Toward a New Economics

ESSAYS IN POST-KEYNESIAN AND INSTITUTIONALIST THEORY

ALFRED S. EICHNER

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Preface

Two considerations have prompted me to bring out this collection of essays. The first is that it has taken longer than anticipated to complete the textbook which I had hoped would be the more immediate follow-up to *A Guide to Post-Keynesian Theory*. It will probably be at least two more years before *The Macrodynamics of Advanced Market Economies* appears, and in the interim there is a need for a more sophisticated treatment of the theory outlined in the *Guide*—something the more advanced student, and indeed the already established economist, will find useful.

The second consideration is that, upon rereading the articles and unpublished papers from which the collection is drawn, I could see that there was an underlying theme which tied the various pieces together, and indeed was of such importance that it deserved to be highlighted. That theme is the need to abandon the supply-and-demand framework of the orthodox theory if a realistic model of the U.S. and other advanced market economies is ever to be constructed. Indeed, it can be argued on the basis of the essays contained in this collection that supply and demand curves, with price as the common explanatory variable, play the same role in economic analysis that a belief in Divine intervention plays in scientific work in general: it is an extraneous element which obscures the factors actually at work.

The proof that the U.S. economy can be modeled more realistically by abandoning the conventional supply-and-demand framework will be found in the following essays. Here all I would plead is that this notion, so outrageous to those steeped in the orthodox theory, not be dismissed out of hand—without waiting to see what sort of case can be made on its behalf.

Much credit goes to a number of persons for the essays that have been brought together in this volume. The critical support I have received from Len Forman, Eli Ginzberg, Aaron Warner, and Mike Sharpe is reflected in the volume's dedication. In addition, I would like to cite the intellectual debt I owe to, among others, William Casey,

C. Wright Mills, Gardiner Means, Alfred Chandler, Joan Robinson, Wassily Leontief, and Luigi Pasinetti for the direct personal influence they have had on the development of the ideas reflected in these essays. I would also like to thank Dick Bartel for inviting me to write the paper on which essay six is based and then helping to edit that paper; Philip Arestis for inviting me to give the paper on which essay seven is based; and Mario Seccareccia and Jacque Henry for inviting me to give the paper on which essay eight is based. Finally, I would like to acknowledge the debt to my wife, Barbara Eichner, both for her contribution to the development of my ideas about human development and for the strong moral and other types of support she has given me over the years.

Alfred S. Eichner

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1 Introduction

The essays that have been brought together in this volume are directed toward those who, whether long-time students of economics or only now just completing their graduate training, are reluctant to turn away from the orthodox theory, as represented by the neoclassical synthesis, because they believe there is nothing better to put in its place. The thrust of the essays is that there is, indeed, something better.

That something better is based on a set of ideas developed by economists working outside the mainstream of the discipline. In recognition of the fact that its core derives from the efforts by several of Keynes' closest associates at Cambridge University, in the years following his death in 1945, to go beyond just the principle of effective demand in describing the dynamics of an advanced market economy, this set of ideas has been labeled post-Keynesian. But it could just as well be termed post-classical, or even post-Marxist, since it also picks up where the classical mode of analysis left off following the marginalist revolution in the 1870s. Indeed, it could well be described as institutionalist since an important characteristic of the theory is the prominent role it ascribes to the dominant institutions of the twentieth century—in particular, the large multinational corporation, trade unions, and credit money. The purpose in bringing these essays together in one volume is to present this body of post-Keynesian theory as an integrated whole, thereby demonstrating that it is just as comprehensive and coherent as the neoclassical synthesis, the dominant theory in economics today, while at the same time being far more applicable to economic systems like those of the United States and the other OECD (Organization for Economic Cooperation and Development) countries.

The precise ways in which post-Keynesian theory differs from the neoclassical synthesis will be brought out in the following essays. What needs to be understood, even before turning to that subject, is why an economic analysis is almost certain to go astray when it is based on the orthodox theory. Only by understanding where and how economics has gone wrong will it be possible to put the discipline back on a progressive path of development and, once there, prevent it from being sidetracked again. What follows in this introductory essay is not a wide-ranging critique of economics—that can be found elsewhere (see, for example, Eichner, 1983a; Robinson, 1972; Ward, 1972; Hicks, 1974; Bell and Kristol, 1980; and Thurow, 1983)—but rather an attempt to point out the one flaw that invalidates virtually the entire body of orthodox theory. Indeed, the need to purge economics of that fundamental error is the principal theme of this first essay, tying together several strands of the argument to be found in the essays that follow.

