Business Competition and Micro-Macro Linkage in Post Keynesian Economics

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Abstract: There has been a heated debate among Post Keynesian economists about whether there is a need for micro-foundations for macroeconomic theory recently. While some scholars argue that there is no need for it, others maintain the opposite and develop micro-foundations of macro economics. Both groups overlook business competition and its role in understanding the linkage between microeconomics and macroeconomics. The underlying argument in this paper is that business competition which manifests itself as behavior as well as mechanism is the missing linkage that inherently connects microeconomics and macroeconomics as a whole. While first section reviews the extant literature on the subject, second section outlines business competition in Post Keynesian economics and demonstrates the intrinsic connection between the two levels before summarizing the findings in the last section.

In mainstream economics, there is a belief that microeconomics serves as the foundation for macroeconomics. For those who defend the idea of microeconomics as the foundation of macroeconomics, microeconomic analysis is essential for well-grounded, secure and reliable macroeconomic analysis. There is a group of scholars think the opposite that microeconomics needs a solid macro perspective (Hoover: 2010). Post Keynesian economics is not immune to this heresy historically. There has been a debate between those who maintain that Post Keynesian macroeconomics requires a rigorous micro foundation and those who claim that microeconomics needs a sound macro foundation. There is a third dimension to the debate that suggests that micro and macro levels are not separable. Therefore, they should be related and integrated without reducing one to another.

However, such attempts take either the micro or the macro level as a reference or starting point, instead of analyzing the dynamic, evolving, and uncertain nature of the relationship between the two levels of analysis. This essay suggests that this problem can be solved through bringing business competition into analysis, which may also help overcome the implicit assumption of equating business competition with cooperation because business competition also manifests itself as conflict and results in bankruptcies. Finally, business competition as the

source of uncertainty for business enterprises may overcome the problem of treating markets and industries as static entities, especially in the case of oligopolistic industries. While the extant literature is summarized in first section, business competition is analyzed in section two. Third section discusses the implications of business competition for the micro-macro debate and states the conclusions.

Literature Review

Clarifying what microeconomics and macroeconomics refer to as a two key concepts is useful before reviewing the literature. According to, Kevin H. Hoover, mainstream microeconomics studies the behavior of individual economic agents and macroeconomics investigates the behavior of economic of aggregates, including but not limited to gross domestic product (GDP), employment, unemployment, inflation, and interest rates (Hoover: 2010, pp. 330). Typically, a person, household, or firm is the agent for deriving the behavior in microeconomic models and explanations. In other words, typical modeling pictures an agent as a set of ordered preferences over mixtures of consumption goods and budget constraint is introduced before modeling behavior of the agent as an objective function in the form of the choice of the most preferred attainable mixture of goods. In the case of a firm, the model is based on the idea of profit maximization which is subject to the limitation of the available technology in a particular time. (Hoover: 2010, p. 330)

Steven Farrazi suggests that the term 'microfoundations' has come into discussions of Post Keynesian theory from neoclassical analysis. In broad sense, microfoundations are about the behavioral requirements or conditions for individual economic actors in macroeconomic models and behavioral requisites of individual agents. For him, the term has a narrow meaning in neoclassical analysis in that it is concerned with the linkage between macroeconomic models and the maximization of utility and profit by individual agents (Farrazi: 2003, p. 252).

Steven Pressman characterizes financial instability, exchange rate regimes, unemployment, trade deficits, and inflation as macroeconomic policy issues, while immigration, crime, and education as microeconomic policy issues (Pressman: 2011). In other words, the starting point in Pressman's conceptualization is based on the understanding that economic issues have more immediate and strong impact on the society, but issues such as crime, education, and immigration have less immediate effect. According to Tae-Hee Jo, micro-level

comprises individual actions, whereas socio-economic structures are the focus of macro level of analysis (Jo: 2007, p. 2). In Jo's definition, agency and socioeconomic structures within are closely linked and interrelated. Agency behavior is meaningful within the broader socio-economic structures. For Frederic Lee, the subject matter of heterodox macroeconomic theory is to analyze and explain 'aggregate levels of output and employment via the theory of effective demand (Lee: 2011a, p. 7) Microeconomics deals mainly with outlining and explicating the subsystems of the economy (business enterprise, other private business organizations, households, and state and public sector organizations) and the interdependencies between them like profit-employment, private investment government expenditure, wages-capitalist income relations, etc. (Lee: 2011a, p. 17). In Lee's vision, studying the whole requires understanding the subsystems and the nature of interactions between them.

