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Title: *Keynesian microeconomics and institutional change*

Abstract:

Keynes has been interpreted as a utilitarian during the time of the *Neoclassical Synthesis* and by Neo Keynesians. Though this was regarded as “Bastard Keynesianism” (Joan Robinson) there is probably more than a grain of truth in it if we consider the influence of Marshall and Pigou on him in Cambridge and his attempt to accommodate his new ideas with the traditional habits of thought of his “fellow economists” (Fazzari 2003).

Based on his ideas about conventions some colleagues seem to interpret Keynes as if he was an institutional economist (Dow 1995, Hodgson 1988 and Lee 2003).

Considering fundamental uncertainty and his remarks on “animal spirits” and founded on Keynes’s *Treatise on Probability* others see his microeconomics as close to the Austrians’ (Davidson 1995 and Parsons 2003). Similarities seem to exist with von Hayek’s ideas on markets as discovery process and Schumpeter’s notion of the entrepreneur, despite some disagreement about the role of government.

This paper will try to provide an overview over these different microeconomic interpretations of Keynes’s work and the communalities and linkages between the different schools of thought. Considering this review of quite considerable diversity, it may well be that all of these interpretations contain a kernel of truth.

Did Keynes attempt to construct a “general theory” of economic behaviour? And if so, did he actually succeed in providing an all inclusive and comprehensive micro synthesis? If not, is such an endeavour possible? What is missing?

In answering the questions just raised, the paper will also show that Keynes’s procedural rationality of the speculator is based on a reasonable most of the time non-numerical subjective probability consideration. Economic actors who feel obliged to rationalise their tendency to favour a particular option in an unstable set of possible ones will try to collect and at the same time evaluate information (the weight of arguments). This concept of rationality is distinctly different from the utilitarian one underlying Neoclassical

Economics.

Moreover, Herbert Simon's plea for *the plurality of rationalities* and his concept of *bounded rationality* is deeply influenced by Keynes. After a thorough discussion of the microeconomic ideas expressed in the twelfth chapter of the *General Theory* Simon concludes: "Only the fear of pronouncing an egregious anachronism prevents me from claiming Keynes, […], as the true originator of the economics of bounded rationality" (Simon 1997: 16). Simon's alternative concept of rationality, however, is the theoretical foundation of Behavioural Economics. Kahneman consciously entitled his lecture delivered when he received the Nobel Prize: *Maps of Bounded Rationality: Psychology for Behavioural Economics* (2003). The paper will reconstruct this common threat of a particular approach of microeconomics and show its links to Austrian and Institutional ideas.

The notion, though somewhat modified, of bounded rationality equally underlies New Institutional Economics (Williamson 1994: 81). This led to new theoretical developments like mental models (Arthur Denzau and Douglass North), bricolage (John Campbell) and institutional entrepreneurs (Colin Crouch) in New Institutional Economics and the neo-institutionalism of political science and economic sociology which provide some of the missing theoretical elements and thus, support Keynes's basic microeconomic claims.

I. Keynes's Conception of Economic Action

Keynes was propagating if not initiating the distinction between micro and macro in economics: "The right dichotomy is, I suggest, between the Theory of the Individual Industry or Firm and of the rewards and the distribution between different uses of a *given* quantity of resources on the one hand, and the Theory of Output and Employment *as a whole* on the other hand" (Keynes 1964: 293)[1]. As apparent in this quote (one amongst many which one can find in the *General Theory*), he also had to relate his own ideas to Marshallian analysis. As Keynes was trained in what he called the *Classical System* (Peterson and Estenson 1996: 75), he felt the necessity to use it in his arguments at least in part to make himself understood by his *fellow economists*. However necessary, this rhetoric strategy appeared to him, it also led to quite a degree of misunderstandings and misinterpretations amongst his colleagues.

[1] Page numbers refer to the American paper back edition of the *General Theory*, first published 1964. However, these are congruent with page numbers of Vol. VII (1973) *General Theory* in the *Collected Writings of John Maynard Keynes* edited by the Royal Economic Society, Macmillan and Cambridge University Press, Cambridge UK.

One example is the IS-LM system which is at least in some of its underlying assumptions an inaccurate representation of Keynes's micro economic views. Fitzgibbons argues: "The IS-LM system was bastard theory, as Joan Robinson called it, because it drew upon two opposing philosophies to formulate a theory that was consistent with neither of them" (1988: 149). Minsky points out that the Hicks/Hansen model while it includes some of Keynes's ideas, remains nonetheless an unjustified and naïve representation of his beliefs because it ignores the importance of uncertainty in portfolio and investment decisions and because it is a model oriented towards equilibrium and not process (1990: 60). Minsky adds to his critique of the neoclassical way of interpreting Keynes that the emphasis on "sticky" wages as the problem was not what he had in mind. From Keynes's point of view, wage flexibility would make things even worse.

One can come across the often repeated and nonetheless wrong belief that Keynes had an underdeveloped micro foundation for his macro economic theories (e. g. Winter 1997: 11). However, this misinterpretation is due to the common understanding that a conception of micro economics has to be based on methodological individualism and assumptions of high degrees of autonomy in individual choice. Though it has often and strongly been criticised by feminists, economic sociologists and heterodox economists (England 1993, Etzioni 1990, Galbraith 1972, Granovetter 2005, Held 1993, Mansbridge 1990, Sen 2002, Veblen 1998[1898], to name only a few) this particular ontological starting point is continuously planted into the heads of a succession of economics students all over the world because it is widely propagated in neoclassical standard textbooks.

