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Retrospectives

Lange and von Mises, Large-Scale Enterprises, and the Economic Case for Socialism

Joseph Persky

This feature addresses the history of economic words and ideas. At a minimum, the hope is to deepen the workaday dialogue of economists. At best, such discussion may cast new light on ongoing questions. If you have comments or criticisms about this column or suggestions for future topics or authors, please write to Joseph Persky, c/o *Journal of Economic Perspectives*, Department of Economics (M/C 144), The University of Illinois at Chicago, Box 4348, Chicago, Illinois 60680.

Introduction

Surely the socialist claim that most rankled conservative economists in the past was the assertion that socialism would be more efficient, more rational than capitalism. That claim is now ridiculed in many quarters. How could any serious economist have ever suggested that dynamic entrepreneurs should be replaced by government bureaucrats?

This question received considerable attention in the course of the debates over “economic calculation” launched by Ludwig von Mises in 1920 and extending well into the 1940s. The central issue of those debates concerned the ability of a socialist economy to achieve allocative efficiency. Von Mises emphasized that a collectivist state would have great difficulty in gathering and acting on relevant information; therefore, under socialism, even well-intentioned bureaucrats would lack a meaningful system of values on which to calculate.

■ *Joseph Persky is Associate Professor of Economics, The University of Illinois at Chicago, Chicago, Illinois.*

Defenders of socialism, such as Oskar Lange, countered that a market socialism could match demand to supply just as well as capitalism and meet the range of static conditions required for Pareto optimality. That debate is a rich and interesting story that has been told a number of times before.¹

But in all that has been written, an important aspect of the original debate has been lost. Somewhat oddly, both the socialists like Oskar Lange and the advocates of private ownership like von Mises and Friedrich Hayek maintained that they were defending the progressive tendencies of competitive capitalism against the deadening hand of monopoly power. This historic paradox deserves consideration, if only because it serves to focus attention on our still incomplete theories of large-scale enterprises under socialism and capitalism.

Lange on the Choice Between Monopoly and Socialism

Oskar Lange is best known for his contributions to welfare economics. Much of his 1938 essay “On the Economic Theory of Socialism” can be viewed as an ingenious application of that theory. Lange tried to show that socialists could imitate perfectly competitive markets. However, in an argument that has often been overlooked, he also claimed that socialism could achieve efficiency where private ownership failed—that is, where private ownership led to monopoly. The question of monopoly formed a keystone of Lange’s “economist’s case for socialism.” Back in the nineteenth century Marx had argued that the concentration and centralization of capital made the transition to market socialism both desirable and inevitable. Lange agreed.

Quoting *The Communist Manifesto* at considerable length, Lange waxed eloquent on the historical contributions of early competitive capitalism to economic development. With as much enthusiasm as ever a von Mises or a Hayek mustered, Lange described how entrepreneurs in the quest for profit searched out innovations. As long as competition remained plentiful and effective, vested interests could not prevent this progressive march. In fact, Lange (p. 120) went so far as to suggest that it was neither necessary or wise to abolish “private enterprise and private property of the means of production in those fields where real competition still prevails, i.e., in small-scale industry and farming. In these fields private property of the means of production and private enterprise may well continue to have a useful social function by being more efficient than a socialized industry might be.”

But outside of these fields, Lange believed that this almost Austrian picture of the economy represented a thing of the past. No longer was the economy a

¹For an early and even-handed treatment, see Bergson (1948). In the 1950s and ’60s the general consensus held that Lange had won the debates with his formal arguments from welfare economics. But in the 1980s, a revisionist interpretation emerged. Discounting the importance of static welfare conditions, it emphasized the Austrian appreciation of the dynamics of entrepreneurship and market processes (Murrell, 1983; Lavoie, 1985).

mass of entrepreneurs, individuals aggressively seeking out innovations. Individuals had largely been replaced by large corporations enjoying considerable economies of scale and wielding monopolistic power. Only socialism could avoid the worst characteristics of monopoly: the attempts to restrict production and seek political power.² Lange concluded (p. 120) that “monopoly, restrictionism, and interventionism can be done away with only together with private enterprise and the private ownership of the means of production.”

Lange has been accused of presenting a static, textbook solution to the problems facing socialism; admittedly, much of his discussion of socialism attempted to demonstrate the practicality of a trial-and-error mechanism that imitated the Walrasian auctioneer. But he clearly stated that the competitive sectors of the economy might best be left in private hands for efficiency reasons, while the rest of the economy came under centralized direction. “The real issue,” Lange wrote (p. 110), “is *whether the further maintenance of the capitalist system is compatible with economic progress.*” Quite reasonably, Lange wanted to base his case on a dynamic conception of efficiency. However, at the time he wrote, economists lacked a consensus as to the influence of monopoly on dynamic efficiency. In fact, such a consensus has yet to emerge.

