Heise, Arne

Working Paper

A Post Keynesian theory of economic policy - filling a void

Arbeitspapiere für Staatswissenschaft, No. 28

Provided in cooperation with:
Universität Hamburg (UHH)

Suggested citation: Heise, Arne (2008) : A Post Keynesian theory of economic policy - filling a void, Arbeitspapiere für Staatswissenschaft, No. 28, http://hdl.handle.net/10419/41336

ARBEITSPAPIERE FÜR STAATSWISSENSCHAFTEN –

WORKING PAPERS ON ECONOMIC GOVERNANCE

Department
Wirtschaft und Politik

Universität Hamburg

No. 28

A Post Keynesian theory of economic policy – filling a void

Arne Heise

March 2008

ISSN: 1613-7000

Die Arbeitspapiere für STAATSWISSENSCHAFT/ Working Papers on ECONOMIC GOVERNANCE werden in unregelmäßiger Folge von der Professur Wirtschaftspolitik/ Economic Governance am Department Wirtschaft und Politik der UNIVERSITÄT HAMBURG ausschließlich in elektronischer Form herausgegeben:

Prof. Dr. Arne Heise
Universität Hamburg
Fakultät Wirtschafts- und Sozialwissenschaften
Department Wirtschaft und Politik
Von-Melle-Park 9

D-20146 Hamburg

Tel.: -49 40 42838 2209
e-mail: Arne.Heise@wiso.uni-hamburg.de

Das Verzeichnis aller Arbeitspapiere und anderer Veröffentlichungen/ List of all working papers and other publications:
www.hwp-hamburg.de/fach/fg_vwl/DozentInnen/heise/Materials/heise-downlds.htm

Zitierweise:

Autor (Jahr), Titel, *Arbeitspapiere für Staatswissenschaften* Nr. X, Department für Wirtschaft und Politik der Universität Hamburg

Citation:

Author (Year), Title, *Working Papers on Economic Governance* No. X, Department of Economic s and Political Science at Hamburg University

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 (REH), 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 harm- than helpful. Therefore, both criticisms are united in their rejection of state interventions. In this paper, a Post Keynesian alternative will be presented which is situated between nomocratic abstinence and teleological controllability.

Key words: Economic policy, Post Keynesianism, policy coordination

A Post Keynesian theory of economic policy – filling a void

Arne Heise, Hamburg University

1. Introduction

If one is asked to briefly characterise Keynesianism, one surely would be directed towards certain policy orientations which may be dubbed as 'easy money' and 'discretionary fiscal policy' as they are the most prominent ones. Although they follow from hydraulic ISLM Keynesianism which has lost a lot of its appeal over the past three decades and has never been accepted by Post Keynesians as appropriate interpretation of Keynes' *opus magnum*, still most Post Keynesians would probably willingly subscribe to the above-mentioned policy tools as instruments, perhaps still most important instruments, of macroeconomic fine-tuning of an otherwise unstable economy (see e.g. Arestis/Sawyer 1998 and the articles in Gnos/Rochon 2006)[1]. This is quite interesting to realise as on the one hand, Post Keynesians are far from being united over theoretical issues explaining the laws of motion of the unstable economy (see e.g. Dunn 2000; Holt/Pressman 2001a; Davidson 2005; Lavoie 2005) and, on the other hand, neither in Keynes' *General Theory* nor in most Post Keynesian textbooks do we find a distinct chapter on 'Economic policy' or the like[2].

This appears to suggest that despite all theoretical differences among Post Keynesians and between Post and standard Keynesians, i.e. however 'Keynesian results' of lasting unemployment and the instability of capitalist economies are derived, 'Keynesian' policy proposals always end up very similar and almost uncontested.[3] Probably, that is why no distinct Post Keynesian theory of economic policy has been elaborated other than a number of partial policy measures seemingly following from any kind of 'Keynesian' theorising. 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 is the doctrine that is concerned with the systematic relations of means and ends in order to achieve overall welfare maximisation (policy dimension). This not only touches upon the optimal use of scarce resources by the political actor (polity dimension) but also on questions about the willingness of political actors to behave in a certain way and to achieve what has been normatively set (politics dimension)[4].

---

[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/Vilasuso (1994/95). The contributions by many prominent Post Keynesians were irritating in the respect that most of them attributed 'Keynesian demand management' somewhat disaffectedly to standard or bastard Keynesianism, yet did not present any recognisable alternative and seemingly accepted it as - albeit narrow - representation of Keynesian policy.

[2] See e.g. Davidson (1994), Palley (1996), Lavoie (2006). Also, in both ‚Guides to Post-Keynesian economics' (Eichner 1979; Holt/Pressman 2001) there is no chapter on economic policy.

[3] Actually, also Keynes' original, policy-related work supports this view: see e.g. Keynes (1931); Keynes (1933).

[4] For a distinction of the different dimensions see Witt (2003).

