

Article 1.1

THE UNREAL BASIS OF NEOCLASSICAL ECONOMICS

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Ten years after the financial crisis, we still find mainstream economists engaging in overly simplistic analysis that does not accurately capture the dynamics of the real world. People studying economics need to know that the principles of mainstream economics are hopelessly unrealistic. In this short article, we demonstrate that the 10 principles of economics in Gregory Mankiw's best-selling textbook are divorced from reality and reflect an extreme and unwarranted bias towards unregulated markets. Mankiw's "Ten Principles of Economics" should more accurately be titled "Ten Principles of Unrealistic Neoclassical Theory."

Mankiw's Principle #1: People Face Tradeoffs/ There is no such thing as a free lunch.

Mankiw ignores the historical determination of the distribution of resources and the crucial distinction between those whose income comes almost entirely from the performance of labor and those whose income comes from their ownership of capital. As a result he is unable to recognize the political power that results from the concentration of wealth in the capitalist class, and to analyze the distributional impact of decisions in which those who gain are often significantly different from those who lose. In addition, history is full of accounts of forcible appropriation of resources that appeared to be "free" to those who acquired them.

Mankiw's Principle #2: The Cost of Something Is What You Give Up to Get It/Opportunity Cost

Insofar as individuals are able to make decisions, their choices can be described as "giving up" one opportunity in order to take up another. This tells us nothing about the determination of the choices that are available to them. The "choice" of

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Insofar as individuals are able to make decisions, their choices can be described as "giving up" one opportunity in order to take up another. This tells us nothing about the determination of the choices that are available to them. The "choice" of a worker as to whether to take on a dangerous job or face eviction from a home requires a very different analysis than one suitable for a discussion of the choice between apples and oranges. On a different level, an analysis of the "trade-off" between income now and increased income in the future requires an understanding of ecological limits to the growth of material production.

Mankiw's Principle #3: Rational People Think at the Margin.

Neither consumers nor producers, nor humans in many other social roles, generally act on the margin. The assertion of marginal analysis that decisions must be such as to equate marginal benefit with marginal cost is simply a restatement

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of the first derivative condition resulting from maximization subject to a constraint, rather than a reflection of real human choice. Mainstream theory then defines behavior according to this mathematical construction even though it does not govern actual choice in the real world. But more important is the presumption that all decision-making is guided by the well-being of isolated individuals, and thus that "rationality" consists of behavior that maximizes the benefit of the individual decision-maker. This dismisses the fact that people are social animals whose decision-making recognizes the interaction between individuals, and it ignores how in the real world people make decisions considering their whole situation under possible alternatives, material restraints, imperfect information, their

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Mankiw's Principle #4: People Respond to Incentives.

This is tautological. Furthermore, models based on monetary incentives by self-ish, isolated individuals and firms in perfectly competitive markets are unrealistic and ignore crucial real-world issues. Monetary incentives are not all that matters. In the real world, people make many decisions on the basis of their evaluation of the resulting well-being of many people beyond themselves, or on social and cultural norms.

Mankiw's Principle #5: Trade Can Make Everyone Better Off.

Trade can increase total production, but trade has distributional impacts, with winners and losers. Trade in modern capitalism tends to foster inequality while undermining wages and working conditions for many laborers. This principle promotes unregulated trade, but unregulated trade has not proven to be the best route to economic development, nor is it good for all people. In the real world, infant industries, immiserating growth, terms of trade shocks, and increasing inequality render this principle useless as a policy guide.

Mankiw's Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

As there are no measurable units by which one can classify all specific economic activities in the real world as "good" or not, principle #6 is nothing more than a neoclassical ideological declaration of faith. Markets are human creations that operate differently in various economic systems, and the various existing and potential economic systems themselves are human creations. The first real question then is if under an existing system private capitalist markets driven by the profit motive do better than possible alternative human creations for providing the good or service, potentially driven directly by the desire to meet specific human needs. Important examples providing evidence of the inferior performance (efficiency and effectivity) of private capitalist market-driven systems are well run social security systems and single-payer health care systems. Avoiding the error of accepting the system as given, a deeper question would be if under some different

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economic system, which was not built to favor capitalist accumulation, alternatives could outperform profit-driven markets operating in capitalist systems.

Mankiw's Principle #7: Governments Can Sometimes Improve Market Outcomes.

