Post Keynesian Macroeconomics

Essays in honour of Ingrid Rima

Edited by

Mathew Forstater, Gary Mongiovi and Steven Pressman

Routledge Frontiers of Political Economy

Post Keynesian Macroeconomics

Post Keynesian economics has focused primarily on the problems of unemployment from a macroeconomic perspective. The works of Ingrid Rima have provided a notable exception to this tradition and this volume examines some of her main ideas and contributions to Post Keynesian thought.

The first part of this book analyses the links between Post Keynesian economics and earlier economic thinkers such as Quesnay, Marx, and Marshall. Further contributions in the second part of this volume discuss issues such as uncertainty, speculation, aggregate demand and aggregate supply, and government policymaking based on Post Keynesian macroeconomics and Post Keynesian models. The third section contains essays which expand on issues such as institutions, technological and sectoral changes, innovation and globalization.

The contributions selected for *Post Keynesian Macroeconomics* demonstrate the breadth of Post Keynesian thought and its incisive analysis of real world problems. It also demonstrates how Ingrid Rima has moved Post Keynesian economics forward.

Mathew Forstater is Associate Professor of Economics and Director of the Center for Full Employment and Price Stability at the University of Missouri at Kansas City. **Gary Mongiovi** is Professor of Economics at St John's University and co-editor (with Steven Pressman) of the journal *Review of Political Economy*. His forthcoming edited book *Sraffa and Modern Economics* will also be available from Routledge. **Steven Pressman** is Professor of Economics and Finance at Monmouth University. He is the author of *Fifty Major Economists* (Routledge, 1999, 2006).

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Contributors

Stanley Bober is Professor Emeritus at Duquesne University. He is the author of several books, including *Capital, Distribution and Growth: A Look at Neo-Keynesian Economics* (University Press of America, 1980), *Pricing and Growth: A Neo-Ricardian Approach* (M.E. Sharpe, 1991), *Recent Developments in Non-Neoclassical Economics* (Ashgate, 1997), and *Alternative Principles of Economics* (M.E. Sharpe, 2001).

Mathew Forstater is Associate Professor of Economics and Director of the Center for Full Employment and Price Stability at the University of Missouri, Kansas City. He is the co-editor of *Growth, Distribution and Effective Demand: Alternatives to Economic Orthodoxy* (Routledge, 2003), *Reinventing Functional Finance: Transformational Growth and Full Employment* (Edward Elgar, 2003), and *Contemporary Post Keynesian Analysis* (Edward Elgar, 2005).

Geoff Harcourt is Professor Emeritus at Jesus College, Cambridge University, and serves on the Editorial Board of the *Journal of Post Keynesian Economics* and the *Review of Political Economy*. He is the author of numerous books, including *Some Cambridge Controversies in the Theory of Capital* (Cambridge University Press, 1972), *On Political Economists and Political Economy* (Routledge, 2003), and *The Social Science Imperialists* (Routledge, 2003).

Richard P.F. Holt is Professor of Economics at Southern Oregon University. He has published a number of books, including *A New Guide to Post Keynesian Economics* (Routledge, 2001) and *The Changing Face of Economics: Conversations with Cutting Edge Economics* (University of Michigan Press, 2004). His latest book, with Steven Pressman, is *Empirical Post Keynesian Economics: Looking at the Real World* (M.E. Sharpe, 2006).

Daniel Kostzer is Director of Macroeconomic Research and Coordination at the Ministry of Labor, Employment and Social Security of Argentina, and also a Lecturer at the University of Buenos Aires. He has served as a consultant for the International Labour Organization and the United Nations Development Program on issues related to employment and income distribution, and also serves as a member of the editorial committee of the journal *Estudios del Trabajo* of ASET (Association of Labor Studies Experts of Argentina).

Jay R. Mandle is the W. Bradford Wiley Professor of Economics at Colgate University. He has published widely on economic development and Caribbean development. Mandle's most recent book is *Globalization and the Poor* (Cambridge University Press, 2003). He is presently working on a book entitled *United States Democracy in the Age of Globalization*.

