

The Difference between the general structure of Classical theory and orthodox theory in its approach to economic analysis

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The term classical economics is applied to a school of economic thought that began with Adam Smith's *The Wealth of Nations* in 1776. Besides Smith, the principal contributors to classical theory are Say, Ricardo, Malthus, and Mill. This school is especially dominated by the works of Ricardo and so, in this paper, I will focus on the theory of Ricardo. After examining the system of classical economics, I will explain the differences between classical and orthodox (neoclassical) theory.

The general structure of Classical theory

The concern of classical economy is to enunciate the natural laws of the economy, because classical theorists generally think that natural laws govern the economy just as they govern the movement of planets. To the classical economists, economics is primarily concerned with understanding economic growth and the distribution of income. It becomes evident that all economic development depended on the existence of a disposable surplus, that is to say, upon the capacity of an economy to produce more commodities than those which have to be used up in the annual process of production. Therefore, classical economists sought to identify the determinants of surplus and find the natural laws of the economy in it. This theory of the accumulation of surplus has been regarded as the core of classical economics.

The French physiocrats had laid stress on the position of agriculture in the economy, claiming that this sector was the source of all economic wealth. Smith rejected this view and drew attention to the development of manufacturing and the importance of labour productivity. Ultimately, according to Smith, labour is the true measure of value. That is, the values of goods and services are determined by the cost of producing these goods and services. Most of these costs can be reduced to labor. Ricardo took up this idea and suggested a theory of relative prices based on costs of production in which labour cost played a dominant role, although he accepted that capital costs were an additional element. It is Smith's labor theory of value, rather than his treatment of competition, that Ricardo developed further in his own writings. In *Principles of Political Economy*, Ricardo explains that wages above the subsistence level led to the expansion of labor force, which in turn demanded more intensive agriculture or cultivation of inferior land. Given the laws of production and given the view that higher wages will cause rapid increases in population, economists in the early nineteenth century drew gloomy conclusions. The increased number of workers will need more food. Farm land will have to be cultivated more intensively or less fertile land will have to be brought into use. The extension of cultivation led to lower profits and higher rents, and accordingly, the whole tale of economic development led to a stationary state in which profits were too low to command any net investment, wages returned to the subsistence level, and only the landlords were affluent.

The general structure of orthodox (neoclassical) theory

In reaction to Marx's reformulation of Classical economy, a group of marginalist thinkers

emerged at the end of the 19th century to found neoclassical economic theory, which remains dominant in capitalist societies. The so-called Marginal Revolution of the 1870s, generally associated with Walras, Jevons, and Menger, marked a shift in emphasis in economics away from production towards the demand side. For the rising neoclassical school in the 1870s, the classical theory of value seriously lacked generality - especially in determining value of goods with inelastic supply curves. Instead, Jevons and Menger separately formulated their marginal utility theory, in which value depends entirely on utility. The idea that the end of economic activity is the satisfaction of individual consumers is deeply rooted in the structure of marginalist thought, which sees subjective utility evaluation as the regulating factor of price and value.

Neoclassical economists' starting point is to capture the essence of economic man in a set of axioms, based upon which they then generate hypotheses. Neoclassical theorists argue that consumers seek to maximize utility by consuming goods and services, subject to the constraints of their incomes and prevailing price levels, and so, choices are related to preferences. Agents are rational in the sense that their choices are determined by their preferences. Likewise, individuals provide labor to firms, by balancing the gains from offering the marginal unit of their services with the disutility of labor itself. This results in a theory of demand for goods, and supply of productive factors. Similarly, producers attempt to produce units of goods so that the marginal cost is just balanced by the revenue it generates. In this way they maximize profits. In this process, the decision problems are worked out in markets. Prices are the signals that tell agents whether their conflicting desires can be reconciled. Accordingly, value is determined in exchange (supply and demand) rather than in production and value fully reflects the individual's contribution to production. These neoclassical arguments developed into an interpretation of capitalism, in terms of the phenomena of market exchange, as a system which allocates given resources among alternative uses by means of competitive prices. Indeed, the theory of resource allocation was often regarded as the core of what has been called neoclassical economics.

Neoclassical model was characterized by microeconomic theoretical systems constructed to explore conditions of static equilibrium. Statements about macro-events were often derived from the aggregation of micro-relationships. Equilibrium is achieved at full employment by changes in factor prices. Essentially, the neoclassical school has been concerned with the problems of equilibrium and growth at full employment.

The difference between classical and orthodox theory

Classical and neoclassical theories are distinguished in terms of their themes in analyzing economy, methodology, and value theory. In this section, I will discuss these points.

The question of Economics

Classical economists investigated two central economic questions: what causes an economy to grow? what determines the distribution of income into its three forms of wages, rent and profit? The classical theme is the accumulation and allocation of surplus output, and therefore their emphasis was on production and on the factors that influence the supply of goods.

Neoclassical economics, unlike its classical predecessor, focuses on individual choices,

which unavoidably reflect subjective preferences and beliefs, and the allocation of given resources among alternative uses. Indeed, the marginalist revolution is a shift in focus from capital accumulation and growth to utility maximization and production efficiency as the aims of economic policy. This shifted the foundation of economics from production to exchange.

