

# **POST-KEYNESIAN THEORY AND POLICY FOR MODERN CAPITALISM**

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What is distinctive about post-Keynesian economics and what can it offer that is useful for heterodox economic theory and for economic policy? This article briefly describes the ancestry of post-Keynesian economics and the characteristics that distinguish it from other schools of thought, particularly mainstream theory. Recognising the central role of price theory in mainstream economics, attention then turns to the different perspective offered by post-Keynesians on the determination and role of prices in the economy. The final section suggests a post-Keynesian policy package.

## **Ancestors**

We start with the ancestors of what now comes under the rubric of post-Keynesian economics, as well as our own mentors. When GCH gave this paper to the NSW Branch of the Economic Society of Australia at the Reserve Bank of Australia, an RBA officer commented: why worry about ancestors, the application of theory to an issue is all that matters. This is reminiscent of a general view among many economists, summarised in a comment told to Heinz Kurz by a colleague and to GCH by Phoebus Dhymes: “Why bother with the history of economics? What is good is all in Samuelson’s *Foundations of Economic Analysis*, and what is not there to be found can’t be any good” (Kurz 2006: 468). In reply we note three important considerations. First, it is good manners to acknowledge the source of ideas. Second, our generation was not trained *as if* economics started ten years ago (with a moving peg) and so was able to avoid rediscovering what were often inferior wheels. Finally, economic ideas are the result of an ongoing process of development and change. Without understanding whence they came, and the specific questions to which

they were designed to respond, it is not possible to have a deep understanding of those ideas.

So our elders and betters include the classical political economists and Marx; Alfred Marshall<sup>1</sup>; Thorstein Veblen; Joseph Schumpeter; Allyn Young; Maynard Keynes; Richard Kahn, Austin and Joan Robinson, Piero Sraffa; Nicky Kaldor; Richard Goodwin, Luigi Pasinetti; and, independently and increasingly importantly, Michal Kalecki, in our view the greatest all-round economist of the 20<sup>th</sup> Century. In Australia GCH had, as his principal mentors and inspiration, Eric Russell and Wilfred Salter.

### Characteristics

The post-Keynesian view of the economy is as an historical process, with the unchangeable past influencing the present, and with inherent uncertainty about the future. This leads to a concern with historical time, where expectations have a significant and unavoidable impact on economic events. The world is messy and all important economic decisions are made within an environment of inescapable, fundamental uncertainty (in the sense posited by Frank Knight and Keynes). This environment gives rise to the use of conventions, rules of thumb, and ‘satisficing’ behaviour (looking for the first needle in the haystack that will do the job, not for the sharpest) (Baumol 1979: 76; Kriesler 1999; Halevi, Hart and Kriesler 2013).

Money and finance matters are integrated with real factors from the start of the analysis of what Keynes called the monetary production economy. This overturns the (neo) classical dichotomy between the two sets of factors – money and real production - and the associated view of the long-run neutrality of money. For post-Keynesian economists, monetary factors influence real factors and real factors influence monetary ones in both the short and the long period (Harcourt 2012a; Kriesler 1997).

Post-Keynesian economists also recognise that economic theory may be written in terms of a whole spectrum of languages, running all the way from poetry and intuition through lawyer-like arguments to formal logic

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1 and A. C. Pigou (increasingly by default).

and mathematics. All have a place and role, according to what issues, or aspects of issues, are being analysed (Harcourt 1987).

Post-Keynesian analysis includes the presence of conflict and antagonism between different classes, with different characteristics and roles to play in the economic saga. This is especially so in the sphere of production where, given the existing methods of production and the current state of the class war, the potential surplus is created. Its extraction, distribution and use depends as well upon conditions in the sphere of distribution and exchange, for, though it is dominated by the sphere of production, it is nevertheless aggregate demand and the distribution of income (and its effect on saving) which determine how much of the potential surplus is realised in fact. These processes are all aspects of Marx's saying: "Accumulate, accumulate, that is Moses and the prophets". (We do not know whether puns are permitted in German but, for the English version, we are tempted to write 'profits').

Underpinning this analysis is a view of society as driven along by ruthless, swashbuckling capitalists (comprising all three: industrial, commercial and financial) rather than by lifetime utility-maximising consumer queens.

Imperfectly competitive and oligopolistic market structures, increasingly those containing large multi-national oligopolies, dominate national governments and the creation of institutions, national and international. Firms in these markets have economic and political power, which they use to improve their profits and further expand their power.