Behind this assertion is the idea that markets are natural and could run without any government intervention, and that such natural markets tend to be efficient but sometimes are not quite optimal. In those cases the efficiency of markets could be improved by government tweaks. To the contrary, in the real world, all markets are created by governments, which both establish the rules of the game and enforce them, and thereby determine market outcomes. If the government passes laws requiring that food be safe, that changes the market for food, and yields different market outcomes than if those laws did not exist. With this understanding, principle #7 is reduced to the not very profound statement that because governments create markets, they have the ability to create them with better or worse outcomes. Further, the issue always ignored by neoclassical economics of social divisions is particularly important for considering "better market outcomes": better for whom? Market rules are shaped by power structures to benefit some classes and other social groups more than others (for example capitalists at the expense of workers, First World countries at the expense of Third World countries, etc.).

Mankiw's Principle #8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services.

Higher GDP per capita does not necessarily result in a higher material standard of living for all people within, as well as between, countries. Furthermore, neoclassical economics operates with a definition of "standard of living" as the amount of goods and services consumed, so this principle reduces to the not quite tautological, but not very insightful, claim that the amount of goods and services consumed in a country depends on its ability to produce them. In the real world, what people are concerned with is their quality of life, which includes social respect, power to act on one's desires, conditions of work (and not just pay), social relations, and much more. Neoclassical economics does not address the extension of principle #8 to what people in the real world are actually concerned with, their

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Mankiw's Principle #9: Prices Rise When the Government Prints Too Much Money.

Since the neoclassical definition of "too much money" is the amount that makes prices rise, this is a tautology. In the real world, the relationship between prices and the money supply is complex: expanding money might cause a jump in prices or it might cause no price increases at all, depending on many other things in the economy. The applied policy transformation of this into the incorrect claim that

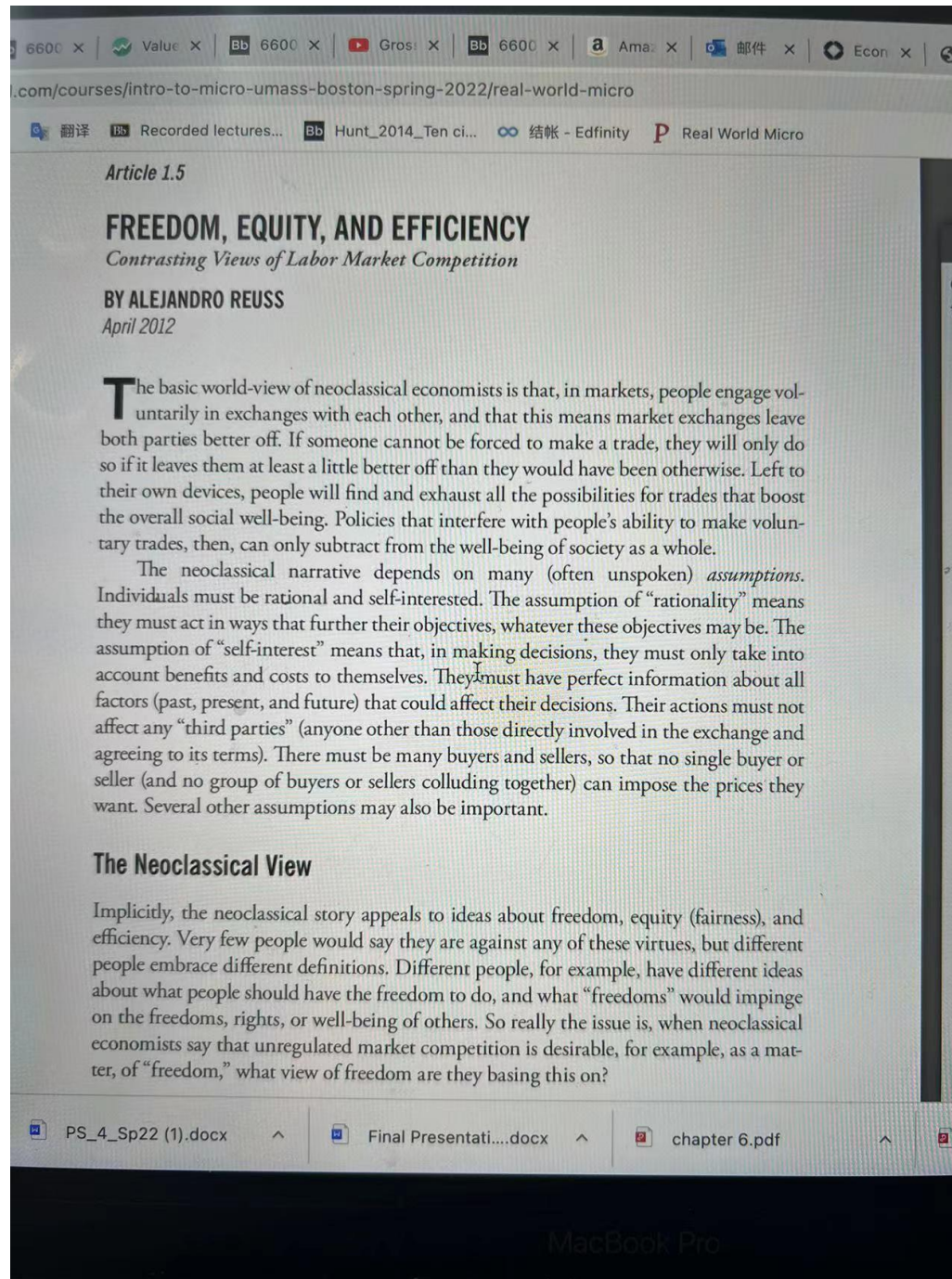
"prices rise when the government prints more money" is an ideological artifice, used today to justify austerity policies and keeping wages low.