Though he wrestled with the question of how rational purposeful economic action can be possible[2], Keynes's founding assumptions were different. Keynes's taxonomy of four types of economic behaviours: cold calculation, speculation, following conventions and impulse based on animal spirits (Keynes, 1964: Chapter 12 and Keynes, 1973[1937]) includes a variant resembling the neoclassical atomistic rational maximisation – *cold calculation* – as a special case (Skidelsky 1994: 59). Moreover, after explaining the importance of the state as economic actor, he definitely defended individual self-interested action in the concluding remarks of the *General Theory*: "But there will still remain a wide field for the exercise of private initiative and responsibility. Within this field the traditional advantages of individualism will still hold good. Let us stop for a moment to

[2] According to Skidelsky, this was Keynes's motivation for writing the *Treatise on Probability*: "It was conceived as an answer to the question: what are the principles of rational choice and action when the future is unknown or uncertain?" (1994: 58).

remind ourselves what these advantages are. They are partly advantages of efficiency – the advantages of decentralisation and of the play of self-interest" (Keynes 1964: 380).

Though Keynes might have had this undercurrent of a "rationalist conception of action" as Hodgson seems to suggest (1988), and though he often referred to calculation and self-interest, I agree with Fitzgibbons's conclusion that his most favoured ideal type conception of human action was crucially different from the neoclassical one: "Keynes did not deny that people would try to act as utilitarians; this is the element of truth in the picture of Keynes as utilitarian. However, he believed that their attempt to do so required a "false rationalization" because of uncertainty and organic unities or that rational self-interest was not necessarily rational after all" (1988: 95). Keynes made this very clear in his defence of the General Theory in the pages Quarterly Journal of Economics: "Actually, however, we have, as a rule, only the vaguest idea of any but the most direct consequences of our acts. […] Thus the fact that our knowledge of the future is fluctuating, vague and uncertain, renders wealth a peculiarly unsuitable subject for the methods of the classical economic theory. […] The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, […]. About these matters there is no scientific basis on which to form any calculable probability whatever" (Keynes 1973[1937]: 113-114).

As can be gathered from the aforementioned quote, which refers to the uncertainty of events *and* our knowledge of it, real, incalculable uncertainty is the key to an understanding of Keynes's ideas. This was debated and pointed out repeatedly by a number of post-keynesian scholars in the last thirty years (Carabelli, 1985, Dow/Dow 1985, Fitzgibbons 1988 and 1991, O'Donnell 1991, Cardim de Carvalho 1992, Lawson 1994, Skidelsky 1992 and 1994) and in several articles in King (2003). Though the root cause of uncertainty lies in the complexity and surprising nature of economic reality, it's relevance for economic action has primarily to do with the organic yet insufficiently calculable embeddedness of actors within it.

Complexity and a dynamic of surprising changes as such would not cause major problems for the rational economic actor as long as she can fathom and steer it. However, the crux is the actor's inability to process and interpret the incoming information about the ever changing jumble which the real life economy is. As Skidelsky states in his discussion of the Keynesian debate on probability: "We may say there are two sources of uncertainty: randomness in nature and ignorance" (1994: 85). Which of the causes led to uncertainty is, however, of lesser importance for the economic actor and micro economic theory than the consequence following from it – bounded rationality.

Herbert Simon in his plea for *the plurality of rationalities* and his concept of *bounded rationality* is deeply influenced by Keynes. After a thorough discussion of the microeconomic ideas expressed in the twelfth chapter of the *General Theory*, Simon concludes: "Only the fear of pronouncing an egregious anachronism prevents me from claiming Keynes, […], as the true originator of the economics of bounded rationality" (Simon 1997: 16). Simon defines bounded rationality as follows: : "Bounded rationality, a rationality that is consistent with our knowledge of actual human choice behavior, assumes that the decision maker must search for alternatives, has egregiously incomplete and inaccurate knowledge about the consequences of actions, and chooses actions that are expected to be satisfactory (attain targets while satisfying constraints)" (1997: 17). The source of such inaccurate knowledge can have ontological or epistemological reasons. However, there is definitely a lot of similarity in Keynes's and Simon's microeconomic concepts, that is the assumption of uncertain and therefore limited knowledge and the plurality of modes of behaviour to deal with it, depending on the specific circumstances. Marchionatti supports such an interpretation: "The hypothesis of bounded rationality enables us to appreciate the modernity of Keynes' analysis on the issue of economic behaviour under uncertainty" (1999: 427). However, I doubt whether Keynes would have fully accepted Simon's conclusions concerning *procedural rationality* because this includes a strong emphasis of social embeddedness, emotional bonds and shared patterns of behaviour based on *loyalty and identification* (Simon, 1997: 43). These assumptions about human behaviour link Simon very strongly with original American institutional economics and recent developments in economic sociology (Etzioni 1990, Galbraith 1972, Granovetter 2005, Hodgson, 1988, 2000, Rutherford 1995 and Veblen 1998[1898]).

