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The Politics of Market Socialism

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One of the most enduring proposals in modern economics is market socialism: an economy in which firms are owned and controlled by the government but then sell their products to consumers in competitive markets. A reasonable person might expect that recent events in eastern Europe would put this proposal to permanent and well-deserved rest. Instead, these events seem to have given hope to the market socialists. After all, eastern European countries are starting out with virtually all firms controlled by the state. In contrast to capitalist economies, where in order to get to market socialism the state must first nationalize the economy, in eastern Europe and Russia this step was completed decades ago. If only privatization can be stopped, eastern Europe presents mouthwatering possibilities for experimentation with market socialism. Peculiar as it may seem, the escape from socialism has only encouraged many socialists.[1]

This paper takes another stab at the problem of market socialism. We focus on an issue that is often mentioned, but rarely seriously discussed in the debates over market socialism. Under all forms of market socialism, from Lange (1936) to the present, the state ultimately controls the firms, and hence politicians' objectives must determine resource allocation. Market socialists have traditionally assumed that politicians will pursue an efficient resource allocation, and only paid lip service to the idea that the state becomes "bureaucratized." They dismiss the tragic socialist experience as irrelevant because

[1]Examples include Yunker (1992), an article in this journal by Bardhan and Roemer (1992), and papers collected in Bardhan and Roemer (1993).

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totalitarian systems are not what they have in mind. Rather, market socialists count on a democratic socialist government that pursues efficiency. The question of what such a government will maximize is therefore absolutely central to the discussion of market socialism.

We begin by reviewing the debate over market socialism, pointing out the essential role played by assumptions about the objectives of the government. We then discuss a series of economies: totalitarian socialism, democratic socialism, and democratic capitalism. Our argument against democratic market socialism is basically twofold. First, we argue that *no* democratic government is likely to place sufficient weight on economic efficiency, regardless of whether the economy is capitalist or socialist. Second, we claim that the damage from the government pursuing its "political" objectives will be much greater under socialism than under capitalism because, under socialism, the government has a greater ability to determine outcomes at the firm level.

The Market Socialism Debate

Analytical debate over market socialism started with Barone (1908 [1935]), who pointed out that the Central Planner, like the Walrasian Auctioneer, can solve n equations with n unknowns and so determine prices that simultaneously clear all markets. The state can then control firms and make lump sum redistributions to promote equality, and still get efficient outcomes for any distribution of income.

Barone's argument invited objections from von Mises (1920 [1935]) and Hayek (1935), who argued that the state does not have the necessary information to determine equilibrium prices. These objections, however, were effectively rebutted by Lange (1936), whose paper remains the most coherent and articulate case for market socialism. Lange argued that, while it is true that the state has only limited information, so does the Walrasian Auctioneer. The process of price adjustment in a market economy, according to Lange, takes the form of price increases on goods that are in excess demand, and price declines on goods that are in excess supply. The Central Planner can follow exactly the same procedure: raising prices in response to shortages and cutting prices in response to surpluses. Lange thus established quite convincingly that a benevolent Central Planner can, in principle, clear markets.

Not satisfied with establishing the equivalence between market and socialist resource allocation, Lange went on to present several reasons why socialism is superior. First, the state can distribute income more equitably. Second, since the state controls all firms, it can solve the problem of externalities. Third, since the state sets prices and determines entry, it can avoid monopolies. Aside from excessive prices, monopolies in Lange's model have two disadvantages. They are responsible for rigid prices and therefore contribute to business cycles; and they are only interested in preserving economic rents and hence are incapable of innovation. By crushing monopolies, the socialist state can both solve the business cycle problem and increase the rate of innovation.

Lange's arguments rely heavily on the government's pursuit of efficiency. His basic argument that the government raises prices of goods in short supply presumes that it actually wants to do so—rather than to maintain shortages. The pursuit of income redistribution, of internalizing externalities, and of competition rather than monopoly all presume efficiency-maximizing politicians. Indeed, Lange makes this assumption quite explicitly. For example, he writes: "The decision of the managers of production are no longer guided by the aim of maximizing profit. Instead, certain rules are imposed on them by the Central Planning Board which aim at satisfying consumers' preferences in the best way possible" (Lange, 1936-1938, p. 75).