Traditionally, the policy and the polity dimensions of economic policy-making on the one hand are separated from the politics dimension which is left to the political science or which has carved out its own disciplinary niche: (new) political economy[5]. Although this separation somewhat artificially disassociates the question of the need and ability to intervene into economic interactions on the one hand from the willingness to do so and from vested interests and power relations in (economic) politics on the other, there is good analytical reason to distinguish between the normative and the positive theory of economic policy: the former is concerned with efficiency matters (sometimes termed 'output legitimacy') being typically the domain of economic rationality, while the latter is concerned with effectiveness matters ('input legitimacy') being the domain of political rationality. Although I strongly advocate not to forget the one over the other, I will concentrate on the normative approach to economic policy-making here, i.e. I will pose the question whether the traditional theory of economic policy is appropriate from a Post Keynesian perspective and, if not so, how the features of a Post Keynesian theory of economic policy may look like.

The paper is structured as follows: Firstly, a brief overview of the traditional theory of economic policy and its critics is given. Then a Post Keynesian alternative will be outlined and the distinctions between teleological 'controllability', nomocratic 'abstinence' and 'constrained feasibility' elaborated. The focus will be placed on the institutional context of Post Keynesian policymaking rather than on supposedly novel policy instruments or a novel application of them. The paper ends with a brief confrontation of the different approaches.

2. The traditional theory of economic policy

Economic policy-making is concerned with reducing the variance of actual outcomes of such economic variables from their desired values that are supposed to determine the welfare of a society – and to do so at minimum cost. This, of course, implies a) the ability to specify objectives or ordered configurations of objectives (welfare functions) as dependent variables on the one hand and knowledge about instruments in linear causality to such objectives as independent variables on the other; 2) at least as many (independent) instruments as there are (independent) objectives; 3) exogeny of instruments in a control sense and 4) unitarity of the political actor who is controlling the instruments (see Acocella/Di Bartolomeo 2007). If we add the assumption that the difference of actual from targeted variables only occurs due to market failures (i.e. information deficiencies or price and quantity rigidities) we have briefly summarized the traditional theory of economic policy based on the seminal works of Tinbergen (1952) and Theil (1956) which are grounded in Walrasian

[5] Certainly, Public Choice is the most prominent and dominant school of New Political Economy (see Mueller (1989) and Besley (2007) for the newest developments) but there are also other approaches from a constructivist orientation (see e.g. Heise 2005).

welfare economics[6] – a 'market repair theory of economic policy' as Riese (1986: 178) dubbed it. The political actor is different from the market actors in the respect that he has control over the exogenous variables (means) while the market actors have not (see Eggertsson 1997: 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 optimise 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 we assume rational expectations in the ordinary sense, market actors will anticipate the behaviour and the respective outcome of the political actor, for instance expansionary monetary or fiscal policies, and adjust their behaviour accordingly[7] – the result being 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 mould, elaborated during the hay-days of socio-technocracy, appears to be valid only in the short period under sticky expectations, while structural economic policy (or *Ordnungspolitik* in German), changing the structural environment of markets, is appropriate in the long period[8] in order to re-establish the conditions of exogeny of independent variables and endogeny of dependent variables. With the shift in the dominant economic discourse away from market failures towards government failures, a shift from quantitative to structural economic policy can be observed; or to put it differently: (de-)regulating markets has become much more a focus of economic policy-making than intervening into (existing) markets.

3. 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 come under criticism not only by the Lucas critique but more generally with respect to the assumption of a unitary policy actor, the assumption of endogeny of independent variables (means) for the market actors and, indeed, the assumption of information problems underlying market failures in the first place (see Acocella/DiBartolomeo 2007). Once the political actor falls apart into different authorities (agents) forming own and independent preferences (such as the independent Central Bank and the Fiscal authorities for instance) and market actors are able to assert impacts on the endogenous variables (such as trade unions on the

[6] Walrasian welfare economics allows to circumvent the problems of Arrow's 'Impossibility theorem' in so far as Pareto optimality merely follows from individual utility maximisation. The general equilibrium outcomes – as targets – therefore need not to be derived from the specification of a separate welfare function.

[7] „The New Classical macro was probably best known for ist classical policy ineffectiveness propositions that publicly announced demand management policies would be completely offset by the utulity and profit-maximizing responses of agents with rational expectations. Economic policies simply could not matter in a pure New Classical economy" (Wible 2004: 127).

[8] For a distinction see Eggertsson (1997: 1190).

price level for instance), the ‘controllability’ inherent in linear means-ends-systems of the Tinbergen-Theil type is lost.[9] It can only be re-established when targets are unambiguously assigned to single actors (such as price stabilisation to the Central Bank or employment determination to the trade unions) and clear-cut policy rules (such as the monetarist quantity rule for monetary policy or the productivity rule for wage policy) specified – compliance to these rules implies the preponderance of a cooperative Nash equilibrium; or to put it more succinctly: all cooperation problems featuring so prominently in ‘policy games’ since Barro/Gordon (1983) and Nordhaus (1994) are simply banned, a working assignment can be interpreted as ruling strategic behaviour out or, which comes to the same conclusions, as a particular form of cooperative behaviour. 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).