Maria Cristina Marcuzzo is Professor in Economics at the University of Rome ("La Sapienza"). She is also the co-author of *Ricardo and the Gold Standard* (Macmillan, 1991), co-editor of *Monetary Standards and Exchange Rates* (Routledge, 1997), co-editor of *Economists in Cambridge*: *A Study through their Correspondence, 1907–1946*, (Routledge, 2005), and co-editor of *The Economics of Joan Robinson* (Routledge, 1996).

Gary Mongiovi is Professor of Economics and Finance at St. John's University. He also serves as co-editor of the *Review of Political Economy*. He is the editor of *Macroeconomic Theory: Diversity and Convergence* (Edward Elgar, 1993), *Growth, Distribution and Effective Demand: Alternatives to Economic Orthodoxy* (Routledge, 2003), and *Sraffa and Modern Economics* (Routledge, 2004).

Laurence S. Moss is Professor of Economics at Babson College and editor of the *American Journal of Economics and Sociology*. He is also the author of *Mountifort Longfield: Ireland's First Professor of Political Economy, A Study of the Development of 19th Century Economic Theory* (Green Hill Publishers, 1976); and the editor of *The Economics of Ludwig von Mises: Toward a Critical Reappraisal* (Sheed, Andrews and McMeel, 1976), *Joseph A. Schumpeter: Historian of Economics* (Routledge, 1996), and *Talcott Parsons: Economic Sociologist of the 20th Century* (Blackwell, 2006).

Edward J. Nell is the Malcolm B. Smith Professor of Economics at the New School University. He is the author of numerous books, including (with Martin Hollis) *Rational Economic Man* (Cambridge University Press, 1974), *Prosperity and Public Spending: Transformational Growth and the Role of the State* (Unwin & Hyman, 1988), *Transformational Growth and Effective Demand* (Macmillan, 1992), *Making Sense of a Changing Economy* (Routledge, 1996), and *The General Theory of Transformational Growth* (Cambridge University Press, 1998).

Mark Perlman was Emeritus Professor of Economics at the University of Pittsburgh before his untimely death in May 2006. He was also the founding editor of the *Journal of Economic Literature*, and served as editor of the journal from 1969 to 1981. His books include *Labor Union Theories in America* (Greenwood Press, 1976), *Evolving Technology and Market Structure: Studies in Schumpeterian Economics* (University of Michigan Press, 1991), *Schumpeter in the History of Ideas* (University of Michigan Press, 1995), and *The Character of Economic Thought* (University of Michigan Press, 1996).

Steven Pressman is Professor of Economics and Finance at Monmouth University in West Long Branch, NJ. He also serves as co-editor of the *Review of Political Economy*, and as Associate Editor and Book Review Editor of the *Eastern Economic Journal*. He has authored or edited a dozen books, including *Quesnay's* Tableau Économique: *A Critique and Reconstruction* (Kelley, 1994), *A New Guide to Post Keynesian Economics* (Routledge, 2001), and *50 Major Economists*, 2nd ed. (Routledge, 2006).

Warren J. Samuels is Professor Emeritus at Michigan State University. He is also co-editor of *Research in the History of Economic Thought and Methodology.* His many books include *The Classical Theory of Economic Policy* (World Publishers, 1966), *European Economics of the Early Twentieth Century* (Edward Elgar, 1998), *Economics, Governance and Law: Essays on Theory and Policy* (Edward Elgar, 2002), *Essays in the History of Economics* (Routledge, 2004), and *The Legal-Economic Nexus* (Routledge, 2006).

Eleonora Sanfilippo is a Research Fellow in the History of Economic Thought at the University of Rome "La Sapienza" and Junior Lecturer of Macroeconomics at the University of Cassino, Italy. She is also the author of *Markets, Money and Capital: Hicksian Economics for the 21st Century* (Cambridge University Press, forthcoming).