From a post-Keynesian perspective, the principal sequence associated with the processes at work in modern capitalism is regarded as finance → investment → saving. This view reflects the insights that arise from Keynes's 1937 analysis of the finance motive. To this is joined an insight that derives from James Meade's summing up of the Keynesian revolution: the investment dog wags its saving tail, rather than the other way around as in mainstream macroeconomic and growth theory (Meade 1975). So, for post-Keynesian economists, effective demand is the key determinant of the levels of employment and output, and of the rate of economic growth.

All economic action occurs in the short run in response to the impacts of both short-period and long-period factors on decision-making. Such an approach overcomes the disconnect between the short period and the long period, that is to say, the incoherence of the medium period/run in

mainstream analysis (Solow 2000; Kriesler, Nevile and Harcourt 2014). The economic growth rates identified by Harrod - that is, the actual rate of growth, the expected rate of growth, the natural rate of growth (given by the growth rate of the work force and of their productivity) and the warranted growth rate (the growth rate which fulfils the plans of decision makers) - are all interrelated and interdependent, giving rise to the cyclical growth models associated especially with Goodwin (1967) and late Kalecki (1968).

Modern post-Keynesian economists also observe that the finance sectors are increasingly dominated by what John Hicks (Hicks 1954; 1983) called 'snatchers', who try to profit from short-run situations as opposed to 'stickers', who are interested in long-term profits. This, combined with technical advances that have reduced the short run in financial markets from months to days, or even hours or seconds, and the emergence of 'credit for all' instruments and institutions so that consumers behave more and more like accumulators, tends to produce greater amplitudes in the cycle and sustained, prolonged, deep slumps.

Cumulative causation processes are also integral to post-Keynesian economics. These processes were identified by Adam Smith and explanations of them were developed during the last century by Veblen, Myrdal, Allyn Young and Kaldor. Circular and cumulative causation, rather than equilibration, characterises important markets - such as the stock exchange, foreign exchange markets, housing markets - and even whole economic systems. It is associated with markets where stocks dominate flows, and expectations and speculation dominate traditional economic fundamentals in the determination of prices and quantities (Kaldor 1939).

Persistent inflation is explained by bringing together the work of Rowthorn (1977) and Marglin (1984) on models of conflict inflation. This approach views sustained rates of inflation as the mechanism that brings about an uneasy truce between wage-earners and profit-receivers because the sum of their aspirational claims on the whole national product exceeds what the economy is producing. Rates of inflation associated with demand-pull and cost-push factors determine that neither gets what they aspire to, but their position does not deteriorate over time (Harcourt 2006, ch 6). Of course<sup>2</sup>, these relative bargaining positions

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2 As one of the referees for this article noted.

change and evolve, and, in the current international economic environment, the position of labour has been weakened by decades of neo-liberal policy.

Underlying all of this is the importance of institutions, and of economic and political forces in shaping economic events. As a result, post-Keynesian economists deny the validity or the usefulness of general theories, because different economies at different times will have different histories and different institutions, all influencing their economic dynamics. As a result, they take a ‘horses for courses’ approach, in which key institutional, social and economic developments will change the underlying dynamics of the economy<sup>3</sup>.

Within the post-Keynesian tradition, class considerations and the dynamics of social change also play a central role. The role of dynamic social change is related to the idea that economies, firms and industries evolve, and that evolution involves changes in practices which are not predetermined, but rather are dependent on history and society (Kriesler 1999; Halevi, Hart and Kriesler 2013). For this reason a central consideration is that of path determinacy, whereby the actual path taken determines where the economy or the industry or the firm is heading, through processes of cumulative causation. For this reason, any concept of equilibrium is regarded as not particularly useful (but see Harcourt 1981 and Kriesler 1999 on centres of gravitation and rest states). Similarly, due to the evolving nature of economic behaviour, uncertainty is seen as permeating all economic decisions. This uncertainty often

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3 If we take Keynes’s statement in the 1939 Preface to the French edition of *The General Theory* as his final position on why he “called [his] theory a general theory” (Collected Writings Vol. vii: xxxii), we find that his definition fits well within the ‘horses for courses’ approach of post-Keynesians. Keynes wrote: “I call my theory a *general theory*. I mean by this that I am chiefly concerned with the behaviour of the economic system as a whole, -with aggregate incomes, aggregate profits, aggregate output, aggregate employment, aggregate investment, aggregate saving rather than with incomes, profits, output, employment, investment and saving of particular industries, firms or individuals. And I argue that important mistakes have been made through extending to the system as a whole conclusions which have been correctly arrived at in respect of a part of it taken in isolation” (xxxii). A referee disagrees with us, arguing that Keynes “is using ‘general’ as a rather confusing synonym for ‘macroeconomic’”. The referee adds that our “dismissal of ‘general theories’ is overdone”. We are guided by Joan Robinson’s view that to provide another “complete theory” is “just another box of tricks” (Robinson 1979: 119).

plays a central role in economic analysis and, as a result, means that economic agents cannot have any certainty in their actions. Rather than being maximising agents, as depicted in neoclassical analysis, they tend to do the best they can, using rules of thumb and habits which have evolved from past behaviour (*cf.* Simon's concept of 'satisficing' behaviour).