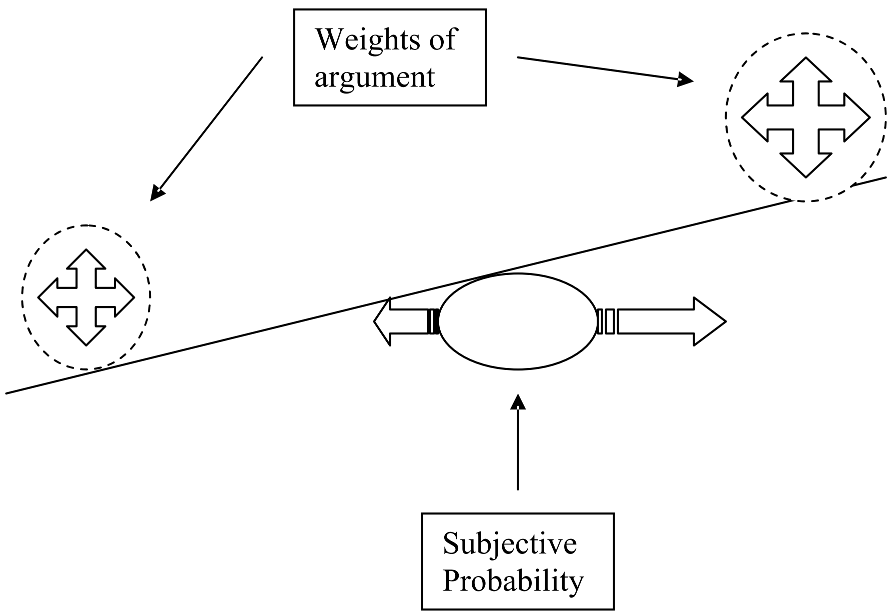
For Keynes, however, the core behavioural mode is more subjective, or to be precise, his ideal economic actor – the speculator, is socially entangled in quite a different way and exercises a different kind of procedural rationality. One might even call the investor confronted with real uncertainty the tragic hero of the *General Theory*. He or she tries to plan ahead and figure out the probability of expectations about the future usually under extremely uncertain conditions. Therefore for Keynes, Lawson argues, uncertainty corresponds to a situation of numerically immeasurable probability which is a property of knowledge of belief (1994: 353). Or as Dow and Dow put it: "Probability then was defined by Keynes as being "concerned with degrees of rational belief"" (1985: 52). For a better understanding of these degrees of uncertainty, Sheila Dow develops a taxonomy along the criteria of calculability and knowability or ignorance (1995).

Keynes's procedural rationality of the speculator is based on a reasonable most of the time non-numerical subjective probability consideration. Economic actors who feel obliged to rationalise their tendency to favour a particular option in an unstable set of possible ones will try to collect and at the same time evaluate information (the weight of arguments). O'Donnell describes this decision process among alternative paths of action as follows: "Weight and probability are independent characteristics of an argument – as the amount of available information expands, weight will always increase, whereas probability may rise or fall. Weight reflects the total amount of information, but probability depends on the balance between its favourable and unfavourable parts" (1991: 71)[3]. Keynes continued to use this microeconomic notion of probabilistic decision making under uncertainty in the *General Theory*: "In the *General Theory*, Keynes substituted the concept of confidence for the weight of arguments" (Mizuhara 2002: 103).

Hence, in the way that the tendency to favour a particular alternative is based on incoming information the investor is embedded in a web of communication, in this sense economic action is social or organic (Park and Kayatekin 2002). Whilst it is filtered by more or less reasonable evaluation, it includes a degree of subjective judgement: "Keynes as a philosopher of action did not think that strict logic was necessary to reach a reasonable conclusion, because he thought (and said) that demonstrable reasoning is only a special instance of probabilistic reasoning; another is that Keynes rejected the idea that value judgements are based only on imagination, which means that he rejected subjectivism" (Fitzgibbons 1988: 102). Thus, quantitative *and* qualitative data about the real world is processed by a mind (weight of arguments) trying to rationally evaluate it, however, knowingly plagued by varying degrees of ignorance (subjective probability). This process can be illustrated with the help of the following seesaw model:

[3] For a short and comprehensive explanation and evaluation of Keynes's conception of probability, also in comparison with others, see McCann (2004).

Fig. 1 Keynes's ideal seesaw model of economic action[4]:



The pluralism of Keynes's modes of behaviour can be interpreted as a scale of different types as well as degrees of rationality. In exceptional clear circumstances it might be possible to calculate optimal economic acts in terms of their consequences (the neoclassical ideal or standard situation). For instance whether it is worthwhile travelling to a distant store to obtain the similar pair of shoes which we find priced more expensively in the shop around the corner. In other words, situations where opportunity costs of clearly defined and limited alternatives can be calculated.

In cases where this is not possible one should try to obtain convincing, weighted probability expectations (Keynes's ideal)[5].