Mankiw's Principle #10: Society Faces a Short-Run Tradeoff between Inflation & Unemployment.

The relationship between inflation and unemployment is complex and does not follow a systematic pattern. By the 1970s data from the real world had caused textbooks to go from Phillips Curves to Shifting Phillips Curves to abandoning them entirely. In view of that experience, principle #10 of a short-term trade-off between inflation and unemployment has become a neoclassical ideological justification for challenging those who advocate policies that would reduce the rate of unemployment, by fostering fears of inflation that may never materialize.

In conclusion, Mankiw's so-called "Ten Principles of Economics" ignore crucial realities of the economic world. In particular, Mankiw excludes power imbalances, inequality, social forces, development experiences, the realities of market behaviors, laws and outcomes, realistic measures of quality of life, and recent macroeconomic data from his principles. It is hard to imagine a less useful set of ideas to guide modern societies in designing a good economic system. Unfortunately, almost all other mainstream principles of economics textbooks parrot these same principles. Students of economics will have to look elsewhere for useful analysis of the economy and how to build a democratic economy and society that works for all. □

Source: Gregory Mankiw, *Principles of Economics*, 7th Edition. (Cengage, 2015).



Article 1.5

FREEDOM, EQUITY, AND EFFICIENCY

Contrasting Views of Labor Market Competition

BY ALEJANDRO REUSS

April 2012

The basic world-view of neoclassical economists is that, in markets, people engage voluntarily in exchanges with each other, and that this means market exchanges leave both parties better off. If someone cannot be forced to make a trade, they will only do so if it leaves them at least a little better off than they would have been otherwise. Left to their own devices, people will find and exhaust all the possibilities for trades that boost the overall social well-being. Policies that interfere with people's ability to make voluntary trades, then, can only subtract from the well-being of society as a whole.

The neoclassical narrative depends on many (often unspoken) *assumptions*. Individuals must be rational and self-interested. The assumption of "rationality" means they must act in ways that further their objectives, whatever these objectives may be. The assumption of "self-interest" means that, in making decisions, they must only take into account benefits and costs to themselves. They must have perfect information about all factors (past, present, and future) that could affect their decisions. Their actions must not affect any "third parties" (anyone other than those directly involved in the exchange and agreeing to its terms). There must be many buyers and sellers, so that no single buyer or seller (and no group of buyers or sellers colluding together) can impose the prices they want. Several other assumptions may also be important.

The Neoclassical View

Implicitly, the neoclassical story appeals to ideas about freedom, equity (fairness), and efficiency. Very few people would say they are against any of these virtues, but different people embrace different definitions. Different people, for example, have different ideas about what people should have the freedom to do, and what "freedoms" would impinge on the freedoms, rights, or well-being of others. So really the issue is, when neoclassical economists say that unregulated market competition is desirable, for example, as a matter, of "freedom," what view of freedom are they basing this on?