The actual experience of socialist countries has, of course, been rather different. Instead of raising prices to clear markets, socialist governments typically maintain shortages of many goods for years. Some socialist dictators have pursued economic equality, through murder and repression by others have produced more equality of incomes than of welfare. The notion that the government solves the externality problem is belied by the experience with pollution, which seems to be worse in socialist than in comparably rich market economies (Grossman and Krueger, 1991). Also, monopolies, at least as measured by concentration, are much more common in socialist than in market economies (International Monetary Fund, 1991). Finally, practically no one believes that technological progress has been faster under socialism.

Market socialists familiar with this experience blame it on totalitarian government, and then get on with the business of praising market socialism in a democratic state. Lange (1936, pp. 109–110) briefly mentions the dangers of the state becoming bureaucratized, but does not spend much time on this problem: "It seems to us, indeed, that the *real danger of socialism is bureaucratization of economic life* [italics Lange's], and not the impossibility of coping with the problem of allocation of resources. Unfortunately, we do not see how the same, or even greater, danger can be averted under monopolistic capitalism. Officials subject to democratic control seem preferable to private corporation executives who practically are responsible to nobody."

One obvious problem with this statement is Lange's denial of the importance of incentive and control mechanisms in market economies, including boards of directors, management ownership, large blockholders, takeovers, banks, and bankruptcy (Stiglitz, 1991). Subsequent market socialists have indeed focused on this issue, and have added to Lange's model of market socialism incentives for enterprise managers comparable to those in market economies; for example, a group of socially-owned large banks might have a controlling interest in large companies (Bardhan and Roemer, 1992). In practice, such market-oriented incentive schemes for managers of state enterprises are very uncommon, and are often removed by politicians when managers begin to actually maximize profits (Nellis, 1988). But even more important than the question of incentives for the agent—that is, the manager—is the question of the objectives of the principal—that is, the government. Lange's most controversial assertion is that democratic control of corporate managers will lead to good outcomes, which is effectively a claim that politicians pursue economic efficiency.

In the following 50 years, the discussion of market socialism (except in the public choice literature[2]) has largely swallowed the assumption that the government would maximize efficiency, and proceeded to discuss the more technical issues, such as the ability of the state to complete the markets, or the relative efficiency of various price adjustment schemes. Hayek's warning (1944) that even democratic socialists turn into Hitlers and Mussolinis made a relatively bigger impression on the public opinion than on the economics profession. An analytical discussion of the objectives of a socialist government is still missing. The rest of the paper tries to fill this gap, by discussing first the likely objectives of a socialist dictator, and then turning to the unlikely ideal of democratic socialism.

Totalitarian Socialism

We begin by considering an ideal dictator, who is completely secure from political or military challenges. This dictator does not need to worry about keeping down unemployment, building up defense, paying off or killing off political competitors, feeding the population or any other problems. A strictly rational dictator in such a position would maximize personal wealth, which the dictator can either put in a Swiss bank account or use to build monuments, such as armies, cathedrals, or industrial plants. The question is: does the pursuit of this objective lead to efficient outcomes?

At first glance, one might think that the unthreatened dictator is just a shareholder in the whole economy, and therefore should be interested in maximizing the value of his shares—that is, the profits of all the firms. Moreover, the dictator would internalize the externalities resulting from the operations of these firms and hence produce an even more efficient outcome than the market. But this is only true if the dictator takes prices as given. In fact, of course, such a dictator would control prices as well as production decisions. In this case, profit maximization would call for creation of monopolies in all industries (assuming that the dictator cannot perfectly price discriminate). Far from designing a competitive market equilibrium, the unthreatened dictator would strive for a highly monopolistic and inefficient economy—in stark contrast to Lange's insistence that socialism *prevents* monopolistic tendencies. This result, incidentally, finds empirical support in the tendency of European

[2]The classic work is Buchanan and Tullock (1962). Mueller (1989) surveys the theory and evidence on what governments actually do.

monarchs to create monopolies precisely to maximize personal revenues (Ekelund and Tollison, 1981).

This model seems to better describe the conduct of capitalist dictators, such as Ferdinand Marcos in the Philippines and monarchs in the age of mercantilism, than that of socialist dictators. In socialist countries, rather than observing market-clearing monopoly prices, we see a shortage of most goods. Shleifer and Vishny (1992) address this issue in a model in which a socialist dictator maximizes his income, but is prevented by the constraint of secrecy from openly putting monopoly profits in his pocket. In that paper, we show that the dictator would behave very similarly to a monopolist, but with one important exception. Instead of charging monopoly prices, the dictator would choose to charge low prices, to create a shortage, and then collect bribes from the rationed consumers. In such a model, a socialist dictator constrained by secrecy would allocate resources very similarly to a capitalist dictator, except for the way in which income is collected.