On the other hand, the Classical theory paid comparatively little attention to choices of individuals. The classical economists did not believe that there was much of general interest to be said about the preferences of or choices of individuals. Instead, they divided agents into three major classes: capitalists with their capital or stocks of accumulated goods, landlords with their land, and workers with their ability to work.

The aspect of methodology

Holism vs. Individualism

Methodological holism is a view, according to which properties of individual elements in a complex are taken to be determined by relations they bear to other elements. That is, the whole is more than its parts in the sense that the properties of the whole come from the systematic relational patterns of interaction among its parts and not simply from the aggregation of their atomistic (i.e. non-relational) properties. In other words, the social, aggregative implications of individual choices are often unintended. Methodological individualism, however, is the view that all social events must be explained as consequences of choices made by individuals and allows only individuals to be the decision-makers in explaining social phenomena. Accordingly, methodological individualism does not allow explanations which involve non-individualist decision-makers such as institutions.

Classical economic theories, in general, explained the social phenomena in terms of methodological holism. Their primary interests are social entities such as capitalist society. Moreover, classical economists develop their theory in terms of class such as landlords, workers and capitalists who contest for a larger share of the pie, instead of abstract individuals. In a classical paradigm, the concept of class is more useful than individual agents in analyzing social phenomena. In this way, classical economy has roots in holism, and accommodates social categories like class.

Usually the neoclassical economics is firmly grounded on a research program of methodological individualism, which generally posits that individuals with given preferences and endowments, and firms with given technologies, enter the market process as autonomous entities. Indeed, the adherence to the tradition of methodological individualism has an important bearing on the nature of the neoclassical model. For neoclassical economists, society is the collection of individuals. Individual wants, thoughts, and deeds combine to make society what it is. To understand an economy is then to make sense of the aggregate effects of individual wants and acts. Neoclassical theory does this by demonstrating how individuals maximize their material self-interests by utilizing their resources and the available technology in market transactions. What happens in an economy is always explained as the result of individuals acting in this way. The economy, as neoclassical economists theorize it, is the aggregate end product of individuals.

Historical vs. Ahistorical

In classical economics tradition, historical analysis is called for and mathematical models and statistical investigations are of limited usefulness. The classical economists have made consistent efforts to explain the rise of the capitalist mode of production in terms of historical analysis. They from the beginning have sensed that it was the essence of capitalist production to generate an accumulating surplus, and that the manner of this accumulation was crucially related to the character of the newly emerging social relations of capitalist society. The classical theory of value would be limited to the goods and services that were typical products of competitive capitalism. They regarded the explanation of this historical phenomenon as their primary task.

Instead of the characteristic features of a given socio-economic system, the starting point of neoclassical economics is the ahistorical individual and therefore the neoclassical theories are expressed in mathematical models which exclude the concept of history. For example, in neoclassical traditions, there are only factors of production, namely, labor, land and capital, each of which receives a reward commensurate with its productivity. There are no essential differences among them. This shows the lack of the notion of class which is unique to the stage of capitalist society.

This methodological features arises from the fact that though the great themes of classical economy are dynamic and developmental, the great themes of neoclassical economy are static and allocational.

On value theory

Most schools of economic thought have a theory of value at the heart of their paradigm. In addition to identifying the forces that form prices, the theory of value reveals the basic structure of the paradigm. The particular theory of value with which an economist begins is almost invariably a sort of shorthand expression of the basic attitude which the economist is going to adopt towards the phenomena he seeks to analyze and the problems he seeks to solve. In terms of explanations of what determines the value of different commodities, the different approaches have tended to distinguish two notions of value: the cost of producing the commodity reflected by the supply of it, or determined by the utility it gives a consumer, and reflected in the demand for it.

The classical economists found value to be determined in production, that is, in the workshop or the factory, not the market place; the value of a bushel of corn, for example, was thought to depend on the costs involved in producing that bushel. Since most of the cost of production could be reduced to labor, this approach was refined into the Labor Theory of Value. They were not, however, very concerned about demand as a determinant of value. Ricardo explicitly excepts goods, like rare paintings, whose price depends solely on their scarcity, from the general principles of value determination through labor time. They did recognize that the usefulness or use-value of a commodity is a preconditions for its having exchange value, but also pointed out that the overall usefulness of commodities had no correlation with their value.

The classical theories of value gradually gave way to a perspective in which value was associated with the relationship between the object and the person obtaining the object. The neoclassical "revolution" involved the abandonment of the classical theory of value based on the centrality of labor or work in the production of wealth and its replacement with a preoccupation with the "utility" gained from the consumption of wealth.

Neoclassical economists view value in terms of the relationship between costs of

production and subjective elements, called supply and demand. They emphasize that prices also depend upon the level of demand, which in turn depends upon the amount of consumer satisfaction provided by individual goods and services. The neoclassical theory of value, therefore, is a neoclassical theory of supply-and-demand behavior. For neoclassical economics, the value of a commodity is determined only by its subjective scarcity, i.e. the degree to which people's desire for that a commodity exceeds its availability. It is the Marginal Theory of Value or subjective theory of value . Typically, the neoclassical answer to these value questions involves the specification and use of what might be called market analysis. Markets are considered locations or sites where values are determined.