because it sounded more like ‘physics’. The attempt to emulate the scientific method and basic concepts so successfully used in Newton’s physics was not altogether novel—it had been evident in classical political economy, too—but it reached its peak in neoclassical theory. One critic has called it ‘physics envy’.

Hence the emphasis in neoclassical theory on the behaviour of atomistic units (treating firms and consumers as the ‘molecules’ in the economic system) and on equilibrium conditions (determined by the interaction of those molecules according to the ‘laws of economic motion’). In neoclassical economics, the principal ‘law of motion’ is not gravity, as in Newtonian physics, but economic self-interest. Markets are the natural state in which the equilibrating mechanisms work best.

Some continuity between classical political economy and neoclassical economics can be discerned in all this. An essentially pro-capitalist ideology is the common element. ‘Economic liberalism’ lives on in neoclassical economics. Indeed, it continues to the present day in various extensions of this mainstream current of economic thinking. A preference for the market and a general aversion to state intervention are manifestations of what has come to be known as neo-liberalism, which has shorn away Adam Smith’s ethical concerns and subtle reservations about market behaviour.

There is also a significant discontinuity between neoclassical economics and classical political economy. Gone is the classical political economists’ quest to understand society in its entirety—the complexity of its economic, social, and political institutions, and the conditions for social progress. In its place is the more limited neoclassical concern to model the price system under conditions of market competition. The focus narrows from production, distribution, growth, capital accumulation, and economic crises to exchange relations. We enter a theoretical world of buyers and sellers interacting on a level playing field.

DEMAND AND SUPPLY; PRICES AND EQUILIBRIUM

How are the interactions between buyers and sellers to be understood? Box 18.2 shows the most fundamental of all orthodox economic propositions: the theory of the determination of price by demand and supply, and its depiction as the ‘Marshallian cross’. It represents demand and supply as being of equal importance in determining prices. According to Marshall, ‘we might as reasonably dispute whether it is the upper or under blade of a pair of scissors that cuts a piece of paper, as whether value is determined by utility or cost of production’.


Box 18.2
The determination of price by supply and demand

If sellers supply more of a commodity when its price rises, and buyers demand more of a commodity when its price falls, supply and demand curves can be constructed with the following characteristics:

Price OA ensures that supply equals demand. Quantity OX is bought and sold at that price. The market clears.

The market price will respond to any change in consumer demand. The shift in the demand curve from Demand 1 to Demand 2 in the following diagram may be the result, for example, of a sudden surge in consumers' liking for the product. The equilibrium price rises to OB and the amount bought and sold rises to OY.

The market price also responds to a change in supply conditions. The shift in the supply curve from Supply 1 to Supply 2 in the following diagram may be caused by a lowering of the costs of production following the implementation of new technology. The equilibrium price falls to OC and the amount bought and sold rises to OZ.
Marshall's dual emphasis on demand and supply was not novel, having been evident in Adam Smith's work, for example. It sought to balance the emphasis of the early neoclassical theorists on utility and demand with some consideration of supply conditions. The role of labour in production, which had been the focus of value theory hitherto, was to be regarded as only one of many factors shaping prices.

Three other points about neoclassical theory are notable. One is its posited generality. The theory of demand and supply, as depicted by the 'Marshallian cross', is held to apply to all goods and services, whether they be agricultural products or minerals, manufactured goods or services. It is held to apply equally to factors of production, whether they be different types of labour, or land or capital. For each factor, there is a demand that normally varies inversely to its price, and a supply that responds positively to price changes. For each product or factor of production (except in 'perverse' cases where demand or supply curves bend backwards), there is just one 'market clearing' price at which demand equals supply.

Second, following from this last observation, there is the claim that markets tend towards stable equilibrium. A rise in price will cause supply to exceed demand, so sellers will bid against one another for customers, causing the price to go down again. A fall in price will cause demand to exceed supply, so buyers will bid against one another, causing the price to climb again. An analogy may be drawn with the equilibrium of a ball in a saucer. The ball will be disturbed if the saucer shakes, but it will tend to revert to its central position. So it is with market prices, according to this model. The prevailing prices respond to changes in the conditions of demand (resulting from a change in consumers' tastes, for example) or the conditions of supply (resulting from the development of new production technologies or the entry of new firms into the market, for instance). Each response involves a shift to a new equilibrium position. A systemic stability prevails, underpinning the day-to-day price oscillations characteristic of a competitive market economy.

Third, the way in which neoclassical economics accounts for these posited features of the market economy is distinctive. Everything is modelled according to marginal analysis. The focus is on incremental adjustments—on how small changes in the conditions of demand and supply bring about the small changes in prices necessary to restore equilibrium. The door is opened to the use of differential calculus. Neoclassical theory becomes, in effect, a means of applying that particular mathematical tool to the study of individual and market behaviour. Alongside this distinctive methodology is a distinctive ideology: only small adjustments are necessary in order to achieve optimal economic outcomes. The 'big picture' concerns characteristic of Marxist economics—class struggle, economic crises, and revolution (or even evolution)—have no place in such an idealised world.

**NORMATIVE IMPLICATIONS**

Neoclassical economists claim to be concerned with 'positive' economics—with understanding what is, rather than what ought to be. The range of economic matters that are studied is typically market-oriented. Characteristic questions are 'why do peaches cost more than potatoes?', 'why are carpenters' wages higher than those of clerks?', and 'why is the value of the national currency rising or falling relative to
the currencies of other nations?' These relative prices are held to be the key to understanding how economic resources are allocated. Their explanation requires analysis of the demand and supply conditions relating to each of the products, factors, or assets in question.

Neoclassical economics also has a normative dimension in practice. Notwithstanding the professed emphasis on 'positive' economics, distinct values intrude into the understanding of the price system. On occasions, neoclassical theory is used overtly in the attempt to show the price system as a means of securing an optimal allocation of economic resources. This represents the market economy in its most favourable light, as a mechanism responsive to changes in the conditions of demand and supply, continually reconciling competing interests. Buyers cannot always obtain what they want at the price they want. Sellers cannot charge whatever price they like for their products. But the interaction of buyers and sellers establishes the conditions for mutually acceptable exchanges. The price system resolves conflict.

Is the outcome of such a market process necessarily efficient? Subject to some caveats (to be considered in chapter 23), the neoclassical answer is that, in general, it is. The allocation of resources between industries is held to reflect both the prevailing technologies of production and the prevailing consumer preferences. No particular claim is made about equity but, in terms of allocative efficiency, the market exchange system apparently scores well. Showing capitalism in this favourable light is the normative function of neoclassical theory.

**CONCLUSION**

Box 18.3 draws out the contrasting features of Marxism and neoclassicism. There are significant differences of methodology, significantly different assumptions, and striking contrasts of political interpretation. The neoclassical approach to economic

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**Box 18.3**

**Comparing neoclassical and Marxist views**

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<th>Neoclassical economics</th>
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analysis focuses on an abstract world comprising individuals and markets, not classes and power relationships. A connection between that abstract world of ‘pure’ markets and the real world of capitalism is often implied, though. If the principles of demand and supply can show competitive markets to be efficient allocative mechanisms, one may infer that capitalism, notwithstanding the ‘market imperfections’ it features in practice, has similar tendencies. But how close is the connection? The foundations of this influential theory warrant careful consideration. The analysis of the individual, particularly the individual consumer, is its most distinctive underpinning.