This simple model has several empirical implications consistent with the experience of socialist countries. First, it explains why shortages in socialist economies are so pervasive, since bribe collection afforded by a shortage is the main mechanism for the dictator and his ruling elite to receive income. Second, the model explains why despite shortages, prices in socialist economies are often not raised for years, even on consumer luxuries for which income distribution arguments cannot justify artificially low prices. For example, Russian communists kept the prices of cars and apartments fixed for decades despite years-long waiting lists. Raising prices would eliminate bribe income, contrary to the interest of the ruling elite. Third, the model explains the tendency of socialist economies to produce many goods monopolistically, since monopoly prevents competition in bribes that would bring prices down to competitive levels. In sum, the socialist dictator model goes some way toward explaining why the inefficiency of socialist economies is so much larger than Lange predicted.

While modeling a socialist dictator as maximizing his wealth oversimplifies reality, more realistic models would probably imply an even smaller interest in efficiency on his part. Most dictators, for example, are politically insecure, and hence pursue the personal security of themselves and their supporters. To this end, they spend enormous resources on armies and police, refocus production on military rather than consumer goods, organize firms to make them easy to control and managed by supporters rather than experts, alter prices to transfer resources to their followers and often kill millions of opponents. These are more serious costs to economic efficiency than those caused by secure, wealth-maximizing dictators.

Democracy and Economic Efficiency

Market socialists will deem the above discussion historically relevant, at best, but surely immaterial to their visions of democratic socialism, in which the government is extremely responsive to the will of the people. So let us consider the case of a democratically elected socialist government in control of a nation's firms. Most market socialists presume that such a government will strive for efficient resource allocation. How likely is this objective to occur?

Before proceeding with this question, we must mention three issues that we will *not* address. First, Hayek (1944) has followed the inspiration of Smith (1776 [1976]) and argued that democracy is impossible in a country where a single leader has all the power that comes with controlling capital. We are sympathetic to Hayek's argument. But in this paper, we will grant market socialists the possibility of democratic socialism, and only examine its consequences. Second, Stigler (1965) has complained that even economists skeptical about the state, such as Adam Smith, usually focus on the state's intentions rather than its ability to implement the announced goals. While Stigler is right that even a benevolent state might have serious implementation problems, that is not our focus here.

Third, and most important, market socialists often obfuscate the importance of politician's intentions by imagining complex corporate governance structures. Thus Bardhan and Roemer (1992) imagine a system in which the government controls banks, which also have other shareholders, and that in turn control enterprises. Our view on this issue is simple, but realistic: no matter what smoke and mirrors are used, as long as the government remains in ultimate control of enterprises, which it does by definition in all market socialists' schemes, its objectives are going to be the ones that are maximized. Any manager who dares to stand up to the government, or to the bank controlled by the government, will be acting against personal interest. Similarly, no manager of a bank controlled by the government will refuse to lend money to a large state enterprise when the government that hired him "advises" in favor of the loan. The right focus is therefore on the objectives of the government, regardless of the governance structure through which these objectives are implemented.

The futility of trying to insulate public firms from political pressures is best illustrated by the experience of public enterprises in western Europe, where democratic institutions are strong and hence the conditions for such insulation are ideal (see Bardhan and Roemer, this issue). Despite extensive mechanisms for independent governance, most public firms in western Europe are subject to heavy-handed government interference. Just recall the experience of British Coal, where the Parliament refused to accept layoffs from enormously inefficient coal mines. Or consider the failure of Air France to cut labor, as the government opted for strikers' support and fired the manager. In countries with weaker democratic institutions, such as Italy, as well as many countries in Africa, Asia, and eastern Europe, public enterprises are simply used by politicians to gain political support, and the concept of government non-interference is totally foreign. The experience with public enterprises suggests grave skepticism about the possibility of insulating public firms from the objectives of the government.

So what objectives will the government inherit from the democratic process? Two leading models of democratic decision-making are majority voting and pressure groups. Neither model predicts that the democratic government will maximize economic efficiency, although they differ in the nature of deviations from efficiency that they predict.

The majority voting model predicts that the majority will redistribute resources from the minority to itself even at the cost of reduced efficiency. The reason for inefficiency is that majority voting schemes do not weigh the intensity of preferences. As a result, if a majority can obtain a gain as a result of a redistribution from a minority, it will do so even if the costs to the minority exceed the benefits to the majority. In other words, majority voting does not lead to efficient outcomes (Tullock, 1959).