Strategic behaviour of actors refers yet to 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, the system can be called deterministic and linear means-ends-relations are possible.[10] Yet, it is a very strong, heroic assumption which has been convincingly questioned by the late Friedrich 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 – but, more important, their evolution in historical time is open (‘contingent’) and, therefore, unknown and unpredictable. This poses insurmountable problems to the common rationality postulate and, thus, optimisation pretensions raised against economic and political actors. It is very interesting to see how this insight leads to different recommendations for the behaviour of (private) economic actors on the one hand and the (public) political actor on the other: according to Hayek and the Hayekians, there are two devices of paramount importance which allow the actual path of individual (economic and social) interaction to convergence towards that evolutionary path which would have been chosen as optimal if *ex post* information were available *ex ante*: 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 higher degree (i.e. n > 1 or, as Hayek called it, ‘organized complexity’), the ‘pattern prediction’ (*Muster-Voraussage* in German) of Hayekian economics follows general equilibrium dynamics. Hence, the political actor, who should not pretend to have more or more accurate knowledge, is not supposed to act as ‘market repairer’ but should simply provide the framework

[9] This has partly been understood since the early 1960s when Bent Hansen (1963) published a largely neglected book.
[10] Dequech (2001: 913) argues: „In a broad, general sense, complex merely means complicated“. To make it entirely clear, this is not a correct statement in general and certainly not the definition of complexity I am using here.

(*Ordnung* in German) for self-regulation (i.e. clearly specified property rights and systems of contracts) and self-control (i.e. clearly specified and binding competition laws):

> "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 believe 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." (Hayek 1975: 441)

4. A market participation theory of economic policy – advent of a Post Keynesian alternative?

The somewhat lengthy statement is supposed to show clearly Hayekian reluctance towards economic policy interventions as the other extreme of economic policy-making on Walrasian foundations: traditional determinism in the Tinbergen-Theil world allows for teleocratic controllability, whereas Hayekian complexity demands nomocratic abstinence[11]. 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 John Maynard Keynes can seriously sustain the idea of a deterministic world. Complexity shows in such contingent developments which made Keynes emphasise fundamental uncertainty as compared to deterministic risk.[12] Information problems do not simply stem from an asymmetric distribution of information, processing difficulties or stochastic shocks, but they characterise an 'non-ergodic' world (Davidson 1994: 89ff.) in which many information simply do not exist when decisions need to be taken – most importantly, the future is not only unknown and unpredictable but simply non-existent and, thus, will only be shaped after decisions have been taken.

Keynes was painfully aware that under conditions of complexity and, hence, fundamental uncertainty, individuals are simply unable to do what Walrasian economics accredit to them: to optimally allocate recourses 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 thump and anthropological prerequisites

[11] See Hayek (1968) for the notions of 'teleocracy' and 'nomocracy'.
[12] For the relation of complexity to uncertainty in different Post Keynesian schools see Rosser 2006.

(such as the famous 'animal spirits') enable humans to act nevertheless[13] – and it becomes obvious how important restrictions on human behaviour 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 particularly the institution 'money' and the liquidity premium bestowed on it determining long-term interested rates which marks the difference between a Walrasian barter economy and a Keynesian monetary production economy. From a political perspective, it is particularly the outcome which is important: a long-lasting situation of involuntary unemployment without any tendency of self-adjustment towards full market clearance, or: unemployment equilibrium rejecting Say's and Walras' law as the Keynesian 'pattern prediction'.

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

- Contrary to Hayekian pretensions, unfettered market interaction – even under the best possible circumstances – does not converge towards 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, i.e. structural policy (*Ordnungspolitik*), is clearly not enough.
- The objectives of economic policy are no longer merely functional derivatives of equilibrium solutions of individual egoistic behaviour but must be normatively chosen. Full employment is just as little the 'natural' outcome of labour markets in monetary production (i.e. capitalist) economies as any 'natural' income distribution according to productivity measures exist.
- Although markets may fail when information is missing, competition is restricted or adjustment mechanisms are obstructed, the Keynesian 'pattern prediction' does not follow from 'market failure' but is the result of 'satisficing behaviour'[14] of individual market actors confronted with fundamental uncertainty.
- If societal objectives are not met automatically – which Keynesians believe they are most often not as unemployment will not be accepted as desired

[13] As Keynes (1936: 149ff.) 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." In a recent article, Page (2008) elaborates extensively and exhaustingly on the fundamental distinction between 'optimal behaviour' and 'rule-based behaviour'.

[14] This is to mean that agents can act only ‚bounded rationally' (see Simon 1957, 1959). However, the use of money as the most liquid asset and the introduction of liquidity preferences as expression of the state of expectations and confidence renders human behaviour with respect to resource allocation as 'optimal' as possible. Therefore, the concept of 'bounded rationality' as used here does not merely refer to "*behavioural characteristics* of agents" (Dunn 2001: 568) but encompass fundamental uncertainty. Yet this does not leave decision-making hanging in the air: "'Satisficing' behaviour, making the most statisfactory choice out of those that are reasonably available, is the best we humans can do" (Moore 2006: 105).

outcome[15] in most societies –, societies as principals and the states (or the governments) as agents will have to pursue policies directed towards the achievements of these objectives, i.e. quantitative, interventionist policy (or *Prozesspolitik* in German) is needed. Yet, the political actor cannot be pictured as 'repair man' simply correcting 'market failures' but must be seen as 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 or GDP growth, employment, capital accumulation and prices or inflation rates. Collective actors or the political actor are only distinct in the size of these effects – which clearly rules out the 'neutral money' and '(fiscal) policy inefficiency hypothesis' of (rational expectation) Walrasian economics.
- As 'market participant' the political actor has no more direct control over the targeted variables as any other individual or collective actor; or to put it differently again: contrary to the Tinbergen-Theil world, there are no linear relations between exogenous (instruments) and endogenous variables (targets) in a complex environment on the one hand and once the unitary political actor is dispersed into two or more independent actors (such as the independent Central Bank, the government and other semi-autonomous bodies) on the other hand, problems of policy coordination necessarily arise.