Claudio Sardoni is Professor of Economics at the University of Rome ("La Sapienza"). He is the author of *Marx and Keynes on Economic Recession: The Theory of Unemployment and Effective Demand* (New York University Press, 1987). He is also on the Editorial Board of the *Review of Social Economy* and the *Review of Political Economy*.

John Smithin is Professor of Economics in the Department of Economics and the Schulich School of Business, York University, Toronto, Canada. He is the author or editor of *Controversies in Monetary Economics* (Edward Elgar, 1994), *Macroeconomic Policy and the Future of Capitalism: The Revenge of the Rentiers and the Threat to Prosperity* (Edward Elgar, 1996), *Money, Financial Institutions and Macroeconomics* (Springer, 1997), and *What is Money?* (Routledge, 2000).

1 Ingrid Rima and Post Keynesian macroeconomics

Steven Pressman

Post Keynesian economics developed in the latter half of the twentieth century, following publication of the *General Theory* (Keynes, 1964 [1936]). Some of the main figures in this endeavor were Paul Davidson, John Kenneth Galbraith, Nicholas Kaldor, Michal Kalecki, Joan Robinson, and Sidney Weintraub (see King, 2002). Their key insight was the theory of effective demand and its consequences – it is spending that drives macroeconomic performance, a monetary production economy can experience prolonged bouts of high unemployment, and economic policies are needed to assure full employment, low inflation, and stable financial markets.

For Post Keynesians, the key macroeconomic problem has always been unemployment. While the mainstream views unemployment as a temporary problem that will go away in the long run if wages, prices, and interest rates were sufficiently flexible, Post Keynesians see unemployment as a problem that will not go away unless macroeconomic policies are used to create jobs. Most of the figures instrumental in developing Post Keynesian economics made this point about unemployment by focusing on aggregate macroeconomic models. These models explained how the level of output for the whole economy depended on effective demand, and how unemployment could exist, and why it would persist, whenever demand and output were insufficient.

One drawback to this approach is that ignores real world labor markets. It is, of course, in the labor market that employment decisions get made and that unemployment arises when there are insufficient jobs to meet the needs of a nation's citizens. Neoclassical economics has pointed out that sufficiently flexible markets will clear. Thus, the unemployment problem would tend to get resolved by itself if wages fell and approached the marginal productivity of workers whenever there was high unemployment. This leads to the main policy conclusion of neoclassical economics – that macroeconomic policies were irrelevant and might do more harm (generating inflation) than good. Instead, we need to make labor markets more flexible and more like the perfectly competitive markets that exist in neoclassical models.

It is within this context that Ingrid Rima has made her main contribution to Post Keynesian Economics. She has examined involuntary unemployment as a result of what happens in real world labor markets. She has argued continuously against the neoclassical view that employment in labor markets is determined mainly by the demand for labor, which, in turn, depends on the marginal productivity of workers. And she has moved Post Keynesian economics forward by arguing that employment outcomes in labor markets are not just due to inadequate demand; they are also due to labor market institutions, history, power, and technological, sectoral, structural, and global changes. Unemployment is the result of how these myriad factors impact on labor supply and demand.

Taking on the neoclassical position, Rima (1984a, 1984b, 1986b) has attempted to explicate Keynes's notion of involuntary unemployment, and has argued that viewing unemployment as involuntary makes more sense than the job search models that have fascinated labor economists over the past three to four decades. In addition, she has attempted to bring out the neglected second strand of the economics of Keynes. Seeking to understand how labor markets actually function, and how they are related to the macroeconomy, has led logically to a concern with wages, with income distribution, and with poverty. This set of problems is what Robinson (1972) called, in her Presidential Address to the American Economic Association, "the second crisis of economic theory."