This prediction of majority voting seems to hold true in a variety of cases. Most democratic countries (whether capitalist or socialist) practice progressive taxation, often sharply progressive. Industrial workers sometimes gang up on farmers and expropriate their crops and land even when this strategy leads to devastating losses to farmers and meager benefits to workers. A majority of tenants in a city routinely impose inefficient rent control on the minority of landlords. Ethnic majorities throughout the world force minority businesses to charge prices below cost, hire members of the majority, and pay exorbitant taxes (Sowell, 1990). In light of the multiple examples of the tyranny of the majority, the claim that a majority will elect a government committed to economic efficiency is simply false.

An alternative model for democratic politics is the interest group model (Olson, 1965; Becker, 1983). In this model, interest groups form and pressure the government to pursue policies that benefit these groups at the expense of the rest of the population. Interest group politics leads to efficient resource allocation only under very restrictive conditions. First, forming an interest group and collecting contributions must be completely costless, so that the free rider and other problems are circumvented. In this case, all groups that have a common interest will form. Second, there should be no resource cost of lobbying the government; that is, interest groups should simply bid in cash, which they raise in a non-distortionary fashion, for the policies they want. If both of these conditions hold, then the interest groups model predicts efficient outcomes simply because the interest groups that put a higher value on a policy will bid more for it. Thus, if an industry wants protection that reduces efficiency, the consumer lobby will value free trade more than the industry, pay more for it, and thus ensure free trade. The public interest model with costless group formation and lobbying reduces to an efficient auction of policy choices.

Of course, organizing interest groups is actually quite expensive, because the free rider program discourages joining (Olson, 1965). Many interest groups in which benefits are small and diffuse, such as "consumers for free trade," simply do not form. The interest groups that do form and lobby the government are generally small groups with concentrated benefits, such as "automobile industry for protection." As a result, the organized minorities tend to gang up on the disorganized majority, creating an inefficient resource allocation. Moreover, the assumption of costless lobbying is also false, as rent-seeking can absorb substantial resources.

Examples of inefficiencies resulting from interest group politics are numerous; they form the substance of a vast public choice literature. The well-organized managers of the military-industrial complex can form a lobby that makes sure that the state allocates to them, and not to other firms, the majority of state credits. Farmers, doctors and other groups form effective lobbies that raise prices and redistribute public resources to themselves. Many industries demand and receive protection. We are unaware of any evidence that interest group politics leads to anything like the efficient outcome.

In a provocative but ultimately unpersuasive article, Wittman (1989) argues that the two biases—from majority voting and from interest group pressures—should cancel each other out. Specifically, the majority will vote against candidates who are too favorable to the interests of well-organized minority groups. An example might be that consumers would always vote against protectionist presidential candidates.

However, it is hard to see why these two deviations from efficiency in democratic politics should cancel out in any exact sense. In fact, sometimes the majority is better organized. For example, the majority of the population may be employed in import-competing industries, and hence the majority would favor protection. The disorganized minority that is not employed in such industries will then bear the double cost of neither getting higher wages nor having access to cheap imports. Or consider the case of "democracy" in post-communist Russia, where something close to the majority of the population benefits from state subsidies to inefficient industrial enterprises, and is also vastly better organized through industrial lobbies than the remainder of the population. This majority can then extract tremendous resources from the rest of the population at a huge cost to efficiency.

In sum, there is no presumption that democratic politics will lead to anything like an efficiency-pursuing government (see also Kornai, 1993). Vast amounts of evidence from the United States and western European democracies confirm this point. Even Sweden, long the darling of all socialists, has been suffering from a "crisis" brought about by heavy government intervention in the economy, and has been trying to restore "a highly competitive market system" (Lindbeck et al., 1993). Indeed, the very few governments in the world that might appear to pursue something resembling efficiency, such as those of Korea and Taiwan, are very far from democratic. And even market socialists no longer wish to bet on an enlightened dictator.

Democratic Socialism vs. Democratic Capitalism

A market socialist would intercede at this point (if not earlier) and note, quite correctly, that the inefficiencies of democratic politics plague capitalist as well as socialist economies. After all, protection, subsidies, and state loans to declining firms are common in capitalist economies as well. Why, then, is democratic politics a special problem for democratic socialism?

The public choice literature establishes that democratic politics do not lead to governmental interest in efficiency, regardless of the economic system. To establish our main point—that democratic socialism must be a less efficient economic system than democratic capitalism—we must show that a democratic government does more damage under socialism than under capitalism.