The distinctions between heterodox economics and neoclassical economics represent a fundamental methodological difference. Neoclassical economics is built up by deduction from axioms. These axioms do not necessarily reflect human behaviour, nor can they be applied to environments in which people actually take actions, but are often chosen for certain other properties, particularly tractable mathematical ones. The essential feature is the importance of deduction from these axioms in deriving microeconomic behaviour. Post-Keynesian economics rejects this deductive approach. Rather, it believes that microeconomic analysis should be based on empirical observation. We should base our explanations on what actually happens, and use those observations as the foundation of our analysis. Economic agents will be influenced by different pasts, different institutions and by different social contexts. As a result, we would expect that the rules of thumb and habits that have evolved will differ between different economies, between different sectors of the economy and between different industries. So, post-Keynesians reject the idea that there can be a general theory of economic behaviour. Rather, what we would expect to see are different rules or conventions depending on where we are looking. So, for example, when we consider theories of pricing, what we see is that there are different considerations operating at different places and at different times. The general rule of thumb of pricing for post-Keynesian economics is that prices are determined as a mark-up on costs. But which costs are relevant, and what determines the size of the mark-up will themselves vary across the economy and between different economies.

Another common feature of all post-Keynesian economics is the importance of the institutional framework in influencing actions. Related to this, is the importance of history. The behaviour of individual agents, firms, industries and governments is strongly influenced by historical circumstances and the institutional framework in which they operate. This reinforces our earlier observation that post-Keynesians deny that there can be any universal general theory of behaviour. So, for example, when they look at explanations of pricing, what they see is that there are

many different explanations. This is not because one explanation is correct and the others are wrong. Rather, it is a result of the fact that pricing behaviour is extremely complex and can be influenced by many different factors. The factors which determines pricing behaviour at any particular point of time for any particular firm or industry will depend on a number of circumstances, contingent on historical interaction with other firms and industries and with the institutional arrangements both within that industry, and between it and other relevant industries, as well as macroeconomic factors like the level of demand and employment in the economy (Coutts and Norman 2013; Lee 2013). As a result, actors are not all influenced by the same factors. Nor are they all subject to the same motivation. This contrasts strongly with neoclassical theory, where a single motivation - that of maximisation, whether profit-maximisation of firms or utility-maximisation of individuals - is assumed<sup>4</sup>.

## Pricing

For neoclassical economic theory, price is all. The central theory of pricing determines, at the same time, all equilibrium prices and outputs and distributions in the economy. The theory of what determines price is also the theory of what determines output and what determines distribution. Everything is determined by the same theory, for which the central tenets are that of maximising economic agents engaged in behaviour which, under certain conditions, ensures that optimal prices and outputs - in fact optimal outcomes throughout the economy - pertain. Prices have a central role and are seen as scarcity indexes, allocating resources between unlimited wants<sup>5</sup>. It is because of this function that unfettered markets, which allow prices to be determined naturally, are seen as the optimal way of allocating resources; and hence provide the theoretical underpinnings of neoliberalism.

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4 The best neoclassical economists recognise this as ‘*as if*’ analysis, not as realistic or descriptive analysis.

5 Classical political economists distinguished between value and price. Value is the fundamental concept which underlies price. Modern neoclassical economists use value and price interchangeably, as though they were the same concept. For post-Keynesian economists, as this next section demonstrates, price is determined in an entirely different manner.

However, if we look more closely at this concept of unlimited wants, we see that it is only meaningful if we ignore the dynamics of social behaviour. Scarcity is an artificially constructed concept, which has meaning if we are looking at an economy at a point of time, and ignoring its dynamic potential and the role of production processes. However, if we acknowledge that economies accumulate and grow over time, as the classical economists and political economists do, the concept of scarcity needs to be reconsidered. The economy grows. As an economy grows we are creating both more output and also greater potential for future growth. Since growth implies more is being produced, it is unclear exactly what 'scarcity' means in a dynamic context. For these reasons, political economists reject the idea that prices serve as 'scarcity-indexes', and see them as serving different roles and being determined in very different ways. This distinction was first made by Ricardo, who distinguished non-reproducible goods, such as rare paintings and coins, whose value and therefore price was derived from scarcity alone, from reproducible commodities whose price, he argued, was determined by their cost of production. By situating their analysis of pricing in a static context which, to a large extent, ignores production and accumulation, neoclassical economists reduce the general problem of pricing to that of non-reproducible goods. Post-Keynesian economists, in contrast, are concerned with the role of prices in the production process, and therefore stress reproducibility and accumulation rather than scarcity. Where scarcity becomes important is in the consideration of non-renewable resources, including the environment.

