

# MPRA

Munich Personal RePEc Archive

## **Post-Keynesian Theory of Choice**

Stavros A. Drakopoulos

National and Kapodistrian University of Athens

1999

Online at <https://mpra.ub.uni-muenchen.de/92043/>

MPRA Paper No. 92043, posted 8 February 2019 14:07 UTC

# Post-Keynesian Theory of Choice

By

Stavros A. Drakopoulos

National and Kapodistrian University of Athens

January 1999

## **Abstract**

This short paper is the entry on Post-Keynesian theory of choice for the *Encyclopedia of Political Economy* (ed. by P. A O'Hara, London: Routledge, 1999). The entry describes the main characteristics of a Post Keynesian theory of household choice. Elements of Post Keynesian oriented theory of choice can be found in the works of J. Robinson, L. Passinetti, N. Georgescu-Roegen, A. Eichner, E.J. Nell, P. Earl, M. Lavoie and in J.M. Keynes himself. The underlying framework can be described in terms of six principles: 1) Procedural Rationality, 2) Satisfiable Wants 3) Separability of Needs 4) Needs Hierarchy 5) Growth of Needs and 6) Non-independence.

## **Introduction**

Traditionally, there have been few attempts to form a systematized Post-Keynesian theory of household choice, although recently one can detect an increasing interest with the appearance of works on the subject. In spite of this, there is a considerable degree of coherence concerning the elements that constitute what might be called a Post Keynesian theory of choice. These elements do not originate from Post Keynesian works only but also from a number of economists broadly falling in the non-orthodox category. Thus, elements of Post Keynesian oriented theory of choice can be found in the works of J. ROBINSON, L. Passinetti, N. Georgescu-Roegen, A. Eichner, E.J. Nell, P. Earl, M. Lavoie and in KEYNES himself. The underlying framework can be described in terms of six principles as stated by Lavoie (1994). 1) Procedural Rationality, 2) Satisfiable Wants 3) Separability of Needs 4) Needs Hierarchy 5) Growth of Needs and 6) Non-independence.

**Procedural rationality**, also known as bounded rationality, was suggested by H. Simon (1959) and it is one of the presuppositions of the Post Keynesian paradigm. The additional characteristic of the Post Keynesian approach is that rationality is also bounded by the essentially unknowable future. This type of rationality denies that the economic agent's decisions are characterized by optimizing in the sense of mainstream economics. Bounded knowledge, irreducible uncertainty and limited computational abilities undermine optimizing behaviour. They also imply that agents avoid complex calculations and considerations and therefore base most of their decisions on rules of thumb, CONVENTIONS, customs and habits. The second principle of **satisfiable wants** implies that there are threshold levels of consumption

beyond which a good gives no additional satisfaction. The standard theory has a similar view with the idea of diminishing marginal utility, but satiation from that theoretical point of view, occurs when incomes are infinite or prices are zero. The principle is connected to the view that some NEEDS are more basic than others (the principle of needs hierarchy). The important consequence here is that a distinction between wants and needs is necessary. Wants evolve from needs and they constitute the various preferences within a level of need (Lutz and Lux, 1979). The principle of **separability of needs** says that needs can be distinguished from each other. The mainstream approach has implicitly recognized the existence of separate needs in ideas like the separability of the utility function. The principle can be associated with Lancaster's (1972) theory in which characteristics possessed by a good correspond to a specific need. The obvious consequence of need separability is the restriction of the degree of substitution between goods. The fourth principle, **needs hierarchy**, states that given the separability of needs, needs are subordinate or that they exhibit a hierarchical structure. This idea is quite old and can be found in many economic writings and in Keynes (1936, pp.93, 97, 98). Furthermore, one can find it in other disciplines like, Sociology and Political Science and especially in Psychology with the work of A. Maslow (for a general review see Drakopoulos 1994).

One can combine the principles of satiation, separability and hierarchy in a hierarchical preference ordering with thresholds levels. A special case of such an ordering is the lexicographic ordering that many orthodox texts mention as a perfectly rational system of choice but never develop it further. The next principle, **growth of needs**, implies that the needs of individuals will

grow as their lower level needs are gradually fulfilled. This is mainly due to income effects, since in order to go from lower needs to higher ones, an increase in real income is necessary. Thus income effects seem much more important in explaining the change of expenditures on goods than are substitute effects. Finally, the principle of **non-independence** implies that decisions and preferences are not made independently of those of other agents. (This is very similar to Keynes's idea that relativities matter) In particular, consumers of similar incomes fulfill their needs in the same order and have the same thresholds. Thus norms of consumption will depend on past standards and on imitation as the consumer attempts to emulate those that belong to a higher social strata or their reference group (Eichner, 1986).