* * *

One of the few objections Roy Harrod raised, when he was shown an early draft of *The General Theory*, was to Keynes' argument that it makes no sense to consider the interest rate as the price that equates the supply and demand for savings. Harrod wrote that while Keynes might be justified in arguing that the classical theory was incorrect, he should not say that the theory makes "no sense." As Harrod explained more fully in a subsequent letter:

> You may wonder why I lay such stress on a point that merely concerns formal proof rather than the conclusions reached. I am thinking of the effectiveness of your work. Its effectiveness is diminished if you try to eradicate very deep-rooted habits of thought unnecessarily. One of these is the supply and demand analysis. I am not thinking of the aged and fossilised, but of the younger generation who have been thinking perhaps only for a few years but very hard about these topics. It is doing great violence to their fundamental groundwork of thought, if you tell them that two independent demand and supply functions won't jointly determine price and quantity. Tell them that there may be more than one solution. Tell them that we don't know the supply function. Tell them that the *ceteris paribus* clause is inadmissible and that we can discover more important functional relationships governing price and quantity in this case which render the s. and d. analysis nugatory. But don't impugn the analysis itself. (Moggridge, 1973, XIII, pp. 533–34.)

Keynes nonetheless held to his position. As he later wrote Harrod:

> I still maintain that there is "no sense" in the view that interest is a price which equates saving and investment. . . .Perhaps the clue is to be found

> where you allege that I am doing great violence to the accepted and familiar when I maintain that "two independent demand and supply functions won't jointly determine price and quantities," for my whole point is that the functions in question are *not* independent. (Ibid., p. 338.)

Harrod was quite correct in warning how difficult it would be to persuade economists, the young as well as the old, to abandon the supply and demand framework on which, almost without exception, they have cut their intellectual teeth. If anything, economists have become even more committed to that framework as a result of the neo-Walrasian counter-revolution, based on "general equilibrium" models, which *The General Theory* sparked.

Harrod was nonetheless wrong in urging Keynes to avoid a direct attack on the conventional supply and demand framework. What, in hindsight, can be seen with greater clarity is that it was precisely the retention of that framework as the micro foundation of the neoclassical synthesis that has ultimately defeated Keynes' larger purpose. It is that framework that suggests that inflation can occur only as the result of excess demand and that therefore, in order to combat the rise in prices, the Keynesian policy levers need to be thrown into reverse so as to make them the instruments for raising, rather than lowering, the unemployment rate.

Keynes had, in fact, put his finger on the essential flaw in the orthodox theory, micro no less than macro, when he told Harrod it makes no sense to argue in terms of supply and demand if the two factors are not independent of one another. This is precisely the point of essays three, four, and five which follow. In the usual way of delineating the subject matter of economics, these essays fall under the rubric of price theory, labor economics, and monetary theory. Within the framework of *The General Theory* itself, however, they are concerned with the three principal types of markets which serve to regulate the economic system's real and monetary flows. These are the markets for goods, labor, and credit (or finance) (Chick, 1983).

In *The General Theory*, Keynes denied, though only implicitly, that for the economy as a whole to be in "equilibrium" it is necessary for supply to be equal to demand in each of these three types of markets. Rather, all that is necessary is that aggregate savings be equal to aggregate investment. Still, Keynes failed to make the point as strongly or as explicitly as he might have—if indeed he realized the full import of defining the equilibrium condition in the way he did. The closest he came to an explicit statement was when he explained why "full employment" could not be achieved through wage cuts. But even then he avoided attacking the notion of a separate supply curve for labor, basing his argument instead on the depressing effect wage cuts are likely to have on the "marginal efficiency of capital." As for the interest rate, little of the argument made to Harrod in private found its way into *The General Theory*.

What Keynes should have made clear, and what essays three, four, and five bring out in the course of presenting a post-Keynesian alternative to the standard price theory, labor economics, and monetary analysis, is that in each of the three principal types of markets, the supply is not necessarily independent of the demand. Rather, the demand determines the supply, making the one a function of the other.

In the goods markets, at least when the goods are industrial products, it is the level of aggregate demand that determines the supply, once the necessary plant and equipment have been installed and a labor force recruited. Even over the longer run, it is the final demand vector, in conjunction with the set of fixed technical coefficients, that determines the quantity produced, and hence supplied, by each separate industry.

In the labor market, it is again the level of demand, in this case the demand for each firm's output, that determines the number of employment opportunities, and hence the number of individuals who will receive the on-the-job training needed for the development of a skilled labor force.

In the credit markets, it is the demand for new loans that determines the increase in bank deposits and hence any growth in the means of payment.

For each type of market, then, it is the demand that determines the supply. Moreover, and this is the critical point, it does so *independently of the price prevailing in that market.*

It will immediately be clear to anyone who has studied economics how radical a critique this is of the orthodox theory. What it implies is that virtually the first thing economists are taught—namely, to specify a supply curve which is separate and independent of the demand curve—is wrong in almost every case.

