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A Post Keynesian theory of economic policy—filling a void

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A Post Keynesian theory of economic policy—filling a void

Abstract: *The traditional theory of economic policy of the Tinbergen-Theil-type has come under severe criticism: in the ontological setting of the “new classical macroeconomics” based on the rational expectations hypothesis, economic policy is ineffective or neutral with respect to real variables. In the ontological setting of Hayekian economics based on informational deficiencies, economic policy is without orientation and, therefore, more harmful than helpful. Therefore, both criticisms are united in their rejection of state interventions. In this paper, a Post Keynesian alternative is presented which is situated between nomocratic abstinence and teleological controllability.*

Key words: *economic policy, policy coordination, Post Keynesianism.*

If a brief characterization of Keynesianism were requested, it is highly likely that reference would be made to certain policy orientations that may be dubbed “easy money” and “discretionary fiscal policy,” as they are the most prominent ones. These policies follow from hydraulic IS-LM Keynesianism. This has, however, lost a lot of its appeal over the past three decades and has never been accepted by Post Keynesians as an appropriate interpretation of Keynes’s magnum opus. Despite this, most Post Keynesians would probably willingly subscribe to the above-mentioned policy tools as instruments, perhaps still the most important instruments, of macroeconomic fine-tuning of an otherwise unstable economy (see, for example, Arestis and Sawyer, 1998, and the articles in Gnos and Rochon, 2006).¹ This is an important and interesting realization

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¹ Some years ago, a mini-symposium in the *Journal of Post Keynesian Economics* discussed the question of the viability of Keynesian policies raised by Cunningham and Vilasuso (1994–95). The contributions by many prominent Post Keynesians were

as, on one hand, Post Keynesians are far from being united over theoretical issues explaining the laws of motion of the unstable economy (see, for example, Davidson, 2005; Dunn, 2000; Holt and Pressman, 2001b; Lavoie, 2005), and, on the other hand, neither in Keynes's *General Theory* nor in most Post Keynesian textbooks can a distinct chapter on "economic policy" be found.²

This would appear to suggest that, despite all of the theoretical differences among Post Keynesians and between Post and standard Keynesians (that is, however, the "Keynesian results" of lasting unemployment and the instability of capitalist economies are derived), "Keynesian" policy proposals have a strong tendency to relative conformity and are largely uncontested.³ That is, presumably, the reason why no distinct Post Keynesian theory of economic policy has been elaborated other than a number of partial policy measures that seemingly follow from any kind of "Keynesian" theorizing. However, the theory of economic policy is not merely concerned with a single or a bundle of policy instruments being simply imposed on a theoretical model, but it is the doctrine that is concerned with relating means and ends in a systematic way so that the goal of achieving overall welfare maximization may be met (policy dimension). This touches not only upon the optimal use of scarce resources by the political actor (polity dimension) but also upon questions about the willingness of political actors to behave in a certain way and to achieve what has been normatively set (politics dimension).⁴

Traditionally, the policy and the polity dimensions of economic policy-making are separated from the politics dimension. The latter has been left to the political science literature or has become the subject of its own disciplinary niche—(new) political economy.⁵ Although this separation

irritating in the respect that most of them attributed "Keynesian demand management" somewhat disaffectedly to standard or bastard Keynesianism, yet did not present any recognizable alternative and seemingly accepted it as—albeit narrow—representation of Keynesian policy.

² See, for example, Davidson (1994), Lavoie (2006), and Palley (1996). Also, in both "guides to Post Keynesian economics" (Eichner, 1979; Holt and Pressman, 2001a), there is no chapter on economic policy.

³ Actually, also Keynes's original, policy-related work supports this view; see, for example, Keynes (1981a; 1981b).

⁴ For a discussion of the distinctions between the different dimensions, see Witt (2003).

⁵ Certainly, "public choice" is the most prominent and dominant school of New Political Economy (see Besley, 2007, and Mueller, 1989, for the newest developments), but there are also other approaches from a constructivist orientation (see, for example, Heise, 2005).

somewhat artificially disassociates the question of the need and ability to intervene in economic systems, on one hand, from the willingness to do so and from vested interests and power relations in (economic) politics, on the other, there is a sound analytical reason to distinguish between the normative and the positive theoretical elements of economic policy: the former is concerned with matters of efficiency (sometimes termed “output legitimacy”) and is typically the domain of economic rationality, whereas the latter is concerned with matters of effectiveness (“input legitimacy”) and is the domain of political rationality. Although it will be strongly advocated here that neither should take precedence over the other, this paper will concentrate on the normative approach to economic policymaking. In other words, this paper will pose the questions of whether the traditional theory of economic policy is appropriate from a Post Keynesian perspective and, if it is not, what might the features of a Post Keynesian theory of economic policy look like.