On the basis of the above six principles it is possible to give a simple formal example which incorporates the gist of the Post Keynesian theory of choice. Suppose that  $x$ ,  $y$  are commodities or bundles of commodities which satisfy the primary need to eat. The threshold level of this need is  $e^*$  and this might involve a combination of both commodities. This implies substitution between the two commodities as far as the first need is concerned since  $x + y = e^*$ . But if  $y$  satisfies better the secondary need which is assumed to be taste, then  $y$  will come into the picture when the primary need is satisfied. In symbols ( $P$  means preferred to):

$(x_1, y_1) P(x_2, y_2)$  iff

either  $x_2 + y_2 < x_1 + y_1 < e^*$

or  $x_1 + y_1 = x_2 + y_2 \leq e^* ; y_2 < y_1$

or  $x_2 + y_2 < e^* < x_1 + y_1$

or  $e^* < x_1 + y_1, x_2 + y_2; y_2 < y_1 < y^*$

It is possible to extend the choice system to represent cases where there are more than two needs. Thus the existence of  $y^*$  implies that there is a threshold for the second need after which a third need takes effect. The above system will produce quasi-indifference curves or behaviour lines. It is also possible to express the above in "hierarchical" utility terms if utility is represented as a components-ordered vector (Canterbery, 1979).

There is also scope for connecting the above system to a conventional consumption savings framework. If we have a hierarchical utility function for an individual given as:

$$U = U(C_N, S, C_L)$$

where  $C_N$  is consumption of necessary goods or threshold consumption,  $S$  is savings and  $C_L$  is consumption of luxuries. Taking  $C_N$  as the first priority,  $S$  as the second (because of risk aversion or other psychological reasons), and also income as being higher than  $C_N$  expenditure with no borrowing, then it is possible to derive the familiar idea that the marginal propensity to consume is less than unity (Drakopoulos, 1992).

The Post Keynesian choice theory implies that price substitution effects are very modest especially with reference to broad categories of consumption expenditures. Thus non-substantial fluctuations of price will have insignificant impact on quantities sold, given that goods respond to a need or set of needs. This means that there is a case for more attention to the income

effects and thresholds levels. Furthermore, macroeconomic models which deal with income classes and income effects are a natural consequence of Post Keynesian choice theory. On a more theoretical side the hierarchical choice model will give kinked demand curves with kinks representing the relative efficacy of goods in satisfying different needs (Earl, 1986). Accepting that threshold levels will be similar for categories of goods (necessary and luxury goods) for large groups of population with similar incomes, then kinks will appear in the aggregate level as well. Apart from the obvious price rigidity, this might also imply a non-market clearing situation in the case of fixed capacity. In general, Post Keynesian theory of choice can provide the microfoundations of the main results of the Post Keynesian approach.

## References

- Canterbery, Ray. (1979) "Inflation Necessities and Distributive Efficiency" in James Gapinski and Charles Rockwood (eds), **Essays in Post-Keynesian Inflation**, Cambridge MA, Ballinger.
- Earl, Peter. (1986) **Lifestyle Economics: Consumer Behaviour in a Turbulent World**, Brighthon, UK, Wheatsheaf.
- Eichner, Alfred. (1986) **Toward a New Economics: Essays in Post-Keynesian and Institutional Theory**, London, Macmillan, M. E. Sharpe.
- Drakopoulos, Stavros. (1992) "Keynes' Economic Thought and the Theory of Consumer Behaviour", **Scottish Journal of Political Economy**, 39, no 3: 318-336.
- Drakopoulos, Stavros. (1994) "Hierarchical Choice in Economics", **Journal of Economic Surveys**, 8, no 2: 133-153.
- Keynes, John M. (1936) **The General Theory of Employment, Interest and Money**, London, Macmillan.
- Lancaster, Kelvin. (1972) **Consumer Demand: a New Approach**, New York, Columbia University Press.
- Lavoie, Marc. (1994) "A Post Keynesian Theory of Consumer Choice, **Journal of Post Keynesian Economics**, 16, no 4: 539-562.
- Lutz, Mark and Lux, Kenneth. (1979) **The Challenge of Humanistic Economics**, Menlo Park, CA, Benjamin/Cummings.
- Simon, Herbert. (1959) "Theories of Decision-Making in Economics and Behavioural Sciences, **American Economic Review**, 49: 253-283.