In attempting to understand and explain both unemployment and the maldistribution of income, Ingrid has brought to labor economics many of the key insights from Post Keynesian economics – the importance of history (rather than equilibrium), the use by firms of markup or cost-plus pricing over (mainly labor) costs, and the importance of wage-setting institutions (rather than marginal productivity theory) to explain wages. More importantly, following the lead of Robinson, she (Rima, 2003) has argued that the level of money wages is an historical accident that depends on the ability of workers to maintain relative wage rates. It depends on things like history, institutions, and the bargaining power of workers. This is one of the key factors that keep wages from adjusting when unemployment rates are high. But Ingrid has also brought to the analysis of unemployment and inequality her own unique perspective, one that has been neglected by both the mainstream and Post Keynesians. This analysis has focused on sectoral changes in employment, and the existence of dual labor and product markets, especially in a global economy, as main causes of unemployment and income inequality; and it has led Ingrid to call for worker training, public sector employment, and wage subsidies for the working poor (Rima, 1996, 2000b, 2003).

Ingrid was born in Barmen, Germany, not far from Cologne. Around a year after her birth, her parents arrived in the United States. She grew up in Brooklyn, New York, where her father worked as a textile engineer. Both her parents stressed the importance of education, and Ingrid listened to their advice – taking the college preparatory track rather than the commercial track in high school.

After high school, Ingrid did her undergraduate work at Hunter College in New York City. Besides studying dance, Ingrid took a course in price theory. As she has told Olson and Emami (2002, p. 19), she "loved all those graphs that looked so beautiful and orderly, and thought market equilibrium was quite an extraordinary phenomenon. . . . I thought that the most beautiful concepts in the world were marginal cost and marginal revenue."

Fortunately, her mentors at Hunter were Dorothy Lampen, author of *Adam Smith's Daughters*, and Hazel Roberts, a leading scholar on the economics of Physiocrat Marshall Vauban (Olson and Emami, 2002, pp. 19–20). Lampen and Roberts introduced Ingrid to the history of economic thought. Two early figures intrigued her most – William Petty and François Quesnay (Rima, 2005). Both were physicians before they began to study economics; as such, when approaching economic questions, their instincts were to come up with solutions to the problems faced by individuals. This became the hallmark of Ingrid's approach to economics – the economy can develop illnesses, and it is the job of the economist to understand the causes of the disease and also figure out what can be done to heal the ailing patient. Besides Petty and Quesnay, Ingrid also studied Marshall, Robinson's (1933) *Economics of Imperfect Competition*, and Keynes. A careful reading of the *General Theory* led logically to an interest in the problem of unemployment.

After graduating from Hunter in 1945, Ingrid applied to several graduate programs in economics. She chose to attend the University of Pennsylvania because it was not in New York and also not far from New York. At Penn she specialized in monetary and international theory, as well as industrial relations, the closest thing to the field of labor economics at the time. Sidney Weintraub arrived at Penn shortly after Ingrid began studying there and soon became her mentor. Weintraub sparked her interests in macroeconomics and introduced her to Post Keynesian thinking (Olson and Emami, 2002, p. 27). Her M.A. thesis was on equilibrium exchange rates. After receiving her M.A. in 1946, she was offered a research position at the Federal Reserve Bank of Philadelphia. One of her professors at Penn told her that Temple University was expanding. Ingrid applied for a job, received an offer, and accepted a teaching position there. Since 1947 she has taught at Temple University. She became an assistant professor after receiving her Ph.D. (in 1951) following the successful defense of her dissertation on public utility rate making. In 1967 she became a full professor. As Ingrid has remarked: "In a sense, 1967 is when my life as an economist began. The only date that really counts is 1967. . . . Until then nobody took me seriously (Olson and Emami, 2002, p. 24).

Ingrid has certainly been taken seriously as an economist, and has also been remarkably productive as a scholar. She has served (in 1993–94) as President of the History of Economics Society. Perhaps more important, Ingrid was one of the founders of the Eastern Economic Association in 1974, and served as editor of the *Eastern Economic Journal* from 1979 to 1991. Besides establishing the principle that the journal would be an open forum for all perspectives in economics and all areas of specialization, she also established the practice of double-blind refereeing, something that is now common in economics but was not common when Ingrid introduced it. Several contributors to this volume (Bober, Moss, Pressman, and Smithin) were appointed to the Editorial Board of the *Eastern Economic Journal* and mentored by Ingrid. Two (Moss and Pressman) followed in Ingrid's footsteps, becoming journal editors themselves.