If even this is not achievable, the better motive counts (Kant's ideal): "When there is radical uncertainty, then the rationality of motives rather than ends comes into play" (Fitzgibbons 1988: 101), and: "Keynesian rationality means having the right reasons even if the answer is wrong" (Fitzgibbons 1991: 131, see also Dow and Dow 1985: 51). Moral behaviour in this sense is basically rule-following and very much resembles procedural rationality in Simon's sense. However, rules of behaviour to overcome inability of action

[4] I took this form of graphical illustration from Herbert Margolis who used it as a visual representation for a totally different concept (see Margolis, 1990: 241/242)

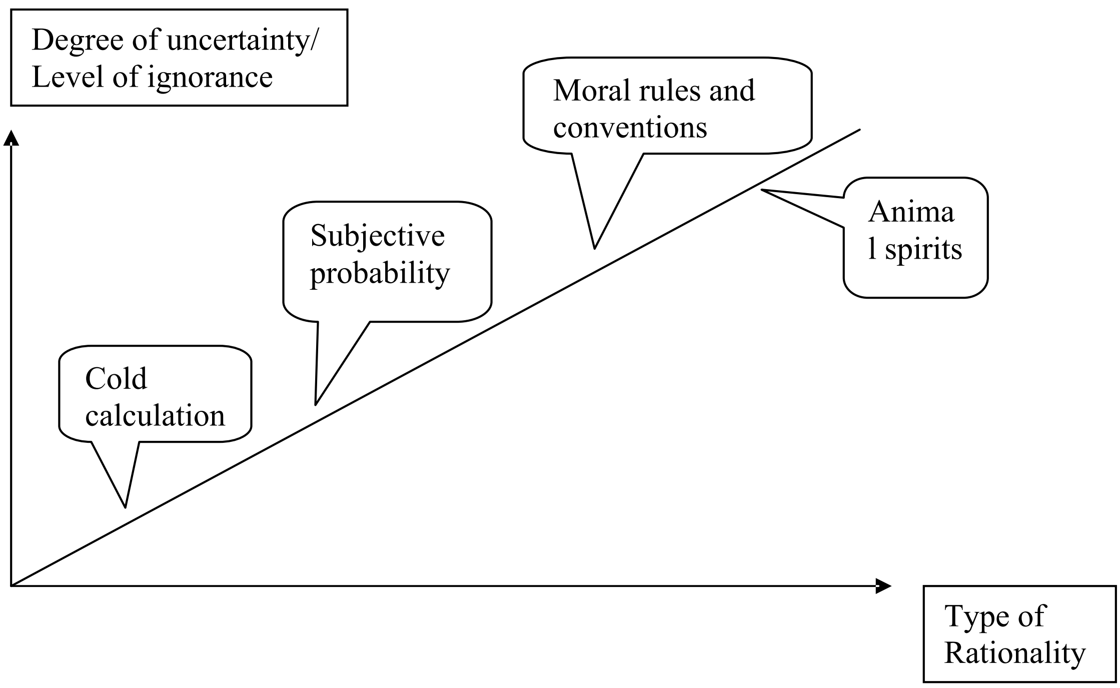
[5] Hence, I totally agree with Bill Gerrard's conclusion: "Although the emphasis of the new fundamentalists is on the task of interpretation, there is a clear implication that Keynes's logical theory of probability may provide the basis for the development of an alternative economic theory of behaviour under uncertainty" (2003: 160).

because of uncertainty do not have to be ethical ones, but can be much simpler conventions (Dow 1995) routines (Nelson and Winter 1982) or habits of thought (Veblen 1998). This links Keynesian microeconomics with institutional economics (see the following part II).

Where no rational arguments, motives or rules of behaviour are obtainable one might be left with nothing else than to rely on spontaneous intuition. One has to turn to gut feelings or emotional impulse to come to a decision. For the sake of analytical clarity, I interpret Keynes's notion of *animal spirits* in this way though Roberto Marchionatti regards animal spirits as congruent with the aforementioned seesaw model (1999) which can be founded on how Keynes describes animal spirits in the General Theory: "But individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits, so that the thought of ultimate loss which often overtakes pioneers, as experience undoubtedly tells us and them, is put aside as a healthy man puts aside the expectation of death" (1964: 162). As I see it, at least as a Weberian ideal type emotional impulse can be seen as one extreme position on a scale of possible modes of rational behaviour. However: "Consideration of animal spirits is not contradictory per se with calculations" (Cardim de Carvalho 1992: 122).

This discussion of Keynes four modes leads to the following scale of rationality of action:

Fig. 2 Degree of Uncertainty and Type of Rationality:



Such a scale represents the movement from one mode of decision making to another depending on the degree of uncertainty and ignorance which a particular situation presents for the individual. As such animal spirits and calculation do not contradict each other in principle. They are just two modes of evaluating possible options to act. However, on a meta level the decision maker is left with the question of which mode to choose. Keynes's proposed weighing of arguments is probably the best way to critically reflect on the outside conditions of uncertainty and the inside conditions of ignorance in a particular situation. This will require a combination of gut feeling and detached processing of information[6]. The neat and clear theoretical separation of modes will probably rarely be found in practice.

II. Keynes an institutionalist?

The other option if uncertainty is overwhelming and no clear motives can be identified is to fall back onto conventional behaviour and do what everybody else does: "Yet, however valuable these conventions might be, and Keynes said they were inferior to the prudence that could take direct cognizance of the powers and uncertainties of the world. The convention can preserve stability only so long as it is reliable" (Fitzgibbons 1988: 81/82). According to Keynes (1964: 152 and 152 and 1973: 114) an investor, relying exclusively on following conventions or moral values which quite resembles Simon's conception of feelings of loyalty or identity (1997: 43) is only applying a second best procedure and this mode of behaviour is only rational if circumstances do not allow for an evaluation of weighted arguments and qualitative probabilities (Mizuhara 2002: 108).