For neoclassical theory, the theory of price and the theory of output are part of the same theory. Markets determine optimal prices and optimal quantities simultaneously. The essence of the post-Keynesian view, however, is that pricing decisions and output decisions are separate. Prices are determined on the basis of particular economic considerations, while outputs are determined by different economic considerations. These decisions are interrelated but they are not the same decision.

Heterodox microeconomics also rejects as completely unrealistic the main assumption that neoclassical economics makes about the industrial structure, namely, that perfect competition is a reasonable approximation to actual markets; or the related assumption that the analysis of perfect competition will provide profound insights into the workings of actual markets. Post-Keynesians, in rejecting these assumptions, follow Kalecki's view that markets have never been perfectly competitive and



the perfect competition is not useful as a model that can reflect aspects of reality for any sector of the economy. The treatment of competition as free competition by the classical economists, Marx and Marshall is a different matter. For them, it was a dynamic concept, closely associated with the evolution of the economy, relying on the movement of capital in response to profit rate differentials, and definitely not assuming a world of certainty<sup>6</sup>. The characteristics of accumulation were stressed, as well as those of production and prices in a competitive environment.

Because post-Keynesian economists contend that there are no universal principles of pricing and output, they posit that the conventions influencing pricing decisions vary. In general, however, there is agreement that most markets tend to be oligopolistic in nature. An oligopoly is defined as an industry containing a sufficiently small number of firms that the actions of any one firm will influence its rivals. Thus the essential feature of oligopoly is the interdependence of sellers/producers. Because of the small numbers and the fact that firms face downward-sloping demand curves, firms have influence over the setting of the price of their products, unlike firms in perfect competition. These factors, especially interdependence, make oligopoly the most difficult market situation to analyse. Interrelationships between firms can vary substantially throughout the economy and over time, for all the reasons discussed. Mainstream economists have sought to analyse these complex and evolving situations by the application of game theory, whereas post-Keynesians have stressed the role of rules of thumb, such as mark-up pricing, as well as analysing the industrial environment in which the interrelationships between firms evolve.

Despite the difficulty in generating general rules, there are some basic conventions that permeate all post-Keynesian models of the determination of price, particularly in the manufacturing sector. Following Kalecki, there is a general assumption among post-Keynesian economists that firms in manufacturing industries operate with excess capacity and with fairly constant cost structures up to the level of full capacity. This suggests that firms can substantially vary output with little if any significant changes to costs. On top of this assumption and/or empirical observation of reasonably constant costs, there is the

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6 For a discussion of the distinction between free and perfect competition, see Hart (2012: 81-84).

observation that firms use a particular rule of thumb in determining their selling price - they apply a mark-up to costs. Research has disclosed a number of motivations for applying mark-ups, mostly to do with it being a sensible rule in an uncertain world - uncertain, both in terms of macroeconomic variations in demands for each firm's product and, equally importantly, in terms of the actions and reactions of rival firms. In other words, the pricing decision is seen as part of an 'administrative' and 'strategic' decision within enterprises, rather than being determined by the competitive process of markets.

For post-Keynesians there are therefore two important questions:

1. what cost do firms use as the basis of their pricing decision?;
2. how are mark-ups determined?

On the former question: firms need the price of their products to cover not only direct costs of production - such as labour and raw materials, which vary with output, but also indirect (or overhead) costs, such as energy, rent, and salaries, which are independent of output in the short run. Some economists stress that prices are determined on the basis of variable costs, with overhead costs being covered in the mark-up (Coutts and Norman 2013; Lee 1998, 2013). Others believe that firms normalise their costs to include average overheads, allowing for cyclical variability (*ibid*). This is a matter for further empirical research. What is evident is that, regardless of which notion of costs particular firms adopt, except if there is extreme volatility in economic activity, there tends to be remarkable consistency.