It may be the correct way to analyze the situation in certain commodity markets, those which have not yet been organized into a producer's cartel or stabilized through some type of government intervention. It may even be the correct way to analyze the shape-up which occurs almost daily in urban ghettos around the world for casual jobs requiring unskilled labor. But these are the exceptions. For the most part, a separate supply curve does not exist. To support the contention that it does, economists are forced to invent stories that are caricatures of reality—such as the story that industrial firms are subject to decreasing returns when they expand output or the story that workers who cannot obtain jobs are merely exercising their preference for leisure.

This is not to say that supply and demand have no place in economics as analytical categories. It is often useful to separate the factors influencing the quantity supplied from the factors operating on the demand side—as long as one does not assume that the two will automatically be brought into balance with one another through a change in the market price. It is the latter error, one that permeates the entire body of orthodox theory, that has led to the present intellectual bankruptcy of economics.

Why it is essential to purge economics of this error will become clear in essays six and eight. One reason is so that the underlying causes of the secular inflation which has afflicted the world's advanced market economies in the post-World War II period can be properly understood and an effective remedy, one that does not transform the problem of rising prices into the far more serious problem of stagnation, can be devised. Essay six shows how stagflation, which the orthodox theory cannot account for within a supply and demand framework, is easily explained by the alternative body of post-Keynesian theory. It also indicates the types of public policies which, as complements to the more conventional fiscal and monetary policies, will have to be implemented to bring the problem of inflation under control.

The other reason for purging economics of the conventional supply and demand framework is so that economics can finally be raised to the level of a scientific discipline. Essay eight, after noting that the conventional theory fails to meet any of the empirical tests that characterize a scientific body of knowledge, indicates how the post-Keynesian alternative can be used to free empirical research from its present conceptual straitjacket, enabling both the theory and the empirical research to advance in tandem with one another.

Essay seven meanwhile shows how the various elements of post-Keynesian theory, including those covered in essays three, four, and five, can be combined into a single macrodynamic model, one that lends itself both to improved empirical research and to better public policy. This entire group of essays is less concerned with pointing out the defects of the orthodox theory than with providing a positive alternative. Thus essay three indicates what can be substituted for the orthodox theory of the firm, essay four describes what can be used to replace the conventional model of the labor market, essay five offers a different way of analyzing the money and credit markets, and essay seven presents a macrodynamic model of the American economy to supersede the standard Hicks-Hansen LM-IS model. In each case, it is argued that the alternative body of post-Keynesian (and institutionalist) theory is no less coherent and comprehensive than the orthodox theory, does not run counter to what can be observed of the real world, and avoids positing a supply curve that is independent of demand. It is in this last way that the alternative body of post-Keynesian theory avoids the fundamental error that has largely invalidated the orthodox theory, especially the "general equilibrium" model which serves as the micro foundation of the neoclassical synthesis.

One last situation in which the orthodox supply and demand framework applies can be identified. This is a situation in which the mechanisms that have been put in place to soften what would otherwise be a socially unacceptable outcome of the market process have broken down. The characteristic institutions of the twentieth century—the large multinational corporation, trade unions, and credit money—are precisely these types of mechanisms. They have evolved over time as a way of insulating at least certain groups in society from the harsher effects which a sudden change in supply or demand conditions can produce within a commodity type of market, and they need to be understood as such, not as some perversion of an ideal form of economic organization. This is precisely the point essay two attempts to make in describing the historical evolution of the large multinational corporation, or megacorp. The essay suggests that the megacorp emerged toward the end of the nineteenth century as a protective response to the ruinous competition among firms that was threatening to destroy the entrepreneurial class directing the industrialization of the United States. It can be argued that trade unions and credit money emerged as institutions for similar reasons—though not necessarily to protect the same groups.

The dysfunctional nature of commodity markets in an economy undergoing industrial development is, however, only one of several themes developed in essay two. More broadly, it attempts to explain the dynamics of institutional innovation, using the megacorp as an example. At the same time, it offers an institutionalist framework for integrating the social sciences, one that can be viewed as an alternative to the better known Marxian theories of societal development. Finally, it is meant to indicate the broader social context in which any economic analysis, post-Keynesian or neoclassical, needs to be carried out. In this respect, it serves as a further introduction to the more narrowly focused essays on economic theory which follow.