To sum up: Post Keynesian theory of economic policy emphasises the need and efficiency of quantitative, interventionist policies, yet does not ignore the limitations to 'controllability', i.e. it results in a strong plea for what might be termed 'constrained feasibility' between the extremes of Cartesian 'controllability' and Hayekian 'non-decisionism' – a *'market participation theory of economic policy'*. And it is this critical knowledge about the limits to policy control on the one hand and the acceptance of a quite different 'pattern prediction' as compared to Walrasian and Hayekian economics on the other hand which renders the following critique unfounded:

> "In fact, the Post Keynesians' own vision of pervasive uncertainty would seem to lean against such conclusions (traditional demand management; A.H.), 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" (Dempster 1999: 80).

5. Creating market constellations

[15] Although some individuals, societal groups or classes may not be interested in full employment; see Kalecki (1943); Heise (2008a).

It is crucial to understand the different implications of complexity involving fundamental uncertainty on the one hand – something with which all the different market participants are faced similarly – and the possibility to act purposefully – something which Hayek and the Hayekians apparently and mistakenly confine to private, individual actors in providing private goods only – on the other hand. But why should not the political actor – as 'political entrepreneur' – provide public goods just as well, although he similarly has to accept the possibility of missing his objectives as any private actor (as consumer, producer, investor, etc.) else[16]? No better knowledge or more appropriate information on the side of the political actor is needed, but a purpose to produce public goods: desired or targeted market outcomes which the market does not provide automatically!

However, the metaphor of 'providing public goods'[17] for 'economic policy-making' is a very useful one as it pinpoints the constraints which 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 labour for administrative purposes[18], 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, on prices and income distribution. Nonetheless, he cannot be sure about how much of the impact will fall on price- and how much on quantity measures[19], he cannot be sure – once there are more than one independent public bodies involved – how possible trade-offs are dealt with or whether the effects are symmetric in either direction of causation (i.e. expansionary or restrictive)[20]. Outside the Tinbergen-Theil world, the political actor has lost absolute control, yet this does not imply the claim for entire abstinence:

- First and foremost, basic institutions must be created and secured in order to minimise the cost of economic interaction necessary in a world of extensive

[16] And, of course, the political actor may be punished for his misjudgement (by loosing electoral votes) quite as much as the private actor (by loosing money); see Witt (2003: 82). For the somewhat opaque notion of 'political entrepreneur' see Hederer (2008).

[17] Public goods can be ‚public utilities' as well as ‚price stability' or ‚full employment'.

[18] The political actor can also hire labour for productive purposes. In high times of privatisation and the focus on the allocation instead of the stabilisation function of governmental action, public ownership of productive capacity is almost completely lost.

[19] In the General Theory, Keynes (1936: 305f.) at great length discusses this issue with respect to monetary policy by elaborating 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."

[20] In Heise (2006a), the ‚constrained feasibility' and asymmetric causation has been shown in detail.

division of labour, i.e. 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'[21] and the amount of courses of action open to the economic agents. Although 'cognitive scarcity' cannot systematically be reduced, the political actor by its 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 regressed adaptability to market change and, therefore, cost-benefit analysis of institutions may turn out negatively[22], 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', i.e. to turn non-cooperative games into cooperative ones.

The specific set of norms and institutions which are purposefully created (external institutions) in combination with cultural norms and conventions (internal institutions) form the environment which has been termed 'market constellations' (see e.g. Heise 2008b)[23] and they help shaping the behaviour of private as well as political market participants. It is evident that such 'market constellations' have to be moulded according to the societal objectives, yet facilitating specific market constellations (*Gestaltbarkeit* in German) should not be mixed up with 'controlling' certain outcomes (*Machbarkeit*), hence 'constrained feasibility' again.

This cannot be the place to elaborate in full detail the features of different market constellations, their systematic impacts on market outcomes[24] and the specific use of

[21] By ‚cognitive scarcity' Wible (2004: 136ff.) combines the two elements of informational problems involved here: firstly, the sheer lack of information and, secondly, the computational restrictions of human beings.

[22] 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*).

[23] The term ‚market constellation' sounds surely unfamiliar to most readers. It is intended to capture specific market outcomes which are determined by certain formal and informal institutions. An alternative term used fort he 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), we would like to keep the somewhat cumbersome ‚market constellations' term for distinction.