Ingrid's scholarly output includes numerous books and journal articles covering a wide range of topics in labor economics, the history of economic thought, international economics, and macroeconomics. Taken as a whole, what is perhaps most remarkable about Ingrid's scholarly work is its great range. Besides her main fields, the history of economic thought and labor economics from a global and macroeconomic perspective, she has written on poverty (Rima, 1986b, 1990), on technical change and innovation (Rima, 1989), and on the history of econometrics (Rima, 1988, 1995). Such breadth has been one of Ingrid's greatest strengths as an economist and a scholar.

Continuing her early interests in the history of economic thought, Ingrid has written extensively on Alfred Marshall, John Maynard Keynes, and Joan Robinson (Rima, 1986b, 1988, 1990, 1991, 2003). Her *Development of Economic Analysis* (Rima, 2000a) is one of the best-selling history of economic thought textbooks, and will soon be in its seventh edition. It has introduced tens of thousands of students to the history of economic thought. An edited volume honoring Joan Robinson (Rima, 1991) explores the important contributions of this important Post Keynesian economist. Ingrid's essay in the Robinson volume draws attention to Robinson's contribution to the Keynesian Revolution. She notes that "It was Robinson who pushed Keynes to recognize the revolution he precipitated stemmed from his abandoning the concept of equilibrium to move toward that of history" (Rima, 1991, p. 196).

A concern with getting history right is evident in Ingrid's work on Alfred Marshall and labor markets. Rima (1986a) makes clear that Marshall was not responsible for the conventional wisdom that remuneration to factors of production is governed by the same principles that determine commodity prices. Labor markets are thus different from other types of markets for Marshall, a position that is similar to Keynes in the *General Theory* and to the view that Rima has stressed throughout her career.

Ingrid's interests in the history of thought, labor economics from a macroeconomic perspective, and the real world consequences of unemployment all converge in a paper on Marshall's view of poverty (Rima, 1990). In the second edition of the *Principles*, Marshall identified a growing *residuum* of individuals who were incapable of doing a good day's work or earning a decent wage. Rima argues that Marshall was concerned with this *residuum* on humanistic as well as moral grounds, and that he was interested in developing policies to assist the poor. At an analytic level, Marshall was concerned with explaining the existence of this *residuum*. Rima then shows that Marshall's inquiry into labor market peculiarities bridges the gap between his analytic and humanistic concerns. Chapters 4 through 6 (Book VI) of the *Principles* trace the problem of the *residuum* to the disadvantages of labor in wage bargaining. Poverty persists from generation to generation, according to Marshall, because nothing is done to break the cycle of poverty or improve the bargaining position of labor.

This analysis has numerous linkages with Post Keynesian thought. It emphasizes history and cumulative causation rather than equilibrium, it sees wages as determined by some bargaining process rather than by worker productivity, and it focuses on the real world problems of poverty and income distribution. It also dovetails with the analysis of Galbraith (1958, 1964, 1979) concerning the causes of poverty in both the United States and the developing world.

More recently, as globalization has become increasingly important, Ingrid has turned her attention to the global economy. The global economy is important because it changes the dynamics of the labor market (Rima, 1996, 2000b). For example, US workers in a global economy have to compete not only against other US workers with similar characteristics, expectations, and living standards, but they also must compete with workers in less developed countries. In many of these places, workers receive a good education and acquire the skills necessary to compete with US workers. They also live in places where the average living standard is one-fifth or less of US living standards, and where US laws that seek to prop up wages and demand (e.g., minimum wage laws) and establish a certain level of working conditions do not apply. For all these reasons, this leads to an exodus of jobs from the US to these less developed nations. But this movement also leaves many problems in its wake; these are all problems related to the labor market – unemployment and greater income inequality.