Our argument boils down to a single assertion: when the government controls firms, it has considerably more ability to convince them to pursue its political objectives than when the government must persuade private shareholders. Becker (1983) is characteristically perceptive: "Even though Schumpeter and others have identified selfish pressure groups with democratic capitalism, I believe that pressure groups of workers, managers, intellectuals, etc. have an incentive to be more rather than less active under democratic and other forms of socialism because a larger fraction of resources is controlled by the State under socialism than under capitalism."

Let's examine this argument for the superiority of democratic capitalism in greater detail. Suppose the government wants a firm owned by private shareholders to do something that they might not want to do if they maximized profits, such as employ extra people, pay extra wages, undertake a "socially desirable" investment project, produce output for the war effort, and so on. If the government does not control this firm through regulation, it must pay the shareholders the opportunity cost of meeting the government's wishes, since these shareholders, rather than the government, have the control rights over the decisions of the firm. For example, governments often pay firms to maintain employment through tax breaks, procurement contracts and so on. And however the government raises money to make those payments—whether through taxes, borrowing, or the printing press—it is likely to encounter some opposition from the broader public. As a result, such political interference in privately-owned firms is rather limited.

Of course, governments often find a cheaper way to get firms to pursue political objectives—through regulation. Regulation gives the governments some control rights over firms whose profits are privately owned, so that it can compel them to follow the political will without compensating shareholders. By effectively expropriating the wealth of a few shareholders rather than taxing a broader segment of the population, the government faces a lower political price of enforcing inefficient allocations through regulation. Nonetheless, as with any form of taxation, regulation is not free to politicians.

Under true market socialism, the government both owns the cash flows from firms and controls their decisions. In this case, when the government makes a firm produce inefficiently, the Treasury pays the opportunity cost of such production. From this viewpoint, market capitalism and market socialism appear quite similar: under capitalism, the government must pay shareholders to pursue politically motivated policies and must raise taxes to do it; under socialism, the Treasury gives up profits because of the same politically motivated policies, and hence must pay for the foregone profits by raising taxes. Since a democratically elected government bears the political cost of having to raise taxes in either case, its willingness to enforce economic inefficiency might be similar under socialism and capitalism.

But there is a critical difference between capitalism and socialism. Under socialism, the government is much richer relative to the wealth of the economy than under capitalism: it owns the cash flow of most or all of the firms in the economy. As a result, the government can afford many more politically motivated inefficient projects that lose money than it could in a capitalist economy. For example, the Soviet government could use the wealth from the country's natural resources to build an extremely inefficient, militaristic economy. Many African countries wasted their mineral and agricultural wealth on failed industrialization. When, in contrast, resources are privately owned, the government cannot as easily spend them to pursue its objectives. Surely it can tax and regulate to extract some wealth, but that gives it much less wealth than owning all the assets to begin with.

Moreover, the private owners of the assets often use both economic mechanisms and the political process to keep their wealth away from the government. No matter how eager the United States Congress and the President are to spend more money, their political ability to raise tax revenues is limited. As a result, the U.S. government is much poorer, relative to the U.S. economy, than the Russian government is relative to the Russian economy, and therefore has many fewer resources to expend on inefficient projects than the Russian government does, relative to the economy. The reason that democratic socialist economies must be much less efficient than market economies is not that the democratic process leads to worse government *objectives* under socialism than under capitalism, but that the government can afford to pay for much more politically motivated inefficiency under socialism than under capitalism.

Conclusion

Under both capitalism and socialism, the democratic process does not generate governmental objectives consistent with the pursuit of efficiency. But under socialism, the government turns these inefficient objectives into much more damage to the economy than does a capitalist government. The theoretical case for economic efficiency under democratic socialism simply does not work.

For the purposes of our argument here, we have granted market socialists the assumptions that democratic socialism will not degenerate into totalitarianism and that it has the power to implement its plans. Removing either of these assumptions, or adding the actual economic record of socialism in the Soviet Union and eastern Europe, would only strengthen the case for democratic capitalism.

In this context, it is instructive to keep in mind who the supporters of "market socialism" in eastern Europe are. The supporters, who inevitably talk about Sweden, tend to be former communist officials and managers of doomed state enterprises—the people who stand to personally benefit the most from continued government ownership. It is unfortunate that, like the Soviet communists in the 1930s, these advocates of market socialism are getting support from idealists in the West.

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