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Freedom

By “freedom,” neoclassical economists mean freedom from force or threat of force. They would recognize that someone making an exchange when threatened with violence—when confronted with “an offer they can’t refuse,” in the *Godfather* sense of that phrase—is not really engaging in a voluntary transaction. That person could very well make an exchange leaving them worse off than they would have been otherwise (except that they may have saved their own neck). On the other hand, suppose a person is faced only with very undesirable alternatives to engaging in a trade. Suppose they have “no choice” but to accept a job, because the alternative is to starve. Neoclassical economists would point out that these circumstances are not of

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the potential employer’s making. It is quite unlike, in their view, conditions that are directly imposed by the other party (like having a gun held to one’s head). If the impoverished worker accepts a job offer, even at a very low wage or under very bad working conditions, the neoclassical economist would argue that this is evidence that he or she really is made better off by the exchange. Restricting his or her freedom to engage in this exchange, in the neoclassical view, only makes him or her worse off.

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Equity

Neoclassical economists argue that restrictions on market competition can unfairly benefit some market participants (buyers or sellers) or potential market participants at the expense of others. This kind of equity concern enters into neoclassical theory in several ways:

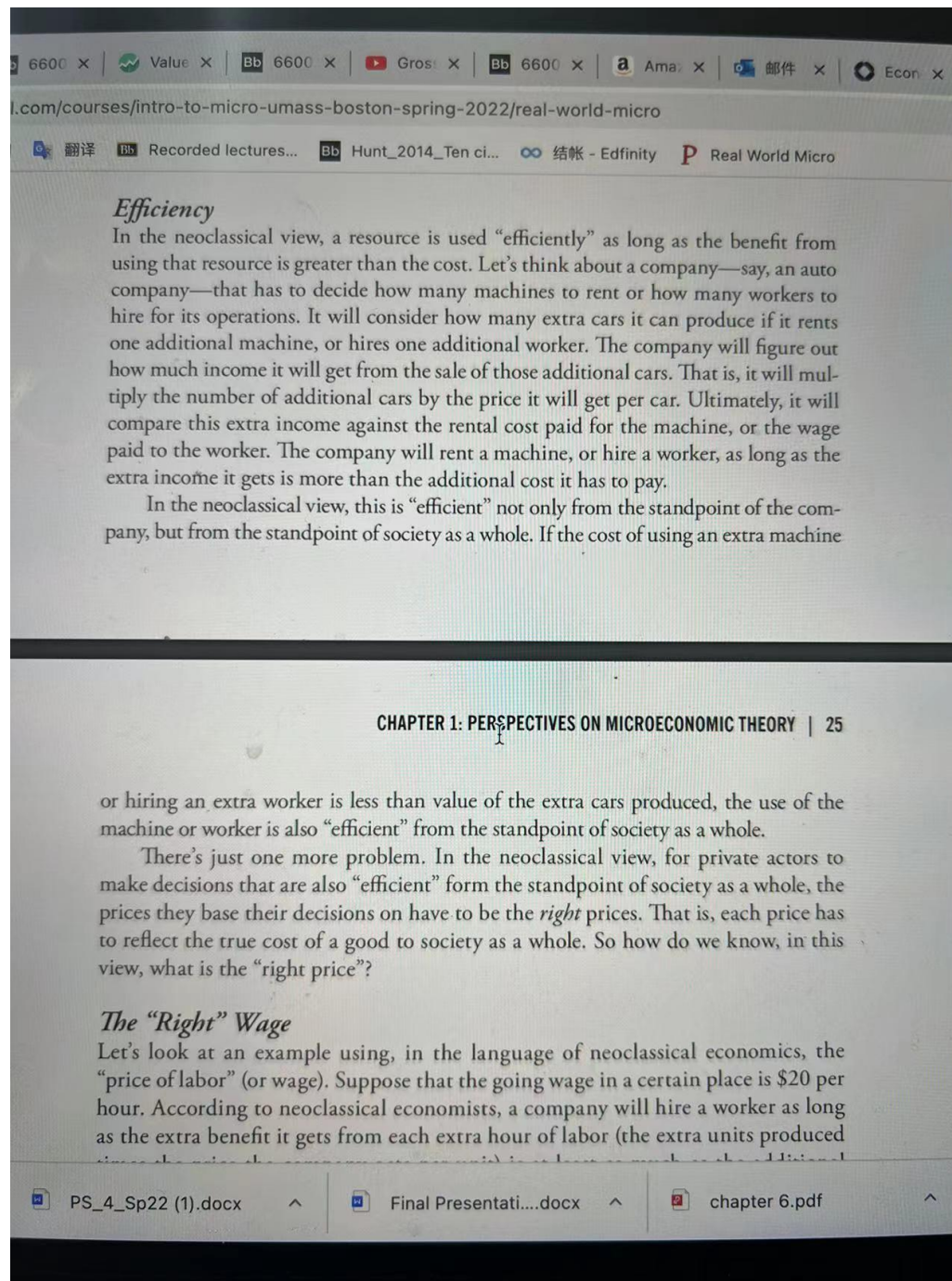
First, restrictions on competition may affect the ability of different people (or firms) to participate in a market—to offer what they have for sale or to bid on what others offer for sale. Suppose that the government issues special licenses to some people or firms that permit them to engage in a certain trade, like driving a taxi, while denying such licenses to others. (Such policies create “barriers to entry,” in the language of neoclassical economics.) Such restrictions are, in the neoclassical view, unfair to the unlucky (or less-influential) individuals or firms who do not receive licenses and so are locked out of the market.