The traditional theory of economic policy

It can be argued that the main goal of economic policymaking is to reduce—for those economic variables that are held to determine the welfare of a society—the deviation of actual outcomes from their desired values. This must, in addition, be done at a minimum cost. This, of course, implies (1) the ability to specify objectives or ordered configurations of objectives (welfare functions) as dependent variables, on one hand, and knowledge about instruments in linear causality⁶ to such objectives as independent variables, on the other; (2) at least as many (independent) instruments as there are (independent) objectives; (3) exogeneity of instruments in a control sense; and (4) unitary nature of the political actor who is controlling the instruments (see Acocella and Di Bartolomeo, 2007). If we add the assumption that the difference between the actual values of the variables of interest and their desired ones only occurs due to market failures (i.e., information deficiencies or price and quantity rigidities), the traditional theory of economic policy based on the seminal works of Theil (1956) and Tinbergen (1952) has been briefly summarized. Such works are grounded in Walrasian welfare economics⁷—a “market repair theory

⁶ Linear causality merely indicates a unidirectional way of causation between instruments and targets and should not be confused with the linearity (or, in most cases, nonlinearity) of functional relationships such as utility or loss functions.

⁷ Walrasian welfare economics allows the problems of Kenneth Arrow’s “impossibility theorem” to be obviated insofar as Pareto optimality merely follows from individual utility maximization. The general equilibrium outcomes—as targets—therefore need not be derived from the specification of a separate welfare function.

of economic policy” as Riese dubbed it (1986, p. 178). The political actor is different from the market actors in the respect that he or she has control over the exogenous variables (means), but market actors do not (see Eggertsson, 1997, p. 1189). They simply have to accept the outcome of the endogenous (dependent) variables (ends), which, if policy is being conducted in an appropriate way, will optimize society’s welfare. However, as the famous “Lucas critique” argued convincingly—at least against the background of Walrasian economics—the efficiency of economic policy in a quantitative, teleological manner depends crucially on information and, therefore, expectation problems. For, if rational expectations in the ordinary sense are assumed, market actors will anticipate the political actors’ behavior and, hence, the attendant outcomes, such as, for instance, expansionary monetary or fiscal policies. They will, as a result, adjust their behavior accordingly.⁸ This will lead to a welfare loss for society, but an increase (e.g., rents for certain market participants) in utility for individuals or collective actors (such as cartels or unions). Therefore, quantitative economic policy in the Tinbergen–Theil mold, elaborated during the heyday of sociotechnocracy, appears to be valid only in the short period under sticky expectations, while structural economic policy (or *Ordnungspolitik*) that sets the regulatory and institutional environment of markets is appropriate for the long term⁹ in order to reestablish the conditions of exogeneity for the independent variables and endogeneity for the dependent variables. As the dominant economic discourse has shifted away from market failure toward government failure, there has been a corresponding and observable move away from quantitative to structural economic policy. In other words, (de)regulating markets has become much more a focus of economic policymaking than intervening directly in (existing) markets.

Critique to the traditional theory of economic policy—limits to market repair

The traditional theory of economic policy in its quantitative (i.e., market intervention or market repair) orientation has been impugned not only by

⁸ “The New Classical macro was probably best known for its classical policy ineffectiveness propositions that publicly announced demand management policies would be completely offset by the utility and profit-maximizing responses of agents with rational expectations. Economic policies simply could not matter in a pure New Classical economy” (Wible, 2004, p. 127).