According to Lange, monopolistic firms with considerable fixed capital had a powerful incentive to protect the value of such investments in the face of potential technological changes. The separation of ownership from the entrepreneurial function intensified this pressure, “for the industrial enterprise has to replace the full value of the capital invested or fail.”³ The results, according to Lange, were devastating. “Interventionism and restrictionism” had become the dominant economic policies of the corporation. When the potential profits achievable from innovation did lure some capitalists, the periodic introduction of new technologies would only make matters worse. “The stability of the capitalist system is shaken by the alternation of attempts to stop economic progress in order to protect old investments and tremendous collapses when those attempts fail” (p. 114).⁴

What could be done? A return to free competition seemed unlikely if the large size of modern business units was due to technological efficiencies of scale. Alternatively, the government might attempt to regulate the large corporations. Anticipating George Stigler, Lange (p. 119) had little doubt that large firms

²In this respect Lange had been anticipated by Vilfredo Pareto at the turn of the century. Pareto, despite his hostility to socialism, thought that a collectivist state might be well-prepared to deal with increasing returns (Pareto, 1906 [1971], p. 269). Pareto had also appreciated that a collectivist economy might take as its starting point the same marginalist efficiency rules as presumably governed perfect competition.

³Lange notes that this result is strictly true only if all capital has been raised through bond financing. If capital has been raised in the stock market he still felt a decline in stock prices might injure firms severely.

⁴Lange was vague as to why the failures of individual monopolists should lead to economy-wide macro-effects. Perhaps an argument based on the bunching of truly major innovations could close the gap.

would quickly capture their supposed regulators. “The great economic power of corporations and banks being what it is, it would be they who would control the public planning authorities rather than the reverse. The result would be planning for monopoly and restrictionism.” The conclusion was clear (p. 121):

The most important part of modern economic life is just as far removed from free competition as it is from socialism; it is choked up with restrictionism of all sorts. When this state of things will have become unbearable, when its incompatibility with economic progress will have become obvious, and when it will be recognized that it is impossible to return to free competition, or to have successful public control of enterprise and of investment without taking them out of private hands, then socialism will remain as the only solution available.

Here is the essence of the “economist’s case for socialism.” Lange asserted that the inevitable growth of firms had destroyed the progressive character of private ownership over a large share of the economy. The argument drew explicitly on the work of Berle and Means, and reflected a popular distrust of large corporations common in the United States from the 1890s through the Great Depression. Far from ignoring the problem of entrepreneurship, Lange made the problem of innovation central.

From this perspective, it seems clear that Lange’s case for socialism depended critically on his appraisal of large firms under capitalist and collectivist management. The question of how best to foster efficiency and innovation in the socialist economy had been broached earlier by the Italian economist Enrico Barone. Barone (1908 [1935], p. 288) had proposed that the ministry of production would have to conduct a program of “experiments on a very large scale” to determine the “economically most advantageous technical coefficients.” He was particularly critical of those socialists who hoped planning could do away with “anarchist production.” On the contrary, a pseudo-competitive process would always have to be sustained. The ministry of production would have to decide which organizations were the most “advantageous to maintain in existence and to enlarge to obtain the collective maximum more easily, and which, on the other hand, it is best to discard as failures” (p. 289). Barone didn’t speculate on how such decisions might be made or enforced. Like Barone, Lange recognized that the Central Planning Board would also have the responsibility of evaluating performance and encouraging innovation. “In a socialist economy there can be, of course, grave mistakes and misdirection of investments and production,” he wrote (1938 [1964], p. 106). “In a socialist economy a mistake is a mistake, too, and has to be corrected.”

Lange was vague as to how such mistakes would be handled or why managers of large state enterprises would be motivated to avoid them. While acknowledging that “*the real danger of socialism is that of a bureaucratization of economic life*” (p. 109, emphasis in the original), Lange suggested that at least

the bureaucrats of the state would be subject to democratic control. Still, Lange failed to give these issues extended attention. He offered no explanation of why democratic control should prove more effective than stockholder control. He thought the whole matter belonged to “the field of sociology.”

Clearly, Lange had only begun to piece together a theory of large-scale firms under capitalism and socialism. Nevertheless, we can see the central importance he attached to the fact that socialism must be judged not against a competitive capitalism, but with respect to a monopoly capitalism.

Monopoly and the Austrians

As early as 1920, Ludwig von Mises had categorically denied that capitalism had any inevitable tendency to produce monopoly. For von Mises, monopolies were difficult to form and to maintain, while large corporations generally represented efficient production and reduced prices. With the exception of highly concentrated natural resources, like diamonds, monopolists continually had to contend with potential competition (von Mises, 1932 [1951], p. 390): “Power over reproducible means of production does not as a rule allow permanent monopolization. New enterprises may always spring up.”