Keynes relies on a typical original institutional argument about the at least short term stability of habits as a basis for the propensity to consume: "For a man's habitual standard of live usually has the first claim on his income, and he is apt to save the difference which discovers itself between his actual income and the expense of his habitual standard; or, if he does adjust his expenditure to changes in his income, he will over short periods do so imperfectly" (1964: 97). Sheila Dow highlights the stabilizing effect of institutions: "As far as analysis of uncertainty is concerned, the discussion here suggests that the role of conventions is more complex than normally portrayed; not only do conventions supply knowledge to decision-makers, but they may provide refuge from confronting ignorance"

[6] These considerations were inspired by some comments by my colleague Jerry Courvisanos who critically reviewed an earlier draft of this article.

(1995: 126 and 127)[7]. In filtering information conventions are a means to weigh arguments.

According to King "… the Fundamentalist Keynesians who had the closest affinity with the institutionalists … saw conventions, habits and routines as solutions to the problem of reasoned choice under radical uncertainty; Paul Davidson, especially, had always stressed the role of money-denominated contract as the central institution of a capitalist economy (Davidson, 1972a)" (2002: 227). 'To hold money' is an important convention: "According to John Maynard Keynes, money is a means to dealing with an uncertain future" (Hodgson, 1998; 10). In the words of Paul Davidson: "In an uncertain world, he who hesitates by remaining liquid is able to make a decision another day" (1995: 114). And: "The institution of forward money contracts where delivery and payment are specified at a future date is an institutional arrangement which permits agents to deal with, and control the outcomes of, otherwise uncertain future" (Davidson 1989: 481).

Since investment decisions are long run, however, and not short run, following conventions is only an inferior mode of dealing with uncertainty.

However, in a world of uncertainty portfolios necessarily have to be speculative, as Minsky emphasises (1990; 105) and following a 'convention of holding money' still entails a subjective element: "… Keynes's hypothesis of the way speculators form their expectations is remarkably simple, even primitive. Each speculator has his/her notion of what constitutes a 'normal' rate of interest" (Chick, 1992: 181) and some sort of rational evaluation: "Summing up, convention is a kind of device created by human beings in history to cope with the precariousness of knowledge arising from uncertainty regarding the future. Keynes himself never regarded conventional behaviour in an uncertain environment as inconsistent with rationality" (Mizuhara 2002: 107). Thus, if Keynes was an institutionalist, then he was one who stressed institutional change instead of stability and one who believed in the opportunity of reasonably designing improved institutions. In summarizing the debate on conventions as a weak form of rationality Skidelsky seems to reach a similar kind of sceptical conclusion: "Carabelli agrees: Keynes considered 'perfectly reasonable the behaviour grounded on conventions in a situation in which the lack of knowledge does not supply better reasons for acting. In this case the label irrationalism seems misplaced.' Lawson believes that Keynes treated conventions as an important repository of relevant social knowledge. On this view, convention, viewed by

[7] She extends this idea of a stabilizing notion of conventions in her article *Babylonian Mode of Thought* while arguing that institutions are socially construted for this purpose (Dow, 2003: 13).

O'Donnell as a weak form of rationality, is the buckle which links the *Treatise on Probability* and the *General Theory*. It seems an odd conclusion to a life's work which started out as a defiant proclamation of the individual's rational right to freedom from conventions!" (Skidelsky 1994: 88 and 89).

This oddity can be resolved, if we take the view that institutions are not rock solid like Weber's famous metaphor of the 'iron cage', but social constructions which can be altered by agents of social changes – in other words: entrepreneurs. The types of rationality underlying particular modes of behaviour illustrated in Fig. 2 have to be seen as ideal types. They can be combined and might overlap each other in practice. In a similar vein, Hodgson writes: "An alternative to Austrian subjectivism, and to the much greater uniformity of expectations-formation with the rational expectations hypothesis, is to use the building block of specific social institutions rather than the anonymous and abstract individual" (1988: 239). As a stepping stone toward a concept of an institutional entrepreneur it is useful to look for a possible fruitful combination of Austrian and Keynesian ideas.

III. Entrepreneurs - a link between Keynes and Austrian Economics?

For the Austrian school of economics the entrepreneur is the central figure in there specific set of economic ideas. Gordon for instance concludes: "To the Austrians, the individual is basic; to Keynes, the individual position depends on an extravagant view of our capacity to know the basic parts composing an aggregate" (1992: 158). Considering the overview of Keynes's microeconomic conception above, this critical note appears to be a gross misunderstanding of Keynes's ideas and typical for an overemphasis on the difference between Austrian and Keynesian economics. To the contrary, King highlights the linkages between both schools: "Some potential points of contact between Austrians and Post Keynesians can be inferred from this brief summary. Above all, the role of uncertainty and time and the resulting suspicion of formal, closed-system models of economic processes were common to both schools. Though never himself quite an Austrian, George Shackle was often seen as a bridge between the two traditions" (2002: 230). Considering the numerous theoretical links and overlaps between the two economic belief systems, Parsons points out: "All this might suggest that any disagreements between the two schools are merely cases of 'disagreements between friends'. However, the history of the relationship between the two schools is one of mutual indifference, incomprehension, and even downright hostility" (2003: 6).