⁹ For a distinction, see Eggertsson (1997, p. 1190).

the Lucas critique but also, and more generally, by the doubts that have been raised about the validity of a number of its underlying assumptions. These assumptions include a unitary policy actor, the endogeneity of the independent variables (means) for the market actors, and, indeed, the assumption of information problems that underpin the notion of market failure in the first place (see Acocella and Di Bartolomeo, 2007). Once the political actor is disaggregated into different authorities (agents) that have their own, independent preferences, which can be contradictory, such as those held by an independent central bank and the fiscal authorities, and once market actors are able to exert an influence over the endogenous variables (such as trade unions on the price level, for instance), the “controllability” inherent in linear means-ends systems of the Tinbergen–Theil type is lost.¹⁰ It can only be reestablished when targets are unambiguously assigned to single actors (such as price stabilization to the central bank or employment determination to trade unions) and clear-cut policy rules (such as the monetarist quantity rule for monetary policy or the productivity rule for wage policy) are specified. Complying with these rules implies the preponderance of a cooperative Nash equilibrium. Put more succinctly, this implies that all those cooperation problems that have, since Barro and Gordon (1983) and Nordhaus (1994), featured so prominently in “policy games” are simply dismissed. An assignment of duties to an organization that functions in the way in which it was intended can be interpreted as means that either rules strategic behavior out or that ends in the same outcome, promoting a particular form of cooperative behavior. It is, however, not very convincing simply to request from political and market actors what game theory predicts to be rather unlikely: “irrationality without regret” (see Frank, 2005).

Reference to the strategic behavior of actors highlights yet another problem of the teleological postulates of the traditional theory of economic policy—complexity. A system (i.e., economic reality) is supposed to be complex by the degree n , if it can assume n different states of development (and, hence, becomes contingent in the possible outcomes). Only under the assumption of $n = 1$ can the system be called deterministic and linear means-ends relations can be possible.¹¹ Yet it is a very strong, heroic assumption that was convincingly questioned by the late Friedrich

¹⁰ This has been partly understood since the early 1960s when Hansen (1963) published a largely neglected book.

¹¹ Dequech argues: “In a broad, general sense, complex merely means complicated” (2001, p. 913). To make it entirely clear, this is not a correct statement in general and certainly not the definition of complexity that is used here.

August von Hayek (1964; 1975). According to Hayek, economic systems are not only complicated in the sense that an immense amount of information about present and future developments needs to be collected and processed—which in itself may overburden the economic and political actors in it—but, more importantly, their evolution over time is open (“contingent”) and, therefore, unknown and unpredictable. This poses insurmountable problems to the common rationality postulate and, thus, gravely undermines the assumption that is made about the optimization capabilities of economic and political actors. It is very interesting to see how this insight leads to different recommendations for the behavior of (private) economic actors, on one hand, and the (public) political actor, on the other. According to Hayek and the Hayekians, there are two devices of paramount importance that allow the actual path of individual (economic and social) interaction to converge toward that evolutionary path that would have been chosen as optimal if *ex post* information were available *ex ante*. These devices are the principles of self-regulation (i.e., market interaction) and self-control (i.e., atomistic competition). As long as the market functions as “discovery procedure” (see Hayek, 1978), even under conditions of complexity of a higher order (i.e., $n > 1$ or, as Hayek called it, “organized complexity”), the “pattern prediction” (*Muster-Voraussage*) of Hayekian economics follows general equilibrium dynamics. Hence, the political actor, who should not pretend to have either additional or, to put it another way, more accurate knowledge, is not supposed to act as “market repairer,” but should simply provide the framework (*Ordnung*) for self-regulation (i.e., clearly specified property rights and systems of contracts) and self-control (i.e., clearly specified and binding competition laws). As Hayek noted:

Of course, compared with the precise predictions we have learnt to expect in the physical sciences, this sort of mere pattern prediction is a second best with which one does not like to have to be content. Yet the danger of which I want to warn is precisely the belief that in order to have a claim to be accepted as scientific it is necessary to achieve more. This way lies charlatanism and worse. To act on the belief that we possess the knowledge and the power which enables us to shape the processes of society entirely to our liking, knowledge which in fact we do *not* possess, is likely to make us do harm. (1975, p. 441, italics in original)

A market participation theory of economic policy—advent of a Post Keynesian alternative?

The inclusion of the somewhat lengthy quotation above is designed to show clearly Hayekian reluctance toward economic policy interventions

as the other extreme of economic policymaking on Walrasian foundations: traditional determinism in the Tinbergen–Theil world allows for teleocratic controllability, whereas Hayekian complexity demands nomocratic abstinence.¹² This then raises a question: Where does a Post Keynesian theory of economic policy fit in?