The key difference between the mainstream and Post Keynesian economists is that the latter do not assume the whole as a simple aggregation of individuals because the sum of the parts is different from the simple aggregate. Different subsystems of the economy can be analyzed in relation to one another, rather than in isolation (Jerpersen: 2009, p. xiv; Lee: 2011a). Post Keynesians do not simply analyze individual actors independently of their socio-economic context. They are interested in understanding the individual economic actors within the broader context. However, there is a debate where to start the analysis in the relevant literature.

Crotty (1980), Kregel (1987), and Jespersen (2009) argue that microeconomics needs a macroeconomic foundation because individual behavior takes place within a broader capitalist market economy. Their behavior is constrained by the capitalist socio-economic structures. Individual behavior becomes meaningful only in the broader capitalist socio-economic environment. For instance, Kregel makes a strong case for establishing a macroeconomic foundation for microeconomics.

> Post Keynesian theory thus proposes the macrofoundations of microeconomics, and the development of a theory of the behavior of money prices based on liquidity preference. (Kregel: 1987, p. 520).

In his vision of the macro foundations, the role of money in the economic system and the individual actors' response to uncertainty are the two important factors that play a crucial role. For him, individual actors' behavior is only meaningful within the broader socio-economic context.

Similarly, according to Crotty, Post Keynesians and neo-Keynesians seek to answer the question of what the macro foundations of microeconomics are. They investigate the process of how investment, savings, and financing decisions interact with one another in a monetary economy. In this vision of the capitalist market economy, the future is perceived as uncertain, production takes time, the capital stock is not changeable, and there is no efficient spot market for durable goods (Crotty: 1980, p. 21). Without knowing such broader issues and how they interact and influence each another, individual behavior is not meaningful.

Jespersen makes a similar claim as well: "For me, it is the primary aim of macroeconomic science to illuminate macroeconomic reality, independently of particular interests" (Jespersen: 2009, p. 15). That macroeconomics is open and unpredictable by nature influences microeconomic behavior in such a way that expectations-formation and decisions become context-dependent. In other words, they make sense in a broader context and specific time frame. In his view, macroeconomics is independent of microeconomics and influences microeconomic behavior. It is essential to analyze macroeconomic issues separately from microeconomic issues to reach impartial results for unbiased public policy recommendations.

There is a second group of Post Keynesians who argue the opposite. For instance, Alfred S. Eichner proposes a new microeconomics and describes it as follow: "The new microeconomics is intended, first and foremost, to provide a more useful model of firm and industry behavior." (p. 28) Modern corporation or the megacorp is the typical firm and an important source of independent decision-making within the economy. It is an organization, not an individual. The economy consists of industries which are mainly oligopolistic in nature and the megacorp has market power to maintain a certain profit margin or mark-up over time. The megacorp competes against other business enterprises on the basis of various types of investment, research and development, advertising, and offering different products, not on the basis of price. However, it does not operate in a vacuum. Product innovations, inter-firm competition, and change in government policies are factors that may cause the economic system to deviate from secular growth path from time to time (Eichner: 1985, pp. 28-74). Eichner extrapolates from this micro foundation to advance a macroeconomic theory. However, there is an implicit assumption that oligopolistic industries are stable. This is problematic, given that the whole economy is perceived as an open system in the first place.

Claudio Sardoni is another Post Keynesian economist who defends the idea that macroeconomics should be based on a rigorous microeconomic foundation which requires analysis of individual behavior (Sardoni: 2001, p. 4). For Sardoni, individual units make economic decisions in a decentralized capitalist economy, not a central decision-making body. Behavior of such individual agents is important because the observed macro-phenomena are the outcome of individual decisions and actions. A satisfactory analysis of the working of the macro economy is important for a rigorous analysis of individual behavior. Sardoni notes: "Individuals are *social entities*, so that their decisions and actions necessarily are historically and socially conditioned." (Sardoni: 2001, p. 6) Historical and social conditioning of individual decisions and actions serves as the foundation that separates Post Keynesian microeconomics from the neoclassical homo economicus who makes unconditioned decisions without being influenced by the wider environment and independently. However, Sardoni does not elaborate on the nature of the connection between the two levels.