[24] This has been done in Heise (2006b; 2008b) and Heine/Herr/Kaiser (2006).

instruments, nevertheless some ideas about the institutional requirements of a 'functional' market constellation[25] – i.e. external institutions shaped by the political actor and rule-based quantitative policies – can be derived from the above expositions:

- In order to reduce the range of possible future events – particularly with respect to the fundamentals of monetary economies: creditor-debtor-relationships-, the valuation of goods, services and assets ought to be as stable as possible. Institutional economics as well as empirical evidence suggests that this can best be secured by granting *independence to a Central Bank*[26]. However, this appears to be merely a necessary but insufficient 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 behaviour. 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: 108ff.), financial market regulation needs deeper investigation than can be provided at this point[27].
- Assuming given commodity market structures and mark-up pricing, commodity prices are dependent on nominal unit labour costs. Again, institutional economics and vast empirical evidence suggest that *strong collective actors* on both sides of the labour market (corporatist or encompassing institutions) are best suited to prevent races to the bottom, deflationary scenarios (nominal anchor) in the advent of high and rising unemployment as well as to enable the internalisation of external (price) effects in times of low and falling unemployment. Moreover, corporatist collective bargaining institutions also shelter better 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 Walrasians foundations which favour a deregulation of labour markets and a decentralisation of labour market institutions under the verdict of competition.

---

[25] By ‚functional' market outcomes, I refer to a notion used by Fritsche et al (2005: 70ff.). Having followed my expositions carefully, the inclined reader will be aware that I am slightly reluctant in using this expression as I have pointed out that there are – contrary to Walrasian welfare economics – no functional objectives in Post Keynesian policy-making but only normative ones. 'Functional' in the sense meant here rather refers to market constellations that facilitate full employment and price stability – two macroeconomic targets which are pursued by most democratic governments at least as lip service.

[26] For a critical view see Wray (2007).

[27] Interestingly, financial market regulation is covered by the Post Keynesian literature only marginally. Even Minsky's (1986: 313ff.) expositions remain rather scanty ("… it is easy to list objectives, but much more difficult to deliver – to establish institutions and to start processes which will achieve those objectives"; p. 287) and e.g. in only 3 out of 33 issues since 2000 of the Journal of Post Keynesian Economics, papers with related topics can be found. Even the 'Keynesian' Tobin Tax has received low and ambiguous attention (see Keynes 1936: 159f.; Davidson 1997; Dimand 2004).

- Monetary, fiscal and wage policies are caught in policy games. Institutions must be created in order to transform the non-cooperative structure of these policy games[28] into a cooperative one; otherwise neither of the actors can reach its highest utility level and, more important, full employment and price stability cannot be achieved simultaneously – commonly experienced market constellations which have sparked off a variety of NAIRU- and 'conflicting claims' approaches in the economics profession (see e.g. Rowthorn 1977; Sawyer 2001). The institution – *a 'Macroeconomic Dialogue', 'Concerted Action' or 'Social Pact'*[29] – 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[30] but the 'norms of contents' describing this cooperation and forming the macroeconomic policy mix which is supposed to achieve a high and stable level of aggregate demand in order to combine full employment, price stability and fiscal sustainability. The instruments are not at all novel, but so is their rule-based, correlated perspective and their equi-proportionate contributions – Post Keynesianism can neither be portrayed as 'fiscalism', nor as primarily monetary oriented[31]: a) 'active' monetary policy according to an employment-augmented Taylor or Post Keynesian rule, b) sustainable fiscal policy according to a 'capital-budgeting' rule and c) wage policy according to a 'distributional margin' rule (see Heise (2008b: 95ff.) for more details on these rules and Atesoglu (2007) specifically for a Post Keynesian monetary policy rule).

6. 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

---

[28] In most cases, the policy games turn out to follow a Stackelberg leadership (of fiscal policy or wage policy), but non-cooperative Nash equilibria are also possible if there are no collective actors that are able and willing to take a Stackelberg lead.

[29] All of the afore-mentioned institutions can be found in reality: the European Union has institutionalised a ‚European Macroeconomic Dialoque (EMD)', the German 'Stability and Growth Act' allows for the establishment of a 'Concerted Action' and Austria or 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 macroeconomic policies. However, the results are very mixed indicating different and as the case may be inadequate institutionalisation.

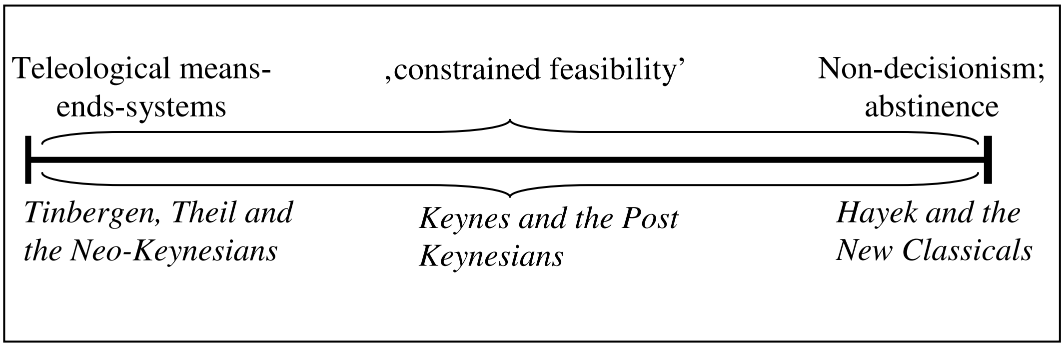
[30] As mentioned above, the Walrasian policy assignment of restrictive monetary policy, zero-deficit (fiscal) policy and moderate wage policy can also be interpreted as particular form of cooperation, yet hampering growth and employment potentials.