Instead, he held that anti-capitalist forces in society bore responsibility for existing monopolies. His view of the historical record was that efforts to create monopolies apart from control of “natural resources or of particular land sites” had to resort to “tricks and artifices to secure even a temporary success.” Even worse than these efforts were the persistent government interventions to create monopolistic conditions. “Manufacturing and commercial monopolies owe their origin not to a tendency immanent in capitalist economy but to governmental interventionist policy directed against free trade and *laissez-faire*” (von Mises, 1932 [1951], pp. 390–391). Or as he put it in his magnum opus, *Human Action* (1949, p. 384): “It is a grotesque distortion of the true state of affairs to speak of *monopoly capitalism* instead of *monopoly interventionism* and of *private cartels* instead of *government-made cartels*.” For von Mises, the schemes of socialists pointed toward a universal monopoly.

While von Mises acknowledged that managers of large-scale companies might be tempted to pursue personal interests at odds with those of shareholders, he maintained (1935, pp. 117–118), “in the long run it will generally be to the advantage of the solid company administrator, who is not merely bent on making a transient profit, to represent the shareholders’ interests only in every case and to avoid manipulations which might damage them.” By contrast, for managers running nationalized undertakings, this “motive force disappears with the exclusion of the material interests of private individuals.” The socialist manager has none of the motivations of the private manager: ownership of “share capital,” potential profit from “stock-exchange speculation in the com-

pany's shares," and the possibility of bequeathing to their heirs a portion of their influence in the firm.

Many of von Mises' themes reappeared in the work of Friedrich A. Hayek. Hayek explicitly accepted Lange's contention that capitalist monopolies attempted to preserve capital values in the face of technological change, but maintained that socialist monopolies would simply worsen the situation. Such enterprises would be sorely tempted to overvalue existing assets at more or less historical prices. With little motivation to innovate, the socialist management would maintain old technologies and old capital long after their economic obsolescence. The socialist firm might not seek monopoly profit, but it would have little reason to seek out change. The argument was much the same as Lange's, only now blatant and uneconomic waste would take the place of monopoly profit on a much expanded scale (Hayek, 1935, pp. 227–228).

Connections

Lange and von Mises both knew monopoly was bad. In the Marxian tradition, Lange held that the economies of scale inherent in modern production technologies inevitably produced large monopolies which in turn restricted progress. Socialism would handle large-scale production better than capitalism. In contrast, the Austrians maintained that with the exception of a few natural resource monopolies, the competitive pressures of capitalism, including those generated by potential entrants, disciplined large-scale firms. They thought socialism would prove a nightmare of bureaucracy.

Testimony from the various experiments of Eastern Europe increasingly questions the ability of state-owned firms to meet the test of efficiency (Kornai, 1990; Brus and Laski, 1989). Thus, defending socialist reform, short of accepting private ownership of large production units, increasingly hinges on the question of devising new incentive mechanisms for virtually monopolistic state firms.

My favorite candidate is a scheme suggested by Evsey Domar (1974). Domar considers the problem of monopoly "restrictionism" by socialist firms allowed to set their own prices. Domar's bonus plan requires no knowledge of production technology on the part of the central authority. Under his scheme, firms are rewarded not only for generating "profits," but also for generating revenue. The dependence of bonuses on revenues encourages firms to expand output. It pushes monopolies toward marginal cost pricing. The profit term maintains a reward for innovation.⁵ Domar's approach does require that the central authority be able to observe the level of revenues. Some suspect that

⁵Domar's approach required restrictions on the elasticity of demand. Work by Tam (1981), using profits and (negative) price in the bonus, rather than profits and revenue allows for the more general case. Both these schemes use trial and error to converge on the efficient level of production.

even this exceeds the capability of the planning agencies. Recent theoretical work, strongly influenced by the ongoing debacle in Eastern Europe, has taken a rather pessimistic view, constructing hierarchical paralysis that bonus schemes only make worse (Dearden, Ickes and Samuelson, 1990). Von Mises would approve.

Here at home, the notion of the despotic monopoly has largely disappeared from both academic and public discourse.⁶ Does this mean large firms weren't as bad as Lange thought? Or did people just get used to large firms? Or have large firms somehow been domesticated? In the midst of the Great Depression, the claim that large corporations had lost their dynamism carried considerable plausibility, while the ability of such corporations to adopt new technologies and introduce new products in the decades that followed stands at odds with Lange's analysis. The recent difficulties of American corporations in meeting international competition, maintaining productivity growth and supporting a rising standard of living may yet reawaken those earlier fears.

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⁶Still, there are exceptions. For a good old-fashioned attack on bigness, see Adams and Brock (1986). Readers interested in a radical treatment that links slowing productivity growth and declining levels of competition, much in the spirit of Lange, might examine Weisskopf, Bowles and Gordon (1983).

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