Although, as mentioned earlier, Post Keynesianism is far from being a coherent theoretical body, no one referring to the work of Keynes can seriously sustain the idea of a deterministic world. Complexity is revealed in contingent developments. Such developments led Keynes to emphasize fundamental uncertainty as compared to deterministic risk.¹³ Information problems do not simply stem from an asymmetric distribution of information, processing difficulties, or stochastic shocks, but they characterize an “nonergodic” world (Davidson, 1994) in which many pieces of relevant information simply do not exist when decisions need to be taken—most importantly, the future is not only unknown and unpredictable, but simply nonexistent and, thus, will only be shaped after decisions have been taken.

Keynes was acutely aware that under conditions of complexity and, hence, fundamental uncertainty, individuals are simply unable to do what Walrasian economics accredit to them: to allocate resources optimally in time and space. Only the introduction of conventions and routines (such as prolonging past developments into the future until new information demands adjustments), institutions (such as collective bargaining systems), rules of thumb, and anthropological prerequisites (such as the famous “animal spirits”) enable humans to act, despite fundamental uncertainty.¹⁴ In addition, it becomes obvious how important restrictions on human behavior are in order to form short- and long-term expectations and attribute a state of confidence to them. From a theoretical point of view, it is, in particular, the institution of “money” and the liquidity premium bestowed upon it determining long-term interest rates which marks the difference between a Walrasian barter economy and a Keynesian monetary production economy. From a political perspective, the outcome is especially

¹² See Hayek (1968) for the notions of “teleocracy” and “nomocracy.”

¹³ For the relation of complexity to uncertainty in different Post Keynesian schools, see Rosser (2006).

¹⁴ As Keynes noted: “The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. . . . If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as a result of cold calculation” (1936, p. 149–150). In a recent article, Page (2008) elaborates extensively and comprehensively on the fundamental distinction between “optimal behavior” and “rule-based behavior.”

important—a long-lasting situation of involuntary unemployment without any tendency of self-adjustment toward full market clearance. To put it differently, this is a view of unemployment equilibrium that rejects Say's and Walras's laws as the Keynesian "pattern prediction."

The consequences for the principles of Post Keynesian economic policy are far-reaching:

- Contrary to Hayekian pretensions, unfettered market interaction—even under the best possible circumstances—does not converge toward Pareto optimal solutions, but may waste productive capacity, skills, and qualifications for very substantial periods. Providing property rights and contract rules in combination with securing (perfect) competition—that is, structural policy (*Ordnungspolitik*)—is clearly not enough.
- The objectives of economic policy are no longer merely functional derivatives of equilibrium solutions of individual egoistic behavior, but must be normatively chosen. Full employment is just as much a "natural" outcome of labor markets in monetary production (i.e., capitalist) economies as any "natural" income distribution is according to productivity measures that exist.
- Although markets may fail when information is incomplete, competition is restricted or adjustment mechanisms are obstructed, the Keynesian "pattern prediction" does not follow from "market failure" but is the result of "satisficing behavior"¹⁵ of individual market actors confronted with fundamental uncertainty.
- If societal objectives are not met automatically—which Keynesians would contend often occurs, as unemployment will not be accepted as a desired outcome¹⁶ in most societies—societies as principals and the states (or the governments) as agents will have to pursue policies directed toward the achievements of these objectives. This, subsequently, suggests that a quantitative, interventionist

¹⁵ This means that agents can act only in a "boundedly rational" way (see Simon, 1957; 1959). However, the use of money as the most liquid asset and the introduction of liquidity preferences as an expression of the state of expectations and confidence renders human behavior, with respect to resource allocation, as "optimal" as possible. Therefore, the concept of "bounded rationality" as used here does not merely refer to the "*behavioral characteristics of agents*" (Dunn, 2001, p. 568, italics in original), but also encompasses fundamental uncertainty. Yet this does not leave decision making hanging in the air: "'Satisficing' behaviour, making the most satisfactory choice out of those that are reasonably available, is the best we humans can do" (Moore, 2006, p. 105).

¹⁶ Some individuals, societal groups, or classes may, however, not be interested in full employment; see Heise (2008a) and Kalecki (1943).

policy (*Prozesspolitik*) is needed. Yet the political actor cannot be pictured as the “repairman” simply correcting “market failures,” but must be seen as a market participant whose aim is to alter the market outcome in a desired way.