Post Keynesian scholars in the third group maintain that it is not meaningful to separate micro and macro level analytically because they are closely related. For instance, Tae-Hee Jo, in his dissertation entitled *Microfoundations of Effective Demand*, attempts to relate and integrate micro and macro analyses without reducing one to another. Yet, he analyzes micro relations and macro structures separately in order to offer a better explanation of society or an economic event after establishing a synthetic foundation (Jo: 2007, pp. 9-10). In other words, he provides a detailed analytical and conceptual breakdown of abstract concepts to better capture socio-economic reality. According to him, the business enterprise is a social agency and going concern with uncertain life span and exists in a social milieu and is part of the social provisioning process. (Jo: 2007, p. 4) "Hence all business activities are social in the sense that their actions take place and have meanings only in the social context." (Jo: 2011, p. 11) Jo suggests that investment decisions of the business enterprise is the key to understanding the linkage between micro- and macro-analysis (Jo: 2007, p. 150)

The whole economy is pictured as interrelated industries in Joe's input-output matrix (Jo: 2007, p. 48) Business competition and technological change are the two driving forces behind the emergence of oligopolistic industries (Jo: 2007, p. 77) Cartels, trusts, joint ventures, and trade associations play a role in explaining how markets work (Jo: 2007, p. 9). There is an implicit assumption in his analysis that once an industry consolidates, it becomes oligopolistic

and dominant firms dictate their wishes to the industry one way or another. In fact, this is against the assumption of open-endedness and uncertainty in Post Keynesian economics. In other words, there is no place for conflict between business enterprises and bankruptcies that follow intense business competition in his analysis. Moreover, it is not clear how the broader socio-economic context influences investment decisions of the business enterprise.

In the same way as Jo, Frederic Lee dismisses the dichotomy between microeconomics and macroeconomics because heterodox economics takes 'the economy as a differentiated, disaggregated whole and not as a set of macroeconomic aggregates' as its starting point. The economy is perceived as an emergent and open system with various developing, evolving and interrelated sub-systems. It is not analytically possible to divide such a system into disjointed sub-systems of microeconomics and macroeconomics in order to be theoretically coherent and consistent. Analyzing a productive and monetary structure of the social provisioning process, of organizations and institutions, and of agency requires a holistic and historical approach. The main task is to identify and analyze sub-systems, their reproduction and how these different yet interrelated parts work as a whole (Lee: 2011b, pp. 14-17).

However, both Lee and Jo take a specific vantage topic in their approach. Jo starts his analysis with the microfoundations, like Eichner and Sardoni. Lee paints a specific vision of macro economy and then searches for analytical tools to understand subsystems and the interdependencies between them in line with that macroeconomic framework. In that sense, his approach is similar Kregel, Crotty, and Jespersen. There are two commonalties in Jo and Lee's analysis in that they put a heavy emphasis on cooperation between business enterprises in the oligopolistic market, even though they acknowledge business competition. In other words, cooperation is privileged at the expense of conflict. Second, there is no space for business bankruptcies and disappearance of some business enterprises. To overcome this problem, this paper suggests that business competition should be analyzed through business cycles.

Business Competition and Micro-Macro Debate

Post Keynesians perceive competition within a broader context instead of confining it to the market. Ethical dimension of competition is essential, since it serves as a means for expression of freedom, but it is situated, not unlimited, freedom. According to Edward J. McKenna and Diane C. Zannoni: "Freedom requires a social matrix for its existence, that is,

freedom is situated freedom." (McKenna and Zannoni: 1993, p. 405) Both individuals and firms exist within a large social environment and therefore, their freedom is not unlimited. They have mutual rights and responsibilities towards each other. Consequently, they should be concerned about public implications of their private actions.

As Alfred Eichner and Jan Kregel stated firmly, Post Keynesian economics is "rooted in a dynamic process" and concerned with "the analysis of the economy in disequilibrium." (Eichner and Kregel: 1975, p. 1296) Post Keynesians, according to Peter Kenyon, perceive business competition as a process, not an end-state along with the classical and Marxian theories. Business competition takes place through investment and capital accumulation (Kenyon: 1979, p. 40). Alfred Eichner described the Post Keynesian vision of business competition as follow:

> In a post-Keynesian analysis, competition need involve no more than a continual effort by business firms to exploit the most profitable investment opportunities. It is only competition in this limited sense that generally prevails throughout the world – a fact that the classical economists clearly recognized (Eichner: 1979, p. 16)