Essay nine, the last of the essays included in this volume, brings the discussion full circle by pointing out the broader policy implications of a post-Keynesian perspective on the world's economy. Here the argument is that, just as economic theory needs to be reconstructed along post-Keynesian lines, so the types of social democratic policies that Keynes' ideas have inspired in the past need to be supplemented so as to make them more appropriate to the contemporary economic situation. High on the list of this post-Keynesian agenda for political action is the creation of a new international order as a substitute for the system of flexible exchange rates which has replaced the Bretton Woods arrangement, and the establishment of some form of indicative planning, with an incomes policy as the key component so as to avoid having to rely solely on monetary and fiscal policy to control inflation.

* * *

Since ingrained habits of thought are not easily altered, economists will not find it easy to abandon the supply and demand framework of the orthodox theory. In this regard, Harrod knew all too well what he was talking about. Nonetheless, until economists do abandon that framework, they cannot hope to make any real progress in understanding how an advanced market system like that of the United States and the other OECD countries actually works. Contrary to what some would argue, it is not enough merely to modify or alter the way the supply and demand curves are specified to cover the particular market situation. The curves themselves need to be abandoned as a way of trying to understand how the economic system works. That is the harsh truth economists must face if they want to make their discipline both intellectually respectable and a useful guide to public policy.

On the other hand, economists need not fear that there is nothing better to put in place of the orthodox theory. There is, in fact, a body of theory that is just as coherent and comprehensive as the neoclassical synthesis while at the same time being far more consistent with what can be observed of the real world. By replacing the conventional supply and demand framework with this other paradigm, economists will no longer have trouble explaining the dynamics of an advanced market economy like that of the United States. That is the prospect that should enable economists to face up, at last, to the truth about the orthodox theory.

2

The Megacorp as a Social Innovation

History can be seen as the process by which human beings have developed the tools called social institutions, not just to give themselves some control over the forces of nature but also, even more generally, to enhance the options available to them over their lifetime. From this prespective, to understand history one must be able to comprehend the nature of social institutions, including their very real limitations as enhancers of individual options.

This essay consists of two parts. In the first half, a conceptual framework for understanding the institutional structure of a society is presented, with the historical experience of the United States used to show how social development depends on institutional innovation. In the second half, the process by which the megacorp emerged as the dominant type of firm within the U.S. economy is examined in detail to see what further light the same conceptual framework can shed, in this particular instance, on the determinants of institutional innovation.

* * *

In attempting to understand the role played by social institutions, the student of history will find himself up against the intellectual poverty of the sister discipline of sociology. Among contemporary sociologists only Talcott Parsons has attempted to provide a general theory of social institutions; yet in deliberately choosing concepts without any real-world counterparts except as figments of that reality, and by refusing to specify any behavioral models to accompany his schema, Parsons has made his work unusable for historians.[1] It is for this reason that Ginzberg and Eichner, coming out of institutional economics rather than sociology and building on their work as part of the Conservation of Human Resources Project at Columbia University, have attempted a different approach to the study of social institutions.[2] It is an approach that views historical development in terms of the interaction among four institutional dimensions—the normative, the political, the economic, and the anthropogenic, or human developmental.[3]

The normative dimension of society consists of all values, or implicit assumptions that underlie the behavior of individuals in the course of everyday life. To say hello when greeting acquaintances on the street, to be at work on time, not to steal from one's neighbors—these may all be part of the normative structure, or value orientation that characterizes a particular society. Values of this sort, which have important implications for the way in which society functions, can be distinguished from mere preferences—such as for shiny yellow sports cars, Mozart concertos, and Chinese cooking—that bear only on which specific options are exercised, not on the range of options available.

It can, of course, be questioned whether values, as just defined, have any existence separate and distinct from the behavior of either the individuals or the institutions that make those values manifest. And indeed, the value orientation of a society is in a certain sense basic to the way in which all other social institutions function. In the broadest sense, an institution is merely a habitual way of doing things (Berger, 1963). But this only means that the four dimensions coexist, not that one dimension can be subsumed under the others. Just as a particular point on a cube exists along the scalar dimension of width as well as the scalar dimension of length, so a particular social phenomenon—say the belief that government should be organized along parliamentary lines—can be viewed as part of the value orientation of that society as well as part of the same society's political structure.

What makes it necessary to consider the value orientation separately in its own right is the fact that part of the value orientation of any society deals with values themselves, that is, with the process by which certain values come to be legitimated and accepted. Since values represent the implicit assumption upon which human behavior is predicted, some such process is essential for consistency and coherence of behavior, if for no other reason. Whether in fact the assumptions that values represent are true is not an unimportant question, for it will determine whether the behavior predicted upon those values, or assumptions, will be appropriate to the actual situation that exists. It is therefore useful to know how appropriate a given value orientation is, the basis for determining this being the scientific method that has gradually developed over the last 500 years as the yeast of Western civilization (McNeil,