The main point of disagreement is not so much about the role played by the entrepreneur in general, but rather about the appropriate institutional framework for entrepreneurial behaviour. From my reading, the crucial disagreement between Austrian and Post-Keynesian economists can be pinned down to the question whether policy makers should try to enable and constrain entrepreneurial activity by experimenting with a variety of institutional arrangements depending on the circumstances, or whether minimal interference with the basically auto-poetically emerging market is seen as best practice[8]. Post Keynesian Paul Davidson for instance writes: "Entrepreneurs do not merely discover the future, they create it!" (1995: 113). However, these acts of creation are not divine or necessarily acts performed by geniuses. Davidson describes the Austrian conclusion as follows: "Today's decision-makers, therefore, can make short-run errors, regarding the uncertain (i.e., risky) future for they do not possess sufficient mental processing power to 'know' the objective probabilities regarding the future – even if 'information' exists in the form of past and present market data" (Davidson, 1995: 110). Pierre Garello in interpreting von Mises finds a large conceptual overlap between the two theoretical perspectives on decision under uncertainty: "There are situations in which, Mises says, 'we know, with regard to a particular event, some of the factors which determine the outcome; but there are other determining factors about which we know nothing' (*HA;* 110). It is for those situations that this concept is designed. This concept seems therefore to come closer to the subjective probability concept or perhaps to Keynes's 'necessary view' of probability" (1996: 95).

The decisive difference from an Austrian point of view is that such erroneous entrepreneurs will be weeded out via the market as discovery process at least in the long run (Hayek 1978): "Any decision has necessarily an entrepreneurial dimension, for any decision rests on a subjective perception of reality. One should therefore expect the economic universe to be filled partly with 'good' entrepreneurs – those whose plans are fulfilled and whose actions end in profit; and partly with 'bad' entrepreneurs, those whose plans turn out differently from what was expected" (Garello 1996: 92). Post Keynesians, however, see fallible decision making also as a probable long term phenomenon (Davidson 1995). The system is not necessarily self-regulating and hence, the need for

[8] However, there is definitely awareness of the importance of institutionally embedded entrepreneurial behaviour amongst Austrian economists: "More precisely, one should study to what extent institutions (in the large sense of the word including the constitutions, the law, rules of commerce, contracts and the various social institutions) by themselves and through their evolution promote the convergence of subjective perceptions, thereby reducing the weight of uncertainty" (Garello 1996: 97). Thus, even this distinction seems to be a matter of degree.

government intervention and institutional design (Davidson 1996: 34).

However, at least if we include Joseph Alois Schumpeter in the Austrian school of thought, some remarkable similarities concerning the notion of the entrepreneur can be conceived. Roberto Marchionatti who uses the term animal spirits to label the particular Keynesian evaluation process (that is, the seesaw model) observes: "The motivation of entrepreneurs, as presented by Schumpeter, amounts to a specification of Keynes' animal spirits – i.e. 'non-rational' factors that induce entrepreneurial activity toward investment" (1999: 430). Paul Davidson links his notion of the crucial decision maker as well to "Schumpeter's theory of the entrepreneur" (1996; 32).

In Schumpeter's words the entrepreneur is a person who breaks away from conventions and habitual behaviour and is willing to try out something new though it means to face uncertainty: "First, outside these accustomed channels the individual is without those data for his decisions and those rules of conduct which are usually very accurately known to him within them. Of course he must still foresee and estimate on the basis of his experience. But many things must remain uncertain, still others are only ascertainable within wide limits, some can perhaps only be 'guessed'" (Schumpeter 1934[1911]: 84 and 85). From my point of view, the Schumpeterian concept of entrepreneurial behaviour is absolutely compatible with Keynes's seesaw model and animal spirits in extreme circumstances: "Here the success of everything depends upon intuition, the capacity of seeing things in a way which afterwards proves to be true, even though it cannot be established at the moment, and of grasping the essential fact, discarding the unessential, even though one can give no account of the principles by which this is done" (Schumpeter 1934[1911]: 85). Note that Keynes's ideas were in part inspired by the philosophy of intuitionism (Skidelsky 1992: 28).

Moreover, Schumpeter (1934[1911]: 75) explicitly and analytically distinguishes between the entrepreneur and the investor or banker – one might say, the one who provides the money contract (Davidson, 1989: 481): "He stands between those who wish to form new combinations and the possessors of productive means" (Schumpeter (1934[1911]: 74). According to Schumpeter, whilst persuading the investor to borrow him or her money the entrepreneur also shifts the burden of uncertainty towards the provider of financial funds: "It also settles the question whether the ordinary shareholder as such is an entrepreneur, and disposes of the conception of the entrepreneur as risk bearer" (Schumpeter

1934[1911]: 75)[9].

For Deirdre McCloskey, this power of persuasion is the outstanding characteristic of Schumpeter's entrepreneur, for it is he or she, who persuades banks to invest in innovations (McCloskey 1994: 372). In her book *Knowledge and Persuasion in Economics* she collects a bulk of evidence for the economic significance of persuasion under the heading *The Economy as a Conversation* (1994: 370) and uses the example of Donald Trump to point to the power of persuasion and *the art of felicitous speech acts* to close deals. However, these powers of persuasion might not only play a role in acquiring financial funds for investment. They might also be used by institutional entrepreneur (lobby groups, public intellectuals, advisors and politicians) to shape the economic environment.

