

Reopening the Socialist Calculation Debate

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Many economists, particularly those belonging to the Austrian school, claim that it is logically impossible to have a properly functioning price system in a socialist economy given the necessary absence of markets for intermediate inputs. If they are right, they have made their own contribution to the case against socialism, one that is independent of the standard “human nature” argument. This paper will challenge this claim by showing that, despite the absence of markets for intermediate inputs, there would be no obstacles to socialism having such a price system as long as the “human nature” problem is resolved through the emergence of an effective alternative to the profit motive. The paper concludes by suggesting that such a change in behavior is plausible and that a price system based on it would be superior to the one we have under capitalism.

Introduction

Many economists believe that economic theory provides its own case against socialism, one that is independent of the standard human nature or motivation argument on which opponents of such a system usually rely. They contend that, even if we were all highly motivated "socialist angels", an economic system based on social ownership of the means of production¹ would still face severe difficulties caused by its inability to carry out economic calculation. The Austrian economists Ludwig von Mises and Frederick Hayek, and their followers, have led the charge on this question. Their seminal works on the subject include Mises 1981 (1922) and 1998 (1963), and Hayek 1935, 1940 and 1948. The Ludwig von Mises Institute web site is a source for much of the relevant literature.²

Essentially the argument can be presented as a syllogism. First premise: a complex modern economy has a considerable efficiency advantage if it has a properly functioning, decentralized

¹ These are the intermediate goods that enterprises produce for each other rather than for the final consumer, and comprise instruments of labor, components, raw materials and energy. Under social ownership you cannot have markets for means of production because they are under unified ownership. Although, to the extent that the world remains divided into separate states, intermediate goods would be exchanged between them.

² See <http://mises.org/>.

price system. Second premise: a socialist economy where the means of production are socially owned, and so not bought and sold, cannot have such a price system. Conclusion: a socialist economy would be wracked by inefficiencies. If we accept the premises, the case is cut and dried. It is a simple piece of logical deduction unlike the human nature argument which requires inductive reasoning based on empirical evidence that is open to opposing interpretations.

I fully accept the first premise, notwithstanding the fact that it has been common for socialists to argue that we could get by quite well simply with material measures of inputs and outputs. Demand in consumer markets³ need to direct derived demand for intermediate inputs and producers need to be able to determine the least cost method of production. Furthermore, in the absence of perfect ex ante coordination of interdependent minute by minute decisions over the uses of innumerable resources, choices have to be made ex post between alternative uses, and people close at hand are generally in the best position to determine the most highly valued of these alternatives through a bidding process.

The second premise is the one with which I take issue. In this paper I argue that none of the claims for why socialism is incompatible with an effective price system stands up to scrutiny if we assume that people under such a system are generally diligent and innovative, despite the fact that they are not motivated by profit nor by the threats and inducements of those who are. This would be the case if they found work to be its own reward and desired to see it contribute to an efficient and dynamic economy. So, when the dust has settled we will be left with the debate about human nature and, therefore, no special contribution by economic theory to the anti-socialist cause. Finally, I argue that the required changes in human motivation are far from implausible and would give socialism a price system that was superior to the capitalist one.

³ Under socialism the transactions of individual consumers would continue to be market exchanges. Wages earned in the labor market would be used to make purchases in the markets for final goods and services.

The Case against a Socialist Price System

The case against a socialist price system relies essentially on three claims, each of which would be sufficient on its own. These are: (1) the inherent nature of social ownership necessitates a central controlling organ representing society as a whole and this would not permit the level of decentralization required of an effective price system; (2) decentralized transactions based on price offers by producers and bids by users are necessarily market exchanges; and (3) any price system under social ownership would be greatly inferior to its capitalist counterpart. These claims are examined in turn below.


The first claim, that socialism has to be centralized, is most famously propounded in Hayek's *Road to Serfdom* (Hayek 1943). The flaw with this view is that it ignores the possibility of individuals acting as responsible custodians of social property and being entrusted with decentralized decision making. Such custodianship would simply mean that workers did their best to ensure that the resources under their charge were used efficiently and that they were not tempted to divert them for their own benefit. This is what you would expect from "socialist angels".

Hence, there is nothing in the nature of social ownership itself that would prevent decisions being delegated to what was judged to be their most appropriate level. A socialist government would then only need to centralize a limited range of decisions. Institutional arrangements and taxation are obvious examples, as is the decision on the level of total income to be allocated to investment, including research and development, rather than immediate consumption.