- The economic action of any market participant has a measurable impact on macroeconomic variables, such as national income and gross domestic product (GDP) growth rates, employment, capital accumulation, and inflation indices. Collective actors or the political actor are only distinct in the size of these effects. This clearly rules out the “neutral money” and “(fiscal) policy inefficiency hypothesis” of (rational expectation) Walrasian economics.
- As a “market participant,” the political actor has no more direct control over the targeted variables as any other individual or collective actor. In other words, first, and contrary to the Tinbergen–Theil world, there are no linear relations between exogenous (instruments) and endogenous variables (targets) in a complex environment, and second, once the unitary political actor is disaggregated into two or more independent actors (such as the independent central bank, the government, and other semiautonomous bodies), problems of policy coordination necessarily arise.

To sum up, the Post Keynesian theory of economic policy emphasizes the need and efficiency of quantitative, interventionist policies, yet it does not ignore the limitations of “controllability”; that is, the theory results in a strong plea for what might be termed “constrained feasibility” between the extremes of Cartesian “controllability” and Hayekian “non-decisionism.” This can be expressed as a “market participation theory of economic policy.” In addition, this critical knowledge about the limits to policy control, on one hand, and the acceptance of a quite different “pattern prediction” as compared to Walrasian and Hayekian economics, on the other, renders Dempster’s critique unfounded:

In fact, the Post Keynesians’ own vision of pervasive uncertainty would seem to lean against such conclusions [of traditional demand management], for how, in a world of such uncertainty, could the government possibly form policies that are compatible with full employment and price stability? . . . To claim that government can improve upon free-market outcomes by reducing uncertainty, one must somehow infer that the government is able to obtain information that is unavailable to market participants in regard to future prospects. (1999, p. 80)

Dempster’s claim would be well grounded if economic reality were an unpredictable oscillation around a (Pareto optimal) general equilibrium.

This, of course, is the common “pattern prediction” of Walrasian and Hayekian economics. However, once the “pattern prediction” is that of a (Pareto suboptimal) underemployment equilibrium, macroeconomic policy intervention is not based on unattainable information about future oscillations (which would clearly make it fuzzy) but draws upon the deduction of wasted productive resources in the event of *laissez-faire*.

Creating market constellations

It is crucial to understand the different implications of complexity involving fundamental uncertainty, on one hand—something that all of the different market participants similarly face—and, on the other, the possibility to act purposefully—something that Hayek and the Hayekians apparently and mistakenly confine to private, individual actors in providing private goods only. Despite the fact that the political actor—as “political entrepreneur”—has to accept the possibility of missing the stated objectives, as, indeed, any private actor (as consumer, producer, investor, etc.) must do, why should the political actor not provide public goods just as well as any private actor(s)?¹⁷ No better knowledge or more appropriate information on the side of the political actor is needed, but a purpose to produce public goods is—that is, the desire to achieve targeted market outcomes that the market does not provide automatically!

However, the metaphor of “providing public goods”¹⁸ for “economic policymaking” is a very useful one as it pinpoints the constraints that the political actor (as much as private actors) has to face: by supplying the money market with high-powered money, by buying investment and consumption goods or hiring labor for administrative purposes,¹⁹ by levying taxes and contributions or, more generally, by participating in market processes, the political actor will certainly impact on the national income and capital accumulation, on (direct and indirect) employment and wage developments, and on prices and income distribution. Nonetheless, the

¹⁷ In addition, the political actor may, of course, be punished for any misjudgment (by losing electoral votes) as much as the private actor (by losing money); see Witt (2003, p. 82). For the somewhat opaque notion of “political entrepreneur,” see Hederer (2009).

¹⁸ Public goods can be “public utilities” as well as “price stability” or “full employment.”