[31] Standard Keynesians emphasised as much fiscal policy (see e.g. Friedman/Heller 1969) as Post Keynesians (at least of 'horizontalist' perspective) emphasise the priority of monetary policy – notable exceptions are Arestis/Sawyer (2003; 2004a; 2004b) and Setterfield (2007).

and institutional rigidities, moreover structural policies (de-regulation) and laissez-faire in the long run. In its non-deterministic interpretation, the recommendation for structural policies and non-intervention is extended even to the short period as 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 fig. 1). The political actor is no longer an ‘external’ one, simply correcting market failure or, even more restrictively, providing merely the legal framework for private market participants, but he is a market participant himself who, 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 labour market organisations) and among private (collective) actors (such as trade unions or employer organisations), this can no longer be termed a unidirectional, linear *government* process, but is a multidirectional *governance* process of rule-based coarse-tuning.

Figure 1: Economic policy antinomy



Discretionary fine-tuning as in the hydraulic ISLM 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 stabilisers and feed-back mechanisms built into policy rules (such as e.g. 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.

Literature

Acocella, N., Di Bartolomeo, G.; Towards a new theory of economic policy: Continuity and innovation; in: Neck, R., Richter, C., Mooslechner, P. (eds.); Quantitative Economic Policy Theory and Applications. Essays in honour of Andrew Hughes Hallet, Vienna 2007, pp. 15 - 34

Arestis, P., Sawyer, M.; Keynesian Policies for the New Millennium; in: Economic Journal, Vol. 108, 1998, pp. 181 – 195

Arestis, P., Sawyer, M.; Reinventing fiscal policy; in: Journal of Post Keynesian Economics, Vol. 26, 2003, pp. 3 – 25

Arestis, P., Sawyer, M.; Fiscal Policy: a potent instrument; in: The New School Economic Review, Vol. 1, 2004a, pp. 21 – 32

Arestis, P., Sawyer, M.; On the effectiveness of monetary and fiscal policy; in: Review of Social Economy, Vol. 62, 2004b, pp. 441 – 463

Atesoglu, H.S.; The natural rate of interest and a new monetary policy rule; in: Journal of Post Keynesian Economics, Vol. 29, No.4, 2007, pp. 689 – 697

Barro, R.J., Gordon, D.; Rules, discretion and reputation in a model of monetary policy; in: Journal of Monetary Economics, Vol. 12, 1983, pp. 101 – 120

Besley, T.; The New Political Economy; in: Economic Journal, Vol. 117, No.6, 2007, pp. F570 – F587

Cunningham, S.R., Vilasuso, J.; Is Keynesian Demand Management Policy Still Viable?; in: Journal of Post Keynesian Economics, Vol. 17, No.2, 1994-95, pp. 187 - 210

Davidson, P.; Post Keynesian Macroeconomic Theory, Aldershot 1994

Davidson, P.; Are grains in the wheels of international finance sufficient to do the job when boulders are often required?; in: Economic Journal, Vol. 107, No.3, 1997, pp. 671 – 686

Davidson, P.; Responses to Lavoie, King and Dow on what Post Keynesiansm is and who is a Post Keynesian; in: Journal of Post Keynsian Economics, Vol. 27, No.3, 2005, pp. 393 – 408

Dempster, G.M.; Austrians and Post Keynesians: The Questions of Ignorance and Uncertainty; in: The Quarterly Journal of Austrian Economics, Vol. 2, No.4, 1999, pp. 73 – 81

Dequech, D.; Bounded Rationality, Institutions, and Uncertainty; in: Journal of Economic Issues, Vol. XXV, No. 4, 2001, pp. 911 – 929

Dimand, R.W.; Minsky and Tobin on the Instability of a Monetary Economy; in: Lavoie, M.; Seccareccia, M. (eds.); Central Banking in the Modern World. Alternative Perspectives, Cheltenham 2004, pp. 226 – 243

Dunn, S.; Whither Post Keynesianism; in: Journal of Post Keynesian Economics, Vol. 20, 2000, pp. 345 - 364

Dunn, S.P.; Bounded rationality is not fundamental uncertainty: a Post Keynesian perspective; in: Journal of Post Keynesian Economics, Vol. 23, No. 4, 2001, pp. 567 – 587

Eicher, A.S.; A Guide to Post Keynesian Economics, New York 1979

Frank, R. H. ; Departures from Rational Choice: With and without Regret; in: Parisi, F., Smith, V. (eds.); The Law and Economics of Irrational Behavior, Stanford 2005, pp. 13-36.