The second of the three claims suffers from the same blind spot. The belief that decentralized transactions between different enterprises would necessarily be market exchanges if they employed a price system, ignores the possibility that they could instead entail the transfer of

responsibility or custodianship over resources rather than of ownership. In keeping with it not being a market exchange, no individuals would financially profit or lose.⁴

Assuming that actors performed their custodial role conscientiously, it is not difficult to imagine the prices used in such non-market transfers of intermediate goods and services being the result of adjustments by actors on the spot to changes in demand and supply conditions. What an enterprise was prepared to bid or pay for an input would depend on what they expected to recover from their customers and the cost of substitute inputs. What they would recover in the case of final goods and services would depend directly on consumer demand while intermediate inputs would depend on it indirectly through derived demand. At the same time, the price at which enterprises offered their products would cover the costs of provision - which they would diligently endeavor to minimize - and ensure that the products went to their most valued use.

The third claim  contends that socialism could have decentralized dealings between enterprises based on prices, but contend that any such price system would be inferior to a capitalist one based on markets for intermediate inputs. There are two attempts at making this claim. The first attempt is based on demolishing a straw man. This is the economic model of socialism contrived by the Polish economist Oskar Lange. (See Lange and Taylor 1964 (1938).) Lange's model allows for decentralized price adjustment for consumer goods in line with changes in supply and demand but not for the goods used in production. The prices of the latter are regularly adjusted by a central agency based on observed excess demand or supply as reflected in inventories. Enterprises producing these goods are then required to supply whatever they can at that price while covering their costs.

The Austrian economists have successfully shown that the price system in this model is nothing like a genuine one. (See Hayek 1940 and 1948.) In the real world, enterprises do not simply find prices as given parameters. Instead, they bid inputs away from other less valued uses

⁴ In the case of "market socialism" as practiced in Hungary and Yugoslavia prior to 1990, such transactions were market ones because those in the enterprise, particularly management, had a financial interest in the result. They rented or borrowed capital from the state and owned the final output.

and offer their output at prices that undercut more costly alternatives. Many goods and services are one-offs that are produced under contract so there would be no excess or insufficient stockpiles to be observed. Then there is the sheer complexity. Most goods can be broken down into 100s or 1000s of varieties often with different costs and there is a constant flow of new goods or varieties of existing ones. Even identical goods differ in terms of required time of delivery and this can affect the cost. If pricing were not left to those closely involved, there would be excessive lumping together of items and untimely price adjustment. This is all very true, but it is a straw man because no reason is given as to why the limitations of this model would necessarily apply to socialism.

The second attempt to make the case is found in the work of the Austrian economist Don Lavoie (see Lavoie 1981 and 1985). He contends that any price system under social ownership would be inferior to a market based one because it would be unable to reflect the discovery process that emerges from competition between market participants. According to Lavoie, it is important, in the presence of uncertainty, to have numerous participants trying out different approaches to problems, based on their own opinions, guesses and hunches. Those who come up with the best and most highly valued products using the cheapest methods win out in this competitive contest. I fully agree. However, if, as I contend, decentralized custodianship is compatible with social ownership, diversity of approach should not be a problem.

Under social ownership, it would still be very common for an individual enterprise or facility to be just one of many producing the same good or close substitutes and each of them would be free to try out different production methods and product designs. Some would be new entrants who were either existing enterprises moving into a new field with synergies or starts ups established by enthusiasts with ideas that the incumbents were not open to or capable of developing. This diversity would be greatly assisted by having numerous independent agencies being responsible for disbursing funds in each industry and making their own assessment of what

were good investments. At the same time, enterprises would be free to choose their suppliers based on cost and quality, and would have to outbid other users of a resource or intermediate good. **Discovering and adopting the best methods and products would of course mean the abandonment of some activities and the closure or reorganization of many enterprises.** Part of being a “socialist angel” is the willingness to take the risk that one’s efforts end in disappointment rather than success.

Summing up this section, the only obstacle to a decentralized socialist price system would be the absence of daring and conscientious custodians - in other words, the human nature problem.

The Superiority of a Socialist Price System

If, as generally believed, human nature presents socialism with an insurmountable obstacle, the discussion of economic calculation should end here. However, I believe that there is considerable room for dispute over this question, and that it is therefore appropriate to move on to an examination of how socialism could greatly improve on capitalism’s price system.