IV. Keynes and Institutional Change

Keynes himself may serve as an example. He was not only a successful investor – as a result, he left a fortune when he died (Skidelsky 2000: 479), but also a very successful institutional entrepreneur. Not least when it came to propagating his ideas: "Keynes believed in, and was a great practitioner of, the art of persuasion" (Davidson 1996: 27). To the lament of his Austrian/Public Choice critics whilst using his powers of persuasion he was even able to change the British fiscal constitutional convention of a balanced public budget which "… rests on the forces of custom and acceptance alone" (Buchanan, Burton and Wagner 1978: 37). Oddly enough and contrary to their own behavioural assumptions held in public choice models this confirms the importance of ideas relative to the influence vested interests, at least in the long run. A notion emphasised by Keynes: "I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas", (Keynes, 1964: 383).Otherwise self-seeking politicians should have changed this rule much earlier[10], namely as soon as it would have suited their interests.

Keynes as a civil servant also acted as a political/institutional entrepreneur. Consider his role in negotiating the Versailles treaty and the related acts of persuasion (Skidelsky 1992: 370pp.) or his role in the construction of the Bretton Woods agreement (Vernengo 2003 and Skidelsky 2000). In 1944 he led the British delegation at the Monetary Conference at

[9] Frank Knight

[10] It is also quite inconsistent in Buchanan et al.'s argument, that the authors assume rational maximizing behaviour in some parts of the text (e.g. 1978: 19), but seem to assume irrational expectations concerning the future in other parts (e.g. 1978: 22).

Bretton Woods, where the International Monetary Fund and the World Bank were planned and established. Later, he was appointed Governor of both institutions. In addition: “For three months in 1945 he acted as the chief British negotiator in the most difficult financial diplomacy in history, which resulted in the American Loan Agreement” (O’Brien ??? 192). However, though Keynes definitely fulfilled that role himself, he had no theory of political entrepreneurship or the social construction of stabilizing institutions to ensure that deficit spending by governments during recessions will be followed be by building up a budget surplus in boom times.

However he seemed to be quite aware of this theoretical gap as he reveals at the very end of the General Theory: “Is the fulfilment of these ideas a visionary hope? Have they insufficient roots in the motives which govern the evolution of political society? Are the interests which they will thwart stronger and more obvious than those which they will serve? I do not attempt an answer in this place. It would need a volume of a different character from this one to indicate even in outline the practical measures in which they might be gradually clothed” (1964: 383). Thus, Buchanan et al. (1978) have a point when they criticize Keynes for this lack of institutional political economic theory of implementation[11]. He might not have been motivated enough to develop such concepts because of his own elitist attitude and access to political circles (Buchanan et al. 1978: 16) and because he strongly believed that: “The powers of vested interests and government could be tamed and controlled by reason” (Hodgson 1988: 229) and that the minds of political leaders can be oriented towards the public good: “Culture was not regarded as a force to reshape social relations, but to reorient the elite to ‘what is good” (Skidelsky 1992: 249). This elitist characterization comes also through in O’Brien’s account: “He believed in liberty but not in equality. His social outlook was that of a cultivated aristocrat interested in things of the mind, a patron of the fine arts, *arbiter elegantiarum”* (O’Brien ??? 198).

Though coming from the opposite side of the political spectrum than Buchanan et al. (1978) Michał Kalecki raised the issue of political implementation already in his article *Political Aspects of Full Employment* in 1943.

However, there is definitely a need to explain how public political entrepreneurs create favourable, welfare enhancing institutions. Fortunately, the current debate about path dependence, institutional change, varieties of capitalism, bricolage and institutional

[11] I am grateful to my colleague Graham Brownlow for refering me to this critique.

entrepreneurship in sociology and political science (Campbell 2004 and Crouch 2005) might be helpful to fill this gap.

Campbell attempts in his book *Institutional Change and Globalization* to summarize and synthesize the three major streams of institutionalism in the social sciences: i.e. a rational choice, an organizational and a historical one. This leads him to discuss the important mechanisms of institutional change which he identifies as: *path dependence, bricolage, actors as entrepreneurs, diffusion, translation and enactment.* These concepts are used to explain institutional change and share the same conundrum. According to Campbell: "The problem for institutionalists is that although these concepts are central to our causal arguments, they often remain vague and mysterious" (2004: 62). He concludes, the reason for this vagueness is the absence of micro-level theorizing. However, this conceptual gap creates an opportunity for collaboration between institutional political scientists, Post Keynesians and Institutional Economists. While the latter may provide clearer ideas about macro economic policy and micro foundations as discussed above, the former are able to contribute concepts of institutional change and entrepreneurship. Campbell for instance puts the thesis forward that: "Interests are a particular type of idea among many" (ibid. 91). Though he maintains that it is certainly an open and complicated question, "… what the relationships are between interests and other types of ideas" (ibid. 123), a possible outcome of the ongoing debate could be an integration of the Marxian and rational choice focus on interests in an encompassing framework based on ideas which appears to be close to Keynes's notion of institutional political change in the long run. To provide an example for such a type of analysis, according to Campbell: "Jack Knight's (1992, 2001) work is representative insofar as he shows that actors build political institutions through complex bargaining games in which they struggle to assure acceptable distributional outcomes for themselves" (ibid. 88).