Friedman, M., Heller, W.W.; Monetary versus Fiscal Policy. A Dialogue, New York 1969

Fritsche, U. et al.; Macroeconomic regime and economic development: the case of the USA; in: Hein, E. et al. (eds.); Macroeconomic policy coordination in Europe and the role of the trade unions, Brussels 2005

Gnos, C., Rochon, P.(eds.); Post-Keynesian Principles of Economic Policy, Cheltenham 2006

Hansen, B.; Lectures in Economic Theory: Part III: The Theory of Economic Policy, Cairo 1963

Hayek, F.A.v.; The Theory of Complex Phenomena; in: Bunge, M. (ed.); The Critical Approach to Science and Philosophy. Essays in Honor of K.R.Popper, New York 1964

Hayek, F.A.v.; The Confusion of Language in Political Thought; in: Occasional Paper 20, Institute of Economic Affairs, London 1968, pp. 9–36

Hayek, F.a.v.; The Pretence of Knowledge; in: The Swedish Journal of Economics, Vol. 77, No. 4, 1975, pp. 433 – 442

Hayek, F.A.v.; Competition as a Discovery Procedure; in: New Studies in Philosophy, Politics and Economics, Chicago 1978, pp. 179 – 190

Hederer, C.; Political entrepreneurship and institutional change: an evolutionary perspective; in: International Journal of Public Policy, Vol. 3, No. 3, 2008 (forthcoming)

Heine, M., Herr, H., Kaiser, C.; Wirtschaftspolitische Regime westlicher Industrienationen, Baden-Baden 2006

Heise, A.; German Social Democratic Politics in the Light of Agenda Theory; in: Intervention – Journal of Economics, Vol. 2, No.2, 2005, pp. 131 – 151

Heise, A.; Limitations of Keynesian demand management through Monetary Policy - Whither Cartesian Policy control; in: Setterfield, M. (ed.); Complexity, Endogenous Money and Macroeconomic Theory. Essays in Honour of Basil J. Moore, Cheltenham 2006a, pp. 438 - 460

Heise, A.; The Political Economy of Meritocracy; in: Review of Radical Political Economy, Vol. 40, No.1, 2008a, pp. 67 - 88

Heise, A.; Economic Governance and Employment. Policy, Polity and Politics of Economic Rise and Decline, Münster 2008b

Holt, R.P.F., Pressman, S. (eds.); A New Guide to Post Keynesian Economics, London 2001

Holt, R.P.F., Pressman, S.; What is Post Keynesian Economics; in: Holt, R.P.F., Pressman, S. (eds.); A New Guide to Post Keynesian Economics, London 2001a, pp. 1 – 10

Kalecki, M.; Political Aspects of Full Employment; in: Political Quarterly, Vol. 14, N0.4, 1943, pp. 322 – 331

Keynes, J.M.; Is it Possible for Governments and Central Banks to Do Anything on Purpose to Remedy Unemployment?; in: Unemployment as a World Problem. Harris Foundation Report of Round Tables, Vol. 11 1931; reprinted in Moggridge, D. (ed.); The Collected Writings of John Maynard Keynes, Vol. XX: Activities 1929 – 1931. Rethinking Employment and Unemployment Policies, London 1981, pp. 529 – 544

Keynes, J.M.; The Means to Prosperity; New Statesman and Nation, April 1933; reprinted in: Moggridge, D. (ed.); The Collected Writings of John Maynard Keynes, Vol. IX: Essays in Persuasion, London 1981, pp. 335 – 366

Keynes, J.M.; The General Theory of Employment, Interest and Money, London 1936

Lavoie, M.; Changing definitions: a comment on Davidson's critique of King's history of Post Keynesianism; in: Journal of Post Keynesian Economics, Vol. 27, No.3, 2005, pp. 371 – 376

Lavoie, M.; Introduction to Post-Keynesian Economics, Basingstoke 2006

Minsky, H.P.; Stabilizing an Unstable Economy, New Haven 1986

Moore, B.J.; Shaking the Invisible Hand. Complexity, Endogenous Money and Exogenous Interest Rates, Houndsmill 2006

Mueller, D. C.; Public Choice II, Cambridge 1989

Nordhaus, W.D.; Policy Games: Coordination and Independence in Monetary and Fiscal Policies; in: Brookings Papers on Economic Activity, No.2, 1994, pp. 139 – 216

Page, S.E.; Uncertainty, Difficulty, and Complexity; in: Journal of Theoretical Politics, Vol. 20, No.2, 2008, pp. 115 – 149

Palley, T.; Post Keynesian Economics, Houndsmill 1996

Riese, H.; Theorie der Inflation, Tübingen 1986

Rosser, J. B., jr.; Complex dynamics and Post Keynesian Economics; in: Setterfield, M. (ed.); Complexity, Endogenous Money and Macroeconomic Theory, Cheltenham 2006, pp. 74 – 78

Rowthorn, R.E.; Conflict, inflation and money; in: Cambridge Journal of Economics, Vol. 1, 1977, pp. 215 – 239

Sawyer, M.; The NAIRU: a critical appraisal; in: Arestis, P., Sawyer, M. (eds.); Money, finance and capitalist development, Cheltenham, 2001, pp. 220 – 254

Setterfield, M.; Is There a Stabilizing Role for Fiscal Policy in the New Consensus?; in: Review of Political Economy, Vol. 19, No.3, 2007, pp. 405 – 418