¹⁹ The political actor can also hire labor for productive purposes. In high times of privatization and the focus on the allocation instead of the stabilization function of governmental action, public ownership of productive capacity is almost completely lost.

political actor cannot be sure about how much of the impact will fall on price—and how much on quantity measures;²⁰ he or she cannot be sure—once more than one independent public body is involved—how possible trade-offs are dealt with or whether the effects are symmetric in either direction of causation (i.e., expansionary or restrictive).²¹ Outside the Tinbergen–Theil world, the political actor has lost absolute control, yet this does not imply or justify the claim for entire abstinence:

- Most importantly, basic institutions must be created and secured in order to minimize the cost of economic interaction necessary in a world in which there is an extensive division of labor—that is, property rights, contract and competition laws, and their ultimate enforcement; this seems to be uncontested throughout the economic profession and calls for structural policies (*Ordnungspolitik*).
- Decision making under the conditions of complexity and fundamental uncertainty is exceedingly hampered due to “cognitive scarcity”²² and the amount of courses of action open to economic agents. Although “cognitive scarcity” cannot systematically be reduced, the political actor by his or her own means is not supposed to increase it either. This requires a rule-based, well-communicated, and credible provision of public goods as opposed to discretionary interventions of the teleological “market repair” type and may be called the “governance” variant of quantitative policies (*ordnungspolitische Prozesspolitik*).
- Moreover, in order to reduce the courses of action open to private market participants, institutions and regulations are needed. Although there is always a trade-off between the uncertainty-reducing nature of such institutions and regulations and the potential cost of

²⁰ In the *General Theory*, Keynes at great length discusses this issue with respect to monetary policy by elaborating on the elasticity of (nominal or, as he called it, money) prices with respect to changes in the quantity of money:

Perhaps the best purpose served by writing them down is to exhibit the extreme complexity of the relationship between prices and the quantity of money, when we attempt to express it in a formal manner. It is, however, worth pointing out that of the four terms e_d , e_w , e_e and e_o upon which the effect on prices of changes in the quantity of money depends, e_d stands for the liquidity factors which determine the demand for money in each situation, e_w for labour factors . . . which determine the extent to which money-wages are raised as employment increases, and e_e and e_o for the physical factors which determine the rate of decreasing returns as more employment is applied to the existing equipment. (1936, p. 305–306)

²¹ In Heise (2006a), the “constrained feasibility” and asymmetric causation has been shown in detail.

²² By “cognitive scarcity,” Wible (2004, pp. 136–138) combines the two elements of informational problems involved here: first, the sheer lack of information and, second, the computational restrictions of human beings.

regressed adaptability to market change, which may, therefore, lead to negative cost–benefit assessments,²³ the course of vindication of neoclassical institutionalism is turned upside down.

- Finally, in order to overcome the cooperation problems accruing from a multitude of independent public (and private, collective) actors, rules, norms, or governance institutions are needed in order to enforce “irrationality without regret”—that is, to turn noncooperative games into cooperative ones.

The specific set of norms and institutions that are purposefully created (external institutions) in combination with cultural norms and conventions (internal institutions) form the environment that has been termed “market constellations” (see, for example, Heise, 2008b).²⁴ They help to shape the behavior of private as well as political market participants. It is evident that such “market constellations” have to be molded according to the societal objectives; however, facilitating specific market constellations (*Gestaltbarkeit*) should not be mixed up with “controlling” certain outcomes (*Machbarkeit*). This, hence, again raises the issue of “constrained feasibility.”

This cannot be the place to elaborate in full detail the features of different market constellations, their systematic effects on market outcomes,²⁵ and the specific use of instruments. Nevertheless, some ideas about the institutional requirements of a “functional” market constellation²⁶—that is, external institutions shaped by the political actor and rule-based quantitative policies—can be derived from the above expositions:

²³ And this may particularly be the case if, as in reality, institutions and regulations are not the outcome of rational consideration but of power relations (*Realpolitik*).

²⁴ The term “market constellation” sounds surely unfamiliar to most readers. It is intended to capture specific market outcomes that are determined by certain formal and informal institutions. An alternative term used for the combination of institutions and outcomes is “regimes,” but as this term has been appropriated by certain schools of thought (the French “Regulation” school and the American “Social Structure of Accumulation” school), I would like to keep the somewhat cumbersome “market constellations” term for distinction.

²⁵ This has been done in Heine et al. (2006) and Heise (2008b).

²⁶ “Functional” market outcomes refers to a notion used by Fritsche et al. (2005, pp. 70–72). Having followed the above expositions carefully, the inclined reader will be aware that this expression is used slightly reluctantly, as it has been pointed out that there are—contrary to Walrasian welfare economics—no functional objectives in Post Keynesian policymaking, but only normative ones. “Functional” in the sense meant here refers to market constellations that facilitate full employment and price stability—two macroeconomic targets that are pursued by most democratic governments, at least as lip service.