Second, restrictions may affect the ability of different people to use whatever advantage they may have, to compete in a market. A price floor, for example, prevents lower-cost sellers from using their cost advantage (their willingness to accept a lower price) to compete in the market. In the neoclassical view, this favors higher-cost sellers at the expense of their lower-cost competitors.

Third, restrictions may affect the ability of sellers to fetch the highest price they can, constrained only by competition from other sellers, and of buyers to pay the lowest price they can, constrained only by bidding from other buyers. A price floor, by restricting producers from competing on price (preventing any from offering prices below the floor), may favor producers in general at the expense of consumers. By the same token, a price ceiling (a maximum legal price) may favor consumers at the expense of producers.

Efficiency

In the neoclassical view, a resource is used “efficiently” as long as the benefit from using that resource is greater than the cost. Let’s think about a company—say, an auto company—that has to decide how many machines to rent or how many workers to hire for its operations. It will consider how many extra cars it can produce if it rents one additional machine, or hires one additional worker. The company will figure out how much income it will get from the sale of those additional cars. That is, it will multiply the number of additional cars by the price it will get per car. Ultimately, it will compare this extra income against the rental cost paid for the machine, or the wage



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The "Right" Wage

Let's look at an example using, in the language of neoclassical economics, the "price of labor" (or wage). Suppose that the going wage in a certain place is \$20 per hour. According to neoclassical economists, a company will hire a worker as long as the extra benefit it gets from each extra hour of labor (the extra units produced times the price the company gets per unit) is at least as much as the additional cost it pays for that extra hour of labor (\$20). Suppose, however, that the wage was only this high because there were barriers to competition in the labor market. If the wage without barriers would have only been, say, \$10, then a company would hire an extra worker as long as the extra benefit it got from each extra hour of labor was at least \$10 per hour.

How do we know whether the "right" wage is \$20 or \$10? In the view of neoclassical economists, the right wage—like any other right price—reflects the true cost to society of the good involved (here, an hour of labor). The cost of labor is whatever pains the worker endures as a result of that hour of work. This includes having to show up for work, when one might prefer to be someone else, having to follow the employer's orders, when one would rather be "doing one's own thing," putting up with the conditions at work, which could be dangerous, unhealthy, or unpleasant, and so on. It is competition in the labor market that makes workers reveal what they really require to compensate them for the burdens of labor.

If the price of labor, due to barriers to labor-market competition, is "too high," then employers will use "too little" labor. If the wage is \$20, due to barriers, then employers will not hire an extra hour of labor unless it results in the production of at least \$20 of additional goods. As a result of the inflated price of labor, society will have turned its back on who-knows-how-many opportunities to get between \$10 and \$20 of goods at a true cost of \$10 worth of labor. In other words, wages that are inflated by barriers to competition result in an "inefficient" use of resources.