Thinking on socialist motivation is still embryonic but there is already a plausible case that cannot simply be dismissed as utopian fantasy. A lengthy discussion is beyond the scope of this paper so I will confine myself to making a number of salient points that should be enough to suggest that there is something to debate:

(1) the failure of inchoate forms of socialism in semi-feudal countries in the middle of the 20th century is of limited relevance when assessing the prospects of socialism’s success in advanced capitalist countries in the 21st century. Socialism requires a modern industrial society and modern people;

(2) In developed economies, the inherent disutility of labor is declining as the vast bulk of laborious and irksome work is well on the way to being eliminated by advances in technology;

(3) Socialism would remove the main obstacle to greater effort and innovation – workers’ alienation from their work. Increased productivity would benefit one’s fellows and not make rich

people richer; and it would not lead to people being thrown on the jobs scrap heap. Also, work would no longer be performed under petty tyranny, and a narrow and demeaning division of labor.

(4) A certain level of motivation creates a virtuous circle. Work can be transformed into something far more desirable when workers who want to do the job neither require nor tolerate the oppressive kinds of authority and excessive division between thinking and doing that we find under the present system; and

(5) the changed behavior involves enlightened self-interest rather than self-denial (i.e., Ayn Rand's dreaded altruism). Shirking, free riding, back stabbing and succumbing to moral hazards are self-defeating and degrading practices.

Optimism on the question of motivation still leaves room for a sober acknowledgement of the short to medium term difficulties of bringing about a change of social system. Those taking over management and entrepreneurial roles would be at the bottom of a steep learning curve while those who have lost their wealth and power would use all of their well-honed skills to reverse the situation. Also, for some time, the more committed would need to keep the less committed on their toes. However, assuming a critical mass of commitment, this may well be less difficult than the challenge faced by capital owners under the present system who have to motivate the rest of us who "only work here".⁵

On the assumption that the motivation issue is being resolved, the superiority of a socialist price system is no great mystery. It is simply the absence of all the distortions caused by the private ownership of the means of production. These are generally well known and fairly obvious. Furthermore, economists have unintentionally strengthened the cause of socialism by showing how attempts by government under the present system to rectify these problems are of

⁵ In the economic literature this is referred to as the principal-agent problem.

limited or little effect, make them worse and/or create new ones. They have even given it a name – government failure. Below is a list of some of the more important price distortions.

(1) Firms are frequently able to create a shortage and so push up the price of the good above cost and capture monopoly profits. They can do this if it is difficult for competitors to readily enter the market. The difficulty can be longer term, as in the case of large sunk costs deterring entry and the ownership of intellectual property by incumbents, or shorter term, as in the case of temporary market power that comes with being first with a new product or process.

(2) Private ownership limits the production and flow of information about supply and demand. Firstly competition between firms leads to secrecy and disinformation and secondly information is a public good, something the market does a poor job of providing. This information failure means firms are limited in what they know about the investment plans of their competitors, suppliers and customers, and this results in a greater risk of industries having too little or too much capacity relative to demand. In contrast, custodians of social property would give and receive an unconstrained flow of information, and make a deliberate effort to coordinate investment plans.


(3) Capitalism has problems with external costs such as environmental degradation that even the best liability laws and assignment of property rights could not eliminate. Under the socialist system these costs would be internalized. No one involved with an enterprise would financially benefit from ignoring them. Generally enterprises would honestly endeavor to determine their extent when presenting investment proposals and the funding agencies would attempt to assess all costs when determining whether a project had a net benefit. Once in operation, production would be monitored through self-regulation by those keen to do the right thing, and this would be fortified by greater transparency to outside scrutiny

(4) Capitalism regularly suffers from financial crises followed by a fall off in aggregate demand which causes unemployment of labor and other resources. When this occurs, the price

system is not doing its job. Socialism is hardly likely to have such a problem because it would not have the requisite debt pyramids where money is borrowed so it can be lent. Funds for investment would mainly come out of a government owned pool comprising tax revenue, and loan repayments and net revenue from enterprises. If enterprises are unable to repay their loans from the government because an investment did not turn out well, there is no danger of the financial chain reaction we often get under capitalism. The government did not borrow the funds it lent.

(5) Market participants (a.k.a. vested interests) are forever endeavoring with a considerable degree of success to get the government to protect them from competition.

Conclusion

This paper contends that the calculation argument does not provide the Austrian economists with their own case against socialism. On the contrary, there is nothing preventing an economy where the means of production are socially owned from having an effective price system as long as people desire to undertake work for its own sake and to serve the common good. Whether such motivation is possible is not a matter that economic theory can address. It is the old “human nature” question. Finally, it is suggested that the plausibility of socialist forms of motivation makes it legitimate to point out that socialism would have a superior price system free of capitalist distortions. 

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