In the spring of 1991, Ingrid organized a conference in Rome on economic restructuring that examined the causes and the consequences of globalization, and set forth policies to deal with the challenges of globalization. The two conference volumes (Rima, 1993) demonstrate both Ingrid's breadth and her Post Keynesian orientation. The papers in these volumes address the stability in the world economy as globalization proceeds, and many papers discuss trying to how we might achieve stability and full employment in a global economy.

The essays that comprise the rest of this volume all touch, and expand, on some of the main ideas and contributions of Ingrid Rima. The first four chapters, comprising Part I of this volume, make connections between Post Keynesian economics and earlier economic thinkers.

Ingrid's early interest in the work of Quesnay was noted previously. Chapter 2 traces some of the main ideas of Keynes and the Post Keynesians back to the work of François Quesnay in the eighteenth century. According to Pressman, there are several things that Quesnay and Post Keynesian economics have in common. Both developed macroeconomic models that could explain economic fluctuations and that did not result in highly desirable outcomes. Quesnay showed how it was possible that economies could continue to decline year after year, and how after years of decline there was no guarantee of greater economic growth; similarly, Keynes and the Post Keynesian showed how unemployment equilibria could persist without appropriate economic policies. In addition, both Quesnay and the Post Keynesians hold that money is not neutral in the economy, but has real economic effects. Next, both believe that investment determines savings, rather than vice versa. In addition, both Quesnay and the Post Keynesians have developed economic models which explain how demand for the goods of different economic sectors can lead to either growth or economic decline. Finally, both employ sequential models, where history is important, rather than general equilibrium models, where everything happens all at once.

In Chapter 3, Stanley Bober discusses the importance of Marx and the relationships between Marx and Post Keynesian economics. He first considers the philosophical basis of Marx's work and his essential message. Then he talks about the relevance of Marx in today's global economy. Current interest in Marx, according to Bober, stems from several factors. Especially important are weaknesses in the foundation of orthodox economics, the reemergence of labor exploitation, and the continuous assault on worker rights in a global economy. Bober argues that if this revival of Marx is to be successful, it must resonate with the current political and social context. This means that Marxists need to be in the forefront of putting worker rights on the same plane with human rights, and to insist that worker rights be part of the democratic institutional arrangements that exist in every country. By focusing on the impact of free markets on labor, and the importance of political power in guaranteeing worker rights and higher labor incomes, a great deal of common ground can be found between Marxists and Post Keynesians.

In Chapter 4, Geoff Harcourt expands upon this theme, and notes a number of other connections between Marx and Keynes. Both figures shared similar views of how capitalist economies work, views that differ greatly from most contemporary attempts to understand capitalism. The main difference between Marx and Keynes concerns how they viewed the economic problems that spring forth under capitalism. Keynes saw these problems as a challenge, and he sought to devise economic policies that would save capitalism and let us reap the benefits of its efficiencies without suffering from its dark side. In contrast, Marx saw these problems as signs of the inherent instability of capitalism and evidence of its ultimate demise.

In Chapter 5, Maria Cristina Marcuzzo and Eleonora Sanfilippo look at the history of the notion that profit maximization guides the behavior of entrepreneurs. Marshall (1920) developed the MC = MR profit-maximizing rule for firms. Keynes (1964 [1936]) accepted this as a good short-run decision rule, as did Robinson and many others at Cambridge in the 1930s and 1940s; but Keynes stressed that investment in new plants and equipment involves a great deal of uncertainty and is not subject to this sort of calculation. As a result, the profit-maximization rule of Marshall could not hold for these long-run investment decisions. But Keynes and most Post Keynesian held that Marshall's maximization rule operated in the short run. It is only with the work of Kalecki that short-run entrepreneurial behavior becomes dependent on customs, habits, and the opinions of other entrepreneurs. At this point in time we move from the Marshallian MC = MR approach to the Post Keynesian approach of markup or cost-plus pricing (see Lavoie, 2001). However, as Marcuzzo and Sanfilippo show, Robinson and Richard Kahn remained skeptical of both Kalecki's work on pricing and the markup approach. So this did not become part of the early Post Keynesian approach to pricing. One important implication of this chapter is that Post Keynesian pricing theory may not have really begun until the mid-1970s. Only with the notion that the markup is determined by the funds needed for investment and firm growth (Harcourt and Kenyon, 1976), did the markup approach become generally accepted by Post Keynesians. With this doctrine Post Keynesians eschew that macroeconomics have microeconomic foundations, argue that they have given microeconomics good macrofoundations, and begin to link up what happens in macroeconomic models to what happens in labor and product markets.