Critiques of the Neoclassical View

Economists associated with different schools of thought may use normative concepts like "freedom," "equity," or "efficiency," but mean something very different by these ideas than what neoclassical economists mean. (Some may choose not to use these terms, and instead invoke other normative concepts, like "justice," "equality," "the good life," and so on.) Here, however, we will focus on contrasts with the neo-

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Freedom

Neoclassical economists emphasize workers’ freedom of choice to accept low wages, long hours, bad working conditions, and so on. Workers would not accept those conditions, they argue, unless doing so would leave them better off than they would be otherwise. In this view, institutions like unions or policies like minimum-wage laws interfere with workers’ freedom to make a deal that would leave them better off.

Many liberal and almost all radical economists, on the other hand, emphasize how the conditions that an individual will “freely” accept depend on the alternatives available to them. If the only alternative is to starve in the street, most people would work even very long hours, under very bad conditions, for very low pay. Instead of seeing these workers as having “freely” accepted such agreements, however, one could view them as lacking any real freedom to *refuse* these conditions.

Union contracts, minimum-wage laws, and other restraints on competition between workers do, indeed, restrict each individual worker’s “freedom” to accept lower wages, worse conditions, and so on, just as neoclassical economists argue. However, this view ignores the benefit to each worker—that these institutions also *protect* each worker from other workers undercutting him or her. Instead of seeing

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lower wages, worse conditions, and so on, just as neoclassical economists argue. However, this view ignores the benefit to each worker—that these institutions also *protect* each worker from other workers undercutting him or her. Instead of seeing restraints on labor competition as robbing workers of the freedom to accept lower wages or worse conditions, one can instead see them as giving workers the freedom to demand higher wages or better conditions.