On the second question, regarding the determination of mark-ups: a number of different factors may be distinguished. The first follows directly from the work of Kalecki, and sees the mark-up being shaped by competitive factors within the industry in which the firm operates. For this analysis, the main factor that firms look at is the behaviour of their rivals - both pricing and non-pricing behaviour. So the mark-up may be determined by market/institutional variables, and/or strategically to achieve goals such as prevention of entry of new firms, maximisation of growth, etc. Another explanation ties the determination of the mark-up directly to class struggle. Here the mark-up, reflecting as it does the determination of the potential surplus, emerges from the struggle between capital and labour. Finally, the mark-up can be interpreted as part of the strategic pricing decision responding to the investment

requirements of firms (Ball 1964; Eichner 1973, 1974; Wood 1975; Harcourt and Kenyon 1976). This analysis is predicated on the observation that most firms finance investment decisions with a combination of external funds (either through debt or equity) and internal funds. Internal funds are generated from the surplus over costs, and hence by the mark-up.

### **A Package Deal of Policies**

Post-Keynesian economists are usually strongly policy-oriented. We propose a package deal of policies, that is to say, take the lot, don't cherry pick individual items from it, as happened, for example, with the Henry Report on taxation reform in Australia. What follows is a list of the ingredients of our proposed recipe.

Full employment is an overriding aim; it is to be associated with relatively equitable distributions of income and wealth and environmentally sustainable rates and forms of growth.

To achieve full employment we must take fully into account the different economic, political and social factors associated with recovery after a deep slump, when all classes – wage-earners, profit recipients and the government – may be expected to favour achieving full employment. This is different from *sustaining* full employment when economic, social and political power will cumulatively pass from capital to labour. In the latter conditions, the sack ceases to be effective, and inflationary forces tend to build up. We dub this the Kalecki dilemma, as it was first set out by Kalecki in his famous 1943 article, '*Political Aspects of Full Employment*'. To tackle the dilemma requires permanent incomes policies, such as those associated with the proposals of Kaldor, Russell and Salter, which take into account the historical and sociological characteristics of each national economy (King 2009; Harcourt 2006). The aim is to get all money incomes rising at rates which reflect *overall* productivity improvements plus price changes. This, combined with full employment, ensures that both efficiency and equity are attained.

Marshallian-Pigovian carrot and stick measures need to be designed to tackle the harmful systemic effects of speculation. Many important markets – the stock exchanges, foreign exchange markets and housing markets - are characterised by stocks dominating flows. In these markets

expectations are as important as traditional economic fundamentals, sometimes more so (Harcourt 2012, ch. 14; Kriesler and Nevile 2008).

In deep slumps quantitative easing should take the form of governments writing cheques on central banks in order to finance, for example, green infrastructure projects, influenced by and related to medium- to long-term factors. (This is a more direct and effective measure than purchasing financial assets to allow financial institutions to lend to non-existent borrowers.) Such expenditures would not be inflationary nor would they directly increase indebtedness. As the economy achieves higher levels of employment and faster rates of growth, debt finance could increasingly be used until near full employment. Then, there could be a switch to balanced budget financing.

Government capital expenditure should be guided by medium- to long-term considerations. Short-run aggregate demand would be tackled by jacking up or down the structure of tax rates (which are themselves designed to achieve equitable outcomes), according to the levels of expenditure expected to emanate from the other major components of aggregate demand.

Central banks should develop instruments with which to persuade banks and other financial institutions to take into account the long-term viability of borrowers, as opposed to their short-run cash-flow problems, so as to minimise Minsky-type impacts on the inescapable real cycles of activity that occur in advanced economies (Harcourt 2001; 2012 ch. 14). Minsky pointed out that, because finance of investment resulted in inescapable financial payment commitments, if expectations were not realised this would lead to real expenditure decisions which increased the amplitude of economic cycles. Interest rate changes need to be complemented by quantitative caps on certain types of finance during specific periods of the cycle.

We note that, if agreeable cyclical growth rates are achieved, debt to income ratios do not expand indefinitely, as Evsey Domar showed long ago (1944). This implies that permanent government deficits can be sustained. Balancing the budget over the cycle, or achieving a surplus, has no legitimate justification in the context of this proposed policy package, principally because we do not live in a stationary state.

Finally, it is pertinent to note that, in an increasingly globalised world, international cooperation and measures are more than ever needed. Always, though, we should heed Keynes's dictum that achieving internal

balance must take precedence over achieving external balance. Keynes advocated permanent capital controls and only freer trade until, or perhaps even if, internal balance had been attained nationally and internationally. To us, this still seems a wise guiding principle.

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*The authors are much indebted to, but in no way implicate, Frank Stilwell and two anonymous referees for helpful comments on an earlier draft.*

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