As a useful starting point to analyse the influence of ideas on institutional change, Campbell suggests a distinction into four different categories: programs, paradigms, frames and public sentiment. He shows in his book that these mechanisms filtered the influence of neo-liberal globalization in the political process and hence, led to different outcomes from country to country (he compares Sweden and the USA).

In quite a similar vein as Campbell, Colin Crouch attempts to explain institutional change through entrepreneurial intervention. Building on a comprehensive summary and critique of the debate on *Varieties of Capitalism* in economics, political science and sociology he starts from path dependence, a necessary diversity of institutional arrangements and a broader concept of the agent: “human individuals are assumed to operate in a permanent dilemma between following the rules of the institution within which they operate and challenging, breaking, innovating against, those rules” (Crouch 2005: 19). His behavioural model is a Schumpeterian one of institutional entrepreneurs or historically and socially embedded path creators. Conflicting rationalities and interests, diversity of institutional forms or governance mechanisms and latent redundant capacities lead to degrees of freedom used by institutional entrepreneurs embedded and empowered by networks to bend path dependence by emulation and discovery of functional equivalents. Potential institutional change, according to Crouch is constrained as well as enabled by path dependency. To analyze these processes clearly defined Weberian ideal types might be useful instruments, but: “The fundamental point is: Empirical cases must be studied, not to determine to which (singular) of a number of theoretical types they should each be allocated, but to determine which (plural) of these types are to be found within them, in roughly what proportions, and with what change over time” (ibid: 26).[12]

This notion of ‘mongrel’ elements is has quite some resemblance with Geoff Hodgson’s “impurity principle”. Hodgson derives it from a critique of Marx and inspiration by institutional and evolutional economists (Veblen, Myrdal, Kapp, Polanyi and Schumpeter among others). The impurity principle is defined by him as: “The idea that every socio-economic system must rely on at least one structurally dissimilar subsystem to function. There must always be a coexistent plurality of modes of production, so that the social formation as a whole has the requisite structural variety to cope with change” (Hodgson 2001: 72). According to Hodgson every system relies on its ‘impurities’ which are based on differences in historical experience, language and culture. From this principle he concludes: “The particular subsystem, the nature of the combination, and the precise boundaries of the demarcation profoundly affect the nature of the specific variety of capitalist system. *A corollary of the impurity principle is the contention that an immense variety of forms of any given socioeconomic system can exist.* In particular, an infinite variety of forms of capitalism is possible” (Hodgson 2001: 74). As a consequence of the impurity principle, the rich and diverse variety of capitalisms can not be pressed into a straightjacket of typology based on rational choice.

According to Crouch, “Institutional entrepreneurs may be found in many places, including within public policy, consultancies, or representative associations” (2005: 101) and “…

[12] For a comprehensive critical review of the Varieties of Capitalism literature, compare Nielsen and Kesting 2008.

develop along the paths provided by history, but attempt mindfully to depart from it" (2005: 100). Similarly to the aforementioned arguments put forward by Hodgson, Crouch summarises: "Our agent, *A*, could find new paths only when there were some 'mongrel', even incongruent elements in her environment. *We can therefore observe innovations of this kind only if our models of real-world institutions have allowed us to find elements of complexity and incoherence. This will not happen if a false interpretation of the law of parsimony requires us to simplify the cases we study so that they seem to be the embodiments of ideal types*" (2005: 99). Based on his model of economic governance Crouch is able to show how the neo-liberal turn in Britain was already present as an ideological undercurrent in the Londoner City: "The monetarist, non- (pre-, anti-, post-) Keynesian practices that came to dominate during this period had always been the policy preferences of the financial sector; the secondary neoliberal path had run alongside the dominant Keynesian one throughout the post-war period" (2005: 148). To enact institutional and policy change, ideological persuasion and vested interests worked hand in hand: "Neoliberal academic economists and 'think tanks' supported by the power interests who would gain from the change had articulated the monetarist policy models that replaced Keynesian mechanisms" (Crouch 2005: 149).

Conclusion

This paper demonstrates that Keynes developed a particular micro economic model as a foundation to explain investment and speculative behaviour. Later this concept was further developed by Herbert Simon. This set of ideas shows a lot of similarities with the notion of entrepreneurship in Austrian economics. All these related microeconomic approaches stress the evaluation of incoming information (weight of argument) and the difficulties of dealing with real uncertainty for the actor (subjective probabilities). Further research may answer the related questions whether even modern behavioural economics can be traced back to Keynes's ideas about microeconomics and whether the Keynesian notion and its contemporary refinements may lead to a viable alternative to utilitarian neoclassical mainstream microeconomics.

Another goal of this paper was to link entrepreneurship in the Keynesian and Austrian sense to institutional change. Recent debates among institutional political scientists and economic sociologists widen the understanding of entrepreneurship beyond its role in commerce and business. They show that entrepreneurs can also be found in the public arena of politics. From this perspective they are the agents of institutional change. Keynes himself was a busy and sometimes quite successful public entrepreneur. Moreover, his microeconomics can enrich the understanding of the notion of the public entrepreneur in modern political science which is lacking so far in its behavioural foundation. Whether fruitful solutions will arise from such a trans-disciplinary cross fertilization remains to be seen.

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