- In order to reduce the range of possible future events, the valuation of goods, services, and assets ought to be as stable as possible. This is particularly important with respect to the fundamentals of monetary economies—creditor–debtor relationships. Institutional economics as well as empirical evidence suggest that this can best be safeguarded by granting *independence to a central bank*.²⁷ However, this appears to be merely a necessary rather than a sufficient condition: the potential principal–agent problem of central banks following their own (hidden) preferences must be tackled and *financial markets must be regulated* in order to prevent erratic and instable market behavior. The still ongoing British experiment with instrument instead of target independence of the Bank of England appears not to have solved the principal–agent problem appropriately (see Heise, 2008b, p. 108–113); moreover, financial market regulation needs deeper investigation than can be provided at this point.²⁸
- Assuming given commodity market structures and markup pricing, commodity prices are dependent on nominal unit labor costs. Again, institutional economics and vast empirical evidence suggest that *strong collective actors* on both sides of the labor market (corporatist or encompassing institutions) are the most appropriate means to prevent races to the bottom, deflationary scenarios (nominal anchor) in the advent of high and rising unemployment. In addition, they enable the internalization of external (price) effects in times of low and falling unemployment. Moreover, corporatist

²⁷ Critical views on central bank independence (CBI) (see, for example, Carvalho, 1995–96; Jackson, 2002; Lapavistas, 2001; Wray, 2007) indicate that this position is not uncontested among Post Keynesians. Strictly speaking, the credibility and reliability of monetary policy is crucial in the argument above. CBI comes in only as the mechanism designed to achieve these objectives. Clearly, the gains from CBI can be outweighed by losses if an independent central bank refuses to pursue a policy adequate for stable growth and employment performance (see, for example, Lyons, 1999); this is exactly why any independent central bank must be embedded into a cooperative institutional setup. Put more succinctly, CBI is not to be mistaken as *carte blanche* for noncooperative behavior on the part of the central bank. For Keynes’s views on central banking and CBI, see Bibow (2002).

²⁸ Interestingly, financial market regulation is covered by the Post Keynesian literature only marginally. Even Minsky’s (1986, pp. 313–328) expositions remain rather scant (“it is easy to list objectives, but much more difficult to deliver—to establish institutions and to start processes which will achieve those objectives”; *ibid.*, p. 287) and, for example, in only 3 out of 33 issues since 2000 of the *Journal of Post Keynesian Economics* can papers with related topics be found. Even the “Keynesian” Tobin tax has received low and ambiguous attention (see Davidson, 1997; Dimand, 2004; Keynes, 1936, pp. 159–161).

collective bargaining institutions provide better shelter against personal income dispersion which adds to demand deficiencies and poverty. Here, Post Keynesian recommendations are in fact contrary to those based on self-regulating Walrasian foundations; the latter favor a deregulation of labor markets and a decentralization of labor market institutions under the disciplining effects of competition.

- Monetary, fiscal, and wage policies are caught in policy games. Institutions must be created in order to transform the noncooperative structure of these policy games into a cooperative one.²⁹ If this is not the case, neither of the actors can reach its highest utility level, and, more importantly, full employment and price stability cannot be achieved simultaneously. The failure to achieve those latter two objectives simultaneously leads them to become commonly experienced market constellations that have sparked off a variety of nonaccelerating inflation rate of unemployment (NAIRU) and “conflicting claims” approaches in the economics profession (see, for example, Rowthorn, 1977; Sawyer, 2001). The institution—a “*Macroeconomic Dialogue*,” “*Concerted Action*,” or “*Social Pact*”³⁰—needs to establish communication among the actors and set and monitor accepted policy rules for the actors. Again, the Post Keynesian recommendation of coordination contradicts the Walrasian assignment approach.

Of course, from a Post Keynesian perspective, not only cooperation per se is important,³¹ but so, too, are the “norms of contents.” These describe this cooperation and form the macro-economic policy mix that is supposed to achieve a high and stable level of aggregate demand. This demand, in turn, is designed to combine full employment, price stabil-

²⁹ In most cases, the policy games turn out to follow a Stackelberg leadership (of fiscal policy or wage policy); however, noncooperative Nash equilibria are also possible if there are no collective actors that are able and willing to take a Stackelberg lead.

