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Neoclassical Economics and the "Cult" of Economic Efficiency: Understanding the Ghosts of the Past

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Introduction

As part of this panel on ecological economics, I have been asked to critique neoclassical economics, the persuasion to which most economists ascribe. To do this, one must be familiar with economic efficiency, the cornerstone of neoclassical economics. Indeed, economic efficiency provides the foundation for the work of neoclassical economists and for much of our policy making. For example, cost/benefit analysis, which is a tool many of you use, is a derivative of the principle of economic efficiency and is believed to be the automatic outcome of markets that are functioning perfectly.

Adam Smith's world and legacy

The roots of the preoccupation with economic efficiency and the idea of perfectly functioning markets go back to the work of Adam Smith. During the 16th, 17th, and 18th centuries the long history of feudalism was coming to an end in Europe and a different type of economic system was emerging. Smith was trying to make sense of this changing world. In 1776 he published his seminal work, *The Wealth of Nations,* where he articulated for the first time a systematic treatment of the market economy and highlighted the benefits therein.

Smith was a great proponent of natural law. He saw human nature as complex and characterized by many different "impulses," some of them contradictory. The market economy seemed to him to build on and balance out innate inclinations that included "self love, sympathy, a desire to be free, a sense of propriety, a habit of labor, and the propensity to truck barter and exchange one thing for another" (Roll 1974:146) Smith presumed that social harmony grew out of individual self-interest under the organization of the market economy. He stated: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." We are all acquainted with the metaphor of the invisible hand. Producers follow their own self-interest; that is, to make money and are led "by an invisible hand" to provide people with what they want (Smith 1776 [1969]:18).

Smith highlighted the fact that we all have a natural proclivity to truck barter and exchange, which encourages a division of labor, thereby making us more productive. The limit of the division of labor is thereby dictated by the extent of the market.[1] Finally, Smith recognized the importance of competition to assure that the freedom of individuals to trade was not corrupted by economic power. Again, the market economy, by building on and balancing our natural proclivities, was considered by Smith to be the natural order of society.

Neoclassical economics and the meaning of economic efficiency

Over the course of the 19th century, Adam Smith's idea that the market economy was the natural order of society eventually ossified into a system of thought we refer to as "neoclassical economics." Neoclassical economists worked out a highly mathematical, mechanistic framework for modeling the market economy that gave new meaning to the notion of the natural order. The market economy was thought to behave like the laws of Newtonian physics, mechanistic and deducible from first principles. In this model, individual decision-making is the entry point and focus of analysis. Individuals are thought to be self-interested maximizers of utility and profits. The complexity of human nature acknowledged by Smith was reduced to the crass utilitarianism and individualism of Jeremy Bentham as espoused in his book *An Introduction to the Principles of Morals and Legislation* (1780 [1969]). Provided there is no coercion or "market power" and provided that individuals have all relevant information, the "invisible hand" of the market is thought to automatically assure that individuals get what they want in the amounts they want at the lowest possible price, all without central planning and big government. This is specifically what is meant by "economic efficiency." Thus the market channels individualism and self-interest into what is considered an optimal allocation of resources. The model of the economy, known in principles of microeconomics courses as "perfect competition," is the systematic presentation of this framework.

In the neoclassical model of perfect competition or perfectly functioning markets there is no concentration of economic power and no advertising. Information is perfect and so is foresight, and markets are accessible to all who want entry. Individuals maximize their utility and firms maximize profit under these arrangements and all costs and benefits of production and consumption are reflected in market prices.

But the reality is markets never function perfectly. Over time, the concentration and centralization of market power have become facts of economic life and the nature and size of the economy has changed dramatically. We've moved beyond pin factories, Adam Smith's quintessential example of modern production. Moreover, markets have been plagued by the presence of externalities, common-property resources, and other sorts of "market failure." Indeed, many costs and benefits of production and consumption are simply not registered in the market. Furthermore many environmental services and amenities, such as healthy ecosystems and the presence of wilderness, have no market values attached and are simply not considered in market decision-making. Ascribing market value to environmental amenities that cannot be priced is contrived and always inadequate.[2] Nonetheless, after several centuries of the reality of imperfectly functioning markets we are still using the model of perfect competition as the norm or standard by which we judge how well real markets are functioning.