The second part of this book contains a set of chapters that focus on Post Keynesian macroeconomics and Post Keynesian models.

In Chapter 6, Richard P.F. Holt presents the four fundamental features of Post Keynesian economics. First, there is a concern with the real world. Second, there is an emphasis on historical time. Third, Post Keynesians see the world as non-ergodic, where uncertainty prevails, rather than as being ergodic and predictable. Fourth, for Post Keynesians institutions are important in determining behavior. This is true not only of the behaviour of individuals and firms; it is likewise true of the behavior of policymakers. A well-functioning economy thus not only needs good theory; it also needs competent public servants who understand this theory and who get rewarded for efficiently implementing public policies. Holt ends by questioning the Babylonian methodological approach in Post Keynesian economics, arguing that by placing a premium on accepting alternative viewpoints it takes us away from the main contributions that Keynes made in the *General Theory*.

In Chapter 7, John Smithin examines the evolution of the concepts of aggregate demand and aggregate supply over the past seventy years. These notions were first introduced into macroeconomics by Keynes in the *General Theory*. Smithin argues that macroeconomics would have progressed further had the Post Keynesian model of aggregate demand and supply in *Z,N* space, put forward by such writers as Davidson and Smolenksy (1964) and Weintraub (1961), been more widely accepted. This would have made it easier to understand Keynes's original concept of effective demand. In contrast, the aggregate demand/aggregate supply models, in *P,Y* space, that are employed in mainstream macroeconomics have evolved along different lines, and have been used to support neoclassical analysis and conclusions. Smithin then suggests an approach that, if not able to completely reconcile the existing alternatives, at least makes clear their differences and similarities. He also shows how Post Keynesian macroeconomic models can avoid the charges of logical inconsistency and theoretical error leveled at some of the mainstream constructs. His re-especified Post Keynesian aggregate demand/aggregate supply model affirms broadly Keynesian results. An increase in effective demand will tend to increase output and employment, and will do so permanently, not just for the short run.

In Chapter 8, Claudio Sardoni discusses Kaldor's theory of speculation. One important issue in Post Keynesian macroeconomics is why interest rates don't fall to assure that savings and investment are equal, and to help the economy reach full employment. For Keynes (1964 [1936]), the answer lied in the liquidity trap and his monetary theory of interest; interest rates are determined by the supply of money and the demand for money, and there is a minimum interest rate. From this perspective, greater savings does not lower interest rates and generate growth through greater investment. Sardoni argues that Kaldor got similar results by following a different path. For Kaldor, the demand for liquidity involves a shift from long-term to short-term securities rather than from securities to cash. Very short-term rates are determined by the supply and demand for money, but rates on longer-term securities, which determine long-run investment decisions, depend on the willingness to undertake long-term commitments facing an uncertain future. Thus, as for Keynes, investment is determined mainly by speculative factors. But Kaldor's analysis brings Post Keynesian macroeconomics closer to modern monetary theory, where the speculative demand for money is regarded as obsolete in a world of sophisticated financial markets, and where numerous financial instruments exist that are nearly as liquid and as safe as money.

