Classical and Neoclassical Economics: An account of evolution

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Classical Economics

Classical School/political economy- the first structured body of economic thinking that emerged in Western Europe from late 18th century and continued to be dominant till late 19th century

- Usually Adam Smith's '**An inquiry into the nature and causes of wealth of nations'**(1776) is taken as the beginning of economics as a discipline
- Other notable classical economists include David Ricardo, Thomas Malthus and Karl Marx (Marx as a critique)
- Some of the key ideas in classical economics: the invisible hand(Smith), efficacy of free trade between nations through comparative advantage(Ricardo), supply creating its own demand(Say)
- Analytical blocks were social classes with distinct interests(capitalists, workers, landlords) and the main analytical question was to understand the dynamics of the economy based on the interrelationship between these classes
- The primary focus was on production of goods (and to a lesser extent services)

Neoclassical Economics

- Initiated in the late 19th century in the works of Stanley Jevons and Leon Walras and gradually acquired dominance in the 20th century with Alfred Marshall
- The analytical unit was the individual or the firm (microeconomics) with clearly defined goals of optimizing their self-interest and participating in market transactions
- Advent of calculus in economic theory which became more sophisticated over time
- The broad principle that self-interested economic agents participating in freely operating markets will generate socially optimum outcomes
- The focus changed to market exchange from production in classical economics
- Political economy became economics with the added connotation of a distinct ‘science’
- Major contributors in the development of neoclassical economics in the 20th century- Paul Samuleson, Kenneth Arrow, Gerard Debreu

Price Theory

- How are prices fixed in the market?
- Demand-Supply equilibrium
- What is behind these forces?
- Cost of production approach for supply (producer’s problem)
- Some notion of rational choice for demand (consumer’s problem)

Consumer’s problem

- How does a consumer value different goods?
- The basis of determining use-value
- Marginalist revolution and diminishing marginal utility
- The basic marginalist calculus (equating marginal benefit and marginal cost)
- Choice and rationality
- Necessary conditions for rationality- completeness and transitivity
- Additional condition of monotonicity or non-satiation to formulate the choice problem

Subjective valuation and utility

- Can utility me measured?
- Cardinal vs. ordinal understanding of utility
- Preference ordering expressed in terms of utility function vs. revealed preference