

**What is “new” and what is “classical” in neo-classical economics, and how and why were they combined?**

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John Maynard Keynes (1883-1946) wrote: “... *the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else*” (Keynes, 1949, p. 383). With these words, the distinguished economist encapsulates why studying previous trends in the ever-evolving landscape of economic thought is crucial. One may agree or disagree with previous thinkers, but understanding the current world requires a frame of reference within which the past can be understood. Modern economics often stems from a direct continuation or critique of past points; thus our view of current times will always be a synthesis of previous thinkers and new realities.

Events throughout history have led to shifts in mainstream academia, such as the prominent move from classical to neo-classical economics. This prompts questions; what triggers reorientations of economic thinking and do some of the old tenets stand the test of time? What will last and what will renew? This paper will explore these questions applied to the specific case of classical and neo-classical economics, examining *new* elements in neo-classicism and the persistence of *classical* ideas. Within the framework of political and economic thought, *how* and *why* the transition of economic schools took place will be scrutinized. As such, this paper will explore selected characteristics of the two schools and the context in which they were shaped, and finally briefly relate this to later challenges to orthodox thinking in the economic field.

## I. CLASSICAL ECONOMICS

### **The Father of Modern Economics - Adam Smith**

Professor of moral philosophy Adam Smith (1723-1790) laid the foundation for classical economy with *An Inquiry into the Nature and Causes of the Wealth of Nations* (Smith, 1976) in 1776 (Backhouse, 2002, p. 131). 18th-century Europe was dominated by mercantilism, characterized by states using protectionist policies to secure a positive trade balance, and with a slow but steady emergence of industrialism in the late 1700s, Smith found an audience in industrialists eager to get rid of the market restrictions (Roll, 1942, p. 156; Backhouse, 2002, p. 58). As the full title of his main work proclaims the causes of the wealth of nations - of economic growth - is seen as an imperative and became the concern of Smith and the classical school of economics (Barber, 1967, p. 27).

The first chapter of *Wealth of Nations* announces his most important explanation of economic growth, namely “The Division of Labour” (Smith, 1976, Book I, Chap 1). Characterized by the idea of specialization, Smith famously illustrated the concept through an imaginary pin factory, showing that division of labour would increase the production of a factory, just as it would lead to production efficiency in a society (Barber, 1967,

p. 28). Seeing that Smith asserted that “*labour is the measure of value*” (Smith, 1976, Book I, Chap 5), the value of a given good was determined by the amount of labour required for its production, thus economic growth is embedded in the division of tasks as it leads to a more efficient allocation of labour resources. This was the foundation for the labour theory of value, which was to later be adopted by the likes of Ricardo, Malthus, and Mill, making it a distinctive feature of classical economists (Barber, 1967, p. 107).

Inspired by a Hobbesian state of nature, the framework of Smith’s ideas assumes individual rationality (Backhouse, 2002, p. 123). In *Wealth of Nations*, he asserts that every man “*intends only his own security; (...) intends only his own gain*”, furthermore man “*would be led by an invisible hand to promote an end which was no part of his intention*” (Smith, 1976, Book IV, Chap. 2). The introduction of “the invisible hand” signifies an early acknowledgment of the market mechanism, here illustrated by how rational actions can inadvertently promote social benefits (Pedersen, 1981, p. 21). Not only does the market mechanism shape individual choices, but it also crucially influences prices. Building on the labour theory of value, Smith distinguished between the natural price - equal to a good’s value stemming from labour - and the market price - at which the good was being sold (Smith, 1976, Book I, Chap 5). When these prices did not coincide, the market mechanism of the forces of competition in a free market could be expected to push the market price toward the natural price. Without explicitly using the term, Smith is portraying what would later be recognized as *equilibrium* (Barber, 1967, p. 33).

The best circumstances for the market to flourish, Smith advocated, was a system of “natural liberty” characterized amongst other things by free competition. The British mercantilist system of the time, dominated by tariffs and monopolies, mended the market to suit the interests of the government, but Smith proclaimed that a better outcome was expected if instead the only regulation present was that of the invisible hand (Barber, 1967, p. 33). This laissez-faire attitude does not call for no government at all though, some government institutions like justice and defense were needed. However, Smith stressed that it had no role in any attempt at regulating parts of the market sector as mercantilist policies clearly did by increasing the internal circulation of money (Backhouse, 2002, p. 129).

### **From Corn Laws to Comparative Advantage - David Ricardo**

Concerned with extending the tradition launched by Smith, David Ricardo (1772-1823) went on to become a front figure of the classical school of economics (Barber, 1967, p. 76). Understanding economic growth and its determinants was of utmost importance (Pedersen, 1981, p. 32), but Ricardo added a new dimension to this by directly stating that understanding the laws of distribution was “*the principal problem in Political Economy*” (Ricardo, 1951, p. 5). Four decades had passed since the publication of *Wealth of Nations*, and Britain, marked by the Napoleonic wars and the dawn of industrialization, had a severely challenged economy.