Firms compete with each other on the basis of price and non-price elements to make a continuous profit (Sawyer: 1994, p. 10). This does not mean that they do not have other goals. The primary objective remains, that is, to be profitable which is essential for their survival in the market (Lee: 2002, p. 122). In that sense, business competition is a dynamic process which both 'enforces and expresses' the attempt of individual business enterprises to remain profitable (Eatwell: 1987, p. 539). There are two key aspects to this definition that correspond to different levels of the competitive process – expression and enforcement. On the one hand, *expression* refers to the individual business enterprise level. Competition is a way through which business enterprises express their strategies and behaviors to gain an edge vis-à-vis their competitors in their attempt to make a profit. In the process, they also modify their organizational structures to adapt themselves to the changing market environment. On the other hand, *enforcement* insinuates that competition functions as a mechanism that forces business enterprises to follow a certain path within their broader operational environment. Perceiving competition as both expression and enforcement, that requires analysis of individual enterprise, industry and inter-industry levels

of analysis simultaneously, is essential to capture its internal working dynamics as well as its outcomes.

Joseph Steindl provides a vivid analysis of market competition by focusing on the actual behavior of business enterprises (Steindl: 1987, p. 6). Instead of working within the framework of a static theory, Steindl explains the formation of prices and profit margins in a dynamic and changing market conditions. Going one step further, he argues that there is no one type of business enterprise that plays a leading role and disrupting the order in the industry. There is more than one, 'defensive (weaker) or aggressive (stronger)' and 'conservative or innovative' business enterprises, for example (Steindl, 1987, p. 11).

In explaining his theory of long run growth, Steindl links cost differentials between business enterprises to intensity of competition, formation of prices and profit margins (Steindl, 1952, p.17). Facing strong competition, even medium or fairly large business enteprises may be reduced to the level of normal profits, if the progressive business enterprises achieve a sufficiently large cost differential. In other words, normal profits are not necessarily characteristic of small business enterprises alone. Big business enterprises can be marginal in an industry as well, provided that competitive pressure is strong enough. The only difference to be noted is in the duration that it takes, in that a longer time is required for progressive business enterprises to exert serious pressure on larger 'marginal' business enterprises (Steindl, 1952, p. 53).

The starting point for Steindl is the effects of continuing technical progress and cost reductions. Business enterprises do not produce more than a negligible proportion of the industry's total output initially. Instead of having a uniform price, business enterprises have a structure of prices that corresponds to the different qualities and types of the product (Steindl,

1952, p. 40). Progressive business enterprises have greater gross profit margins, and therefore, higher net profit margins than their marginal counterparts due to cost-reducing technical innovations. They adopt new technical methods to decrease their costs and improve their profit margins because not all business enterprises, especially small ones, can adopt new technical methods. If the progressive business enterprises expand faster than the growth of the industry, the absolute market share of other business enterprises necessarily declines, thereby facilitating absolute concentration in the concerned industry after a certain number of current business are eliminated from the market (Steindl, 1952, p. 42).

New products compete with each other, as they compete with old ones at the same time. Pricing in stratified or imperfectly competitive markets has an impact on product demand as well as on competition for that demand. Aggressive price cuts attract new customers from different income groups, widening the market for products (Shapiro and Mott, 1995, p. 44). Business enterprises use their market power to raise the growth rate of markup during business upswings (Atesoglu, 1997, p. 646). Kunal Sen and Rajendra R. Vaidya observe that whenever there is an excess demand as in the case of rising markets, actual prices are higher than long-term average prices, because business enterprises raise their prices at this point in the business cycle in order to deal with their inability to meet the immediate excess demand in rising markets. High profit margins attract new competitors naturally. When the growth in demand for industry products becomes stable, business enterprises correct the deviation of actual price from its long-run level by cutting prices in the next period (Sen and Vaidya, 1995, p. 42).

In explaining when business enterprises cut or raise prices, Nai-Pew Ong emphasizes the existence of defensive as well as offensive pricing in a stratified industry. As Ong observes:

> The competitive aspect of the pricing decision is revealed when we analyze how the dominant firm can reduce the total market share of all its marginal rivals through stages. This can be achieved either through the *defensive target pricing* strategy, which is aimed at depriving the marginal producers of accumulation funds necessary to keep up with market growth, or additionally, through a final *offensive target pricing* strategy, which is aimed at eliminating them altogether in a destructive price war (Ong, 1981, p. 103).

