Microfoundations

Microfoundations refers to a concept in economics associated with a research program that developed in the 1940s and which apparently became uninteresting to economists by the 1980s. If macroeconomics is associated with aggregate economic models, and microeconomics is associated with the individual behavior of households and firms, “microfoundations” was taken to be the demand that macroeconomic models have microeconomic foundations (Weintraub 1979). That is, no macroeconomic model was to be deemed acceptable if it could not be derived from underlying individual choice behavior.

Though this seems unobjectionable, it in fact carried some intellectual baggage. In the 1940s, there were two strands of economics that vied for the attention of theorists: the first was the economics of Keynes, associated with managing the economy as a whole. The second was general equilibrium theory, a view of the economy as built on the optimizing behavior of individuals and firms, which investigated whether all their independent decisions could possibly lead, as Adam Smith had suggested, to coherent social outcomes. General equilibrium analysis was part of the tradition of the Cowles Commission, then located at the University of Chicago. For Cowles’ economists, Keynesian macroeconomic theory needed to be derived from the foundational work in general equilibrium theory else it would be an ad hoc theory. The neoclassical synthesis, the marriage of neoclassical general equilibrium with Keynesian macroeconomics, begun with Lange’s (1944) *Price Flexibility and Unemployment* was further developed in Klein’s (1947) *The Keynesian Revolution*, and was completed by Don Patinkin’s (1956) *Money, Interest and Prices*. Keynesian models “fell out” as special cases of aggregated general equilibrium models with money.

In the 1950s and 60s many Keynesians were opposed to general equilibrium analysis out of a belief that Keynesian economics was not a special case of rigidities and market failures in those models, and for them “microfoundations” became the code word for a desire to reconstruct microeconomics to support Keynesian macroeconomics. At the same time, anti-Keynesians like monetarist Milton Friedman began constructing equilibrium expectations models that ruled out the idea of the Phillips Curve trade-off between unemployment and inflation that then played a role in standard Keynesian models.
Microfoundations thus became part of the “monetarists versus Keynesians” debate of the 1960s, with the Keynesians asking for non-general equilibrium (disequilibrium or Marshallian partial equilibrium) microfoundations to be developed, and the monetarists asking that Keynesian analysis be reconstructed to accommodate rational expectations equilibrium models.

As is the case for most controversies in economics whose bases are oversimplifications of complex analytic positions, neither perspective on the microfoundations of macroeconomics made contact with much of what was actually going on in economic analysis. Presently, in the first decade of the 21st century, economists do not produce arguments about microfoundations as such. The reconstruction of macroeconomic analysis in the post-Robert Lucas period has resulted in the general acceptability, indeed general requirement, that macroeconomic models be based on optimizing behavior by (perhaps representative) economic agents. Microfoundations now gives only a residual hint of earlier foundationalist thinking, and merely suggests that the choice structure of any particular economic model be clear and well-specified. To the degree that “microfoundations” has a meaning today, it is more on the order of “agents’ decisions and choices should not be based on ad hoc specifications.”

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References