Protectionist measures like the Corn Laws, tariffing imports, served the interests of the landlords but led to class conflicts with the growing industrial class, prompting Ricardo's intervention (Barber, 1967, p. 78). With *Essay on the Influence of a Low Price of Corn on the Profits of Stock* (Ricardo, 1815), Ricardo notably attempted to analyze the economy through a simplified agriculture-based model, enabling him to inspect the distribution mechanisms.

Ricardo found the labour approach to value built into the classical tradition by Smith sufficient, to which he stressed: "from no source do so many errors, and so much difference of opinion in that science proceed, as from the vague ideas which are attached to the word value" (Ricardo, 1951, p. 13). Building upon the labour theory of value and division of labour, Ricardo famously developed the concept of comparative advantage. Emphasizing the advantages of exploiting the comparative strengths of nations, he advocated for free trade, arguing that it would foster a form of the international division of labour ultimately leading to economic growth (Barber, 1967, p. 90). In the context of the exemplary case of the British Corn Laws, Ricardo spoke directly of abolishing the tariffs on corn (grains). This might negatively impact landowners, but the benefits from industry profits, investments, and overall economic growth brought by a tariff-free market would outweigh the consequences, he argued (Pedersen, 1981, p. 45; Galbraith, 1987, p. 80).

A pioneering step toward *marginalism* that was to later occur, was David Ricardo's exploration of the diminishing utility of agriculture. Ricardo observed that as agriculture expanded, it led to the cultivation of marginal poorer lands where more labour input per unit of output was needed than previously before. Additional profits from cultivating these lands would be squeezed, simply leading to diminishing returns (Barber, 1967, p. 82). These insights were the first systematic attempt at applying marginal thinking in economics and partly functioned as a foundational understanding for the neo-classical economists that were to come (Pedersen, 1981, p. 47).

### **Time for Revisionism - John Stuart Mill**

John Stuart Mill (1806-1873) aimed not to originate but to consolidate classical analysis evolving since Smith. His major work, *Principles of Political Economy* (1848), retained the Ricardian framework, while also incorporating criticisms of Ricardo and updating parts of Smith's *Wealth of Nations* (Backhouse, 2002, p. 154). By Mill's time in the mid-19<sup>th</sup> century, many of the policy affairs in which the earlier classicist had been involved, such as the Corn Laws, had been repealed or amended - generally liberalized as promoted by the likes of Smith and Ricardo (Barber, 1967, p. 94). Despite laissez-faire policies contributing to economic growth in the immediate post-Napoleonic war decades, Mill saw that the newfound gains did not reach the least advanced groups in society (Barber, 1967, p. 95). This was thought-provoking to Mill, prompting him to be the first big thinker of many to question a basic premise of classical economics, something later challenged

by heterodox schools of economics; that achieving economic growth was a goal that required no further justification (Barber, 1967, p. 101).

Despite criticizing certain classical points, Mill persistently identified with the classical school of economics. A defining feature hereof was his subscription to the labour theory of value - marking him as arguably the last great classical economist (Barber, 1967, p. 98). However, upon recognizing the limitations of the narrow focus on labour in this approach, he introduced modifications like incorporating the first mentions of utility and demand, and Mill's adjustments signaled the launch of a shift towards a generally more subjective and utility-based understanding of value (Backhouse, 2002, p. 154).

Moreover, an important contribution of Mill was exploring the concept of diminishing utility of production and its implications for marginal cost. The more units of investment, the less the marginal utility of said units will be, reminiscent of Ricardo's diminishing utility in agriculture. "*The increasing power which mankind are constantly acquiring over nature, increases more and more the efficiency of human exertion, or, in other words, diminishes cost of production*" (Mill, 1848, pp. 700-701). This underscored Mill's pioneering role and his insights into the diminishing marginal utility of commodities marked him as a forerunner for the later marginalist breakthrough led by William S. Jevons. On Mill's many economic innovations, of which this paper mentions only a few, it can be said that he "*caught the scent of an issue that was to later preoccupy a generation of economists*" (Barber, 1967, p. 99) - that generation would turn out to be the neo-classical economists.