³⁰ All of the aforementioned institutions can be found in reality: the European Union has institutionalized a “European Macroeconomic Dialogue”; the German “Stability and Growth Act” allows for the establishment of a “Concerted Action”; and Austria and the Netherlands, for instance, have created “Social Pacts” (the “Economic and Social Council” in Austria and the “Socio-Economic Council” and the “Stichting van de Arbeid” in the Netherlands) in order to coordinate their macro-economic policies. However, the results are very mixed, indicating different and potentially inadequate institutionalization.

³¹ As mentioned above, the Walrasian policy assignment of restrictive monetary policy, zero-deficit (fiscal) policy, and moderate wage policy can also be interpreted as particular forms of cooperation, yet this hampers growth and employment potentials.

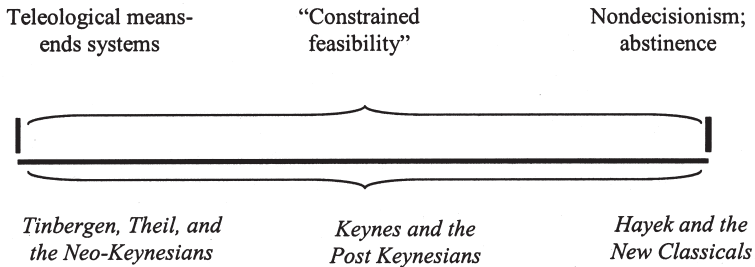
ity, and fiscal sustainability. The instruments are not at all novel. This is also true for their rule-based, correlated perspective and their equi-proportionate contributions. Therefore, Post Keynesianism can neither be portrayed as “fiscalism” nor as primarily monetary oriented.³² There are three main rules supporting this argument: (1) “active” monetary policy according to an employment-augmented Taylor or Post Keynesian rule, (2) sustainable fiscal policy according to a “capital-budgeting” rule, and (3) wage policy according to a “distributional margin” rule. (See Heise, 2008b, pp. 95–108, for more details on these rules and Atesoglu, 2007, specifically for a Post Keynesian monetary policy rule.)

Post Keynesian economic policy—governance of “constrained feasibility”

The traditional theory of economic policy is based on Walrasian equilibrium dynamics. In a deterministic interpretation, this enables linear means-ends systems of quantitative economic policy to be applied in the short period of sticky expectations and institutional rigidities. Moreover, it can be used to support calls for structural policies (deregulation) and laissez-faire economics in the long run. In its nondeterministic interpretation, the recommendation for structural policies and nonintervention is extended even to the short period. This is because complexity, according to this approach, renders any systematic intervention implausible.

A Post Keynesian theory of economic policy rejects both such extreme approaches and replaces them with a theory of “market participation” giving way to “constrained feasibility” (see Figure 1). The political actor is no longer an “external” one that simply corrects market failure or, even more restrictively, merely provides the legal framework for private market participants. Instead, the political actor is a market participant that, after societal objectives have been chosen through a democratic process, pursues such objectives by facilitating market constellations. As facilitating market constellations includes the establishment or support of institutions to foster cooperation among public authorities (such as the central bank and the fiscal authorities) as well as among public and private actors (such as the central bank and the labor market organizations) and among private (collective) actors (such as trade unions or employer organizations), this can no longer be termed a unidirectional,

³² Standard Keynesians emphasized fiscal policy (see, for example, Friedman and Heller, 1969) as much as Post Keynesians (at least of a “horizontalist” perspective) emphasize the priority of monetary policy. Notable exceptions to this are Arestis and Sawyer (2003; 2004a; 2004b) and Setterfield (2007).

Figure 1 Economic policy antinomy

linear *government* process, but is a multidirectional *governance* process of rule-based coarse-tuning.

Discretionary fine-tuning, as in the hydraulic IS-LM model of deterministic policy control, has no place in a Post Keynesian theory of economic policy. However, a whiff of discretion comes in due to the working of the automatic stabilizers and feedback mechanisms built into policy rules (such as, for example, output gaps in the Taylor rule). Although a Post Keynesian theory of economic policy is closer to Hayek than to Tinbergen–Theil in terms of its ontological foundations (which is mirrored in the common preference for norm-oriented public activities), the different “pattern predictions” of Post Keynesian and Hayekian economics distinguish them in terms of their deployment of such norms: active and resource-based market participation here, market regulation (or, as it is sometimes termed, *market making*) there.

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