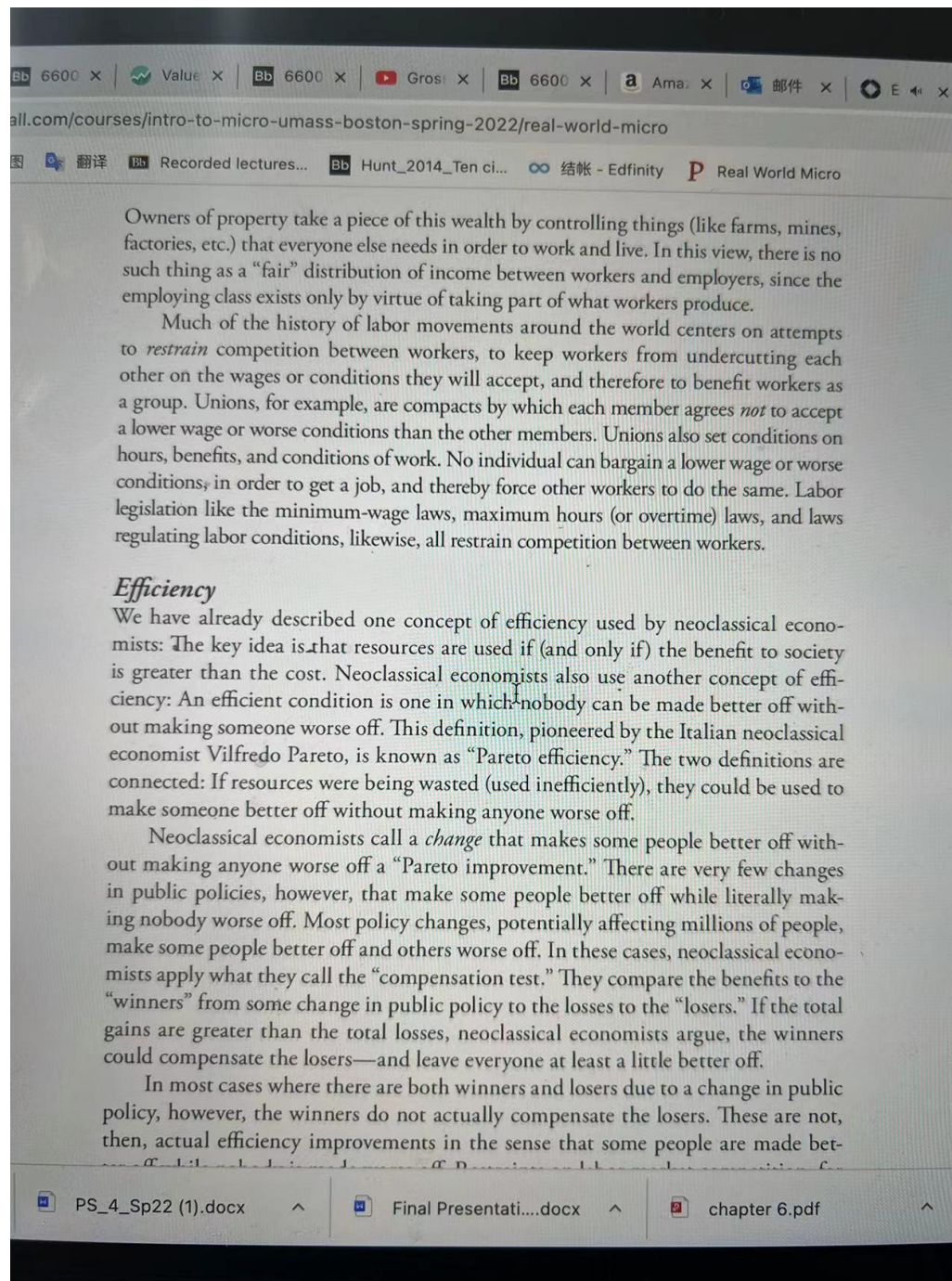
Equity

Barriers to labor-market competition, neoclassical economists argue, favor some workers at the expense of others and workers at the expense of consumers. An alternative view is that restraints on labor-market competition allow workers to get a better deal (higher pay, better conditions, etc.) from employers. The absence of these restraints, on the other hand, may result in higher profits for employers while relegating workers to lower pay and worse conditions. Which outcome one prefers depends on how one values benefits to one group of people (workers) compared to benefits to another (employers).

There are several reasons that someone might favor the interests of workers over those of employers, and therefore approve of changes that benefit workers even if these benefits come at the expense of employers:

1. **Ideas of “fairness” based on social “custom” or “convention.”** In most societies where people work for wages, there are evolving ideas about what is a “fair” wage or “decent” living. Partly, such ideas may be based on what people have become accustomed to in the past. Partly, they may reflect expectations that conditions of life will improve over time, and especially from one generation to the next.
2. **Commitment to greater economic and social equality.** People who get most of their income from property (ownership of businesses, land or buildings, or financial wealth) are likely to be at the top of the income ladder. Most of the people at the bottom or in the middle, on the other hand, get most of their income from work. Therefore, changes that benefit workers as a group (at the expense of employers) tend to bring about a more equal distribution of income in society.
3. **Ideas about who creates and deserves to keep society’s wealth.** Some “radical” economists argue that labor is the source of all new wealth produced in society.

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legislation like the minimum-wage laws, maximum hours (or overtime) laws, and laws regulating labor conditions, likewise, all restrain competition between workers.

Efficiency

We have already described one concept of efficiency used by neoclassical economists: The key idea is that resources are used if (and only if) the benefit to society is greater than the cost. Neoclassical economists also use another concept of efficiency: An efficient condition is one in which nobody can be made better off without making someone worse off. This definition, pioneered by the Italian neoclassical economist Vilfredo Pareto, is known as “Pareto efficiency.” The two definitions are connected: If resources were being wasted (used inefficiently), they could be used to make someone better off without making anyone worse off.

Neoclassical economists call a *change* that makes some people better off without making anyone worse off a “Pareto improvement.” There are very few changes in public policies, however, that make some people better off while literally making nobody worse off. Most policy changes, potentially affecting millions of people, make some people better off and others worse off. In these cases, neoclassical economists apply what they call the “compensation test.” They compare the benefits to the “winners” from some change in public policy to the losses to the “losers.” If the total gains are greater than the total losses, neoclassical economists argue, the winners could compensate the losers—and leave everyone at least a little better off.

In most cases where there are both winners and losers due to a change in public policy, however, the winners do not actually compensate the losers. These are not, then, actual efficiency improvements in the sense that some people are made better off while nobody is made worse off. Restraints on labor-market competition, for example, may benefit workers at the expense of their employers. (Eliminating such policies, meanwhile, may have the opposite effect.)

Judging whether these changes are for the better, then, involves weighing the benefits to some people against the losses to others. How one resolves such an issue depends on one’s normative ideas, or values, about whose interests should take precedence. In other words—which side are you on? □

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