## II. NEO-CLASSICAL ECONOMICS

Though classical economics succeeded in addressing the policy problems from wars and infant industrialization, towards the end of the 19<sup>th</sup> century the school seemed outdated, as Western societies simply had undergone significant economic changes (Backhouse, 2002, p. 165). At this point, the industrial concentrations had immense size and economic power, the gradual formation of trade unions began, and the so far normal market actions no longer consistently led to *natural* and *market* prices, as Smith had argued - all signaling a need for rethinking economic paradigms (Barber, 1967, p. 164). Influenced by the intellectual currents of the time, neo-classicism arose as a response to imperfections in classical economics that called for policy amendments. In this era, analytical focus shifted to systematically understand not just growth, but how the market allocates resources, emphasizing a transition from macro to micro perspectives, with an underlying newfound interest in human behavior (Barber, 1967, p. 163). The movement also embraced a more mathematical approach to the science than previously attempted, and, as aforementioned, marginalism became

crucial; neo-classical economics was “*basically marginalism with a judicious recognition of the surviving contributions of the classical school*” (Brue, as cited in Lund, PET lecture 7, 2023, slide 24).

### **From Labour to Marginal Utility - William Stanley Jevons**

Typical for the time, the economic training of William Stanley Jevons (1835-1882) was based on Mill’s principles, but his main work *The Theory of Political Economy* (1871) contains many disagreements hereof, especially regarding the classicists’ labour theory of value. While Ricardo and later Mill both briefly acknowledged that utility of some sort was necessary for a good to have value, Jevons voiced that the deep-rooted idea of labour as the foundational scale of value was wrong. “*Prevailing opinions make labour rather than utility the origin of value; and there are even those who distinctly assert that labour is the cause of value*” (Jevons, 1888, p. 1). To marginalists, value depended entirely on utility, an approach that characterizes the neo-classical economists, particularly: “*the final degree of utility is that function upon which the Theory of Economics will find to turn*” (Jevons, 1871, p. 52; Backhouse, 2002, p. 168).

Likely inspired by Ricardo’s marginal soil and Mill’s marginal costs, the “final degree of utility” as Jevons words it, can be understood as the marginal utility; the benefit a given consumer receives from the last unit consumed. Thus, the labour theory of value was rejected and now the era of the marginal utility theory had begun (Backhouse, 2002, p. 168), where the utilitarian Jevons stated a general law that “*the degree of utility varies with the quantity of commodity, and ultimately decreases as that quantity increases*” (Jevons, 1888, p. 53). Jevons further scrutinized this, finding that the final degree of utility was determined by supply; “*we have only to trace out carefully the natural laws of the variation of utility, as depending upon the quantity of commodity in our possession, in order to arrive at a satisfactory theory of exchange, of which the ordinary laws of supply and demand are a necessary consequence*” (Jevons, 1888, pp. 1-2). Furthermore, he stated that economists generally had failed at discriminating between the utility in total and this crucial marginal utility, which to fully grasp the latter there was a need for laws of supply and demand - that would later be invented by fellow neo-classicist Alfred Marshall (Jevons, 1888, p. 52; Pedersen, 1981, p. 88).

Jevons’ background as a meteorologist and a chemist heavily influenced his approach to economics, which he found to be a science inherently “*mathematical, simply because it deals with quantities*” (Jevons, 1888, p. 1). He saw economics as an exact science, in which decisions relied on subjective utility maximization, which traces back to Adam Smith’s assumption of individual rationality, but where morals do not influence the outcome. The claim of economics as a purely mathematical science clashed with the moral and social attitude of classical economists like Smith, a professor of moral philosophy, and J.S. Mill who in the preliminary remarks of his main work had stated that “*if the economic condition of nations are caused by moral or*

*psychological causes, dependent on institutions and social relations, or on the principles of human nature, their investigation belongs to moral and social science*” (Mill, 1848, pp. 21-22).

### **The Architect of the Scissor Blades - Alfred Marshall**

“Among neo-classical pioneers, Alfred Marshall was a giant without rival” (Barber, 1967, p. 168). Marshall (1842-1924) held economics to be a study of “*mankind in the ordinary business of life*” (Marshall, 1961, p. 1), emphasizing it should be accessible to a broad audience. Similarly, he saw the role of the economist not in determining normative truths about economic trajectory, but in developing descriptive principles for economic problem-solving (Barber, 1967, p. 168; Backhouse, 2002, p. 181). With “the ordinary business of life” Marshall focused on the behavior of small units in the system, versus classicists’ concern with society as a whole. Microeconomics was brought to the center stage and with this *modus operandi*, mathematics, particularly differential calculus, entered the economic field and became Marshall’s key tool, just like Jevons’ had predicted (Barber, 1967, p. 164).