The problem of misplaced emphasis

It is true that over time neoclassical economics developed models of *im*perfect competition and "market failure" to accommodate economic reality. The recognition of different sorts of market failure, such as common-property resources and the existence of externalities, and the presence of imperfect competition, such as monopolies and oligopolies, became the framework for thinking about the real world. The idea was/is to try to determine how these real-world situations deviate from the "norm"; that is, the norm of perfect competition—which rarely occurs and therefore is not the norm. In this framework. policy-making attempts to militate against the concentration of economic power, internalize externalities, specify property rights, and ascribe prices to amenities that have no prices. In short, these are the strategies used to deal with the "aberrant" markets so that they can be made to function more perfectly and assure the outcome of economic efficiency. This misplaced emphasis places the real world of markets in the shadow of perfect markets, subsumed under the heading "market failure." Efficiency, which is never the outcome of real markets, somehow becomes the *sine qua non* of market outcomes. Things are turned upside down. In part, this is how we are led out of the world of reality and into the world of ideology where beliefs become fixed in an almost irrational way.

But perhaps as problematic as the misplaced emphasis is the fact that we are given the impression that if only we can correct for market failure, things will be "hunky dory." This simply is not the truth. Efficiency doesn't guarantee sustainability or equity. As an example, wilderness can disappear completely from this earth. Fisheries can be depleted. Biodiversity can be lost. Ecosystems can be simplified and degraded. We can have an economy that produces mink coats while people can't access health care. That is not to say that sustainability and equity can't be added on as separate goals; indeed they must be added on if they are to be acknowledged as necessary outcomes of our present economic system.

The problem with making biophysical reality and history irrelevant

Another significant problem with the preoccupation with economic efficiency is that it offers us a framework for envisioning the economy that is removed from biophysical reality and de-emphasizes history. The importance of biophysical reality and qualitative and cumulative effects of the economy over time are sacrificed for the emphasis on rational decision-making of individuals given the constraints they face (reflected in prices) at a point in time. Neoclassical economics tells us that at a point in time there aren't enough resources to produce everything that everyone wants. Thus "the" economic problem becomes one of constrained maximization; that is, getting the most satisfaction out of the resources we have. Individuals maximize utility given the prices they face and their budget constraints and firms maximize profits given the prices of resources. Prices presumably reflect short-run scarcity and all costs and benefits of production and consumption. Efficient markets will assure that existing resources are allocated to resulting maximum satisfaction, therefore guaranteeing that we do the best with what we have.

For a moment let's see where this emphasis takes us. It is assumed that if firms are presented with the scarcity of a particular resource, the price of that resource will increase. In response to the price increase, firms will simply try to find another resource that they can use as a substitute, much as consumers will substitute among products they consume as prices change. Firms have the imperative to find substitutes on the basis of price changes because of the reward of profit or the fear of being put out of business. Moreover, in the longer run, as some resources become scarce, technological change, also induced by price changes, is assumed to be forthcoming to overcome any particular resource constraint. This is a world where all resource scarcity is relative and registered in prices and no scarcity is ever absolute, an economic world disconnected from biophysical reality. The belief is that price changes elicit substitution and technological change, which overcome short-run and long-run problems of scarcity. With faith in technology and the fungibility of resources, there is no concern with the overall scale of economic activity, nor is there concern with absolute scarcity. The primary concern is assuring that market prices register what they should so we get efficient outcomes.

But what do history and biophysical reality actually tell us? They tell us that the rate of change and growth of the economy are unprecedented and both this *rate of change* and its *cumulative effect* are important considerations. They tell us that environmental and ecological sensibilities and understanding are often eclipsed by short-run economic imperatives, and that more often than not we are unable to anticipate in a timely fashion the problems that technology and the scale of economic activity present us. Market prices will never sufficiently capture all that is necessary for a full consideration of the relationship of the economy to the natural world.

Conclusion

Jack Turner's rant on "Economic Nature" in his book *The Abstract Wild* (Turner 1996:51–68) provides an interesting perspective on economics. According to Turner, we must be mindful of the ways that economists colonize the world with their language. Surely we should not allow the world to be colonized by the language of "economic efficiency." It is not magic, it's not natural law, and it can't reflect all of the reality society needs to consider. It cannot assure economic justice or sustainability in the sense that we leave future generations with the same possibilities for fulfillment that we have enjoyed. We should be cautious about using a framework that claims to account for so much and yet accounts for so little. Without proper attention to the dynamic historical reality of the interface between the economy and the natural world, an emphasis that the framework of economic efficiency can't provide us, we will be left trying to deal with global climate change as if it were an externality and wilderness preservation as simply a matter of appropriate valuing in the framework of cost/benefit analyses. It is imperative to think outside the box of economic efficiency. We must account for many things that cannot be encapsulated in the language of efficiency, including the irrationality of unbridled economic growth.

Endnotes

1. The economist, Karl Polanyi, made the following comment about Smith on this point: "In retrospect it can be said that no misreading of the past ever proved more prophetic of the future" (Polanyi 1944 [1957]:43).
2. For an excellent critique of attempts to do so see Ackerman and Heinzerling 2004.

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