Simon, H.A.; Models of Man: Social and Rational, New York 1957

Simon, H.A.; Theories of Decision-making in Economic and Behavioral Sciences; in: American Economic Review, Vol. 49, No. 2, 1959, pp. 253 – 83

Theil, H.; On the theory of economic policy; in: American Economic Review, Vol. 46, 1956, pp. 360 – 366

Tinbergen, J.; On the theory of economic policy, Amsterdam 1952

Wible, J.R.; Macroeconomics, Pragmatism and Cognitive Scarcity: Keynes Should Have Read C.S. Peirce on Probability and Evolutionary Complexity; in: Mooslechner et al. (eds.); Economic Policy under Uncertainty, Cheltenham 2004, pp. 122 – 169

Witt, U.; Economic policy making in evolutionary perspective; in: Journal of Evolutionary Economics, Vol. 13, 2003, pp. 77 – 94

Wray, L.R.; A Post Keynesian view of central bank independence, policy targets, and the rule versus discretion debate; in: Journal of Post Keynesian Economics, Vol. 30, No.1, 2007, pp. 119 - 141

Bisher erschienene Arbeitspapiere

No. 1 Arne Heise: EMU, Coordinanted Macroeconomic Policies and a Boost to Employment in the European Union, September 2002

Nr. 2 Arne Heise: Makroökonomisches Economic Governance: Makro-Dialoge auf nationaler und EU-Ebene, Februar 2002

Nr. 3 Arne Heise: Das Ende der Sozialdemokratie? Konstruktiv-kritische Anmerkungen zu einer dramatischen Entwicklung, Mai 2003

Nr. 4 Arne Heise: Optimale Verschuldung, Konsolidierungstrajektorien und Makroeffekte, Oktober 2003

Nr. 5 Arne Heise: Polit-ökonomische Betrachtung zur Sozialdemokratie. Die Wirtschaftspolitik der ‚Neuen Mitte' im Lichte von Public Choice- und Agenda-Theorie, November 2003

Nr. 6 Arvid Kaiser: Finanzielle Selbstbeteiligung in der Gesundheitsversorgung, Dezember 2003

Nr. 7 Arne Heise: Deutsche Finanzpolitik zwischen Wachstum und Konsolidierung, März 2004

Nr. 8 Leonhard Hajen: Steuerung über Preise erfordert Stewardship, April 2004

Nr. 9 Wulf Damkowski/ Anke Rösener: Good Governance auf der lokalen Ebene, Juni 2004

Nr. 10 Anke Rösner/ Wulf Damkowski: Gender Controlling in der Kommunalverwaltung, Juni 2004

No. 11 Arne Heise: The Economic Policies of German ‚Third Wayism' in the Light of Agenda Theory, October 2004

Nr. 12 Sybille Raasch: Antidiskriminierungsgesetze: Zum Umsetzungsstand der neuen EU-Antidiskriminierungsrichtlinien in Deutschland, Dezember 2004

Nr. 13 Leonhard Hajen: Präventionsgesetz im Interessenkonflikt zwischen Bund, Ländern und Sozialversicherung, Dezember 2004

No. 14 Arne Heise: Limitations to Keynesian Demand Management through monetary policy – whither Cartesian policy control, December 2004

Nr. 15 Norman Paech: Die europäische Verfassung – Ein Schritt zur Demokratisierung der EU?, April 2005

No. 16 Arne Heise: Political Economy of Meritocracy, July 2005

Nr. 17 Arne Heise: Konzentration auf das Kerngeschäft – Anforderungen an eine erneuerte sozialdemokratische Wirtschaftspolitik, November 2005

No. 18 Arne Heise: Market constellations and macroeconomic policy-making: institutional impacts on economic performance, February 2006

Nr. 19 Arne Heise: Keynesianismus, Sozialdemokratie und die Determinanten eines Regierungs- und Politikwechsels.Das Stabilitäts- und Wachstumsgesetz von 1967 im Lichte der Agenda-Theorie, August 2006

Nr. 20 Harry Friebel: Wähler-Macht der geburtenstarken Jahrgänge, Oktober 2006

Nr. 21 Arne Heise: Das Ende der neoklassischen Orthodoxie? Wieso ein methodischer Pluralismus gut täte, März 2007

No. 22 Arne Heise: How to create a growth-oriented market constellation for South Africa, March 2007

Nr. 23 Toralf Pusch: Verteilungskampf und geldpolitische Sanktion, April 2007

No.24 Ruth Hoekstra, Cécile Horstmann, Juliane Knabl, Derek Kruse, Sarah Wiedemann: Germanizing Europe? The Evolution of the European Stability and Growth Pact, May 2007

Nr. 25 Holger Brecht-Heitzmann: Das EU-Grünbuch zum Arbeitsrecht. ‚Flexicurity' als Patentrezept für das Arbeitsrecht in der Europäischen Union?, Mai 2007

Nr. 26 Martina Kliewe: Die Entwicklung der Corporate Finance Strukturen deutscher Unternehmen und deren Auswirkungen auf die Arbeitsbeziehungen. Juli 2007

Nr. 27 Arne Heise: Erlebt Deutschland ein neues Wirtschaftswunder? Betrachtungen auf Grundlage der postkeynesianischen Marktkonstellationsforschung, Januar 2008