Although neo-classical economists at this point explained value with Jevons’ marginal utility theory, Marshall found it insufficient for explaining market prices of commodities seeing that the view of utility had become subjective. This led to an elaborate revisitation of previous analyses of market price formations, and he found supply and demand to be equally important determinants of market price. Though the era of the labour theory of value and Adam Smith’s natural prices was now long gone, it is important to note that the classical assumption of individual rationality persisted (Barber, 1967, pp. 165-170).

Marshall introduced the interplay of supply and demand in determining market prices, with supply influenced by competition, labour, and production. He defined demand as the relationship between quantities demanded and prices, creating a curve if depicted graphically. The classical economists’ view of demand contrasted sharply with this, as it focused on fixed aggregate demand - not expected to vary in response to market prices (Barber, 1967, p. 171). In Marshall’s model, the supply curve would shift should the costs of production change, and likewise the demand curve shifts according to the conditions underlying it. The essence of Marshall’s partial equilibrium analysis - illustrated by the infamous scissor blades - is that at the intersection of supply and demand equilibrium is found (Barber, 1967, p. 175). “*When demand and supply are in stable equilibrium, if any accident should move the scale of production from its equilibrium position, there will be instantly brought into play forces tending to push it back to that position*” (Marshall, 1961, p. 288). The partial equilibrium analysis echoed Smith’s idea of an invisible hand, but with Marshall’s quantitative approach to the matter, this had now been illustrated and for the first time the otherwise invisible hand of the market mechanism seemed visible (Pedersen, 1981, p. 94).

### III. REFLECTIONS

Some components of neo-classical economics were new - like emphasis on utility, marginal analysis, mathematics, and microeconomics - while others adhered to the classical tradition. Jevons based marginal analysis on classic theories on diminishing utility, and Marshall examined the market mechanism influenced by Smith's invisible hand. Other key principles of the classical school that persisted were the liberal views on limited government intervention and free market competition (Barber, 1967, p. 166). These laissez-faire principles were challenged in the 20th century by Keynes, who in the context of The Great Depression and WWI advocated for active government intervention to stabilize the economy. Despite predominant differences, Keynesianism retained echoes of core principles from Smith two centuries prior, like individual rationality and the importance of market mechanisms (Barber, 1967, p. 250; Backhouse, 2002, p. 292). This underscores that when new economic thoughts develop, all prior ideas cannot automatically be condemned as irrelevant.

#### **Challenging Classical Ideas in a Contemporary Landscape**

The dynamic field of economics sees perpetual evolution within its overarching framework and new ideas are forever developing. While some classical and neo-classical ideas still exist in contemporary economics, others have yielded to new dominating economic schools and paradigms. Following neo-classicism, Keynesianism and later monetarism and neo-liberalism came to dominate the field and reshape the discourse on economic principles (Barber, 1967, p. 117; Backhouse, 2002, pp. 232, 294, 321). Despite diverse focuses and approaches, these schools share an enduring emphasis on economic growth rooted in classical times. However, numerous forms of heterodox economics have emerged, challenging the foundation of the orthodox economy.

One heterodox school gaining popularity in the contemporary context of climate change, is ecological economics, questioning growth-centric goals and instead advocating sustainability. Economist Kate Raworth has introduced the concept of the "Doughnut economy" stating that "*the economy's over-arching aim is no longer economic growth in and of itself, but rather to bring humanity into the safe and just space*" (Raworth, 2012, p. 8). This form of challenge to traditional concepts is echoed by behavioral economics, which challenges the assumption of individual rationality. Seeing that an overwhelming part of economic models throughout history has relied on "the rational man", behavioral economists like Nobel-prize winning Richard Thaler highlight that: "*humans do a lot of misbehaving, and that means that economic models make a lot of bad predictions*" (Thaler, 2015, p. 4). These are just a few of the otherwise long-lasting classical and neo-classical ideas that in recent years have been questioned, which prompts reflections on what will be challenged next, and which principles will withstand the ever-changing currents of economic thought.



#### IV. CONCLUSION

This assignment has shown that neo-classical economics retained parts of classical principles, such as rationality and market mechanisms while incorporating new elements to adapt to the historical context of industrialization and post-war struggles. Understanding the various historical contexts helps explain *why* a shift in the science of economics was called for in the late 19<sup>th</sup> century. Ideas from a range of economists have been used, from Adam Smith's founding elements in the early beginnings of classicism to Alfred Marshall's neo-classical partial equilibrium analysis centuries later. This is done to grasp the background of both schools and to exemplify *how* the combination of new and old took place - something that is still done to this day, which is reflected upon in the last part of the assignment.

Not one economic school is definitively better than the others and the science of economics will most likely never slow down on reinvention and reach an agreement. Economics is a dynamic field studying, following, and shaping the everchanging world - and it does not look like the pace of change is going to slow down anytime soon; maybe quite the contrary.

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