In Chapter 9, Warren J. Samuels identifies the key themes in the work of John Kenneth Galbraith. Galbraith, Samuels, and Rima all occupy a similar place in the history of economic thought. They are among the very few recent economists possessing great breadth, and interest in history as well as the social side of economics. In addition, all three share Post Keynesian perspectives about the folly of neoclassical economics and the necessity of government policy to improve economic outcomes. Galbraith accused mainstream economic theory of being a set of shibboleths adopted for the purpose of legitimizing the capitalist system and engendering complacency. But really, for Galbraith, the market was a system of social control. The question was who pulled the levers and who benefits in such a system. Because the capitalist economy was both a system of power and part of a class-dominated society, Galbraith looked to government policy to make the corporate system, the larger economy, and society less hierarchical. Like Keynes, he wanted government activism to support the needs and values that the present system ignores. One of Galbraith's deepest and most important points, according to Samuels, is that government makes choices with every policy that it adopts on every issue. Any government is thus inevitably an activist government. The only question is which group or individual the government will support. There is thus no reason that the government should not choose to support the public purpose rather than the interests of a corporate elite.

Finally, Part III of the book moves forward. The chapters in this section go beyond traditional Post Keynesian macroeconomics, exploring some of the issues that Ingrid has brought to Post Keynesian macroeconomics.

As noted earlier, Ingrid always emphasized the importance of institutions, especially wage-setting institutions, in determining real world outcomes. She also viewed the economy as undergoing structural changes as it moves through historical time. In Chapter 10, Mark Perlman shows that American institutionalism had a very similar idea of economic dynamics, akin to Marshall's partly "biological" approach in some respects, but significantly different in other respects. Perlman focuses on what he calls "the Wisconsin variant" of American institutionalism (so designated because its adherents were based at the University of Wisconsin), to which his father Selig Perlman made important contributions. What distinguishes this approach is its emphasis on synthesis over analytics; like Ingrid's views on labor markets, it aims to provide an account of how the various social and institutional forces operating within an economic system helped to shape its historical development. Formal model building has its place of course, but formal model building also requires understanding the many forces that impact an economy as it develops over time. Unfortunately, Perlman argues, training in the synthesizing approach of the old institutionalists has been completely purged from the modern economics curriculum. He concludes by making a persuasive case that a truly useful economic dynamics ought to draw upon the synthesizing outlook of the institutionalists.

In Chapter 11, Edward J. Nell explores a topic that has been near and dear to Ingrid's heart – involuntary unemployment in the context of different technologies, different economic sectors, and different institutional behavior by firms. Nell contrasts craft-based or Marshallian technology with mass production technologies. In the former case, small firms employ skilled work teams, so it is hard to vary the quantity of output and employment. Here the economy will tend towards full employment. Moreover, adding more workers will tend to lead to lower additional returns, so diminishing returns operate. In this sort of economy, the real wage is likely to be equal to the marginal productivity of the worker because unemployment will lead to lower wages and more hiring. In contrast, with mass production, quantity and employment are easily changed in response to changes in demand, and the costs of production are relatively constant. In this world, employment varies but wages are not very flexible. Moreover, employment is determined by demand, which depends on consumption and investment. Consumption, the biggest component of demand, in turn, is determined by wages and employment. So even if wages do fall in a mass production economy, this would reduce spending, which would have a multiplier impact, and so not likely reduce unemployment.

Chapter 12 concerns innovation, technical change, and (indirectly) sectoral change. Laurence Moss sets forth a view of innovation that depends less on individual behavior and money-making incentives, and more on relationships among individuals and corporate culture. Moss relies on Joseph Schumpeter's distinction between management and entrepreneurship, which admits the possibility of large corporations both creating and growing new businesses. Still, it is somewhat puzzling how large firms can grow their established businesses and *at the same time* create new ones. Moss argues that part of the solution to this puzzle has to with "firm architecture." Firm architecture, plus a set of shared beliefs held by top managers and division managers, gives shape to a genuinely entrepreneurial corporation. In this way the firm institutionalizes the entrepreneurial function. The institutionalization of the entrepreneurial function was described by Schumpeter, especially in his later writings, and was developed further by Galbraith (1967). Via numerous case studies, Moss shows that it is these social, institutional characteristics of firms can lead to innovation and thereby create jobs in a dynamic, global economy.

As we have seen, one of the things that originally attracted Ingrid to economics was the possibility that people's lives could be improved and that the