Whereas the objective of defensive pricing is to protect market share by blocking the expansion of the marginal business enterprises progressively without eliminating them, offensive target pricing is aimed at eliminating the marginal business enterprises by bankrupting them (Ong, 1995, pp. 103-5).

Rate of profit is a good indicator for understanding the timing of this process. A rise in profit margin in an industry leads to an increased rate of internal accumulation, which, in turn, leads to an increase in output. If the output is greater than the expansion of the industry's growth rate, competition between business enterprises becomes intense (Steindl, 1952, p. 45). Progressive business enterprises intensify their selling efforts, which results in the actual loss of sales by their peers. In response to this strategy, other business enterprises either cut their prices aggressively or increase costs by quality competition and more intensive advertisement (Steindl, 1952, p. 43).

Knowing that competition is destructive and that markets are unstable, competitors form trusts and alliances from time to time in order to mitigate the effects of price competition. Such agreements nonetheless are often violated, as the advantages of cutting the price are so great and

the ability to supervise the agreements is limited. Moreover, a strong belief that the agreement will soon be violated in such a crowded environment anyway is itself another factor behind the fact that trusts are not stable (Eichner, 1969, p. 14). Another tactic that especially small business enterprises deploy is adulterating their products and using 'dirty tricks' to sabotage their competitors' business. For instance, small inland refiners in the sugar industry, disappointed with the insufficient domestic demand, mixed glucose made from corn syrup with their regular refinery products because glucose was much cheaper than refined sugar in the 1870s (Eichner, 1969, p. 58).

Eventually, progressive business enterprises initiate price wars and their pricing tactics bankrupt weaker and smaller competitors, whenever they want to grow faster than the industry in which they are operating. Aggressive pricing determines the outcome. Profit margins eventually decline and the business enterprises with the highest cost and/or the lowest financial resilience are forced out of the market. This leads to market concentration, but the consolidation is not absolute in that only marginal business enterprises disappear gradually (Shapiro and Mott: 1995, p. 44). After the elimination of the competitors, the average profit margin in the industry rises again in proportion to costs or to price. If this increase is above a certain level that leads to more internal accumulation in the industry, business enterprises can use the extra surplus for the purpose of expansion of the industry as a whole. Then a new competitive struggle sets in. This can occur either in times of boom or slump (Steindl, 1952, p. 43). From this brief analysis, it is clear that there is an intrinsic relationship between the individual level and the industry level and business competition manifests itself as behavior of individual business enterprises as we as well a mechanism that enforces them to follow certain path.

Conclusions

Industries are very dynamic because of creativity, technological innovation, sizeable power differentials between business enterprises, globalization, and financialization. Business enterprises are not same. Some of them are 'defensive (weaker) or aggressive (stronger)' and others are 'conservative or innovative'. There are considerable disparities in size, production technologies, cost structures, and hence, market power of business enterprises. As a going concern, they aim to remain profitable to stay in business. Competition manifests itself both as a mechanism and as a behavior. Competition on the basis of price has significant impact on the future of business enterprises as well as their industries. It is easier for the large progressive business enterprises to accumulate internal funds at a higher rate than smaller or conservative business enterprises. Internal funds put the progressive ones in an advantageous position. Price adjustments in the process of competition determine the winners and losers.

Intensity of business competition is not directly related to number of competitors, as neoclassical economists would argue. It has to do with profitability. Profit attracts new players and number of players has an indirect influence on competition because effective demand is the key to profitability. Second, business competition evolves in stages and last stage becomes destructive not because actors involved in competition become suddenly 'irrational', but because they want to have a share from a fast shrinking profit margins. Eventually competition overgrows market opportunities. Bankruptcies, market exits, unemployment, and economic recession are some of the consequences of destructive competition. Market exit means that some investors move to other industries. In other words, as Lee and Jo suggest, microeconomics and macroeconomics are not separate because business competition works as behavior and as mechanism. Business enterprises react to business competition, as they feel its pressure. They

also develop specific strategies and express them in the form of individual enterprise behavior to deal with business competition.

This understanding is more dynamic and in line with the openness and uncertainty assumptions of Post Keynesian economics. One limitation of this study, and of Post Keynesian economics, is that empirical evidence is needed from individual industries to understand their dynamics and behavior of individual business enterprises. This can be done through surveys, and interviews to extract rich information and build solid Post Keynesian empirical foundation.

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